



# Market power in pay TV

Annex 7 to pay TV market investigation second  
consultation

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## Section 1

# Introduction

- 1.1 In this annex we assess the extent of any market power within each of the relevant markets that we identified above, namely:
- The wholesale supply of channels or packages of channels containing live FAPL matches (“Core Premium Sports channels”); and
  - The wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Hollywood majors (“Core Premium Movies channels”).
- 1.2 We refer to Core Premium Sports channels and Core Premium Movies channels collectively as “Core Premium channels”.
- 1.3 This annex provides further detail on the assessment of market power contained in chapter 5 of the main second pay TV consultation document.

## The December Consultation

- 1.4 In the December Consultation we defined a “premium sports’ pay TV service” as one which provides live access, often on an exclusive basis, to a specific set of highly-valued key sports events, most notably live FAPL coverage (paragraph 5.26). We stated that Sky was likely to be dominant in the “wholesaling of premium sports content” and that it was unlikely that Setanta could challenge Sky’s dominance in this market in the short to medium term (Annex 13, paragraph 5.52). The definition of “premium sports” kept open the question of what role is played by sports other than live FAPL matches.
- 1.5 In the December Consultation we defined the primary characteristic of a “premium movies’ pay TV service” as providing access on a subscription basis to first-run movies from the six largest Hollywood studios (the “Major Hollywood Studios”) (paragraph 5.36)<sup>1</sup>. We concluded that Sky was likely to be dominant in the wholesale supply of “premium movies” (Annex 13, paragraph 5.69)<sup>2</sup>.

## Overview of the responses to the December Consultation

- 1.6 The majority of respondents agreed with Ofcom’s assessment of market power in the wholesaling of premium sports and movie content. Sky disagreed and claimed that Ofcom’s assessment of market power was technically, analytically and evidentially deficient. Sky considered that there is strong and compelling evidence that supports a view that Sky does not hold a position of significant market power in relation to the supply of television channels in the UK.

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<sup>1</sup> The Major Hollywood Studios are Disney, Fox, Paramount, Sony, Universal and Warner.

<sup>2</sup> In the December Consultation we also assessed the extent of market power in various retail markets. As explained in paragraphs 4.35-4.36 of the main document, our competition concerns our focused on the effects of wholesale market power, and as a result, we have not defined retail markets. Accordingly we do not discuss those parts of the consultation responses that solely relate to the assessment of retail market power.

- 1.7 Sky advanced a number of arguments in support of its position; these are set out later in this annex. In addition, Sky argued that the framework normally used to define markets is not particularly well-suited to the marketplace in which UK TV broadcasters operate. Accordingly, Sky considered that it is appropriate to take into account a broad range of evidence when assessing market definition and market power. In particular, Sky referred to:
- Evidence showing, in Sky's view, an absence of excess profits; and
  - The positive outcomes for consumers, such as high levels of innovation and high penetration of pay TV services.
- 1.8 First, Sky quoted the first bullet point from paragraph 1.21 of the December Consultation which stated that "... Sky has not made returns which could be judged to be excessive, particularly given the risk profile when the early investments were being made." Sky considered that this is strongly corroborative of an absence of significant market power at both the wholesale and retail levels.
- 1.9 Second, Sky stated that key indicators of firms holding positions of significant market power include lack of innovation, indifference to consumers' demands (including poor customer service and infrequent changes to products) resulting in significant consumer dissatisfaction, and pricing levels which suppress demand. Sky referred to the discussion in the December Consultation on outcomes for consumers and the report by PwC at Annex 1 to Sky's consultation response. Sky considered that this showed that: (i) consumer choice of pay TV services is strong, and prices for such services are not out of line with those found in the rest of Europe; (ii) consumers are satisfied with the pay TV services available to them; (iii) penetration of pay TV services in the UK is among the highest in Europe; and (iv) the UK, along with France, has higher take up of innovative new products and services, such as DVRs and HD television services than other countries in Europe. Sky considered that these market outcomes are incompatible with a hypothesis that Sky holds a dominant position at the retail level.

### **Ofcom's response to the broader evidence present by Sky**

- 1.10 Before setting out Ofcom's assessment of market power, we first set out our views on the broader evidence that Sky considers to be relevant, namely evidence on profitability and outcomes for final consumers.

#### Sky's profitability

- 1.11 In terms of profitability, and as a preliminary point, Ofcom considers that Sky has misrepresented the position set out in the December Consultation. Specifically in that document, we explained that the evidence on profitability was inconclusive. For example, Sky quoted the first bullet point from paragraph 1.21 of that document but omitted the second bullet point, namely that "... the ratio of Sky's enterprise value to asset value looks quite high, even after adjustments, although this could be the case for other companies as well".
- 1.12 In any event, as summarised in paragraphs 6.3 and 7.79 of the main document, the evidence of possible high wholesale prices is less clear-cut due to a variety of practical difficulties. We have attempted to assess whether wholesale prices are high by analysing the profitability of the part of Sky's business that wholesales premium channels although we recognise that there are uncertainties involved in this analysis. It is not possible to draw strong conclusions from a review of Sky's financial

performance, due to difficulties primarily with cost and revenue allocation, time periods, and asset valuations. Nevertheless, Sky does appear to be making an operating margin on the wholesale of premium channels of just over 25% – higher than Sky’s 2008 overall operating margin of 15.2%. We have not estimated a return on capital, due to practical difficulties associated with determining the level of capital employed in this part of Sky’s business. We further conclude that the gross margins which Sky makes on premium movie content may be significantly higher than those which it makes on premium sports.

- 1.13 The evidence set out in sections 2 and 3 of this annex suggests that Sky does possess a position of market power. In the light of that evidence, we do not accept that the (less clear cut) evidence concerning overall profitability and whether wholesale prices are high justifies a contrary conclusion. Furthermore, we do not accept that identifying excessive profits is a necessary condition for finding that a firm has a position of market power. Indeed, as noted in paragraph 1.14 of annex 6, it is possible – and indeed likely – that some of the economic rents associated with exploiting content in a narrow market flow upstream to the rights providers. Under this scenario, downstream prices would still be above ‘competitive’ levels, but there need be no evidence of excessive downstream profitability.

### Outcomes for final consumers

- 1.14 We discuss outcomes for final consumers, including the report by PwC that Sky submitted, in section 7 of the main document. In particular, in terms of current outcomes (see paragraphs 7.2-7.5 and 7.7-7.9):
- The most obvious manifestation of reduced consumer choice is the restricted availability of Sky’s premium content on other platforms. From a consumer perspective, consumers on a number of platforms are currently unable to access the most valuable sport and movie content, and this must be a source of concern.
  - Even where content is available on a platform, we do see evidence that consumer choice may be restricted since that content is only made available via a limited range of content bundles. Although Sky does offer a wide range of content bundles, the pricing of these encourages consumers to trade up to a small number of ‘big mixes’. We believe that consumers would benefit from a wider variety of entry-level packages being more widely available for other premium content. Additionally, while we acknowledge the economic efficiencies associated with large bundles of different types of content, we believe that consumers should be able to choose whether they purchase stand-alone premium packages without an enforced buy-through.
  - We see some evidence that platform innovation will be reduced. Whilst the UK pay TV industry has a strong track record of innovations which play to the strengths of Sky’s satellite platform, the same has not historically been true of innovations such as video on demand, which play to the strengths of platforms other than Sky’s. Innovation in areas less well suited to the Sky platform’s strengths might well have proceeded faster if wholesale premium had been more widely available on other platforms.
  - Our analysis of whether retail prices are high remains inconclusive. Nevertheless, in the absence of effective competition, we cannot be confident that prices are at the same level that would be delivered by a competitive market.

- 1.15 As well as looking at consumers' current experience, it is vital to look ahead to the future. We are at a point in the development of the pay TV market when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. We see a real risk that the development of these new platforms could be held back by limited access to Core Premium channels, thereby denying consumers the associated benefits (see paragraph 7.6 of the main document).
- 1.16 Sky considered that the observed market outcome is incompatible with a hypothesis that Sky holds a dominant position at the retail level. We do not agree. Our current overall view is that the situation for consumers would be further improved if retailers enjoyed greater access to Sky's sports and movies channels. We do not regard this situation as being inconsistent with our view that Sky possesses a dominant position in the wholesale supply of Core Premium channels (for the reasons set out in the remainder of this annex).

### **The structure of this annex**

- 1.17 This remainder of this section is structured as follows:
- First, there is a short discussion of the concept of market power and the appropriate legal threshold; and
  - Second, we set out the factors that are relevant to the assessment of dominance.
- 1.18 Then, in section 2 of this annex, we set out our current assessment of dominance in the wholesale supply of Core Premium Sports channels.
- 1.19 Finally, in section 3, we set out our current assessment of dominance in the wholesale supply of Core Premium Movies channels.

### **The concept of market power and the appropriate legal threshold**

- 1.20 We have considered the OFT guidelines on the application and enforcement of Articles 81 and 82 EC Treaty and the CA98 (the "OFT Market Power Guidelines")<sup>3</sup>. We consider that these guidelines are of relevance given the current stage of our market investigation, as they provide a framework for the assessment of market power, although they may not be directly applicable should we ultimately decide to pursue action under a different legal instrument (such as the CA03).
- 1.21 The OFT Market Power Guidelines state at paragraph 1.4 that:
- "Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation."
- 1.22 An assessment of market power is important because it would give Sky the ability to affect downstream competition. In section 6 of the main document we discuss the concerns we consider may result from that market power.

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<sup>3</sup> *Assessment of market power*, OFT, December 2004 available at [http://oft.gov.uk/shared\\_oft/business\\_leaflets/ca98\\_guidelines/oft415.pdf](http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft415.pdf)

- 1.23 We have considered what the most appropriate threshold for assessing market power is. For example, under Article 81 EC Treaty the relevant test is appreciability whereas under Article 82 EC Treaty the relevant test is dominance. In the December Consultation we assessed whether one or more firms enjoy a position of market dominance (Annex 13, paragraph 5.12).
- 1.24 As discussed in section 2, there are a number of legal instruments which Ofcom might deploy in the event that competition issues are identified. Under all of these instruments it will be relevant to consider the extent to which undertakings possess market power in the relevant markets. In order to gauge the extent of any market power we assess below Sky's and Setanta's positions by reference to the concept of dominance, as referred to in section 18 of the CA98<sup>4</sup>. This assessment is made by reference to both existing circumstances and likely future outcomes. We thus consider whether any firm is currently dominant in the relevant markets and whether any firm is likely to be dominant in the relevant markets for the next three to four years<sup>5</sup>. For the avoidance of doubt, we have used the dominance standard for the purposes of using a well-established and widely understood concept. It has no bearing on the legal instrument, if any, that we might seek to use in this process.

### The criteria for assessing dominance

- 1.25 The European Court of Justice has defined dominance as “a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of its consumers”<sup>6</sup>.
- 1.26 The OFT Market Power Guidelines state that, when assessing market power, it is helpful to consider the strength of any competitive constraints i.e. market factors that prevent an undertaking from profitably sustaining prices above competitive levels (paragraph 3.2). Such constraints include:
- Competition from existing competitors;
  - Competition from potential competitors; and
  - Countervailing buyer power (“CBP”).
- 1.27 In sections 2 and 3 of this annex we analyse these three constraints in turn for relevant markets that we have identified.

### Existing competitors

- 1.28 The OFT Market Power Guidelines state that, in general, market power is more likely to exist if an undertaking has a persistently high market share (paragraph 4.2).<sup>7</sup>

<sup>4</sup> Setanta is not active in the wholesale supply of Core Premium Movies channels. Accordingly it is not necessary to assess Setanta's market power within that relevant market.

<sup>5</sup> Looking forward three to four years in this way is consistent with our suggestion that we would consider reviewing any requirement for Sky to make wholesale access to particular content available on regulated terms after three years of its coming into force (see paragraph 9.5).

<sup>6</sup> *Case 27/76 United Brands v Commission* [1978] ECR 207, paragraph 65.

<sup>7</sup> *Aberdeen Journals Limited v Office of Fair Trading (No. 2)* [2003] CAT 11, paragraphs 309-310.



Further, it is unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40% (paragraph 2.12). The European Court of Justice has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%<sup>8</sup>.

1.29 We recognise that market shares are not conclusive. At paragraph 4.5, the OFT Market Power Guidelines identify several reasons for this including:

- “**Bidding markets** – Sometimes buyers choose their suppliers through procurement auctions or tenders ... In these types of markets, an undertaking might have a high market share at a single point in time. However, if competition at the bidding stage is effective, this currently high market share would not necessarily reflect market power.” We recognise that the possibility that high market shares are a relatively temporary phenomenon is particularly relevant, given: first we are also considering whether any firm is likely to be dominant in the relevant markets for the next three to four years; and second the duration of the agreements licensing the rights necessary for a wholesaler to begin supplying Core Premium channels<sup>9</sup>.
- “**Product differentiation** – Sometimes the relevant market will contain products that are differentiated. In this case undertakings with relatively low market shares might have a degree of market power because other products in the market are not very close substitutes.”

### Potential competitors

1.30 The likely constraint from potential competitors is stronger when barriers to market entry and expansion are lower. The OFT Market Power Guidelines state that “Entry barriers arise when an undertaking has an advantage (not solely based on superior efficiency) over potential entrants from having already entered the market and/or from special rights (e.g. to production or distribution) or privileged access to key inputs” (paragraph 5.5; footnotes omitted).

### CBP

1.31 The OFT Market Power Guidelines state that the strength of buyers and the structure of the buyers’ side of the market may constrain the market power of a seller (paragraph 6.1). CBP refers to the relative strength of the buyer (in this case, a retailer) in its negotiations with a prospective seller (such as Sky). CBP exists when a particular purchaser is sufficiently important to influence the price charged for the good or service in question.

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<sup>8</sup> Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

<sup>9</sup> For example, historically the duration of the contract licensing the rights necessary to cover live FAPL matches has been three or four years. As a result, in principle, every three or four years firms’ share of the relevant market could shift dramatically (although as explained later in section 2 of this annex we do not consider that this will occur in practice).

## Section 2

# Market power in the wholesale supply of Core Premium Sports channels

2.1 As explained in paragraphs 4.143-4.146 of the main document, our current view is that the wholesale supply of channels or packages of channels containing live FAPL matches is a relevant economic market. Below we assess the likely strength of competition within this market both at present and over the next three to four years. In particular, we set out our current assessment of (i) competition from existing competitors; (ii) competition from potential competitors; and (iii) CBP.

## Existing competitors

### Factual background

- 2.2 Currently three channels include live FAPL matches, namely Sky Sports 1, Sky Sports 2 and Setanta Sports 1. In the 2007/8 season, 138 live FAPL matches were broadcast. Of these, Sky Sports 1 featured 87 matches (63% of the total), Sky Sports 2 featured five matches (4% of the total)<sup>10</sup> and Setanta Sports 1 featured 46 matches (33% of the total).
- 2.3 We consider that the wholesale supply of Sky Sports 1, the wholesale supply of Sky Sports 2, the wholesale supply of packages of channels containing Sky Sports 1 and/or Sky Sports 2, the wholesale supply of Setanta Sports 1 and the wholesale supply of packages of channels containing Setanta Sports 1 lie within the relevant market. For the avoidance of doubt, we are referring to both the HD and SD versions of the Sky Sports channels; Setanta Sports is not available in HD. There are two firms currently active in the relevant market.
- 2.4 Prior to the FAPL season beginning in August 2007, Setanta did not have the rights to broadcast live FAPL matches (the “Live FAPL Rights”). Hence, prior to that month, Sky was the only firm active in the relevant market.
- 2.5 Sky Sports 1 and 2 are currently wholesaled to Virgin Media and other smaller cable companies both on a standalone basis and as part of a bundle of wholesale channels. Sky also directly retails Sky Sports 1 and 2 on its DSat platform and to customers of Tiscali. Setanta Sports 1 is currently wholesaled to Virgin Media, Tiscali, Top Up TV and BT Vision either as part of a bundle of wholesale channels or as a standalone wholesale channel. Setanta also directly retails this channel on Sky’s DSat platform and to DTT customers.

### Responses to the December Consultation

- 2.6 Virgin Media asserted that while the levels of Sky’s prices might well have been higher in the absence of competition from Setanta and Freeview more generally, Sky’s real price increases and growing subscription numbers do not suggest that Sky is subject to any binding competitive constraints in the provision of “premium sports” (Virgin Media did not make it clear whether its comments related to the wholesale

<sup>10</sup> We understand that live FAPL matches are currently only broadcast on Sky Sports 2 when they are displaced by other sporting events (e.g. a cricket or golf tournament).

and/or retail level). Virgin Media quoted from the December Consultation but did not provide any other evidence in support of its position.

- 2.7 Setanta/Top Up TV stated that while Setanta Sports might be the closest substitute to Sky Sports, the degree of substitutability is nonetheless limited. In support of this view, Setanta/Top Up TV referred to two pieces of evidence:
- Retail pricing behaviour: Setanta stated that when it started to broadcast live FAPL matches in August 2007 it reduced the monthly per subscriber retail price of its package of channels on Sky's DSat platform from £14.99 to £9.99. On 1 September 2007, Sky increased the monthly per subscriber retail price of various packages containing Sky Sports by between 50p and £1.50.
  - Subscription patterns: Setanta stated that very few, if any, of its subscribers on DSat do not also subscribe to Sky's premium sports channels. In other words, on Sky's DSat platform sports subscribers tend to subscribe either to Sky's premium sports channels or to Sky's premium sports channels and Setanta's premium sports channels.
- 2.8 Setanta/Top Up TV considered their view that Setanta Sports is currently unable to impose an effective pricing constraint on Sky Sports is supported by differences in the objective characteristics of the channels. In particular, in the 2007/08 FAPL season Sky provided live coverage of twice as many FAPL matches as Setanta and Sky's expenditure on the Live FAPL Rights is approximately 3.3 times Setanta's expenditure<sup>11</sup>.
- 2.9 Separately, the Four Parties stated in their 29 February 2008 submission that in practice Setanta Sports is a complement to, rather than a substitute for, Sky Sports. This is on the basis of the retail prices changes in the second half of 2007 that are also referred to in Setanta/Top Up TV's submission.

### **Ofcom's position**

- 2.10 Our assessment of the constraint imposed by existing competitors is set out below. First, we address the Four Parties' claim that Setanta Sports is in fact a complement for Sky's Core Premium Sports channels. Second, we set out our assessment of market shares under the market definition we have adopted. Third, we respond to the evidence advanced by consultation respondents. Fourth, we set out an assessment of market shares under alternative market definitions that include some relatively close substitutes that nonetheless (in our view) lie outside of the relevant market.

### **Ofcom's assessment of whether Setanta Sports is a complement to Sky's Core Premium Sports channels**

- 2.11 Product X is a complement to product Y if, when the price of Y increases demand for X falls. Clearly if, in fact, Setanta Sports is a complement for Sky's Core Premium Sports channels then the nature of the competitive interactions between the channels is very different compared to the situation in which these products are substitutes.

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<sup>11</sup> Setanta/Top Up TV made a similar point in relation to sports content more generally. They stated that in 2007/08, Sky's expenditure on sports rights was approximately 4.7 times Setanta's expenditure. Further, the quantity of sports programming available on Sky Sports (including Sky Sports News) is approximately 4.8 times the quantity that is available on Setanta Sports.

- 2.12 We do not accept the Four Parties' claims about complementarity. Rather, survey evidence is consistent with the view that these products are substitutes. Analysis of consumer preferences for the European Commission found that FAPL supporters have a hierarchy of preferences:<sup>12</sup>
- Fixtures that feature subscribers' own clubs are of highest interest ("Own Club matches");
  - These are followed by matches featuring teams challenging for the title, derby matches, title deciders, relegation deciders and matches that determine who will qualify for the Champions League ("Big Matches"); and
  - These are followed by matches that are not Big Matches or Own Club matches.
- 2.13 FAPL fans were asked which they might choose to watch in place of each of the three types of match. In each case, a significant proportion of respondents were willing to watch other types of match. For example, when FAPL fans are asked which type of matches they might choose to watch in place of a Big Match not shown on television, over two thirds say they would be likely to watch Own Club matches if that were available, with over half likely to watch another Big Match. A third of FAPL fans say they would be likely to watch a match that was not a Big Match or an Own Club match<sup>13</sup>.
- 2.14 From the perspective of an individual viewer, both Setanta Sports 1 and Sky Sports are likely to contain a mixture of the three types of match. This similarity in the essential characteristics of Sky and Setanta's Core Premium Sports channels implies that they are likely to be substitutes (although, as discussed below Sky Sports typically shows a greater number of the most attractive FAPL matches). The fact that consumers are willing to consider switching to a variety of different types of FAPL match, if their preferred match is unavailable, provides further evidence of substitutability.
- 2.15 Sky made a number of changes to the retail prices charged to residential subscribers on its DSat platform in September and November 2007. In support of their position, the Four Parties relied upon Sky's increases in certain retail prices shortly after Setanta Sports 1 reduced its prices. From a factual point of view, we note that, in addition to the retail price rises identified by Setanta, certain retail prices also fell.

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<sup>12</sup> *PREMIER LEAGUE FOOTBALL Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*, European Commission, paragraph 111.2. Available at: <http://ec.europa.eu/comm/competition/antitrust/cases/decisions/38173/en.pdf>

<sup>13</sup> *PREMIER LEAGUE FOOTBALL Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*, European Commission, in particular paragraphs 111-117.

**Figure 1** Change in Sky’s monthly retail prices (September-November 2007)

Number of packages of premium channels	Number of basic “mixes”		
	Two mixes	Four mixes	Six mixes
One	[redacted]	[redacted]	[redacted]
Two	[redacted]	[redacted]	[redacted]
Three	[redacted]	[redacted]	[redacted]
Four	[redacted]	[redacted]	[redacted]

Source: Comparison of the figures in annex B to Sky’s 10 November 2006 response to Ofcom’s 12 October 2006 information request and Sky’s November 2007 response to Ofcom’s 22 October 2007 information request

2.16 We are considering wholesale markets and thus, in addition to the retail price changes cited by the Four Parties, we have considered the pattern of changes in wholesale prices. In September 2007, Sky changed the wholesale prices charged to Virgin Media. Figure 2 below sets out those price changes and shows the September 2007 price as a percentage of the September 2006 price.

**Figure 2** Change in Sky’s wholesale prices (September 2007)

Single Sport	Sky Movies 1	Sky Movies 2	Sky Movies 1 and Single Sport	Sky Movies 2 and Single Sport	Dual Movies	Dual Movies and Single Sport	Dual Sports	Sky Movies 1 and Dual Sports	Sky Movies 2 and Dual Sports	Dual Movies and Dual Sports
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %	[redacted] %

Source: Sky June 2008 response to Ofcom information request dated 29 May 2008

2.17 The pattern of changes in wholesale prices in September 2007 is [redacted]. The wholesale price for some bundles of channels [redacted]. In particular, the wholesale price of a single Sky Sport’s channel, which might be regarded as having somewhat similar characteristics to the wholesale bundle of Setanta Sports channels, [redacted]. In the light of this evidence, we do not consider that the (retail) price evidence presented by the Four Parties is sufficiently strong to conclude that there is complementarity (and hence no substitutability) between Sky’s and Setanta’s Core Premium Sports channels.

2.18 In addition, we have considered Setanta’s claim that very few, if any, of its subscribers on satellite do not also subscribe to Sky’s premium sports channels. A November 2007 survey by Ofcom found that 83% of Setanta Sports subscribers also subscribe to Sky Sports<sup>14</sup>. However, particularly for differentiated products such as these, the observation that certain final consumers subscribe to both Sky Sports and

<sup>14</sup> Ofcom pay TV small platforms research, November 2007. Base: Setanta subscribers on DSat (155).

Setanta Sports is not inconsistent with those channels constraining each other's prices<sup>15</sup>.

### Ofcom's assessment of market shares

2.19 We have considered a range of approaches to calculating market shares. As explained above, live FAPL matches are broadcast on Sky Sports 1, Sky Sports 2 and Setanta Sports 1. However, the calculation of market shares is complicated by a number of factors:

- First, Sky Sports 1 and 2 and Setanta Sports 1 are not only sold on a stand-alone basis e.g. Sky Sports 1 is also bundled with Sky's movie channels and other Sky Sports channels; similarly Setanta Sports 1 is bundled with other Setanta Sports channels.
- Second, Sky Sports and Setanta Sports feature (i.e. bundle) other sporting content, as well as the live FAPL matches that we have focused on in our market definition. It could be argued that, if Sky or Setanta include on their channels some other content, which are neither crucial to competing in the relevant market nor the hallmark of Core Premium Sports channels, then this should not affect their share of the relevant market.

2.20 The main measure of market shares that we have used is an estimate of the wholesale revenues earned by Sky and Setanta from the sale of the channels in question. We note that this approach is consistent with the OFT Market Power Guidelines which state that "Often value data will be more informative, for example, where goods are differentiated" (paragraph 4.7). However we have also used the amounts paid for the Live FAPL Rights by Sky and Setanta as a cross-check.

2.21 We have calculated market shares as a proportion of the revenues from the wholesale supply of Core Premium Sports channels. Between August 2007 and May 2008 (inclusive), we estimate that Sky has averaged a [x] share of revenues. Sky's share of revenues has declined over that period as Setanta has acquired more subscribers: in May 2008, Sky's market share was [x]<sup>16</sup>. Setanta accounts for the remainder. We make three observations on the calculation of these figures:

<sup>15</sup> This point can be illustrated using the following (hypothetical) example. Suppose that there are two channels, X and Y, and that the cost of supplying a channel is zero. All subscribers value a single channel at £10/month and both channels at £14/month i.e. the incremental value of taking a second channel is only £4/month. If those channels are supplied by separate, competing firms then the price of both channels will be £4/month (since a subscriber that is already taking channel X is unwilling to pay more than £4/month for the Y channel). The channels constrain each other's pricing, even though the observed outcome is that consumers take both channels. In contrast, rather than setting a price of £4/month for both channels, a monopoly supplier of those channels could increase its profits by setting a per channel price of £10/month (consumers only take a single channel but the effect on profits of increased prices more than offsets the effects of that fall in demand).

<sup>16</sup> The lower end of this range reflects the assumption that the wholesale revenue from the sale of Core Premium Sports channels is equal to the incremental price of adding Sky Sports to a wholesale bundle. The upper end of this range reflects the entirety of the price of the wholesale bundle. An alternative approach attributes to Core Premium Sports channels 50% of the revenue from bundles with equal amounts of sports and movies, 66% of the revenue from dual sports/single movies bundles and 33% of the revenue from dual movies/single sports bundles. This latter approach implies Sky's average market share between August 2007 and May 2008 was approximately [x] and its market share in May 2008 was approximately [x].

- First, both Sky and Setanta are vertically integrated<sup>17</sup>. In the case of Sky, we have assumed that the wholesale prices charged to Virgin Media can be applied to sales by Sky to subscribers on its DSat platform. In the case of Setanta, we have used its wholesale revenue when it distributes its channel via other retailers plus the retail revenue it earns from its retail sales to subscribers on DTT and Sky's DSat platform. We recognise that using Setanta's retail revenues in this way will overstate its wholesale revenue and thus bias upwards our estimates of its wholesale market share.
- Second, Sky bundles its sports channels with its Sky Movies channels. It could be argued that, where a subscriber takes Sky Sports and Sky Movies it is not appropriate to attribute the entirety of the associated wholesale revenue solely to Sky Sports. We have thus varied the proportion of the wholesale price of channel bundles that is attributed to Sky's Core Premium Sports channels; this produces a range of market share figures (see above).
- Third, we recognise that markets shares under this measure will be affected by the attractiveness of the other (non-FAPL) content included on Sky and Setanta's sports channels.

2.22 Paragraph 4.3 of the OFT Market Power Guidelines state that "The history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time, partly because such a snapshot might not reveal the dynamic nature of a market." Prior to August 2007, Setanta did not broadcast live FAPL matches on its channels and thus was not active in the relevant market. Thus, not only does Sky enjoy a high market share in 2008, from the moment it first acquired the rights in 1992, no other firm succeeded in acquiring any Live FAPL Rights until Setanta in 2007. In the 2006 auction, Sky was no longer able to acquire 100% of the Live FAPL Rights due to the European Commission's intervention (i.e. the Commitments). Until August 2007, however, Sky enjoyed a 100% market share for a 15-year period.

2.23 An alternative – although imprecise – approach to assessing market shares is to use the amounts paid for live FAPL rights by Sky and Setanta, as a cross-check on the previous method. For the Live FAPL Rights to the 2007/08-2009/10 seasons, Setanta paid £130m per annum (£2.8m per game) whereas Sky paid £438m per annum (£4.8m per game)<sup>18</sup>. Using this measure Sky's market share is thus 77%; Setanta's market share is 23%.

2.24 Thus, while Setanta currently broadcasts 46 of the 138 FAPL matches that are broadcast live (33%), its market share is markedly lower (around [33%] ) when assessed on a wholesale revenue basis and 23% when assessed on the basis of the amounts paid for the Live FAPL Rights). Setanta's lower market share is consistent with the fact that the live FAPL matches it broadcasts are likely to be less attractive to final consumers. As noted by Setanta/Top Up TV, this is shown by the objective characteristics of the rights packages won by Sky and Setanta. Each FAPL season is divided into 38 "rounds" of 10 matches. In each round, three or four matches are broadcast live. Different packages allow a first, second, third and/or fourth pick of

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<sup>17</sup> A vertically integrated wholesaler could choose to earn profits at the wholesale or retail level, or both. Transfer prices may not therefore be a reliable guide to the value of the wholesale service provided.

<sup>18</sup> Calculated from December Consultation, Annex 10, page 22.

those matches. A first pick match is likely to be more attractive to final consumers than a fourth pick match. As shown in Figure 3 below, Sky currently has all of the first pick matches and 79% of the second pick matches.

**Figure 3 Number of first, second, third and fourth pick live FAPL matches broadcast by Sky and Setanta**

	First pick	Second pick	Third pick	Fourth pick
Sky	38 (100%)	30 (79%)	15 (39%)	9 (38%)
Setanta	0 (0%)	8 (21%)	23 (71%)	15 (62%)

Source: December Consultation, Annex 10, page 22

### Other evidence advanced by consultation respondents

2.25 As noted above, both Virgin Media and Setanta/Top Up TV relied on Sky's retail price increases in September 2007 in their consultation responses as evidence of the weak constraint Setanta imposes on Sky's pricing. This argument is distinct from the Four Parties' claim, based on the same data, that Setanta Sports is a complement to Sky's Core premium Sports Channels.

2.26 As set out in Figure 1 above, we note that, in addition to the retail price rises identified by Setanta, certain retail prices also fell. Moreover, as shown in Figure 2, the pattern of changes in Sky's wholesale prices in September 2007 is [§<]. The wholesale price [§<]. We thus do not consider that the observed prices changes provide strong evidence that Setanta exercises a weak constraint on Sky's pricing of its Core Premium Sports channels. Thus we do not rely on this evidence.

### Implications of alternative market definitions: inclusion of Champions League matches

2.27 For the reasons set out in section 4 of the main document, Ofcom currently considers that the wholesale supply of channels or packages of channels containing live FAPL matches is a relevant market. However we recognised that there may be a degree of substitutability with channels containing live Champions League matches. To investigate the potential effects of this 'out of market' constraint, we have thus also attempted to calculate market shares assuming that channels containing live Champions League matches were in fact part of the relevant market. We recognise that this approach will overstate the impact of such channels, since it assumes they exercise an equivalent constraint to Core Premium Sports channels; we nonetheless consider that it is a useful way of assessing an upper bound for their impact.

2.28 Currently ITV has the first and second pick of the Champions League matches held on Tuesdays with Sky broadcasting any remaining matches. Sky has the live rights to all Champions League matches held on Wednesdays. If Champions League matches are also taken into account, in 2007/08 181 matches featuring FAPL teams<sup>19</sup> were televised (138 live FAPL matches plus 47 unique live Champions League matches). Of these, 114 were broadcast by Sky (92 FAPL matches and 22 Champions League matches) (63% of the total), 46 were broadcast by Setanta (all of which were FAPL matches) (25% of the total) and 22 were broadcast by ITV (all of which were

<sup>19</sup> As noted in section 4 of the main document, our survey data and analysis of product characteristics indicate that matches featuring FAPL teams are very important to subscribers.



Champions League matches) (12% of the total)<sup>20</sup>. Of the 22 live Champions League matches broadcast by Sky, two were broadcast on Sky Sports 1, 13 on Sky Sports 2, one on Sky Sports 3, three on Sky Sports Xtra and three on Sky One.

2.29 Calculating market shares for channels including live FAPL matches and/or live Champions League matches is not straightforward. ITV broadcasts its matches free to air. Moreover both ITV and Sky’s channels include a range of other content. We have thus considered four possible metrics for assessing market share:

- The amounts paid for the rights;
- The number of matches (this includes matches that were broadcast but do not feature any FAPL teams. However we would expect such matches to be relatively unattractive to viewers. As explained in paragraph 4.124 of the main document, it is matches featuring FAPL teams that are very important to subscribers);
- The number of matches featuring at least one team that plays in the FAPL; and
- The total audience watching these matches (this measure thus excludes the audiences that these channels attract for programmes other than live FAPL or Champions League matches; it does include audiences for matches that do not feature any FAPL teams).

2.30 We recognise that each of these measures of market share has drawbacks. However, looked at in the round these provide an indicator of market shares under this alternative market definition. The results are set out in Figure 4 below.

**Figure 4 Current market shares if the market included live FAPL matches and live Champions League matches**

	Sky	ITV	Setanta
Rights payments	75%	6%	19%
Number of matches	73%	9%	17%
Number of matches featuring FAPL teams	63%	12%	25%
Total audience	54%	44%	3%

Source: Ofcom calculations based on publicly available data including BARB audience share figures and Annex 10 of the December Consultation

2.31 In early 2008, the rights for the 2009/10-2011/12 Champions League competitions were awarded. ITV acquired the first pick of matches held on Wednesday; Sky won the remainder of the Wednesday matches and all the Tuesday matches<sup>21</sup>. Since Sky has acquired a greater proportion of the Champions League matches for the 2009/10-2011/12 competitions (having acquired a second pick match from ITV), this suggests that Sky’s market share under this alternative market definition will increase

<sup>20</sup> The Champions League final was broadcast live on both Sky and ITV1. It is thus included in both Sky and ITV’s total.

<sup>21</sup> UEFA press release, 25 March 2008 available at: <http://www.uefa.com/uefa/keytopics/kind=131072/newsid=675605.html>

from 2009/10 onwards. An estimate of the impact of this change is set out in Figure 5 below<sup>22</sup>.

**Figure 5 Estimated future (2009/10-2011/12) market shares if the market included live FAPL matches and live Champions League matches**

	Sky	ITV	Setanta
Rights payments	74%	7%	18%
Number of matches	76%	7%	17%
Total audience	64%	33%	3%

Source: Ofcom calculations based on publicly available data including BARB audience share figures and Annex 10 of the December Consultation

2.32 In summary, even if the market were broadened to include channels broadcasting live Champions League matches, Sky would nonetheless retain a very high market share (over 50%). Moreover, the factors discussed in paragraphs 4.119-4.121 of the main document suggest that there is only a limited degree of substitutability between live Champions League matches and live FAPL matches. This implies that the above market share figures will tend to overstate the competitive constraint imposed by channels containing live Champions League matches.

#### Implications of alternative market definitions: inclusion of other major football contests

- 2.33 As a further sensitivity, we have assessed market shares if channels containing live FAPL matches, live Champions League matches, live UEFA Cup matches, live FA Cup matches and/or live Carling Cup matches were included within the relevant market. Specifically we have included these events because some – although by no means all – of the matches shown feature FAPL teams. As noted above, we do not consider that channels including these additional events lie within the relevant market. However, including these events is a way of investigating the potential effects of this ‘out of market’ constraint.
- 2.34 Live UEFA cup matches are currently broadcast on free to air channels (by the BBC, ITV and Five) and on Setanta Sports. Carling Cup matches are currently broadcast on Sky’s channels. For the 2004/05-2007/08 tournaments, FA Cup matches were broadcast by the BBC and Sky. The 2008/09-2011/12 tournaments will be broadcast by ITV and Setanta.
- 2.35 Once again, calculating market shares is not straightforward and we have thus looked in the round at a range of measures. We estimate that Sky’s share of the amounts spent on live rights to these events is approximately 70% but it is not possible to assess the market shares of other parties from publicly available data (e.g. because the amounts paid by individual bidders is not public). Figure 6 sets out estimated market shares calculated using the number of matches broadcast (including matches that do not feature any FAPL teams), the number of matches featuring teams that play in the FAPL and the total audience for all of these matches.

<sup>22</sup> In calculating Sky’s share of the total audience, we have taken the number of matches that Sky will broadcast in the future and multiplied by the average audience Sky attained when it broadcast a Champions League match in 2006/07. This takes into account the fact a match that would previously have been broadcast by ITV attracts a lower audience if it is broadcast on Sky’s channels.

**Figure 6 Current market shares if the market included live FAPL, Champions League, UEFA Cup, FA Cup and Carling Cup matches**

	Sky	ITV	BBC	Setanta	Five
Number of matches	62%	11%	8%	14%	5%
Number of matches featuring FAPL teams	55%	13%	6%	19%	7%
Total audience for all these matches	37%	30%	25%	2%	7%

*Source: Ofcom calculations based on publicly available data including BARB audience share figures and Annex 10 of the December Consultation*

2.36 Sky's market share is consistently lower under this alternative, wider market definition. However, except on one measure, Sky's market share remains above the 40% threshold identified in paragraph 2.12 of the OFT Market Power Guidelines (and even on that one measure – share of total audience – Sky's share is 37% and thus close to the 40% threshold). Moreover, as discussed above, these alternative market share figures will tend to overstate the extent of the competitive constraints upon Sky because there is likely to be a lesser degree of substitutability between live FAPL matches and the other football contests.

### Ofcom's current conclusion on existing competitors

2.37 While Sky's share of wholesale revenues has declined from 100% following the entry of Setanta Sports, it is still in the region of [30-40]. These market share figures reflect both the greater quantity of live FAPL matches screened by Sky and the generally higher attractiveness of those matches. Accordingly:

- As noted above, the OFT Market Power Guidelines state that it is unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40% (paragraph 2.12). In the light of Setanta's market share (particularly in comparison to that of Sky), our current conclusion is that Setanta is unlikely to possess a dominant position in this relevant market at present<sup>23</sup> or during the next three to four years.
- In contrast, our current conclusion in relation to Sky is that its market shares are consistent with it possessing a dominant position in the relevant market. This view is reinforced by the persistence of Sky's high market share, reflecting the fact that (prior to Setanta's entry into this relevant market in 2007) it acquired all the available Live FAPL Rights.
- We recognise the challenges in defining the boundaries of relevant markets within this sector and that products outside of the relevant market can exercise some degree of competitive constraint. We have thus considered market shares under alternative market definitions and under a range of different measures..

<sup>23</sup> Moreover, our discussion of barriers to expansion below implies that Setanta is unlikely to possess a dominant position during the next three to four years.

With the exception of one measure, Sky's market share remains above the 50% threshold that the European Court of Justice has stated is associated with a presumption (in the absence of evidence to the contrary) of dominance. Moreover we recognise that these alternative market share figures will overstate the strength of the competitive constraint exercised by 'out of market' products and thus understate the extent of Sky's market power. Looked at in the round, we consider that these measures are supportive of our view that Sky possesses a high market share that is consistent with possessing a dominant position.

- 2.38 Accordingly in the analysis of entry and expansion barriers and CBP that follows, we focus on the position of Sky – we do not assess the extent to which Setanta's position is affected by barriers to entry and expansion and CBP<sup>24</sup>.

### **Entry by potential competitors and expansion by existing competitors**

- 2.39 In order to wholesale a channel including live FAPL matches it is essential to possess the Live FAPL Rights. Those rights are sold by the FAPL. Currently Sky and Setanta hold the Live FAPL Rights in relation to the 2007/08 to 2009/10 football seasons. In the first half of 2009, it is expected that the Live FAPL Rights for the 2010/11 to 2012/13 seasons will be sold. If, as a result of that sales process, Sky obtains the rights to fewer games or less attractive games then its share of the relevant market is almost certain to fall. However, if Sky obtains the rights to more games then its share of the relevant market is almost certain to rise. Thus, in assessing the strength of the constraint exercised both by potential entrants and by the expansion of existing competitors, we have considered what the outcome of the next process for awarding the Live FAPL Rights is likely to be.
- 2.40 In the following pages we set out in more detail our thinking on barriers to entry. However, a forward looking assessment of this sort can never be entirely certain. We believe that Sky is unlikely to be constrained by the threat of entry, but in the event that Sky did not win the majority of the Live FAPL Rights, this would clearly constitute a material change of circumstances, and we would need to revisit our assessment of its market power.
- 2.41 The discussion is structured as follows:
- First, there is a factual description of the process by which the Live FAPL Rights are sold;
  - Second, we summarise our view in the December Consultation and provide an overview of the consultation responses
  - Third, we discuss the impact of the staggered availability of sports rights;
  - Fourth, we set out our high level observations on why we believe that Sky is likely to obtain the majority of the Live FAPL Rights;
  - Fifth, we explain why Sky is the most effective retail outlet on the largest platform and why third parties are unable to access that retail outlet as efficiently. As a

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<sup>24</sup> In any event, the implication of our current view (as set out in paragraph 2.150 below), that Sky is likely to win the majority of the Live FAPL Rights is that Setanta's share of the relevant market is unlikely to substantially change in the next three to four years.

result of this advantage, Sky is likely to be able to outbid potential rival bidders for the Live FAPL Rights;

- Sixth, we explain why Sky enjoys a branding advantage over other potential bidders. The effect of Sky generating more consumer value from the Live FAPL Rights is that Sky is likely to be able to outbid rival bidders for those rights;
- Seventh, we discuss other entry barriers claimed by consultation responses but which Ofcom is not relying upon;
- Eighth, we discuss factors that Sky claimed facilitate entry; and
- Finally, we set out our current conclusion on barriers to entry and expansion.

### Sale process for the Live FAPL Rights

- 2.42 Until the 2007/08 FAPL season, all the available Live FAPL Rights had been won by Sky since the early 1990's. However, in March 2006, the European Commission adopted a decision (the "Commitments Decision") to accept binding commitments from the FAPL concerning the sale of various media rights, including the Live FAPL Rights (the "Commitments")<sup>25</sup>. The Commitments apply for the six seasons from 2007/08 onwards (Commitment 11.4) and thus govern the way in which the Live FAPL Rights will be sold when they next become available.
- 2.43 The Commitments require six packages of live rights, each for 23 matches, to be made available (Commitments, schedule 1). The Commitments set transparency and non-discrimination conditions for the bidding process (Commitment 7.2). No one bidder is allowed to acquire all six packages (Commitment 3.2) and packages must be bid for on a standalone basis i.e. the amount bid cannot be conditional on the number of packages a bidder wins (Commitment 7.5).
- 2.44 In spring 2006, the Live FAPL Rights for the 2007/08 to 2009/10 seasons were sold. That sale was subject to the Commitments. Figure 7 below shows the six packages of Live FAPL Rights (A to F) that were sold. On 28 April 2006 it was announced that Sky would be awarded three packages (B, E and F) after the first round of bids. On 5 May 2006 it was announced that Sky would be awarded a fourth package (A) and Setanta two packages (C and D) after a second round of bids. The FAPL chose not to hold a third round of bidding.

**Figure 7 The six packages of Live FAPL Rights sold in 2006**

	Package					
	A	B	C	D	E	F
No. of first pick matches	23				5	10
No. of second pick matches		23		8		7
No. of third pick matches			23		9	6
No. of fourth pick matches				15	9	

Source: December Consultation, Annex 10, page 22

<sup>25</sup> For more details, see:

[http://ec.europa.eu/comm/competition/antitrust/cases/index/by\\_nr\\_76.html#i38\\_173](http://ec.europa.eu/comm/competition/antitrust/cases/index/by_nr_76.html#i38_173)

## The December Consultation and an overview of the consultation responses

- 2.45 When the Live FAPL Rights are next sold, in principle other bidders (either new entrants or Sky's existing competitor, namely Setanta) may acquire a sufficiently large proportion of those rights to undermine any dominant position possessed by Sky. The question is whether this is likely to occur in practice.
- 2.46 In the December Consultation, we identified the staggered availability of sports rights as an entry barrier on the basis that (i) the value of a particular set of rights is greater to a wholesaler with an existing portfolio of other rights; and (ii) it puts a new entrant in a relatively weak bargaining position against retailers (paragraph 5.47). Note that these arguments reflected the definition of "*premium sports*" used in that document, which left open the possibility that sporting events other than live FAPL matches were important to competing within the relevant market.
- 2.47 Respondents advanced a range of arguments on this issue and their high level positions are set out immediately below. The detail of the specific points and arguments that respondents advanced are addressed later in this section.
- 2.48 Setanta and Top Up TV stated that Sky enjoys a substantial advantage when bidding for content rights due to its "downstream incumbency". They stated that Sky will be able to monetise content rights more quickly than an entrant because of its existing subscriber base and thus generates greater value from those rights. In particular, they stated that (i) Sky will be able to bundle any new rights with its existing portfolio of rights and such aggregation increases their value; and (ii) Sky's is able to begin earning revenue from content more quickly. We explain Setanta/Top Up TV's views on these two issues in more detail in the relevant sections below.
- 2.49 Virgin Media considered that Sky possesses an advantage over rival bidders for content rights for a number of reasons. First, Virgin Media implicitly agreed with the position of Setanta/Top Up TV. Specifically, Virgin Media referred to the Four Parties' view that new entrants would find it difficult to build a subscriber base sufficiently fast to be able to monetise the value of the rights acquired. Virgin Media argued that this disadvantage is exacerbated by the short duration of rights contracts. Second, Virgin Media also agreed with the analysis in the December Consultation that the staggered availability of sports rights acts as a barrier to entry. Third, Virgin Media considered that a "large customer base" leads to bidding advantages upstream (Virgin Media appeared to be referring to the total number of subscribers to a channel on all platforms, although its position is not entirely clear). Specifically, as a result of barriers to switching between retailers, a potential new entrant without an existing subscriber base would have to bid for content in the knowledge that a proportion of the incumbent's retail customers would not switch to the new entrant's offer to follow that content. In support of its position, Virgin Media quoted from the December Consultation but did not present any further evidence of its own.
- 2.50 Sky advanced a number of detailed counterarguments to the position set out in the December Consultation. These are set out in the relevant parts of this section below. In addition, Sky set out two higher level criticisms of the approach adopted in that document.
- First, Sky stated that the December Consultation adopted an unreasonable entry benchmark, namely rapid and direct replication of Sky's sports and movie channels. The April 2008 CRA Report expressed a similar view and stated that the key question is whether rival firms can assemble viable channels. Sky argued that other modes of entry are possible, including gradual acquisition of sports

rights (possibly by targeting rights that strongly appeal to a narrower audience). Sky cited the approach adopted by Setanta in support of its view – Setanta initially acquired the rights to less popular sports content targeted at a specific audience, before acquiring the Live FAPL Rights.

- Second, Sky stated that the observed facts are inconsistent with the hypothesis that there are significant barriers to entry. In particular, Sky did not win the maximum five packages of Live FAPL Rights available to a single bidder in 2006. Further, the annual value of the Live FAPL Rights has risen by 260% between the 1997-2001 seasons and the 2007-2010 seasons. Sky also pointed to increases in the price of the rights to Champions League, FA Cup, England international football matches, Football League matches and domestic cricket. In Sky's view, this is evidence of close competition for rights. Sky also claimed that new entrants do attempt to acquire "pay TV sports and film rights", which is inconsistent with the view that there are significant barriers to entry that prevent such firms winning those rights.

2.51 The FAPL stated that content aggregation and collective selling have been considered and accepted by the European Commission. Accordingly the FAPL's sale of rights in compliance with the Commitments will not foreclose any broadcast markets and cannot create a barrier to entry. In addition, the FAPL stated that the position in the December Consultation, namely that the staggered availability of sports rights creates a barrier to entry, runs counter to the available evidence, in particular the launch of Setanta.

## **The impact of the staggered availability of sports rights**

### The December Consultation

2.52 As noted above, the definition of "premium sports" in the December Consultation left open the possibility that sporting events other than live FAPL matches were important to competing within the relevant market. We have now refined our views and currently consider that the wholesale supply of channels or packages of channels containing live FAPL matches is the appropriate market definition. This has implications for the argument set out in paragraph 5.47 of Annex 13 of the December Consultation, which related to the staggered availability of "sports rights". In particular, the Live FAPL Rights are all made available simultaneously, rather than being staggered.

2.53 A prerequisite for the staggered availability of rights to be an entry barrier is the existence of synergies between different rights that are sold at different times. Specifically, it relies upon the value to a wholesale channel provider of holding the rights to both X and Y being greater than the sum of the values of holding X individually and Y individually. As a result, a firm that already holds the rights to X potentially has an advantage when bidding for the rights to Y. This raises the question of the source of that synergy between different rights.

### Consultation responses

2.54 As discussed in section 4 of the main document, the Four Parties asserted in the 6 August 2008 Submission that a "premium channel" requires a range of "premium content" because consumers have a preference for variety. The March 2008 LECG Report made the same point. We understand this argument to be that the need for a range of content means that synergies are created by combining a range of sports rights. The Four Parties also asserted that Sky has an incentive to combine

substitutable sports rights. Synergies exist between substitutable rights (from the perspective of a broadcaster) because combining those rights creates market power. Virgin Media also individually advanced both these arguments in its response to the December Consultation. Apart from a quote from the December Consultation, Virgin Media did not provide further evidence and did not identify what content it considered to be substitutable.

- 2.55 In its response to the December Consultation, Sky disputed that the staggered availability of rights acted as an entry barrier.
- Sky also argued that the December Consultation failed to identify either substitutable or complementary rights that are sold by different rights holders and at separate times.
  - Sky challenged the theoretical basis of the ‘staggering’ argument for two reasons:
    - First, Sky stated that if joint ownership of rights X and Y is more valuable than separate ownership then the advantage in bidding for Y would be ‘priced in’ to all bidders’ valuations of X. This limits the bidding advantage to the remaining period of Y.
    - Second, Sky stated that the synergies from combining complementary rights are likely to be generated at the retail level. These synergies thus arise regardless of whether the rights are acquired by one wholesale channel provider or several (see Sky’s example in footnote 43 below).
  - In any event, Sky asserted that even if substitutable rights were identified, the degree of synergy between them would be small because there is a range of other substitutable rights and because part of any monopoly rents would be reaped by the retailer. Sky presented no evidence in support of these claims.
  - Further, Sky stated that if staggering truly were an entry barrier then rights owners would have a strong incentive to coordinate the dates on which their rights become available. Separately Sky argued that a significant groups of rights become available within a short period of time and listed a range of sports rights that became available in 2006.
- 2.56 Sky also asserted that periodic availability of rights facilitates a gradual entry strategy by new entrants, in comparison to the alternative of large tranches of rights becoming available simultaneously. This is on the basis that staggered availability reduces the risks for new entrants and potentially makes it easier for them to raise finance.

### Ofcom’s current position

- 2.57 Sky asserted that the staggered availability of content rights actually reduces entry barriers, *in comparison to* making large tranches of content rights available simultaneously. However, for the purposes of assessing the extent of any barriers to entry, this relative comparison is not relevant. Rather the key issue is whether potential entrants are in an equivalent position to incumbents. In other words, even if the staggered availability of content rights creates relatively fewer entry barriers in comparison to making those rights available simultaneous, this does not imply that staggered availability creates no (material) entry barriers. Put simply, it could be the case that entry is difficult regardless of whether or not rights are available on a staggered basis.



- 2.58 Notwithstanding the two theoretical criticisms advanced by Sky (as listed in the second main bullet of paragraph 2.55 above), we consider that there are circumstances in which the staggered availability of rights could act as an entry barrier.
- Consider the situation where a number of firms are potentially bidding for the X rights. It is important to distinguish between two benefits that stem from holding the X rights. First, the future advantage from holding the X rights when bidding for the Y rights the next time those Y rights become available. We agree with Sky that this advantage would be ‘priced in’ to all bidders’ valuations of X and does not create an asymmetry between them. However there is a second advantage, namely the additional value from combining X and Y rights that exists for the remainder of the current term of the Y rights agreement. As recognised by Sky, only the current holder of the Y rights enjoys this advantage. It is because of this advantage that staggered availability of the X and Y rights can create incumbency advantages for existing rights holders. The magnitude of this incumbency advantage when bidding for the X rights reflects both the scale of the synergies between X and Y and the remaining duration of the Y rights agreement (measured from the time at which the X rights become available).
  - Insofar as synergies are generated at the retail level (as claimed by Sky), this implies that they can be realised if all the content in question is distributed by the same retailer (at least on each platform). However this then raises the question of whether different wholesalers can access that retailer as efficiently. We consider this issue in detail later in this section (specifically at “Step 2” in our reasoning below). For the reasons set out in paragraphs 2.109-2.117 below, we consider that a vertically integrated firm has an efficiency advantage over firms that are not integrated. This implies that even if synergies from combining content are generated at the retail level, firms that are vertically integrated with the retailer in question are better placed to capture them. Again, this implies that the staggered availability rights can create incumbency advantages for existing rights holders.
- 2.59 We thus remain of the view that, in certain circumstances, the staggered availability of rights is capable of acting as an entry barrier. The issue is whether those circumstances apply to this relevant market.
- 2.60 We agree with Sky that, in order to rely on this ‘staggering’ argument it is necessary to provide an indication of the rights between which synergies exist and an explanation for why those synergies arise. Below we consider two possible sources of synergies.
- 2.61 The first possible synergy stems from the increased profits from dampening competition that suppliers can earn by combining substitutable rights. The magnitude of this effect is linked to the definition of the relevant market:
- To the extent that there are no close substitutes for the wholesale provision of channels including live FAPL matches this implies that the degree to which competition is dampened by combining the Live FAPL Rights with rights to other sporting events is limited.
  - However, as we have explained in section 4, we consider that there is some uncertainty about the precise boundary of the relevant market. There is likely to be a degree of substitutability between Core Premium Sports channels and programs such as live Champions League matches, although this degree of substitutability is probably insufficient to place such programmes within the same

relevant market. Nonetheless, a retailer or wholesaler that supplies channels broadcasting both live FAPL matches and other (weakly) substitutable content, such as Champions League matches, is likely to dampen competition somewhat<sup>26</sup>. This suggests that some synergies may arise between these rights.

- The magnitude of these synergies depends on the extent to which competition is dampened. This, in turn, depends on the extent of substitutability between Core Premium Sports channels and other sporting events. We recognise that the importance of this factor should not be over-emphasised since the degree of substitutability between live FAPL matches and events such as Champions League matches is unlikely to be especially strong.

2.62 The second possible synergy arises because a channel that broadcasts a *collection* of sporting events, crucially including football matches featuring FAPL teams – such as UEFA Cup or Champions League matches – may be an alternative for a Core Premium Sports channel. Synergies arise because individually those events are not a substitute for a Core Premium Sports channel but *in aggregate* they are. This is because no other single competition offers the same volume of highly attractive sport as FAPL. The termination dates of the agreements licensing the rights to those sporting events are staggered. Moreover, many of the content rights which would need to be aggregated to create such an offer are already controlled by Sky. Assembling the necessary portfolio of rights would take time. The staggered availability of rights is therefore an additional barrier to entry in creating such an offer.

### **Sky is likely to win the majority of the Live FAPL Rights**

2.63 Our current view is that it is likely that Sky will win the majority of the Live FAPL Rights when they next become available. The FAPL is likely to sell each package of Live FAPL Rights to the buyer that bids the greatest amount for that package (subject to the overarching requirement that no single bidder can win all six packages). We believe that Sky enjoys two advantages over potential rival bidders for the Live FAPL Rights, which are likely to allow it to outbid other firms:<sup>27</sup>

- Sky is the most effective retail outlet on the largest platform and third parties are unable to access that outlet as efficiently (see paragraphs 2.77-2.126 below); and
- Sky enjoys a branding advantage over other potential bidders (see paragraphs 2.127-2.129 below).

2.64 Our analysis has focused upon the advantages Sky enjoys over potential rival pay TV broadcasters, rather than over free-to-air broadcasters. This is consistent with the outcome when the Live FAPL Rights were last awarded in 2006 (Setanta won the other packages, rather than a free-to-air broadcaster). [§<]<sup>28</sup>.

<sup>26</sup> Since competition is likely to be strongest between retailers on the same platform, this may be an additional reason why a wholesaler channel provider wishes to distribute its channels via the leading retailer on a platform (this argument is discussed further in paragraph 2.88 below).

<sup>27</sup> We are not suggesting that Sky's advantages are necessarily illegitimate or detrimental for either consumers' or society's welfare. Indeed, the advantages we identify stem from Sky's greater efficiency. Rather, the context for this discussion is to explain the basis for our current conclusion that other parties are unlikely to win the majority of these rights.

<sup>28</sup> [§<]. Provided in [§<]'s information request response of [§<].

- 2.65 However, as an overarching remark we note that our view is broadly consistent with the historical position. Until the 2007/08 season, Sky acquired all the available Live FAPL Rights. The sale process for the rights from the 2007/08 season onwards changed as a result of the Commitments. While Sky did not obtain the maximum five (of six) packages that a single bidder is permitted to win, it nonetheless obtained the majority of the Live FAPL Rights for the 2007/08 to 2009/10 seasons.
- 2.66 Before discussing the two advantages Sky enjoys over potential rival bidders for the Live FAPL Rights, we address the following issues:
- Reconciling our position with the observation that Sky won four rather than five packages of Live FAPL Rights in 2006;
  - Sky’s argument that the price of the Live FAPL Rights implies that bidders were closely matched;
  - The FAPL’s argument that the Commitments address any entry barriers; and
  - The appropriate benchmark for entry.

### Why Sky won four rather than five packages

- 2.67 As noted above, Sky has argued that its failure to win a fifth package is evidence that the Live FAPL Rights can be won by rival bidders in the future. We have considered this matter carefully. [redacted]<sup>29</sup>. This supports our view that Sky is likely to win the majority of the available Live FAPL Rights but that there is a degree of uncertainty about whether it wins four or five packages.
- 2.68 In addition, the 2006 Live FAPL Rights award ended after two rounds, rather than continuing until all parties except the successful bidder(s) dropped out. In such an award process, it would appear possible for the bidder with the highest willingness to pay (i.e. Sky) to underestimate the amounts actually bid by rivals and thus fail to win a package<sup>30</sup>. [redacted]<sup>31</sup>. Further [redacted]<sup>32</sup>. It is also consistent with the view expressed in [redacted]<sup>33</sup>.
- 2.69 This may provide one explanation for why other firms continue to attempt to acquire Live FAPL Rights, since there is a chance that the bidder with the greatest

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<sup>29</sup> [redacted][redacted]. Provided in [redacted]’s information request response of [redacted].

<sup>30</sup> We draw an analogy with a sealed bid auction (although we recognise that the sale process for the Live FAPL Rights was not a pure sealed bid auction). “... the outcome [of a sealed-bid auction] is much less certain than in an ascending auction. An advantaged bidder will probably win a sealed-bid auction, but it must make its single final offer in the face of uncertainty about its rivals’ bids, and because it wants to get a bargain its sealed-bid will not be the maximum it could be pushed to in an ascending auction. So “weaker” bidders have at least some chance of victory, even when they would surely lose an ascending auction.” *Auctions: Theory and Practice* (2004), P Klemperer, chapter 3, pp114-116. Available at: <http://www.paulklempere.org/index.htm>

<sup>31</sup> It is estimated that Setanta paid £65m per annum (£195m over three years) for each of packages of C and D of Live FAPL Rights (December Consultation, Annex 10, page 22). [redacted].

<sup>32</sup> [redacted] [redacted]. Provided in [redacted]’s information request response of [redacted].

<sup>33</sup> [redacted].[redacted].

willingness to pay (Sky) does not win. In its response to the December Consultation, Sky argued that the cost of participating in tenders is small. This reinforces our view that other firms are likely to at least submit a bid for the Live FAPL Rights, in the hope of winning, even if the likelihood of that occurring is low. Moreover, the Commitments mean that at rival bidders will be able to acquire at least one package of Live FAPL Rights. [redacted]<sup>34</sup>.

### Does the price of the Live FAPL Rights show that bidders are closely matched?

2.70 We have carefully considered Sky’s observation that the increase in the price of the Live FAPL Rights is inconsistent with the view that these rights are not “contestable”. Figure 8 depicts the amounts paid for the Live FAPL Rights.

**Figure 8 The amounts paid for the Live FAPL Rights**

FAPL Seasons	Total amount paid per season	Number of live FAPL matches	Average price per match
1997/98 to 2000/01	£168m	60	£2.8m
2001/02 to 2003/04	£430m	106	£4.06m
2004/05 to 2006/07	£341m	138	£2.47m
2007/08 to 2009/10	£596m	138	£4.12m

Source: December Consultation, Annex 10, page 19

2.71 It has been suggested that competition between bidders was relatively weak in 2003 (when the Live FAPL Rights for the 2004/05 to 2006/07 seasons were sold), in particular due to the collapse of ITV Digital in May 2002 (December Consultation, Annex 10, page 19). Internal documents support this view: [redacted]<sup>35</sup>. We consider that the much larger amounts paid in 2006 (for the Live FAPL Rights to the 2007/08 to 2010/11 seasons) is likely to reflect greater competition between bidders than in 2003. This is consistent with the view expressed in the Commitments Decision that the Commitments facilitate greater competition. It is also supported by [redacted]<sup>36</sup>. However we note that the average amount paid per game in 2006 is very similar to the amount paid in 2000 (for the Live FAPL Rights to the 2001/02 to 2003/04 seasons), namely £4.12m compared to £4.06m. Sky won all the Live FAPL Rights in 2000.

2.72 We consider that, even though competition between bidders was stronger in 2006 than in 2003, this does not imply that all bidders were on an equal footing in 2006. Rather, for the reasons summarised discussed below, we consider that Sky enjoys a number of advantages over rival bidders. These advantages have allowed Sky to persistently outbid rivals for the Live FAPL Rights, even when competition between bidders has been relatively strong. In other words, even though other firms participate in the sale process for the Live FAPL Rights (reflecting the low barriers to participation discussed above) and thereby drive up the price of those rights, they are unlikely to actually outbid Sky and win a large proportion of those rights.

<sup>34</sup> [redacted]. Provided in [redacted]’s information request response of [redacted].

<sup>35</sup> [redacted] Provided in [redacted]’s information request response dated [redacted].

<sup>36</sup> [redacted] Provided in [redacted]’s information request response dated [redacted].

### Do the Commitments address any entry barriers?

2.73 We have considered the FAPL’s view that the Commitments address any barriers to entry. The Commitments Decision states that the Commitments “considerably improve the scope for ex ante competition for the rights ... [The] increase in the number of live TV rights packages ... will permit greater competition in the acquisition of those rights ... The ban on conditional bidding makes a further contribution to levelling the playing field ...” (paragraph 40). However we do not regard our current conclusion (namely that Sky is likely to outbid rivals and acquire the majority of the Live FAPL Rights) as being inconsistent with the European Commission’s position. The advantages that Sky enjoys over potential rival bidders mean that greater industry profits are generated if Sky wins the Live FAPL Rights. Such a bidder would be expected to win in a competitive auction/bidding process. Thus, in our view, there is no inconsistency between the European Commission’s view that the Commitments increase competition for the Live FAPL Rights and our view that Sky (i.e. the bidder that generates the highest industry profits from those rights) is likely to win the majority of those rights.

### Ofcom’s benchmark for entry

2.74 We have considered Sky’s argument that Ofcom has adopted an unreasonable entry benchmark. It is important to distinguish between two issues:

- The volume of rights that a wholesaler needs to viably enter the market; and
- The scale of entry necessary to undermine any dominant position possessed by Sky.

2.75 In terms of the first issue, we consider that a new entrant does not require the rights to a wide range of sports in order to be viable. [redacted]<sup>37</sup>. We also consider that a new entrant does not need to acquire four packages of Live FAPL Rights (i.e. the number currently held by Sky) in order to operate a viable business. Ofcom does not have a firm view on whether a new entrant requires a minimum of one<sup>38</sup> or two<sup>39</sup> packages of live FAPL rights in order to be viable.

2.76 However, in line with the position in paragraph 1.4 of the OFT Market Power Guidelines, the second issue is also relevant. This centres on whether entry by potential competitors and expansion of existing competitors would prevent Sky from profitably sustaining wholesale prices above the competitive level and/or harming the process of competition (e.g. by weakening existing competition, raising entry barriers or slowing innovation). As noted above, Setanta’s current market share is around [redacted] when assessed on a wholesale revenue basis and 23% when assessed on the

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<sup>37</sup> [redacted] Provided in [redacted]’s information request response dated [redacted].

<sup>38</sup> The Commitments Decision states that “Even just one package of rights ... will be sufficient to give an overview (or “showcase”) of the FA Premier League’s season” (paragraph 41). This implies that a business could be viable with a single package of Live FAPL Rights (such a view is also implicit in the Commitments since that a single bidder can win at most five packages, which would leave only one package for another bidder). [redacted]. [redacted]. Provided in [redacted]’s information request response of [redacted].

<sup>39</sup> Annex 2 of the Joint Submission stated that one package would allow a channel to broadcast a live FAPL match on only six out of every ten weeks in the FAPL season (23 matches over the 38 weeks of an FAPL season). The Four Parties described such an offering as “intermittent” and “not ... commercially viable”. Similarly [redacted]; provided in [redacted]’s information request response dated [redacted].

basis of the amounts paid for the Live FAPL Rights. Given the strength of Sky's current position, small scale entry and expansion is unlikely to undermine any dominant position possessed by Sky, since Sky would still enjoy a high market share. This is the case even if (small) entrants have a viable business.

### **The ability to access final consumers most effectively**

- 2.77 We consider that the first advantage that Sky enjoys over potential rival bidders for the Live FAPL Rights is that Sky is the most effective retail outlet on the largest platform and that third parties are unable to access that outlet as efficiently. This argument involves a number of logical steps. Therefore, we first set out an overview of those steps. Second, we provide an illustrative example to support that overview. Third, we consider in turn the detailed logical steps, including the consultation responses that are relevant to each of those steps.
- 2.78 In overview, this argument involves the following steps:
- **Step 1: the importance of dealing with the leading retailer on each platform.** On most platforms, we observe a leading retailer (e.g. Virgin Media on cable, Sky on its DSat platform) that retails the vast majority or all of the channels available on that platform. In principle, a firm that successfully bid for the Live FAPL Rights and created a channel including live FAPL matches could either directly retail that channel on a particular platform or wholesale that channel to a third party retailer on that platform. Crucially, we consider that greater total industry profits are likely to be generated when that channel is distributed by the leading retailer on each platform.
  - **Step 2: vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently.** We consider that a third party channel provider cannot obtain access to the leading retailer on a platform as efficiently as a wholesale channel provider that is vertically integrated with that retailer. This is for a number of reasons (explained below) that we refer to as the "Access Disadvantages".
  - **Consequences:**
    - An entirely independent bidder faces the Access Disadvantages on all platforms. A bidder that is vertically integrated with the leading retailer on one platform avoids the Access Disadvantages on that platform but faces the Access Disadvantages on all other platforms. An entirely independent bidder will thus be at a disadvantage compared to vertically integrated bidders.
    - When assessing whether one vertically integrated wholesaler-retailer is in a relatively stronger position than another, we consider that the relative size of those firms' subscriber bases is crucial. The effect of the Access Disadvantages is larger on platforms with more subscribers. Since a vertically integrated wholesaler-retailer avoids the access disadvantages on 'its' platform, this implies that the leading retailer on the largest platform is least affected. It is thus likely to be able to outbid vertically integrated retailers on other (smaller) platforms for the Live FAPL Rights.
    - In other words, Sky is the most effective retail outlet on the largest platform (Step 1) and third parties are unable to access that outlet as efficiently (Step 2).

2.79 We now discuss Step 1 and Step 2 in detail.

### Step 1: the importance of dealing with the leading retailer on each platform

2.80 To recap, Step 1 relates to the importance of dealing with the leading retailer on each platform. We observe that, for the majority of pay TV platforms, there is a leading retailer on that platform i.e. a single retailer that sells all/the majority of the content retailed on that platform. Specifically, Sky is the leading retailer on its DSat platform, Virgin Media is the leading retailer on its cable platform and BT is the leading retailer on its platform. The two possible exceptions are Tiscali's platform (where both Sky and Tiscali retail) and Top Up TV's platform (where both Top Up TV and Setanta retail)<sup>40</sup>.

2.81 In principle, wholesale channel providers could directly retail their channels but we observe in practice that the majority of them instead distribute their channels via the leading retailer on each platform.

2.82 Figure 9 below summarises the responses given during the course of Ofcom's review of wholesale digital television broadcasting platforms as to why they do not retail their channels.

**Figure 9 Stated reasons for not retailing**

Cost factors	Broadcaster(s) citing factor
Long lead time associated with establishing a new retail service, and need to build up a subscriber base	[X] [X]
TPS costs are too high	[X] [X]
TPS regime does not provide sufficient long-term certainty to establish a retail business	[X] [X]
Other non-TPS retail costs (marketing, call centres etc.) are too high for an entrant to be viable; by contrast, incumbent retailers benefit from significant economies of scale	[X] [X] [X] [X]
Commercial and demand-side factors	Broadcaster(s) citing factor
Need to build a package with a critical mass of content to drive subscriptions	[X] [X]
Large basic pay portfolios already available: unlikely consumers will pay for two bouquets (particularly given buy-through)	[X] [X]
Unable to compete effectively with existing platform offers (e.g. packages bundled with broadband, telephony etc.)	[X]
Company does not have the experience or competence to retail direct	[X]
Some platforms are closed	[X] [X]

Source: Interviews with broadcasters during the course of wholesale digital television broadcasting platforms review

<sup>40</sup> In any event, Tiscali's and Top Up TV's platforms currently have comparatively few subscribers (compared to cable and Sky's DSat platform). They are thus less central to assessing entry barriers into the market for the wholesale supply of Core Premium Sports channels.

2.83 We consider that greater total industry profits are likely to be generated when a Core Premium Sports channel is distributed by the leading retailer on each platform for three reasons:

- On closed platforms there is obviously no alternative other than dealing with the leading retailer;
- On open platforms the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services; and
- On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent.

2.84 We discuss each of these three factors in turn.

#### *Closed platforms*

2.85 To date, neither Virgin Media nor BT have allowed third parties to retail on their platforms. On such closed platforms there is no alternative other than dealing with the leading (sole) retailer. [3<].

#### *Aggregation by the leading retailer*

2.86 On open platforms the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services. Aggregation of such content in the hands of one retailer facilitates bundling at the retail level. As discussed in the December Consultation, bundling of content that is not closely-substitutable can allow retailers to sell more content, at different price points, to a wider range of consumers<sup>41</sup>. For example, bundling can effectively allow a retailer to charge a high incremental price for content to a consumer that has a high willingness to pay but a low incremental price to a consumer that has a low willingness to pay<sup>42</sup>. We refer to this motivation for bundling below as the “preference smoothing effect”.

2.87 We consider that there are a number of pieces of evidence supporting our view about the benefits of bundling.

- The preference smoothing effect is more likely to be material when consumer preferences are heterogeneous (in contrast, if all consumers had identical preferences then this motivation for bundling disappears). This is the case in the pay TV industry – consumers have widely varying preferences for content (see December Consultation, Annex 14, paragraphs 4.10-4.17).

<sup>41</sup> As noted in the December Consultation, this type of bundling can frequently lead to an expansion of output and efficiency gains.

<sup>42</sup> For instance, one consumer may value sports at £10 and films at £2, and another vice versa. Both consumers would buy a joint package priced at £12, generating total revenue of £24, whereas single packages priced at £10 each would only attract those consumers who valued the individual elements at £10, generating total revenue of £20. Also see, for example, section 4.3.2.1 of B Nalebuff “Bundling, Tying, and Portfolio Effects: Part 1 – Conceptual Issues”, DTI Economics Paper No.1, February 2003, pp 33-37, available from: <http://www.berr.gov.uk/files/file14774.pdf> or M Armstrong and H Weeds, “Public service broadcasting in the digital world”, 1 August 2005, mimeo, pages 12-14 available from: [http://www.econ.ucl.ac.uk/downloads/armstrong/PSB\\_Armstrong\\_Weeds.pdf](http://www.econ.ucl.ac.uk/downloads/armstrong/PSB_Armstrong_Weeds.pdf)



- It is consistent with the fact that retail bundling is widely practised.
  - It is supported by documents produced for industry participants. [3].
- 2.88 In addition, as discussed in the December Consultation, aggregation of the majority of closely substitutable content can increase retail prices for that content above competitive levels. Thus, in principle, there may be an incentive to wholesale a Core Premium Sports channel to the leading retailer, rather than directly retailing that channel in direct competition with any substitutable channels supplied by that retailer. Dampening competition in this way generates higher profits for suppliers (albeit at the expense of subscribers), enabling a greater amount to be paid for the underlying rights.
- 2.89 As we have explained above, we consider that there is some uncertainty about the precise boundary of the relevant market. There is likely to be a degree of substitutability between a Core Premium Sports channel and channels featuring live Champions League matches, although this degree of substitutability is probably insufficient to place both channels within the same relevant market. Nonetheless, a retailer that supplies channels broadcasting both live FAPL matches and other (weakly) substitutable content, such as Champions League matches, is likely to dampen competition somewhat. Where the leading retailer on a platform already supplies such substitutable content, it provides an additional reason to distribute a Core Premium Sports channel via that retailer (we refer to this below as the “competition dampening effect”).
- 2.90 We received a number of responses to the December Consultation relating to the aggregation of content.
- 2.91 Virgin Media stated that since consumers value a range of premium content, Sky's existing portfolio of content will enable Sky to bid more to acquire particular incremental content rights when these rights come up for renewal (as the resulting output is more valuable in a package with Sky's existing rights than if it were to be retailed separately to consumers). Virgin Media did not provide further evidence or reasoning to support its claims
- 2.92 Setanta and Top Up TV stated that Sky will be able to extract more value from particular rights because it can bundle any new rights with its existing portfolio of rights. They did not present any evidence in support of this view beyond citing passages from the December Consultation.
- 2.93 In Annex 5 of its response to the December Consultation, Sky discussed aggregation of content at both the wholesale and retail level.
- At the wholesale level, Sky appeared to agree with the logic behind the preference smoothing effect. Sky argued that this reasoning applies more widely than just to bundling between sports and movies channels, and also applies to bundling between different sports and potentially between different movie genres too. Sky presented the results of consumer research that showed the sports that Sky Sports subscribers liked to watch on TV. Sky considered that this research demonstrated “huge variety” in respondents' preferences.
  - At the retail level, Sky stated that the extent to which a pay TV retailer is in fact able to benefit from bundling efficiencies is significantly limited by three factors. Accordingly, Sky asserted that the scale of the advantage conferred on a

particular retailer by bundling efficiencies is much smaller than suggested in the December Consultation.

- First, retailers have limited information on underlying channel demands.
- Second, Sky stated that to “fully exploit” the bundling efficiencies described above, a retailer would need to offer a vast number of channel combinations. However in practice simplicity and the ability to convey the different packaging options to potential subscribers is important, as shown by the packages offered by Sky and Virgin Media Media.
- Third, Sky gave the example of a new documentary channel. Sky asserted that, the value of that channel to Sky might be quite limited since Sky already offers a range of documentary channels as part of its Knowledge Mix (i.e. for Sky the preference smoothing effect is negligible). Sky asserted that a new documentary channel is unlikely to provide Sky with the opportunity to increase the price of this Mix, particularly given the desirability of prices at integer values (i.e. the competition dampening effect is also negligible). In contrast, a retailer with a much smaller portfolio may significantly value a new documentary channel since it enables that retailer to target a different audience (i.e. for that retailer the preference smoothing effect is significant).

2.94 In Annex 3 of its response to the December Consultation, Sky discussed the bundling of channels by retailers and argued that much of this potential efficiency is generated at the retail level and occurs regardless of whether they are supplied by one wholesaler or several<sup>43</sup>.

2.95 We have considered these consultation responses carefully. We agree with Sky that efficiencies from bundling at the retail are likely to be wider than just between packages of sports and movies. We also agree that bundling benefits can be reaped even where the channels are supplied by different wholesalers – this is why Step 2 (as discussed below) is essential to Ofcom’s position. We have considered Sky’s argument that retailers have limited information on underlying channel demands and that offering a simple and easily understood range of retail packages is important. While we recognise the practical limitations on the extent to which retail bundling occurs, we do not consider that these imply that the benefits of bundling are negligible.

2.96 We have considered Sky’s example of a new documentary channel. Sky’s reasoning relies upon two assumptions:

- First, that the new documentary channel appeals to a very similar audience to existing content sold by the leading retailer. Accordingly, for that retailer the preference smoothing effect from bundling is likely to be limited; and

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<sup>43</sup> Sky provided an illustrative example, in which two channels are each worth £100 to a retailer individually but £250 if they are retailed together. Sky argued that the second channel is worth the same to either wholesaler. For example, if the first channel was wholesaled for £130 by Sky then the value of the second channel, both to Sky or a new entrant, is £120. Sky concluded by noting that “there is a pie of a fixed size, and however large a piece of that pie a new entrant could gain if it won the rights, that is the same piece that Sky loses ... Therefore the right [sic] is still worth the same to both broadcasters.” We note that this argument crucially relies upon the fixed value (£250) to retailer of the channels, regardless of the identity of the wholesalers. For the reasons set out in Step 2 (paragraphs 2.109-2.117) below, we do not consider that this is the case.

- Second, that there are a wide range of substitutes for this channel. As a result, the competition dampening effect is also small.

2.97 We doubt that either of these assumptions applies in the case of channels including a material number of live FAPL matches:

- For the reasons given in section 4 of the main document, we do not consider that a channel containing live FAPL matches channel appeals to a very similar audience to existing content sold by the leading retailer. Rather, live FAPL matches are distinct from other sporting content.
- In contrast to Sky's hypothesised documentary channel, we do not consider that there are likely to be close substitutes for a channel containing live FAPL matches (as reflected in our market definition). While we recognise that other football contests, such as Champions League, may provide a degree of constraint this is unlikely to be strong enough to mean that the competition dampening effect from aggregating live FAPL matches is negligible. Accordingly, it seems plausible that the leading retailer may dampen competition to a degree if it distributes a number of channels featuring live FAPL matches, in comparison to the situation where those channels are retailed by separate, competing entities. By dampening competition in this way, that retailer is likely to generate higher industry profits from those channels.

#### *Delays in building a subscriber base*

2.98 On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent<sup>44</sup>.

2.99 Figure 10 shows the number of paying Setanta Sports subscribers on Sky's DSat platform at the end of each month. This chart thus shows that the number of Setanta Sports subscribers has increased substantially, from under [X] to over [X]. However not all of this subscriber increase had occurred by the end of August 2007, the month in which Setanta began broadcasting live FAPL matches. [X].

2.100 Ofcom draws two implications from this data:

- [X].
- [X]<sup>45</sup>.

#### **Figure 10 Paying Setanta Sports subscribers on Sky's DSat platform**

[X]

Source: Setanta response dated 7 July 2008

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<sup>44</sup> The effects of this delay will be exacerbated if wholesale channel providers enjoy economies of scale with respect to the number of subscribers to their content.

<sup>45</sup> Ofcom considered comparing subscriber numbers to Premiership Plus (a PPV sports channel that featured 50 live FAPL matches) in the 2007/08 season with Setanta Sports subscriptions in the 2008/09 season. In Ofcom's view, however, the evidence and data available do not allow meaningful conclusions to be drawn.

- 2.101 [X]. This [X] also suggests that a firm that wins the Live FAPL Rights for the first time may attract markedly fewer subscribers than the incumbent channel provider.
- 2.102 We have considered possible explanations for this phenomenon. The December Consultation discussed intra-platform switching costs. It stated that switching is relatively simple where a consumer is moving from one retailer to another on the same platform (paragraph 5.105), with the main barrier being contractual provisions at the retail level. Sky specifies a minimum 12 month contract for new customers (paragraph 5.106). We note, however, that such contractual provisions are not a barrier to a subscriber taking a service from an additional retailer, as well as Sky. We have thus not identified any material impediments to a subscriber that wishes to subscribe to an additional retailer on a platform. Rather, it seems more plausible that the delay experienced by Setanta in building up its subscriber numbers reflects two factors: first, consumer inertia and the tendency of some consumers to hesitate before taking up a new service; and second, lower awareness of Setanta's services compared to those of Sky<sup>46</sup>.
- 2.103 We received a number of consultation responses that are relevant to this issue.
- 2.104 BT asserted that a new entrant is unlikely to be able to build-up a DSat customer-base comparable to Sky's within the space of, say, three years. BT did not provide any evidence to support this assertion. Setanta/Top Up TV stated that Sky will be able to monetise rights more quickly than an entrant because of its existing subscriber base<sup>47</sup>. Their arguments appear to be predicated upon an implicit assumption that an entirely new entrant faces a delay in building up its subscriber base, although Top Up TV/Setanta did not make this explicit. Virgin Media referred to the discussion of barriers to retail switching in the December Consultation. The March 2008 LECG Report asserted that there is significant customer inertia (footnote 5). The Four Parties' August 2008 submission acknowledged that the level of switching costs does not impede consumers subscribing to alternative pay TV services (paragraph 5.11). However they nonetheless considered that a new channel is unable to readily and rapidly match Sky's subscriber base (paragraph 5.15).
- 2.105 In addition, both Virgin Media and Setanta/Top Up TV asserted that, if a new entrant distributed its channel on DSat via a wholesale relationship with Sky then this will not resolve this problem, since that new channel would still have no subscribers at the outset. Setanta/Top Up TV did not attempt to reconcile this argument with its view that bundling allows rights to be monetised rapidly.
- 2.106 Sky and the October 2007 CRA Report stated that the costs to taking up a channel on the platform that a household currently subscribes to are likely to be negligible,

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<sup>46</sup> For example, Figure 1 in Annex 14 to the December Consultation shows consumers are more aware of Sky than other multi-channel TV providers (Setanta is not included in this figure). An Ofcom survey in June/July 2007 asked people who did not subscribe to Setanta whether they had heard of the Setanta Sports channels: 26% of cable subscribers and 37% of freeview subscribers stated that they had not heard of them. Further, the majority of respondents who were interested in sports but did not subscribe to Setanta Sports incorrectly believed that Setanta Sports was unavailable on the pay TV platform they subscribed to. Specially, only 48% of DSat subscribers and 42% of cable subscribers stated that Setanta Sports was available on the platform they subscribed to.

<sup>47</sup> Top Up TV/Setanta claimed that Sky can include new content either on existing pay TV channels or as part of a retail bundle with existing channels and increase prices immediately to reflect that additional content. They did not explain why Sky enjoys this advantage over existing competitors, such as Setanta, who already have a portfolio of content and channels.

especially as premium channels are “add-ons” to an existing subscription. The April 2008 CRA Report reiterated this point and argued that low intra-platform switching costs imply that any delays in building a subscriber base are limited and hence barriers to entry are low. Further, it cited paragraph 3.56 of the December Consultation in support. This paragraph referred to German pay TV operator Premiere’s loss of subscribers following its loss of certain football rights. Sky stated that, provided that a new entrant can match the quality of an incumbent’s channels, consumers will be willing and able to switch to that new entrant’s channel. Sky stated that this is particularly true where consumers have an interest in watching a specific event (such as the FA Cup), and are thus likely to follow that content to another channel<sup>48</sup>. Sky asserted in the October 2007 Response that even if it could add a new channel to its existing channel bundles, this would only produce additional revenues insofar as it reduced churn or increased the number of subscribers, as Sky has limited ability to increase prices. Sky did not provide any evidence in support of these claims.

2.107 We have considered Sky’s counterarguments. We agree that the costs to taking up an additional channel on the platform that a household currently uses are likely to be negligible. However this does not imply that a new entrant faces no delays in building up its subscriber base. Rather, as explained above, inertia, hesitation by some consumers and lower awareness of a new entrant (compared to Sky) appear to be more plausible explanations for a delay in take up of a new entrant’s channel, rather than tangible impediments. We regard Setanta’s subscriber numbers as strong evidence that, where a new entrant wins rights from the incumbent and then directly retails the resulting channel, there is a delay while it builds up its subscriber base. The April 2008 CRA Report’s reference to the experience in Germany does not provide strong evidence to counter Setanta’s actual experience in the UK market.

2.108 Virgin, Setanta and Top Up TV consider that, even if the new entrant distributes its channels through the leading retailer (and former incumbent), there is still a delay in building up subscriber numbers for that channel. We have not formed a view on this point, particularly as it does not matter for the purposes of establishing whether entry barriers exist.

- If it is the case that there is a delay in building subscriber numbers even when the channel is distributed by the leading retailer then that delay creates an advantage for the incumbent wholesale channel provider when bidding for those rights (or, equivalently, new entrants face an entry barrier).
- In contrast, if this delay can be avoided by distributing that channel via the leading retailer then it provides another rationale for distributing via that retailer. However, for the reasons given at Step 2 below, a wholesaler channel provider that is vertically integrated with the leading retailer on a platform obtains access to that retailer more efficiently. As explained below, this means that Sky enjoys an advantage over rival bidders for the Live FAPL Rights.

### Step 2: vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently

2.109 We now turn to Step 2. We consider that a third party channel provider cannot obtain access to the leading retailer on a platform on equivalent terms to a wholesale

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<sup>48</sup> Sky’s October 2007 Response and the April 2008 CRA Report stated that the ability to monetise rights faster, even if it arises, is unrelated to vertical integration.

channel provider that is vertically integrated with that retailer. This is for two reasons that we refer to as the “Access Disadvantages”<sup>49</sup>.

*Double marginalisation and aligning retailer and wholesaler incentives*

- 2.110 The first Access Disadvantage is the difficulty of aligning the retailer’s and wholesaler’s incentives. Wholesale prices are structured as a price per subscriber<sup>50</sup>. This has the effect of slightly diminishing the incentive for the retailer to attract additional subscribers by engaging in marketing/advertising or by dropping retail prices (as compared to the situation where the wholesale price is a fixed, lump sum payment). In contrast, a vertically integrated firm does not face this effect because the per subscriber wholesale price is simply an internal transfer within the firm. This is identical to the efficiency effect that can result from a vertical merger, namely avoiding so-called “double marginalisation”<sup>51</sup>.
- 2.111 It is important to recognise that the benefits enjoyed by a vertically integrated firm are likely to be larger in relation to platforms with a large number of consumers that are likely to subscribe to the channel in question. In other words, the benefits of vertical integration with a retailer with 100,000 subscribers will be markedly less than in relation to a retailer with 1 million subscribers.
- 2.112 The submissions we have received appear to support the existence of such incentives. In its October 2007 Submission, Sky (part D, paragraphs 4.17(b)-(d)) identified these differences in incentives as one reason why other retailers has been less successful than Sky at marketing Sky’s channels<sup>52</sup>. BT, Virgin Media, the Four Parties and the March 2008 LECG Report all argued that, even if a new entrant agreed wholesale terms with Sky, Sky would not have the incentive to promote the rival channel in competition with its own channels.
- 2.113 The experience of [redacted] is evidence of the difficulties in aligning wholesale channel provider and retailer’s incentives. [redacted]. This is evidence that wholesale channel providers consider that retailers have impeded their ability to successfully promote their channels. Clearly such difficulties are unlikely to arise in a vertically integrated firm.
- 2.114 While the March 2008 LECG Report (for the Four Parties) argued that Sky would not have an incentive to promote third party channels in competition to its own (footnote

<sup>49</sup> Paragraph 5.124 of the December Consultation set out a number of examples illustrating the potential benefits of vertical integration including information advantages when bidding. The April 2008 CRA Report argued that such information advantages are unlikely to be significant and that, in any event, they are better characterised as incumbency advantages rather than a benefit of vertical integration. We do not rely on such advantages in this document, recognising for example, that less well informed bidders may inadvertently overbid for rights. [redacted],[redacted]. Provided in [redacted]’s information request response of [redacted].

<sup>50</sup> As noted in the December Consultation, per subscriber fees directly address the risk for the channel provider of retail prices collapsing to near zero, given that channels are not sold exclusively.

<sup>51</sup> *Merger guidelines: Competition Commission Guidelines*, Competition Commission, June 2003, paragraph 4.44 and footnote 40.

<sup>52</sup> Sky also stated that it has tried to improve the incentives for retailers to sell its premium channels, for instance by working with cable retailers on non-linear discount structures from the wholesale rate-card prices. These efforts were abandoned, [redacted].

7), it denied that double marginalisation occurs since retailers on other platforms do not have appreciable market power (page 10). In support of this position, LECG cited two pieces of evidence:

- The finding in the December Consultation that only Sky was likely to be dominant in the retailing of packages containing premium sports and movies;
- Second, the incremental retail price of Sky Movies and Sky Sports to subscribers to Virgin's XL package was only 4% higher than the incremental price of those channels to subscribers to Sky's Basic-tier channels (£25/month compared to Sky's £24/month).

2.115 We do not agree with LECG that double marginalisation is not an issue when Core Premium channels are retailed by third parties. Such a conclusion is entirely consistent with conventional economic reasoning. In terms of the two pieces of evidence cited by LECG:

- We do not accept that a firm needs to be dominant before it is able to mark-up prices above the (perceived) marginal cost that it faces. Dominance is a relatively high legal threshold. Accordingly, even if a pay TV retailer is not dominant it may nonetheless possess sufficient market power for double marginalisation to arise.
- Given the prevalence of bundling, we do not accept that the appropriate comparison is the incremental retail price i.e. the retail price of a bundle of Basic-tier channels (only) compared to the retail price of a bundle of Basic-tier channels and premium channels. Such bundles are likely to be targeted at different consumer segments, and priced at a level that reflects those consumers' different preferences. It is thus not appropriate to treat the incremental price as the 'price of premium content'. In any event, even if this comparison were appropriate (which we do not consider to be the case), we observe that LECG's evidence (Virgin Media's slightly higher incremental retail price) is entirely consistent with the existence of double marginalisation<sup>53</sup>.

### *Uncertainty about wholesale prices*

2.116 The second Access Disadvantage is uncertainty both about the level of the wholesale price at the time the rights are bid for and whether a wholesale distribution agreement is agreed. That uncertainty, and the associated risk that a successful bidder incurs losses because it overestimated the wholesale price that it is able to charge to retailers or because negotiations (temporarily) break down, imposes an additional cost on bidders that diminishes the expected value generated from the rights<sup>54</sup>. In contrast, a vertically integrated wholesaler does not face this uncertainty

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<sup>53</sup> LECG referred to the incremental price charged to subscribers to Virgin Media's XL package of Basic-tier channels. We note that the incremental retail price charged by Virgin Media for Sky Sports plus Sky Movies is markedly higher for consumers taking other packages of Basic-tier channels: in September 2008, the incremental price was £26/month for consumers taking an XL package, £31/month for subscribers taking a L package and £37/month for subscribers taking a M package.

<sup>54</sup> In principle, this additional 'uncertainty cost' could be resolved if would-be bidders agree the wholesale price with retailers in advance (such agreements would need to be binding and would presumably be conditional upon the bidder winning the rights). However in practice we generally do not observe such agreements (the exception being that Setanta reached a wholesale agreement with Sky for supply to commercial premises prior to sale of the Live FAPL Rights in 2006). Indeed we would expect such agreements to be uncommon. Since they reduce the disadvantages facing rival

related cost when dealing with its retail arm – the implicit wholesale price paid by that retailer is simply an internal transfer within the firm that does not affect its overall profitability.

- 2.117 It is important to recognise that these uncertainty costs are likely to be larger in relation to platforms with a large number of consumers that are likely to subscribe to the channel in question. Put simply, if a particular platform has 100,000 potential subscribers then the consequences of the uncertainty about the wholesale price paid in relation to those 100,000 subscribers will be markedly less than in relation to a platform with 1 million subscribers.

### Implications of Step 1 and Step 2

- 2.118 Having now discussed Steps 1 and 2, we set out the consequences. When bidding for the Live FAPL Rights, the bidder that is likely to generate the greatest overall profits from the onward sale of the rights (both wholesale and retail) is likely to win those rights. Such a bidder can afford to pay more to the FAPL.
- 2.119 A third party bidder that is not vertically integrated with the leading retailer on any platform is likely to generate less value from the Live FAPL Rights. If it attempts to retail directly on a particular platform then it is likely to generate less revenue (e.g. because it cannot bundle its channel with the leading retailer's content) and incur higher costs (see Step 1 above). If that third party bidder instead wholesales its channel to the leading retailer, it is still likely to generate less value than the leading retailer would if the leading retailer had won the rights. This is because it faces the Access Disadvantages (see Step 2 above), namely an additional uncertainty cost and more difficulties in aligning retailer and wholesaler incentives.
- 2.120 A bidder that is vertically integrated with the leading retailer on a particular platform avoids the Access Disadvantages on that platform. However, in relation to other platforms it is in the same position as a third party bidder i.e. both direct retailing and wholesaling to that other platform's leading retailer generate less value from the Live FAPL Rights (compared to the amounts that that platform's leading retailer would generate). Thus each vertically integrated firm only enjoys an advantage in relation to the platform where it is the leading retailer. The issue is thus the relative size of those advantages. The Access Disadvantages are likely to be larger in relation to platforms with more likely subscribers to Core Premium Sports channels (Step 2, specifically paragraphs 2.111-2.117 above). In other words, a bidder that is vertically integrated with the leading retailer on the platform with the greatest number of likely subscribers to Core Premium Sports channels is in a stronger position than vertically integrated bidders on other platforms.
- 2.121 To assist understanding of this argument, Figure 11 below sets out an illustrative example.

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bidders and thus intensify competition for the rights this discourages vertically integrated firms that are considering bidding for the rights from entering into such agreements.



**Figure 11 Illustrative example****Assumptions:**

There are two pay TV platforms ( $\alpha$  and  $\beta$ ) with 8m and 4m subscribers respectively. There are three firms (A, B and C) considering bidding for key rights that enable them to assemble a pay TV channel. Firm A is vertically integrated with the leading retailer on platform  $\alpha$ . Firm B is vertically integrated with the leading retailer on platform  $\beta$ . If the channel is directly retailed on a platform by someone other than the leading retailer, it generates industry profits of £10/subscriber. If the channel is instead retailed by the leading retailer then it generates industry profits of £12/subscriber (Step 1). If the channel is wholesaled to that leading retailer by a third party there is an additional cost (loss of efficiency) of £1/subscriber, which reduces the industry profits to £11/subscriber (Step 2); this cost is avoided if the wholesaler is vertically integrated with the retailer.

If a firm wholesales the channel to the leading retailer, the resulting industry profits (£11/subscriber) are split 50-50 between the retailer and the wholesaler (NB. the consequences below still hold if a different percentage split is chosen).

**Consequences:**

**Example 1:** Suppose A and C compete for the rights. If A wins, as the leading retailer it will retail the channel on platform  $\alpha$  whereas on platform  $\beta$  it will wholesale that channel to the leading retailer B. If C wins, it will wholesale the channel to the leading retailer on each platform. A thus earns £118m if it wins the rights ((£12x8m) on platform  $\alpha$  plus half of (£11x4m) on platform  $\beta$ ). If C wins the rights then C earns £66m (half of (£11x8m) on platform  $\alpha$  plus half of (£11x4m) on platform  $\beta$ ) and A earns £44m (as the retailer, A receives half of the (£11x8m) generated on platform  $\alpha$ ). A is thus willing to pay up to £74m for the rights (£118m-£44m) whereas C is only willing to pay £66m. **Conclusion: an entirely independent bidder is at a disadvantage compared to vertically integrated bidders when bidding for rights.**

Note that this same outcome arises if C instead retails the channel directly on platform  $\alpha$ . If C wins, it earns £80m on that platform (£10x8m) whereas A receives nothing. If A wins, it earns £96m on platform  $\alpha$  (£12x8m). A is thus willing to outbid C (note that whatever course of action C adopts on platform  $\beta$  does not matter; A can also adopt that course of action and earn just as much).

**Example 2:** Suppose A and B compete for the rights. If A wins, as the leading retailer it will retail the channel on platform  $\alpha$  whereas on platform  $\beta$  it will wholesale that channel to the leading retailer B. The same occurs *mutatis mutandis* if B wins. A thus earns £118m if it wins the rights ((£12x8m) on platform  $\alpha$  plus half of (£11x4m) on platform  $\beta$ ). If, instead B wins the rights then A earns £44m (as the retailer, A receives half of the (£11x8m) generated on platform  $\alpha$ ). Similarly, B earns £92m if it wins the rights and £22m if A wins the rights. A is thus willing to pay up to £74m for the rights (£118m-£44m) whereas C is only willing to pay £66m. **Conclusion: a vertically integrated firm on a larger platform has an advantage over a vertically integrated firm on a smaller platform when bidding for rights.**

- 2.122 Sky is the leading retailer on the largest platform: in June 2007 Sky retailed its Core Premium Sports channels to [redacted] subscribers on DSat as compared to Virgin Media's [redacted] subscribers to those channels on its cable platform. Accordingly, Sky is likely to enjoy an advantage over rival bidders.
- 2.123 We have assessed the extent to which the explanation set out above deviates from observed market outcomes. In particular, we note that:
- First, Setanta directly retails its channels on DSat, rather than distributing them via the Sky (the leading retailer on that platform). Similarly, there are a number of major retailers on Top Up TV and Tiscali's platforms.
  - Second, Sky did not win the maximum permissible amount of Live FAPL Rights (it won four rather than five of the six available packages).
  - Third, Virgin Media is vertically integrated with the leading retailer on the platform with the second largest number of likely subscribers. However Virgin Media did not win those Live FAPL Rights packages that Sky failed to secure.
- 2.124 With regards to the first point, we consider that this is explained by the magnitude of the benefits of distributing via the leading retailer (Step 1) relative to the magnitude of the Access Disadvantages (Step 2). For example, if the Access Disadvantages are large then a wholesaler may choose to directly retail its channel even though it fails to reap the benefits that come from distributing that channel via the leading retailer<sup>55</sup>.
- 2.125 With regards to the second point, we do not consider that this implies that the analysis set out above is incorrect. Rather, in practice there are also other factors affecting bidders. We set out a possible explanation for Sky's failure to win a fifth package of rights in paragraphs 2.67-2.68 above.
- 2.126 With regards to the third point, we do not consider that this implies that the analysis set out above is incorrect. [redacted]<sup>56</sup>.

### **Branding advantages**

- 2.127 We consider that Sky enjoys a branding advantage over other potential bidders. Conjoint analysis of the results of an April 2008 Ofcom survey indicates that, were all the 138 FAPL matches that are screened live available from Setanta then on average consumers would value that content at £42/month. If that same content were available from Sky, consumers would value it at £57.50/month<sup>57</sup>. The effect of Sky

<sup>55</sup> Moreover as explained in paragraph 6.120 of the main document, we believe that where Sky retails via other operators' platforms, it has an incentive to weaken its retail offering, in order to increase the likelihood of customers selecting to take up that content via its retail offer on its own DSat platform.

<sup>56</sup> Provided in [redacted]'s information request response dated [redacted].

<sup>57</sup> Respondents all subscribed to a Sky Sports channel and/or Setanta Sports as well as expressing an interest in sports. The figure thus relate to the valuations of an average subscriber who might be described as a 'sports fan'. We consider that it is the valuation of the average potential subscriber that is relevant to the amount bid for the Live FAPL Rights, rather than the valuation of particular sub-groups of potential subscribers. We also note that consumers that are strongly committed to football would value all 138 FAPL matches at £54/month when supplied by Setanta but would value those same games at £63/month when supplied by Sky. For consumers that are weakly committed to football, the equivalent figures are £26.50 and £44 respectively.

generating more consumer value from its channels is that Sky is likely to be able to outbid rival bidders for the Live FAPL Rights.

2.128 There are a number of possible explanations for this finding. First, it may reflect a consumer preference for Sky's coverage (such as match analysis and commentary). [redacted]<sup>58</sup>. Second, it may reflect the brand that Sky has established over the course of several years. These explanations are supported by Sky's research and the relative amounts spent on advertising. Based on data from Nielsen Media Research, we estimate that, in 2007, spending on the main advertising categories was £115m by Sky, £51m by Virgin Media, £11m by Setanta and £13m by BT Vision<sup>59</sup>. Moreover these figures exclude other forms of marketing carried out by Sky, including set-top box subsidies etc.

2.129 Sky stated that an entrant would need to match the quality of an incumbent's programming in order to extract the same value from the rights, but considered that this creates positive incentives to innovate and improve quality. This may require marketing expenditure by the new entrant, although Sky noted that incumbents have typically previously engaged in such expenditure. Ofcom is not suggesting that the branding advantages identified above are illegitimate. However, as noted in footnote 27 above, we are identifying factors that provide Sky with an advantage over rival bidders for the Live FAPL Rights. We thus regard it as legitimate to consider branding advantages, even where they reflect Sky's more attractive coverage and/or the impact of Sky's accumulated brand-building activities.

### **Other purported entry barriers identified by consultation respondents**

2.130 Respondents to the December Consultation also identified a number of other purported entry barriers, namely:

- The duration of rights contracts (BT, Setanta/Top Up TV, Virgin Media)
- The terms that Sky would agree with wholesalers in return for distributing their channels on its DSat platform (BT, Virgin Media)
- Uncertainty about the level of CA charges on Sky's DSat platform (BT)
- Economies of scale (Virgin Media)
- The risks to rights holders of selling their rights to new entrants (Virgin Media)

2.131 We discuss these factors in turn below<sup>60</sup>.

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<sup>58</sup> [redacted].

<sup>59</sup> Figures reflect estimated expenditure on outdoor, press, radio, cinema and TV advertising. If direct mail and door drops are included the overall pattern of expenditure (including the relative positions of the different firms) is unchanged. These figures do not include online advertising or the cost of producing advertisements and running a marketing operation.

<sup>60</sup> The idea that Sky takes an advantage from having the largest number of subscribers is not dissimilar to the "vicious circle" set out by the Four Parties in their July 2007 Submission. The Four Parties stated in Figure 2 in that document that "Sky's control of the biggest base of pay TV subscribers and the largest pay TV platform inhibits competitive bids from third parties for content".

### The duration of rights contracts

- 2.132 As discussed in paragraphs 2.104-2.105 above, the Four Parties Media considered that a new entrant would face a delay in building up its subscriber base to levels comparable to those of the former incumbent rights holder. In addition, BT and Virgin Media argued that the short duration of contracts does not give new entrants sufficient time to build up a subscriber base to earn a return and effectively compete with the incumbent. Virgin Media added that even a temporary delay in developing a critical mass of subscribers reduces the value of the revenue streams generated by the rival premium channel broadcaster over the duration of the rights contract. Similarly, Setanta/Top Up TV stated that a three years rights agreement is too short for a new entrant to realise a return on its expenditure.
- 2.133 As discussed in paragraphs 2.98-2.108 above, we agree that where a new entrant wins rights from the incumbent and then directly retails the resulting channel, there is a delay while it builds up its subscriber base. As a result, this depresses the value of those rights to the new entrant. However, this effect occurs regardless of the duration of the rights agreement – even if the duration were longer, the valuation of that rights agreement would still be reduced by an amount that reflects the initial delay in building up subscriber numbers. Accordingly we do not accept consultation respondents' claims that the duration of rights contracts creates a further barrier to entry.

### The terms that Sky would agree with wholesalers in return for distributing their channels on its DSat platform

- 2.134 BT and Virgin Media stated that if a new entrant entered into a wholesale agreement with Sky pursuant to which Sky distributed the new entrant's content on Sky's DSat platform then it would have to cede to Sky a significant portion of the revenues that would be generated from the content in question. Virgin Media stated that this would materially disadvantage the third party in its bidding for the rights in the first place. Moreover, BT and Virgin Media added that it is unlikely that Sky would assist its rivals by agreeing wholesale terms that might cause Sky to be outbid for content rights.
- 2.135 We agree that an increase in the retailer's share (i.e. Sky's share) of the revenues earned from a channel (or, equivalently, a decrease in the wholesale price that the wholesale channel provider is able to charge the retailer) will reduce the amount that the wholesale channel provider is willing to pay for the underlying rights. However BT and Virgin Media omit a second important consequence: that increase in Sky's share as a retailer would also make winning the underlying rights less attractive for Sky as a wholesaler.
- 2.136 To illustrate, consider the following hypothetical example. Suppose that firm A is a vertically integrated retailer and wholesaler on a particular platform and that B is a potential new entrant wholesale channel provider that is considering bidding for the rights to a particular piece of content in competition with A. Assume for simplicity that there are no retail or wholesale costs other than the fee the wholesale channel provider charges the retailer. If A retails a channel built around a particular piece of content, it attracts 1m subscribers each of which pays £10.
- Now suppose that, in the event that B wins the rights and begins wholesaling the channel to A, A is able to extract 70% of the value of that content. In other words, of the £10m retail revenue generated when A distributes B's channel, A receives £7m. This is equivalent to a wholesale price of £3/subscriber. Since B only receives £3m from the sale of its channel, it is willing to pay a maximum of £3m

for the underlying rights. In other words, as highlighted by BT and Virgin Media, because A is able to extract a significant proportion of the value of the channel this depresses the amount that B is willing to bid for the rights.

- Note, however, that A earns £7m even if it does not win the rights. Because not winning the rights is fairly attractive to A, this depresses the amount that A is willing to pay for the rights. Specifically, if A wins the rights then it earns £10m i.e. A increases its profits by £3m if it wins the rights. A is thus willing to pay a maximum of £3m for the underlying rights i.e. the same amount as B. Thus, when bidding for the rights, in this simple example B is not at a disadvantage relative to A<sup>61</sup>.

2.137 Thus, absent further reasoning, Ofcom does not accept that the ability of a particular retailer to extract a large proportion of the retail revenue generated by a channel in itself gives that retailer's wholesale arm an advantage when bidding for content rights.

### Uncertainty about the level of conditional access ("CA") charges on Sky's DSat platform

2.138 BT stated that there is uncertainty over the CA charges that retailers on Sky's DSat platform will pay and that this uncertainty disadvantages new entrants when bidding for content. Specifically, BT stated that Sky has reserved the right, in CA contracts with third parties, to change its CA charges on 90 days' notice and, in certain circumstances, on shorter notice.

2.139 Sky Subscriber Services Limited ("SSSL") is required to provide technical platform services ("TPS"), which include CA, on fair, reasonable and non-discriminatory ("FRND") terms. Ofcom has published guidelines on how it will assess Sky's compliance with its FRND obligation in the event of a dispute (the "TPS Guidelines")<sup>62</sup>. While SSSL may have a degree of discretion in how it interprets its FRND obligation, we consider that this discretion is limited by the TPS Guidelines. In particular, paragraph 8.16 of the TPS Statement states that "The [TPS Guidelines] make clear that ... Sky should publish a rate card or methodology by which charges are determined, that charges should apply for a period of a minimum of a year and that Sky should give TPS customers three months notice before changing its prices. This should provide TPS customers with more predictability of pricing." Further, BT has provided no evidence in support of its claims. Accordingly our current view is that uncertainty about CA charges does not constitute a material barrier to entry.

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<sup>61</sup> Varying the split of the amount earned between the vertically integrated wholesaler and the third party retailer will not generate an advantage for the vertically integrate firm. In contrast, varying the amount generated will do so: a crucial assumption in this example is that the total amount earned from the channel (£10m) is unaffected by the identity of the channel wholesaler. However, for the reasons given in paragraphs 2.109-2.117 above (i.e. Step 2) Ofcom considers that a vertically integrated retailer-wholesaler is able to generate more total revenue than if the retailer and wholesaler were separate entities.

<sup>62</sup> *Provision of Technical Platform Services: Guidelines and Explanatory Statement*, Ofcom, 21 September 2006 (the "TPS Statement"). Available at:

<http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/statement.pdf>

### Economies of scale

2.140 Virgin Media also reiterated the Four Parties' argument that a larger subscriber base enables a broadcaster to reduce its average content acquisition costs. The rationale for the claim (i.e. the source of the alleged economy of scale) is unclear<sup>63</sup>. Above we discuss the advantage that stems from vertical integration with the leading retailer on a platform and how this advantage increases in line with the size of the leading retailer's subscriber base; it is unclear whether Virgin Media's point differs from this. Insofar as Virgin Media's argument is distinct from this, we consider that it is unclear and thus do not rely on it.

### The risks to rights holders of selling their rights to new entrants

2.141 Virgin Media stated that there may be significant risks to owners of premium content in selling their content to a new wholesale channel or retail platform. For example ONdigital (later rebranded ITV Digital) acquired live rights from the Football League in 2000 but ceased broadcasting during the contract term, with significant negative consequences for the Football League clubs.

2.142 In our view, it is important to distinguish between two issues: first, the division of risk (e.g. the risk that a rights purchaser goes into administration) between the parties involved; and second, the magnitude of that risk, wherever it may lie.

2.143 With regard to the first issue, we consider that the example cited by Virgin Media (namely ONdigital) demonstrates that there is scope for addressing the issue of risk sharing contractually. In that case it was suggested that the Football League did not extract sufficient guarantees from ONdigital's parent companies in the event that ONdigital went into administration. However there are a number of ways of facilitating risk sharing, including the use of up front payments or guarantees by other firms (such as banks or larger parent companies). It is not clear why the division of risk, in itself, necessarily provides Sky with an advantage over rival bidders.

2.144 With regard to the second issue, we accept that it is plausible that some bidders for rights may be regarded as more risky than others (e.g. because their ability to successfully operate a wholesale channel provision business is unproven). However we recognise that some of the potential rival bidders to Sky for rights are well known companies with established presence in a number of lines of business (e.g. Virgin Media, BT). Moreover, Setanta was able to acquire the Live FAPL Rights in 2006. It is thus not clear whether the magnitude of the risks in dealing with Sky are materially lower than they are in selling rights to such firms, although we accept that it is intuitively plausible that Sky may enjoy such an advantage over an entirely new business. At this stage we thus regard the magnitude of any advantage enjoyed by Sky over new or less well established firms as unproven. Thus, while this argument may be plausible in theory, in the absence of suitable evidence we do not rely on it at this time.

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<sup>63</sup> Virgin Media asserts at paragraph 1.21 of its response to the December Consultation that this view is implicitly supported by paragraphs 6.63-6.67 of the December Consultation. We do not accept that this is an accurate characterisation of the points made in those paragraphs, which relate to the effects of aggregation of a range of content rather than the size of a broadcaster's subscriber base.

## **Factors purportedly facilitating entry identified by Sky**

- 2.145 Sky argued that a significant threat of competitive entry exists at the wholesale channel provider level. Most of Sky's arguments are addressed elsewhere in this section (for example paragraphs 2.74-2.76 address Sky's argument that Ofcom has adopted an unreasonable entry benchmark, paragraph 2.107 addresses Sky's argument that intra-platform switching costs are negligible and paragraph 2.96-2.97 address Sky's argument that new entrants, with few or no rights, value additional rights more than an incumbent).
- 2.146 In addition, Sky and the April 2008 CRA Report argued that Sky's vertical integration does not increase barriers to entry because its DSat platform is open. Specifically, Sky claimed that it cannot restrict access to its platform. Accordingly, Sky considered that a new entrant is certain that it will be able to reach a large number of subscribers. Moreover, Sky argued that the openness of its platform also strengthens a wholesaler's bargaining position when negotiating distribution agreements with a retailer.
- 2.147 Ofcom has considered these arguments carefully. However, in our view, they appear to go to the question of whether Sky is able to refuse access to its platform altogether. In contrast, Ofcom's position (as set out above) does not rely on an asymmetry in the terms of access to a platform. Rather it stems from a combination of certain retailers enjoying a commercial advantage (Step 1) and an asymmetry in the terms of access to those retailers due to vertical integration (Step 2).
- 2.148 Sky also stated that there is a wide range of potential entrants, including both other broadcasters and upstream rights holders. In support of its view, Sky cites media speculation that bidders for the Live FAPL Rights in 2006 included the BBC, ITV, Channel 4, five, Virgin Media and ESPN/Disney. Sky noted that vertical integration by sports bodies is common in the US and that the Scottish Premier League considered establishing its own channel in 2002. Sky noted that while a significant financial outlay would be required to acquire large tranches of rights in a short time period, many entities have access to such funding e.g. Disney/ESPN or BT.
- 2.149 We consider that the relevant question is not whether there are a large number of potential bidders for the Live FAPL Rights but whether those bidders are likely to successfully acquire those rights. We consider that rival bidders are unlikely to be successful – for the reasons set out above, Sky enjoys an advantage over rival bidders.

## **Current conclusion on barriers to entry and expansion**

- 2.150 Our current conclusion, on which we invite comments, is that Sky is likely to obtain the majority of the Live FAPL Rights when they next become available. This reflects a number of advantages that Sky is likely to enjoy when bidding for these rights – these advantages constitute barriers to entry and expansion from the perspective of competitors seeking to acquire the Live FAPL Rights and enter the relevant market.

## **Countervailing buyer power**

- 2.151 The only major independent purchaser of Sky Sports 1 and 2 is Virgin Media, while a number of other parties have sought to acquire these channels in recent years. We have considered whether these actual and potential buyers are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

- 2.152 In the December Consultation we indicated that, on balance, Virgin Media does have a degree of countervailing buyer power but that it is unlikely to be sufficient to constrain Sky's ability to exercise market power.

### **Responses to the December Consultation**

- 2.153 In its response to the December Consultation, Sky noted that certain platforms, such as those of Virgin Media and BT, are closed. Sky argued that this gives rise to a potentially significant 'hold-up' problem. Specifically, a wholesale channel provider is less able to recoup its expenditure in content and acquire customers for its channel unless it can agree terms to access platforms. In respect of closed platforms, a channel provider, including Sky, faces the risk that an agreement to supply a channel to customers on that platform will not be agreed (or will only be agreed on unfavourable terms).
- 2.154 In its response to the December Consultation, Virgin Media stated that Ofcom has erred in concluding that Virgin has some countervailing buyer power, stating that it does not have any buyer power in its relationship with Sky. In particular, Virgin argued that its dealings with Sky cannot reasonably be described as 'negotiations', as revealed by the wholesale prices and the terms and conditions imposed by Sky. In particular, Virgin referred to Sky "refusing to supply" high definition programming, interactive services and related content.
- 2.155 Virgin stated that the strength of its bargaining position depends on the attractiveness of acquiring Sky's content relative to not acquiring that content. Virgin asserted that Sky has a major influence over both these issues since: "Sky's retail and wholesale margins from premium packages are determined by Sky. As a result, Sky can choose to set its retail and wholesale prices such that Virgin Media makes a very low retail margin or a loss on selling Sky's premium channels." In its response, Virgin Media stated that the margin on its XL package of Basic-tier channels is greater than the margin when it supplies a subscriber with that XL package plus Sky Sports and/or Sky Movies.

### **Responses to our July 2008 information request**

- 2.156 In July 2008 we asked Virgin Media and Sky a number of detailed questions regarding negotiations between the two parties over the supply of Sky Sports and Sky Movies by Sky to Virgin Media. We asked the parties about the extent of their dependence on one another and about the commercial relationship between the companies in respect of Sky's premium channels.
- 2.157 [redacted].
- 2.158 [redacted].
- 2.159 [redacted].
- 2.160 [redacted].

### **Our assessment of countervailing buyer power**

- 2.161 The OFT Market Power Guidelines set out four conditions that are relevant to the assessment of CBP. Three of these conditions are particularly relevant to our analysis:



- The buyer is well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one supplier to another while continuing to meet its needs.
- The buyer could commence production of the item itself or ‘sponsor’ new entry by another supplier (e.g. through a long-term contract) relatively quickly and without incurring substantial sunk costs.
- The buyer is an important outlet for the seller (i.e. the seller would be willing to cede better terms to the buyer in order to retain the opportunity to sell to that buyer).

2.162 We have been mindful of these conditions in assessing whether retailers of pay TV services possess CBP in respect of Sky. Most importantly, we believe that if Sky suffers few (or no) detrimental effects if a buyer declines to purchase Sky’s channels, then that buyer does not possess sufficient CBP to offset Sky’s seller power.

2.163 We retain our view that Virgin Media has a degree of countervailing buyer power in relation to the licensing of Sky Sports and Sky Movies. Virgin Media is the UK’s second largest retailer of pay TV services, and is likely to provide Sky with access to some subscribers it otherwise could not reach. We believe that the closed nature of the cable platform increases Virgin Media’s buyer power to some extent, as it affords broadcasters no outside option for accessing the cable customer base (beyond serving these households through other platforms). We also consider that Virgin Media is a well-informed buyer, likely to be aware of any alternative options available to it.

2.164 However, we also retain our view that Virgin Media’s buyer power in relation to Sky’s premium channels is limited. In coming to this view, we have been mindful of the following considerations:

- **The importance of Sky’s premium content to consumers.** We believe that Virgin Media is under significant commercial pressure to offer its customers a content offering that is competitive with that of Sky. This reality conveys a degree of seller power on channel providers with attractive content – power which increases in line with the content’s desirability. As stated in sections 3 and 4 of the main document, we believe that Sky Sports 1 and 2 are important drivers of the take-up of premium pay TV services. Virgin Media does not have available adequate alternative sources of supply to replace Sky Sports while continuing to meet its customers’ needs. As we conclude in paragraph 2.150 above, we believe that there are substantial barriers to entry upstream, such that Virgin Media cannot achieve or sponsor entry quickly or without substantial sunk costs. This vulnerability leaves Virgin Media in a comparatively weak position with respect to Sky.
- [X]. Sky has stated [X]. Sky states that its wholesale prices are set at a level at [X] ([X]), but does not acknowledge that a *range* of such prices exists. Meaningful negotiation with the cable operators might be expected to place a degree of downward pressure on Sky’s wholesale rates, and it is clear that Sky would not expect *lower* wholesale prices to [X]<sup>64</sup>. We accept that the regulatory

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<sup>64</sup> A lower bound on Sky’s wholesale charges may exist for the avoidance of prices that might breach predation rules.

environment may affect Sky's wholesale pricing *structure*, and the upper *limit* of its rates, but [redacted]<sup>65</sup>.

- **Evidence from Virgin Media [redacted].** We would expect the creation of Virgin Media from the merger of NTL and Telewest to have somewhat increased cable's buyer power with respect to Sky. However, we do not believe that the merger has fundamentally improved Virgin Media's negotiating position, not least as it has not directly addressed its reliance on content controlled by Sky.
- **Analysis of Sky's incentives.** Analysis carried out by CRA suggests that Sky has the incentive to wholesale its content to Virgin Media at current wholesale prices. Our own calculations indicate (again, at current wholesale prices), that it would be profitable for Sky to cease its wholesale relationship with Virgin Media if it considered its pay-off over an extended period (see paragraphs 6.100-6.106 of the main document). By contrast, evidence presented by both Sky and Virgin Media suggests that the current combination of wholesale charges and incremental retail price makes it unprofitable for Virgin Media to sell Sky's premium channels to existing basic subscribers (see the second bullet of paragraph 6.2 of the main document). Our view is that this indicates that Sky's wholesale charges have not been effectively constrained by the buyer power of Virgin Media.

2.165 Virgin Media has argued that its failure to secure the supply of Sky's Basic-tier channels is evidence of a lack of buyer power on Virgin Media's part. However, our focus here is on Sky's premium channels. In any case, the fact that Virgin Media can choose from a considerably wider range of Basic-tier channels than premium channels suggests that we should not seek to draw strong parallels between Basic-tier and premium channels. Virgin Media's failure to purchase Sky's Basic-tier channels does not affect our view that Virgin Media lacks CBP in relation to the Core Premium Sports channels.

2.166 In relation to retailers other than cable, we are aware of several retailers that have sought wholesale access to Sky Sports and Sky Movies but have not been able to reach commercial agreements. This contrasts with the example of Setanta, which has very quickly agreed wholesale deals with Virgin Media, BT Vision, Tiscali and more recently Top Up TV<sup>66</sup>. We set out the evidence we have reviewed on these negotiations in the next chapter. We believe that the successive instances where commercial agreements have not been reached are at least indications that Sky does not consider these retailers to be essential outlets for its content. As such, we do not believe that these retailers are able to exercise any significant buyer power with respect to Sky.

### Conclusion on countervailing buyer power

2.167 In summary, our view is that Virgin Media is the most likely retailer to exercise CBP over Sky. However, we believe that, while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship appears to be strongly in favour of Sky.

<sup>65</sup> [redacted] the bargaining process between Setanta and Virgin Media for cable carriage of Setanta's channels, documents relating to which have been provided to Ofcom. The documents show that the two parties put forward proposals and counter-proposals, eventually reaching a negotiated settlement on pricing and packaging which satisfied both parties.

<sup>66</sup> Setanta also has an exclusive wholesale agreement with Sky in respect of commercial customers.

This relationship may be further influenced by Sky's desire to strengthen its position of power in both downstream and upstream markets. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the relevant wholesale market.

### **Conclusions on market power in the wholesale supply of Core Premium Sports channels**

- 2.168 In the light of Sky's very high and sustained market shares, the existence of barriers to entry and limited prospects for countervailing buyer power, our current view, on which we invite comments, is that Sky is currently dominant in the wholesale supply of channels or packages of channels containing live FAPL matches. Further, Sky is likely to be dominant in that relevant market for the next three to four years.
- 2.169 Our analysis suggests that entry barriers are such that market power is likely to persist. However, if the rights ownership situation were to change significantly in the future, we would in any case revisit our assessment of market power. In particular, while we think it is unlikely that Sky will win fewer than four packages of Live FAPL Rights in the next auction, if this were to happen we would need to reassess our finding of market power.

### Section 3

## Market power in the wholesale supply of Core Premium Movies channels

3.1 As explained in paragraphs 4.234–4.236 of the main document, our current view is that the wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios is a relevant market. Below we assess the likely strength of competition within this market over the next three to four years. Below we set out our current assessment of (i) competition from existing competitors; (ii) competition from potential competitors; and (iii) CBP.

### Existing competitors

#### Factual background

3.2 Currently the only channels which include the first TV subscription window of film content from the Hollywood majors are the Sky Movies suite of channels.

3.3 By way of background, Sky, Virgin Media and other smaller cable companies are currently the only firms that retail the Sky Movies channels. Certain Sky Movies channels are also available to Tiscali customers, retailed by Sky<sup>67</sup>.

#### Ofcom's position

3.4 As stated in the December Consultation, Sky is the only firm active in the relevant market and consequently has a 100% market share. Since the early 1990's, Sky has persistently enjoyed an extremely high market share – no other firm has won rights to films from the Major Hollywood Studios for the first TV subscription window.

3.5 For the reasons set out in section 4, Ofcom currently considers that the wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios is a relevant market. However we recognised that there may be a degree of substitutability with other means of viewing movies. To investigate the potential effects of these 'out of market' constraints, we have thus also calculated market shares assuming that a variety of other products lie within the relevant market. We recognise that this approach will overstate the impact of these other means of viewing movies, since it assumes they exercise an equivalent constraint to Core Premium Movies channels; we nonetheless consider that it is a useful way of assessing an upper bound for their impact.

3.6 In calculating these alternative market shares, we have used an estimate of Sky's wholesale revenues from supplying its Sky Movies channels. For the reasons explained in paragraph 2.21 above, such a calculation is complicated both by Sky's self supply of those channels and its bundling of Sky Sports and Sky Movies. We have assumed that the wholesale prices charged for the supply of Sky Movies to Virgin Media can be applied to sales by Sky to subscribers on its DSat platform. Also, as a sensitivity, we have varied the proportion of the wholesale revenue from

<sup>67</sup> Tiscali, Top Up TV and BT Vision do provide some video on demand services, but we believe that these lie outside the relevant economic market.

wholesale sports and movies bundles that is attributed to Core Premium Movies channels when calculating Sky's market share.

3.7 We calculated Sky's market share under three alternative market definitions:

- First, we observe in paragraph 4.195 of the main document that PPV movies may offer a reasonably close substitute for some consumers. Although pay-per-view movies are growing in popularity, they remain small in relative terms with a current annual turnover of under £100m in 2006<sup>68</sup>. It was estimated that Sky accounted for some 56% of this revenue in 2006 with Virgin Media accounting for approximately 42%<sup>69</sup>. This implies that, even if pay-per-view movies are included in the relevant market, then Sky's market share would remain extremely high – specifically, around [3<]<sup>70</sup>.
- Second, DVD rental subscription packages may also offer a close substitute for some consumers, although they lack the convenience associated with both subscription and PPV TV services. The value of online DVD rental services was estimated as £67m in 2006 and £77m in 2007<sup>71</sup>. If we were to recalculate Sky's market share taking DVD rental subscription packages into account, Sky's market share would remain extremely high – specifically, in the region of [3<] albeit declining. Even if we assume that the 15% rate of annual growth in subscription DVD rentals is maintained over the next three to four years, Sky's market share only falls by approximately [3<] per annum and thus remains high.<sup>72</sup>
- Third, movie downloads (to rent or own) are currently a nascent sector. Including them therefore has an immaterial effect on Sky's current market share<sup>73</sup>.
- Even if all three of these products (namely PPV movies, DVD rental subscription packages and movie downloads) were simultaneously assumed to be included within the relevant market, Sky's market share would remain high – specifically, in the region of [3<].

<sup>68</sup> Final consumers' expenditure on VOD movies in 2006 was £83m (excluding VAT). December Consultation, Annex 11, paragraph 27.

<sup>69</sup> December Consultation, Annex 11, Figure 98 on page 69.

<sup>70</sup> The precise market share depends on how the revenue from wholesale sports and movies bundles is attributed when calculating Sky's market share. The lower end of this range reflects the assumption that the wholesale revenue from the sale of Core Premium Movies channels is equal to the incremental price of adding Sky Movies to a wholesale bundle. The upper end of this range reflects the entirety of the price of the wholesale bundle. An alternative approach attributes to Core Premium Movies channels 50% of the revenue from bundles with equal amounts of sports and movies, 33% of the revenue from dual sports/single movies bundles and 66% of the revenue from dual movies/single sports bundles. This latter approach implies results in a market share in the middle of the [3<] range.

<sup>71</sup> *BVA Yearbook 2008*, British Video Association, p89.

<sup>72</sup> The precise market share depends on how the revenue from wholesale sports and movies bundles is attributed when calculating Sky's market share.

<sup>73</sup> It is estimated that UK consumers spent only £0.5m on internet-based VOD in 2006. However this sector is expected to grow rapidly. One forecast of annual digital rental spending in 2011 is £7m plus a further £76m on digital retail (download to own). December Consultation, Annex 11, paragraph 33. Even using the higher 2011 combines retail and rental figure (i.e. £83m), Sky's market share would be in the region of [3<].

- 3.8 Sky's 100% market share suggests a dominant position. If this share is retained over the next three to four years, we would expect any dominance to be retained over that period. Our conclusions are similar under alternative market definitions since Sky's market share remains well above the 50% threshold that the European Court of Justice has stated is associated with a presumption of dominance (in the absence of evidence to the contrary). Moreover we recognise that these alternative market share figures will overstate the strength of the competitive constraint exercised by 'out of market' products and thus understate the extent of Sky's market power.

### Barriers to entry and expansion

- 3.9 In order to wholesale a channel including films in the first TV subscription window from the Major Hollywood Studios it is essential to possess the rights to those films (the "Movie Rights")<sup>74</sup>. The Movie Rights are currently supplied on an exclusive basis to Sky.
- 3.10 In principle, as Sky's current contracts with the Major Hollywood Studios expire, this might mean that Sky obtains fewer Major Hollywood Studios' Movie Rights or a narrower subset of those rights (e.g. just the linear rights, with the subscription VoD being sold to another party). If this were to occur, then Sky's share of the relevant market would fall. Thus, in carrying out a forward looking assessment of market power, we have considered carefully what the outcome of the next process for awarding the Movie Rights is likely to be.
- 3.11 The discussion of barriers to entry and expansion is structured as follows:
- First there is a factual description of the process by which the Movie Rights are sold;
  - Second, we set out our observations on why we believe that Sky is likely to obtain the majority of the Movie Rights;
  - Third, we discuss other entry barriers claimed by consultation responses but which Ofcom is not relying upon;
  - Fourth, we discuss factors that consultation responses claimed facilitate entry; and
  - Finally, we set out our current conclusion on barriers to entry and expansion.

### Sale process for the Movie Rights

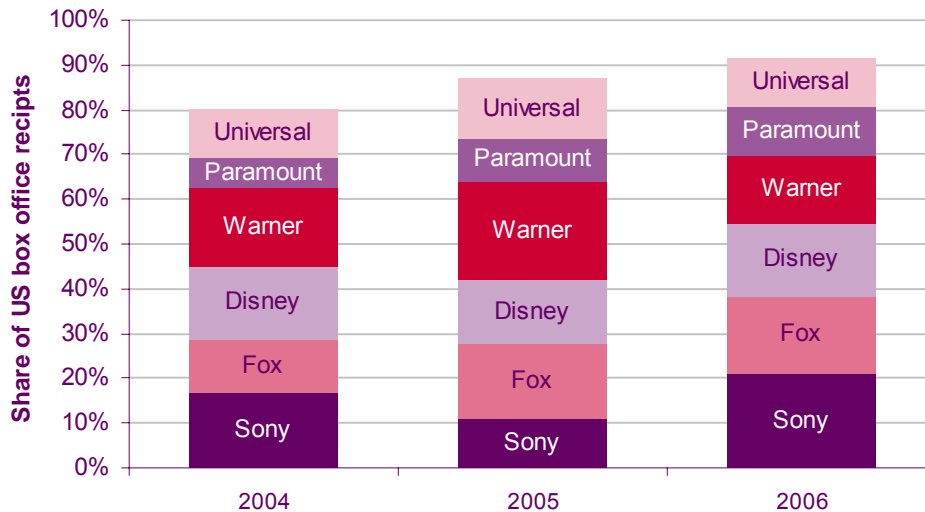
- 3.12 The Movie Rights are sold following negotiations between interested parties and each individual Major Hollywood Studio. Such negotiations may take place before the current agreement to license the Movie Rights expires. This contrasts with the more formalised and collective way in which the FAPL sells its rights. Clearly a Major Hollywood Studio is likely to sell the Movie Rights to the buyer that pays the greatest amount for those rights.

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<sup>74</sup> As explained in section 4 of the main document, linear and/or subscription VoD rights to first run movies from the Major Hollywood Studios are crucial inputs for entry into this market and thus fall within the definition of the Movie Rights. The pay per view rights do not allow entry into this relevant market and are thus excluded from the definition of the Movie Rights.

3.13 To illustrate the relative sizes of the Major Hollywood Studios, Figure 12 below sets out their share of US box office receipts. We accept that these figures do not definitively set out the Major Hollywood Studios’ market shares (these figures relate to the US rather than the UK; they also relate to the films distributed by the Major Hollywood Studios, which includes films produced by subsidiaries and some small third parties; in any event, market shares are volatile, depending on the success of each Major Hollywood Studio’s particular slate of films in a given year).

**Figure 12 Major Hollywood Studios’ shares of US box office receipts**



Source: <http://www.boxofficemojo.com>, retrieved 12 March 2008.

**The December Consultation and an overview of the consultation responses**

- 3.14 When the Movie Rights are next sold, in principle a new entrant might acquire a sufficiently large proportion of those rights to undermine any dominant position possessed by Sky.
- 3.15 The December Consultation stated that an alternative wholesale channel provider is likely to require rights packages from more than one Major Hollywood Studio in order to establish a viable proposition. Due to the varying durations and different expiry dates of rights contracts, it may be a period of months or years before the channel provider has a sufficiently strong package to compete effectively with Sky Movies.
- 3.16 In general, there was substantial overlap between the points made by consultation respondents with respect to both “premium sports” channels and “premium movies” channels (to use the terminology of the December Consultation). We thus only deal with arguments in the case of the wholesale supply of Core Premium Movies channels insofar as they have not already been addressed above.
- 3.17 Sky argued that, in the December Consultation, Ofcom adopted an unreasonable entry benchmark. In particular Sky argued that, based on US evidence, channels based on the Movie Rights of one or two studios can be viable. Moreover, channels could combine movies with other content, such as sports, comedy, drama etc (e.g. HBO in the US). Further, Sky argued that most of the Movie Rights owners are already active in the television sector internationally – for example Time Warner (owner of Warners) which is involved in broadcasting in the US. Sky thus regarded

the owners of the Movie Rights as potential entrants and stated that they could form joint ventures to combine their rights.

### **Sky is likely to win the majority of the Movie Rights**

- 3.18 In principle, as Sky's current contracts with the Major Hollywood Studios expire, this might allow a new entrant to acquire a sufficiently large proportion of those rights to undermine any dominant position possessed by Sky. However, the formal expiry of existing contracts does not imply that those contracts are necessarily contestable. Rather, our view is that new entrants are unlikely to acquire a sufficiently large proportion of the Movie Rights in practice.
- 3.19 Below we first discuss the role of staggered expiry dates of Sky's current agreements with the Major Hollywood Studios. We then discuss other barriers to entry that we consider mean Sky is likely to outbid potential entrants that wish to acquire the Movie Rights. Finally, we discuss obstacles to a Major Hollywood Studio exploiting its Movie Rights directly, by for example developing its own Core Premium Movies channel.

#### The role of staggered contractual expiry dates

- 3.20 Our view in the December Consultation that staggered expiry dates in rights agreements represents a barrier to entry was predicated on two key assumptions. First, the existence of synergies between different Major Hollywood Studios' Movie Rights (see paragraph 2.53 above). Second, the termination dates of the Major Hollywood Studios' agreements to license their Movie Rights were sufficiently staggered that a new entrant would face a material disadvantage. We discuss each of these issues below.
- 3.21 In terms of the first issue, there appears to be two possible sources of synergies between different Major Hollywood Studios' Movie Rights. One possibility is that these rights are substitutes. This implies that, by aggregating the rights from all Major Hollywood Studios, a wholesale channel provider is able to dampen the competition that would otherwise exist at the wholesale level between competing Core Premium Movies channels. Dampening competition in this way is likely to enable the wholesale channel provider to extract greater rents from retailers and ultimately final consumers (see paragraph 1.17 of annex 6). Our market definition (i.e. that the supply of Core Premium Movies channels is a relevant market) suggests that this effect is material. The second possibility is that, in order to be viable, a new entrant would require the Movie Rights from multiple Major Hollywood Studios. Documents provided after the December Consultation was issued shed further light on the minimum volume of rights needed to viably launch a Core Premium Movies channel.
- [redacted]<sup>75</sup>.
  - [redacted]<sup>76</sup>. [redacted]<sup>77</sup>.
- 3.22 In terms of the second issue, Figure 13 below shows the dates on which Sky's current contracts expire.

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<sup>75</sup> [redacted]. Provided in [redacted]'s information request response dated [redacted].

<sup>76</sup> [redacted]. Provided in [redacted]'s information request response dated [redacted].

<sup>77</sup> [redacted]. Provided in [redacted]'s information request response dated [redacted].



### Figure 13 Expiry dates of Sky's current contracts with the Major Hollywood Studios

[X]

Sources: Sky response dated 13 May 2008 to question 1 of Ofcom's information request dated 20 December 2007 (as amended by Sky's letter of 7 August 2008)

- 3.23 [X]. This would appear to give a new entrant a number of opportunities to acquire the necessary rights.
- 3.24 [X]<sup>78</sup>. Further, in principle it may be possible for a new entrant to mitigate the risks that it fails to acquire the minimum volume of rights needed to viably launch a Core Premium Movies channel through appropriate contractual terms. For example, a new entrant might reach an agreement with the first Major Hollywood Studio that is conditional on acquiring the Movie Rights from a second Major Hollywood Studio or by beginning negotiations well in advance<sup>79</sup>. However since Sky has consistently won all the Movie Rights we have not observed such contractual provisions being used in practice and such arrangements would potentially be difficult to agree commercially.
- 3.25 In conclusion, there is some evidence to suggest that the staggering of rights is less important than we previously believed. However, as explained below, we believe that Sky can afford to bid a larger amount than any other bidder for the rights to each individual Major Hollywood Studio's output, and this in conjunction with the staggered availability of rights creates a significant barrier to entry.

#### Sky's ability to outbid other potential entrants

- 3.26 Clearly a Major Hollywood Studio is more likely to sell the Movie Rights to the buyer that pays the greatest amount for those rights. We believe that Sky enjoys an advantage over potential rival bidders for the Movie Rights, which is likely to allow it to outbid potential entrants. Specifically, in paragraphs 2.77-2.126 above, in relation to the Live FAPL Rights, we explained why we consider that Sky enjoys the ability to access final consumers on superior terms. We consider that this reasoning also applies to the Movie Rights:
- Greater total industry profits are likely to be generated when a Core Premium Movies channel is distributed by the leading retailer on each platform (Step 1).
  - Further, a third party channel provider cannot obtain access to the leading retailer on a platform as efficiently as a wholesale channel provider that is vertically integrated with that retailer (Step 2). This is due to the Access Disadvantages (as discussed above).
- 3.27 In June 2007 Sky retailed its movie channels to [X] subscribers on its DSat platform as compared to Virgin Media's [X] subscribers to those channels on cable. We consider that Sky is the most effective retail outlet on the platform with the largest number of likely subscribers to Core Premium Movies channels (namely Sky's DSat platform). Sky's vertical integration allows it to access that outlet more efficiently than third party wholesalers. As a result of this advantage, our view is that Sky is likely to

<sup>78</sup> [X] Provided in [X]'s information request response dated [X].

<sup>79</sup> The timing of negotiations between a Major Hollywood Studio and potential bidders is not fixed. [X]. Sky response dated 13 May 2008 to question 1 of Ofcom's information request dated 20 December 2007.

generate greater value from the Movie Rights than other potential bidders. As a result, Sky is likely to be able to outbid rival bidders for those rights.

- 3.28 This conclusion is consistent with evidence that other potential bidders are unable to match the amounts that Sky pays for the Movie Rights. [redacted]<sup>80</sup>. [redacted]<sup>81</sup>. [redacted]<sup>82</sup>.
- 3.29 [redacted] supports our view that Sky is likely to retain the majority of the Movie Rights.

### Obstacles to a Major Hollywood Studio directly exploiting its Movie Rights

- 3.30 A further possibility that we have considered is that Sky might not lose the movie rights to another bidder, but that a movie studio might decide to exploit its rights directly, by for example developing its own movie channel. We believe that this is a possible outcome, but that it also has barriers to entry associated with it.
- 3.31 A single Major Hollywood Studio that chose to develop its own Core Premium Movies channel would have much less content than Sky. In paragraph 3.21 above we set out evidence on the minimum volume of rights needed to launch a viable Core Premium Movies channel. For example, in order to be successful the Major Hollywood Studio's channel would probably need to be included within a large retail bundle, as is the case for example with the Disney Cinemagic channels. In any event, entry by a single Major Hollywood Studio would still leave Sky with an extremely high market share and thus would be unlikely to erode Sky's market power.
- 3.32 The Major Hollywood Studios might be able to develop a more compelling proposition if they combined their content, but this is made difficult by the staggering of their contracts with Sky. Any agreement which they did reach to sell their content jointly might also be subject to review under competition law.
- 3.33 Further, in the short term any Major Hollywood Studio that chose to develop its own channel would be giving up the additional revenues currently generated from accessing Sky's retail subscriber base more efficiently. As described in paragraph 3.26 above, this retail subscriber base gives Sky an advantage over the Major Hollywood Studios similar to that which it enjoys over other types of potential retailer.

### **Other purported entry barriers identified by consultation respondents**

- 3.34 Respondents to the December Consultation generally identified the same entry barriers in acquiring both the Movie Rights and the Live FAPL Rights. We addressed the additional entry barriers identified by respondents in paragraph 2.130-2.144 above.

### **Factors purportedly facilitating entry identified by consultation respondents**

- 3.35 As noted above, Sky considered that Ofcom adopted an unreasonable entry benchmark in the December Consultation. Sky argued that, based on US evidence, channels based on the Movie Rights of one or two studios can be viable.

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<sup>80</sup> [redacted]. Provided at [redacted] information request response, [redacted].

<sup>81</sup> [redacted] information request response, [redacted].

<sup>82</sup> [redacted]. Provided at [redacted] information request response [redacted].

- 3.36 As noted in paragraph 2.74 above, it is important to distinguish between the volume of rights that a wholesaler needs for viable market entry and the scale of entry necessary to undermine any dominant position possessed by Sky. The first of these issues is addressed in paragraph 3.21 above. In relation to the second issue, Sky currently enjoys a market share of 100%. Given the strength of Sky's current position, small scale entry and expansion is unlikely to undermine any dominant position possessed by Sky, since Sky would still enjoy a high market share. This is the case even if (small) entrants have a viable business. For example, even if a new entrant acquired the rights from one or perhaps two Major Hollywood Studios, then this might only reduce Sky's market share by some 10-40% (based on the Figure 12 above). Rather, it would require an extremely large shift from the status quo to undermine Sky's position materially. Moreover such a shift is without precedent – Sky has historically acquired all of the Movie Rights from the Major Hollywood Studios since the early 1990s.
- 3.37 In addition Sky identified a range of factors that facilitate entry, such as the open nature of its DSat platform, the wide range of potential entrants and low intra-platform switching costs. These arguments were addressed in paragraphs 2.145-2.147 in the context of whether rivals could acquire the Live FAPL Rights.

### **Current conclusion on barriers to entry and expansion**

- 3.38 Our current conclusion, on which we invite comments, is that Sky is likely to obtain the majority of the Movie Rights when they next become available. We believe that Sky can afford to bid a larger amount than any other bidder for the rights to each individual Major Hollywood Studio's output, and this in conjunction with the staggered availability of rights creates a significant barrier to entry. As with our conclusion on Core Premium Sports channels, we recognise that a forward-looking assessment cannot ever be entirely certain – although there is a very extensive history of Sky's enduring ability to win all of the Movie Rights. Should the position with respect to the Movie Rights change materially, we would of course need to review our assessment.

### **Countervailing buyer power**

- 3.39 The only major independent purchaser of Sky Movies channels is Virgin Media, although a number of other parties have sought to acquire these channels. As with premium sport, we have considered whether these buyers (actual and potential) are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.
- 3.40 In the December Consultation we concluded that Sky is in a very powerful bargaining position as regards retailers. We indicated that, while Virgin Media is likely to have some CBP, this is likely to be limited.
- 3.41 The responses to our December Consultation on CBP did not draw a distinction between premium sport and premium movies. As a result, the points set out in paragraphs 2.151 to 2.167 above apply equally here. Similarly, our overall position on CBP with respect to movies is the same as that for sport.
- 3.42 However, we have also been mindful of one additional consideration: [redacted]<sup>83</sup>.

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<sup>83</sup> [redacted]. Provided in [redacted] information request response, [redacted].

### **Conclusions on market power in the wholesale supply of Core Premium Movies channels**

- 3.43 In light of Sky's very high and sustained market shares, the existence of barriers to entry and limited prospects for countervailing buyer power, our current view, on which we invite comments, is that Sky is likely to be dominant in the wholesale supply of channels based on first run Hollywood movies for the next three to four years.
- 3.44 As with our conclusion on Core Premium Sports channels, we recognise that a forward-looking assessment cannot ever be entirely certain – although there is a very extensive history of Sky's enduring ability to win all of the Movie Rights. Should the position with respect to the Movie Rights change materially, we would of course need to review our assessment.