Ofcom's consultation on proposed
BSkyB digital terrestrial television services

BT's Response

14 December 2007

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Executive summary

1. BT welcomes the opportunity to provide comments to Ofcom regarding the proposed new DTT pay TV services to be provided by Sky.

2. The principle of Sky retailing pay TV on DTT may benefit consumers and increase choice but only so long as that proposition has meaningful competition from other DTT retailers who are able to offer at least the same “key content” to consumers that Sky proposes without crippling themselves financially. BT agrees with Ofcom that Sky’s proposal raises competition concerns and that, as stated by Ofcom, “given the critical stage in the development of Pay TV on DTT, the competition issues need to be considered with great care”. Any support for Sky to retail in the DTT market can only be given on the assurance of a fair and equitable framework for competition between DTT retailers and that the concerns identified are resolved in a way which assists the development of a competitive market. Only those conditions will increase consumer choice.

3. In BT’s view, the main competition concern arises from Sky’s control over “key content”. This “key content” is not simply ‘premium’ sports and movie rights, but extends to other content which may be on Sky ‘basic’ channels but is sufficiently important to retail customers that its availability or non-availability has a material impact on customer acquisition/churn (as evidenced, for example, by the recent dispute between Sky and Virgin Media regarding the distribution of Sky’s ‘basic’ channels on the Virgin Media cable platform).

4. As noted by Ofcom, there has been a tendency for one main pay TV operator to emerge on each platform and there is a real risk that Sky could dominate pay TV on the DTT platform. Given Sky’s control over “key content” and its existing market power in retail pay TV on the DTH platform, this outcome would significantly reduce the prospects for developing inter-platform competition.

5. BT also identifies concerns arising from the use of conditional access systems, as well as advantages Sky has over BT in the marketing of triple-play offerings as a result of ex ante regulatory obligations imposed on BT.

6. Ofcom's ex post competition powers would be ineffective in addressing these competition concerns. Accordingly, if Ofcom is to consent to Sky's proposal, this should only be done subject to the imposition of strict and enforceable conditions. These conditions should include:

   i. A condition requiring Sky to wholesale its Sky Sports 1 and Sky Movies SD1 channels to competing operators on the DTT platform. In BT's view, this condition should extend to the Sky One channel, given the significance of that channel for take-up of Pay TV;

   ii. Details of the pricing mechanism to be adopted for such supply. Ofcom has suggested a 'retail minus' approach. Whilst this approach may be appropriate, it is highly complex and will require detailed further consideration to get the correct and appropriate financial model. BT is happy to assist Ofcom by providing further comments, in due course, on this option;

   iii. A detailed condition to address the concerns regarding conditional access systems. In BT's view, one practical option may be a requirement on Sky to simulcrypt the channels it is required to wholesale. The details of any such option need to be considered further and BT is happy to assist Ofcom on this.

BT explains the basis for the above conclusions in the following sections of this response. Part A deals with the services in question and the unmet demand for unbundled pay TV content and highlights the significance of Ofcom's decision in this case for the development of competition in TV services. Part B explains why the Sky Proposal raises competition concerns unless certain conditions are imposed, and comments on what those conditions should be. Part C sets out BT's response to Ofcom's specific consultation questions and should be read in conjunction with the preceding sections.

A. Introduction

a. The proposed BSkyB DTT services

7. On 4 October 2007, Ofcom published a consultation document (the 'Condoc') on the proposed new DTT services to be provided by BSkyB (the 'Sky Proposal').

8. Under the Sky Proposal, National Grid Wireless Ltd and Sky have applied to Ofcom to remove the three free to air ('FTA') channels that Sky currently provides on the DTT platform and replace them with five pay TV channels. These three FTA channels are Sky News, Sky Sports News and Sky Three. Under the Sky Proposal, these FTA channels would be replaced by pay TV channels, including Sky Sports 1, Sky Movies SD1 and Sky One.

9. According to Sky, Sky Sports 1 "provides an average of 22 hours or more sports programming per day, including live coverage of the most popular sports including football (including FA Premier League and UEFA Champions League matches), golf, tennis, international and domestic cricket, international and domestic rugby union and rugby league, as well as a range of other sports"[1].

10. Sky Movies SD1 is "a mixed genre movie channel featuring a mix of recently released and library movies licensed from the major Hollywood studios and independent and European distributors, across the range of genres covered by the Sky Movies channels."[2]

11. Sky One is "Sky's general entertainment flagship channel…and the home to first run US entertainment programmes and UK-commissioned factual and drama series".[3]

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[1] http://media.corporate-ir.net/media_files/irol/10/104016/press/PR011007_background_Document.pdf , para. 2.1.
[2] Ibid.
[3] Ibid.

12. As outlined in a Sky press release, dated 1 October 2007, it proposes to market its new services under the 'Picnic' brand[4]. Sky has not yet published information about its proposed retail pricing and packaging of these new services. It has, however, indicated that "Picnic will also offer broadband and telephony services, available both on a standalone basis and as part of a bundle".[5]

13. Under the heading "Benefits", Ofcom notes that the Sky Proposal, if adopted, would bring new pay TV content onto DTT and thereby increase consumer choice[6]. This underplays its impact. In fact, in BT's view, choice will be reduced for the many DTT consumers who will continue to opt solely for FTA channels on DTT and who would no longer receive Sky's FTA channels.

14. Under the same heading, Ofcom notes that the Sky Proposal would meet any currently unmet demand for the content on the Sky channels in question. In BT's view, however, the issue of unmet demand needs to be considered in a wider context. In particular, the Sky Proposal is by no means the only or even the best way to meet this unmet demand.

15. In BT's view, there is currently significant unmet consumer demand for unbundled pay TV content. BT Vision is aiming to meet this by offering consumers the ability to pay only for the specific programmes and/or channels that they want, rather than having to pay for whole channels, or bundles of channels, in order to acquire that specific content. Sky's retail model, on the other hand, results in consumers paying high prices for bundles of content, in order to acquire the content they actually want.

b. <u>The significance of the outcome of the present consultation process</u>

16. "Key content" is crucial for the development of pay TV services. In this section: we examine what "key content" means for these purposes; we highlight Sky's extensive control of "key content" and its significant advantages over other pay

[4] http://media.corporate-ir.net/media_files/irol/10/104016/press/PR011007_FINAL.pdf; http://media.corporate-ir.net/media_files/irol/10/104016/press/PR011007_background_Document.pdf
[5] Ibid., para. 1.9.
[6] Ibid., para. 3.54.

TV competitors in seeking to acquire or renew rights over this content; and we explain how there is a very real risk of Sky using this control to extend its market power unless appropriate ex ante conditions are put in place. We then advocate the need for appropriate wholesaling obligations to be carefully crafted and implemented via ex ante intervention from Ofcom, along with measures to address the problems identified in relation to conditional access systems.

17. Pay TV on DTT is in its infancy as can readily be seen by comparison of the number of customers on DTT versus those on more mature platforms. Currently, the only providers of pay TV on DTT are BT Vision, Top Up TV ('TUTV') and Setanta Sport Holdings Limited ('Setanta'). As at December 2007, BT Vision has sold approximately [redacted] STBs (and installed approximately [redacted] STBs). BT understands that Setanta has approximately 100,000 DTT customers.

18. The difficulties faced by pay TV operators, including BT Vision, in acquiring sufficient high quality content for which consumers are prepared to pay is one of the main reasons for the relative infancy of pay TV on the DTT platform. As discussed in more detail in section C of this submission, the rights to much of the content are currently held exclusively by Sky.

19. By contrast, by Q1 of its 2007 financial year, Sky had 8.6 million digital pay TV customers on its DTH platform[7]. Also, by Q3 of its 2007 financial year, Virgin Media had 3.1m digital pay TV customers[8].

20. Sky could readily target the over 9 million households[9] who currently have DTT, but do not take pay TV on DTT, as well as the 15% of UK households which will switch from analogue to digital during the course of 2007-2012 and will need to decide which digital platform to rely on[10]. Sky's DTT pay TV strategy would also provide it with the opportunity to target the approximately 2 million homes that can get DTT, but cannot get cable or satellite.[11]

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7 http://media.corporate-ir.net/media_files/irol/10/104016/ResultsRelease011107.pdf
8 http://media.corporate-ir.net/media_files/irol/13/135485/quarterly/Q3_07_PressRelease.pdf
9 Condoc, para. 3.25.
10 Ibid., para. 2.27.
11 Ibid., para. 3.55.

21. As stated by Sky:

> "There are still over 14 million families in the UK that have yet to choose a pay TV provider, but where they have, more than eight and a half have chosen Sky. By broadening our product range we are better able to address some of the more traditional barriers that customers have faced when choosing Sky."[12]

22. It can be expected that, given its content advantages, financial resources and ambitions in this area, the Sky Proposal, if implemented, would have a significant impact on the dynamics of competition for TV services.

[12] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p.5.

B. Competition concerns raised by the Sky Proposal

a. Introduction

23. BT agrees with Ofcom that the Sky proposal raises competition concerns[13] and with Ofcom's statement that "given the critical stage in the development of Pay TV on DTT, the competition issues need to be considered with great care" if Sky is to be allowed to retail on DTT.[14] This is particularly important given that, as noted by Ofcom, there has been a tendency for one main pay TV operator to emerge on each platform[15] and there is a real risk that Sky could dominate pay TV on the DTT platform. Given Sky's existing market power in retail pay TV on the DTH platform, this outcome would significantly reduce the prospects for inter-platform competition.

24. There is also the real risk that the Sky Proposal, without appropriate conditions, could eventually give rise to distortions in wider TV markets. If Sky were to gain a significant foothold on DTT, this may be at the expense, to an important extent, of FTA operators as well as pay TV operators. Their relatively lower customer volumes would then erode the ability of both types of operators to make the [redacted] investments in high-cost content to attract viewers.

25. In this regard, BT agrees with Ofcom's comment that:

> "The principal motivation [of Sky] could be a desire on the part of Sky to avoid a situation in which a rival pay TV retailer was able to establish a position in the retail market which it could use to become a more credible rival in content for premium content rights, particularly premium sports rights."

[13] Condoc., para. 1.14.
[14] Condoc., para. 1.7.
[15] Ibid., para. 3.45.

26. In BT's view, given the significance of the competition issues raised by the Sky Proposal and the fact that, as stated by Ofcom, "if Sky's entry leads quickly to the exclusion of other retailers it is unlikely that ex post measures would be effective in unwinding that position"[16], it is essential that Ofcom adopt a "precautionary principle and put in place ex ante rules to prevent such potential from being exploited"[17].

b. Sky's control of key content

(a) The importance of key content for the development of pay TV services

27. It is self-evident that the quality of content on pay TV channels is a key driver in the development of pay TV.

28. In the previous decisional practice of the UK and EU competition authorities, a distinction has been drawn between 'premium' content and 'basic' content on pay TV. In this section we review the previous precedents and then consider whether this distinction is useful or sufficient in determining what is "key content" for development of pay TV

29. Ofcom notes that 'premium content', such as certain types of sports content or events and first run Hollywood films, "has historically been regarded as an important determinant of take up of pay TV services"; indeed, Ofcom notes that the European Commission has recognised premium content as an 'essential input' for pay TV[18]. Furthermore, Ofcom states that "the distinction between basic and premium content is likely to remain important"[19].

30. The critical nature of premium content for the development of pay TV services is well established in the decisional practice of the UK competition authorities and the European Commission. Thus, for example, in its 1996 Review of Sky's position in the wholesale pay TV market, the OFT found that "premium sports

[16] Condoc, para. 3.73.
[17] Ibid.
[18] Condoc., para. 3.22.
[19] Ibid.

and movie channels are the main drivers of subscription to pay TV”[20]. Also, as stated by the European Commission in *Bertelsmann/Kirch/Premiere* :

“Access to programme rights is even more important in the case of pay TV than it is in the case of free TV since, in order to entice the consumer to subscribe or to take particular productions on a pay per view basis, certain specific types of content are required. Experience of pay TV in Europe so far shows that in order to be sufficiently attractive, a pay TV bouquet must include a combination of rights for the first broadcast of films produced at the major Hollywood studios and for popular sporting events.”[21]

31. Also, in *British Interactive Broadcasting*, the European Commission noted that “BSkyB itself identified ‘movies and sports as key sales drivers’” and that premium film and sports channels “are the basics around which other channels can be offered to subscribers”.[22]

32. Whilst the category of ‘premium’ content is difficult to define comprehensively, one if its main features is its limited availability for acquisition by pay TV operators:

i. The MMC in *Sky/Manchester United* noted that it was unlikely that there were enough commercially valuable rights to popular sports to sustain many premium sports channels[23];

ii. As for premium films, in its 2002 Competition Act Decision relating to Sky, the OFT defined a separate market for premium film channels, characterised by first run categories A and B films (essentially, the major Hollywood films). The availability of such premium content for providing subscription services (which in our view is the driver of revenues) is limited, as explained further below.

[20] See, para. 1.4 of the 1996 Review.
[21] *Bertelsmann/Kirch/Premiere*, Case No IV/M.933, Decision of 27 May 1998, at para. 48.
[22] *British Interactive Broadcasting/Open*, Case No IV/36.539, Commission Decision of 15 September 1999, at paras. 28 and 72.
[23] Report on the proposed merger between British Sky Broadcasting Group plc and Manchester United plc, Monopoly and Mergers Commission, April 1999, at para. 2.56.

33. In BT’s view there are difficulties in adopting a very strict definition of ‘premium content’ as it has been done in the past. The difficulties of distinguishing between ‘premium’ and ‘basic’ content are compounded by the fact that content that may well be regarded as ‘premium’ - such as the US TV series ‘Lost’, ‘24’ and ‘Prison Break’ - is included in channels that are marketed as ‘basic’ TV channels. In BT’s view, the availability or non-availability of TV series such as these has a material impact on churn – as has been highlighted by the recent dispute between Sky and Virgin Media regarding the availability of Sky ‘basic’ channels on Virgin Media’s cable platform.

34. Sky has recently invested very significant sums in content for its ‘basic’ channels. In its Defence in the High Court proceedings between Sky and Virgin Media, Sky acknowledges that it has, in recent years, significantly increased the levels of its investment in obtaining programming content for the Sky Basic channels, particularly Sky One, i.e. "programming content the exclusive availability of which on the Sky Basic Channels is likely specifically to attract and retain large numbers of viewers to those channels and to attract subscribers to packages containing those channels" (para. 34.2 of Sky's Defence).

35. Also, Sky states that, in recent years sports and movies have become less effective in driving new subscriptions and that Sky's "marketing also relies more heavily on the availability of [Sky] Basic Pay TV content" (Sky Defence, para. 34.4).

36. This suggests that ‘key’ content for the development of pay TV services is no longer simply content that has been defined in the previous decisional practice as ‘premium’ content, but also other content and channels that are likely to have a material impact on customer retention/churn.

(b) <u>Sky controls key content for the development of pay TV services</u>

37. Sky has control over a range of content which is a key driver of the take-up of pay TV on any platform.

38. In recent years Sky has enhanced its market position by expending extremely large sums to acquire pay TV content. Thus, for example, Sky has spent £1.6 billion in each of its last three financial years for content.[24] Competing pay TV operators in the UK with smaller customer bases have not been in a position to invest anything like this amount.

39. Sky has spent such huge amounts of money not only for "premium" sports and movie content but also on acquiring a range of other quality content, as the following quote shows:

"We pride ourselves on the unrivalled breadth, depth and quality of our onscreen programming and we have spent the year furthering our leadership in this area. For example, we acquired rights to great shows, such as 'Lost' and 'Prison Break'".[25]

40. The following paragraphs highlight in more detail the range of Sky's control over key content rights.

Sports Content

41. Sky has spent particularly heavily on the acquisition of sports content. A notable part of this investment has been in FA Premier League football rights: in 2006, Sky paid over £1.3 billion for the rights to show 92 of the top FAPL matches live per season for three seasons; this is more than three times the amount paid by Setanta for the rights to show a lesser package of 46 FAPL games per season for three seasons. The FAPL live rights were split into six separate packages. The packages that Sky acquired included the rights to the 'first pick' of matches i.e. the most popular matches during each of the 38 weeks of the FAPL season. In

[24] 2007 : http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, p.9; 2006 : £1.6bn, of which £766m was on sports and £310m on movies (http://media.corporate-ir.net/media_files/irol/10/104016/ar2006/BSkyB_annual_review_2006.pdf, p.5; 2005 : £1.6bn (http://media.corporate-ir.net/media_files/irol/10/104016/ar2005/sky_AR2005_full.pdf, p.16.

[25] http://library.corporate-ir.net/library/10/104/104016/items/258443/AR07.pdf, at p.3.

addition, Sky acquired the rights to show these 'first picks' during the most desirable available time slot of the week: 4pm on Sundays.

42. Premier League football is widely regarded as a key driver for the take-up of pay TV. As stated recently by Rupert Murdoch "sport is the great number one common denominator. And, of that, football [is number one]".[26]

43. Whilst the most valuable sports content is usually made available to TV operators on the basis of a competitive tendering process, this does not necessarily mean that the process is fully competitive. In fact, in tendering processes Sky has an inherent advantage over its rivals.

44. Some of the most valuable rights (such as live rights to FAPL matches) expire after just three years. This means that, first, acquiring firms have a strictly limited time period within which to make a return on their content investment and, second, firms with an established subscriber base downstream enjoy a competitive advantage when bidding for content. In this situation, newer entrants (acting within commercially rational boundaries) are highly unlikely to be able to outbid Sky for valuable key content. Economists have shown that such asymmetries between bidders have a significant impact on auction outcomes (see e.g. Paul Klemperer paper for the Competition Commission, entitled "Bidding Markets"[27]).

Movie content

45. In its financial year 2007 alone, Sky invested £285 million in movies, "a saving of £25 million on the previous year and the lowest absolute cost for seven years, *as we continue to benefit from favourable contract renewals*"[28] (emphasis added). BT understands that Sky has exclusive pay TV subscription contracts with all the major US movie studios (Disney, Columbia, Fox, Sony, Paramount, Universal, Dreamworks and Warner Brothers). In other words, Sky has a 100% share of premium subscription movie rights in the UK. BT also understands that, whilst

[26] Media Guardian, "Murdoch warns on football rights", 22 June 2007.
[27] http://www.competition-commission.org.uk/our_role/analysis/bidding_markets.pdf
[28] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p.23.

Sky has also acquired subscription VOD rights to this key movie content, it chooses not to exploit these right (and effectively prevents any other operator from exploiting these rights). BT has negotiated VOD rights with several studios to their content in the pay per view window but is prevented from offering current movies under subscription packages on its platform. Also, whilst pay-per-view movie rights are also sold, by a number of operators, on a non-exclusive basis, these make up a relatively small proportion of pay TV revenues in the UK.

Popular US TV series

46. Sky has also acquired the exclusive rights to many US TV series that have been very popular in the UK and have driven consumer take-up.

47. A particular advantage Sky has over its rivals is that it already has rights over a sufficiently large bouquet of attractive content to enable it to attract large volumes of retail customers. This bouquet is extended from time to time by the acquisition of new content rights, which periodically become available on a staggered basis. By contrast, competing operators do not have a comparable bouquet of attractive content rights. They are also unlikely to bid as aggressively to acquire specific content rights when available because this content alone may well not be sufficient to attract a large enough base of retail customers in order thereby to recoup the cost of acquiring those rights. In order to attract such a base they would also need separately to acquire other rights that may subsequently become available that would, when aggregated, create a sufficiently attractive bouquet of content to attract retail customers. The uncertainties around this process result in an inherent advantage to Sky in the competition to acquire rights.

48. Inevitably, therefore, as Sky has noted "Sky channels are key to driving the appeal of the Sky Digital platform"[29]. The importance of Sky channels for the development of pay TV on the cable platform has become evident in the context of the recent dispute between Sky and Virgin Media which resulted in the

[29] http://media.corporate-ir.net/media_files/irol/10/104016/ar2005/sky_AR2005_full.pdf; p.12

removal of Sky 'basic' TV channels, including Sky One, from the Virgin Media platform and the resultant detrimental performance of Virgin Media.

49. Sky's advantages are also enhanced by its equity interests in a range of pay TV channels. Although these channels may not constitute 'premium' content, they are important in enabling Sky to develop attractive bouquets of pay TV content. As stated in Sky's latest SEC filing (20-F):

"We hold equity interests in ventures that own 15 (not including time-shifted multiplex versions) of the Sky Distributed Channels (including certain Premium Sky Distributed Channels) which are operated and distributed in the UK, Ireland and the Channel Islands, namely Attheraces, Nickelodeon, Nick Jr., Nick Jr. 2, Nicktoons TV, National Geographic Channel, National Geographic HD, Adventure One, Chelsea TV, MUTV, Paramount Comedy, Paramount Comedy 2, The History Channel, the Biography Channel, and Crime and Investigation Network" (p.8)

(c) The risk of Sky using its control of key content to extend its market power in retail pay TV markets

50. Sky has both the ability and incentive to distort emerging competition in light of its control of "key content". Ofcom rightly suggests in the Condoc that, as Sky is vertically integrated and may be dominant in wholesale content provision, it may not have an incentive to license its content to third parties on viable commercial terms – such refusal may be "intended to foreclose the emergence of rival players on DTT, enabling Sky to strengthen its position in the overall pay TV market."[30]

51. As noted above, in 2002 the OFT found Sky to be dominant in the wholesale and retail supply of premium sports channels and premium movies channels. Since then, Sky has spent very heavily on content, to further its market power in this area.

[30] Condoc., para. 3.71.

52. Given the recognized importance of key content for the development of pay TV services, if the Sky Proposal were to be implemented, without the imposition of any condition as to the supply of content to third parties on viable commercial terms, Sky would inevitably extend its retail market power of pay TV to the DTT platform.

53. It is also worth noting that, [redacted]

54. Any extension of Sky's market power would have a significant impact on the market. Given the forthcoming digital switchover and Sky's stated commitment, as noted above, to target the 14 million families in the UK that have yet to choose a pay TV provider, presumably with a relatively lower-priced Picnic offering, it seems to BT that Sky would be very well placed to acquire a very significant number of pay TV subscribers on the DTT platform.

55. The inevitable extension of Sky's market power would not be in consumers' interests; it is not an efficient way of making content available on DTT and it would not serve to 'promote competition'. Furthermore, it would undermine the Ofcom policy of "fostering an environment that encourages effective competition on the DTT platform and which would also allow for the development of competition between pay TV platforms."[31]

(d) The need for acceptance of the Sky Proposal to be subject to a wholesaling condition

[31] Condoc., para. 3.81.

56. Ofcom notes that "it may be that the competition concerns arise primarily from Sky's position in the upstream wholesale provision of content…and such concerns are unlikely to be effectively addressed by ex post intervention or commitments alone."[32]

57. BT agrees with this Ofcom statement. In particular, ex post regulatory intervention would be far too lengthy a process to prevent irreparable damage being done to the competitiveness of the relevant retail markets. Furthermore, over the next few years, during which the digital switchover will take place, any distortions of competition are likely to become entrenched. As to commitments, in BT's view, this would depend on the nature and scope of any possible commitments, but they are unlikely to provide the level of legal certainty that can be provided by ex ante conditions.

58. As to the scope of any wholesaling requirement that could be imposed on Sky, our views are as follows:

    i. BT notes Ofcom's view that a wholesaling requirement "would clearly raise implications for the position of other providers of pay TV services. It would therefore be necessary to consider the role of such wholesaling requirements across pay TV markets."[33] This statement might be taken to suggest that any wholesaling requirement might more appropriately be considered in the context of Ofcom's separate pay TV inquiry under the Enterprise Act 2002. BT believes, however, that the present Ofcom review of Sky's application may provide an appropriate regulatory framework within which to determine whether certain specific wholesaling conditions should be imposed on Sky.

    ii. Given Sky's market position in the supply of premium channels, any premium channel Sky proposes to retail on DTT should also be offered to competing DTT pay TV operators on a stand-alone wholesale basis. Sky should be required to wholesale its Sky Sports 1 and Sky Movies SD1

[32] Condoc., para. 5.21.
[33] Condoc., para. 5.21.

channels. As to whether the beneficiaries of such an obligation should extend to pay TV operators on other platforms, perhaps this is an issue that could be addressed by Ofcom in the context of its wider pay TV investigation. The primary focus of Ofcom's assessment in the present context should be the promotion of competition on the DTT platform.

iii. Sky should also be required, as a condition of acceptance of the Sky Proposal, to wholesale Sky One to competing DTT pay TV providers on a stand-alone basis. This is because:

- First, Sky One contains content which is "key content", in the sense that its availability on this channel has a material influence on customer retention/churn.

  This is evidenced by the recent dispute between Sky and Virgin Media regarding the availability of Sky's basic channels on Virgin Media's cable platform, as discussed in paragraphs 33-36 above. Also, Sky itself states that in recent years sports and movies have become less effective in driving new subscriptions and that Sky's "marketing also relies more heavily on the availability of [Sky] Basic Pay TV content" (Sky Defence, para. 34.4).

- Second, if this highly popular Sky channel were not included within the scope of a wholesaling obligation on Sky, there is a very real risk that Sky would simply migrate further material elements of its key content to this channel, thereby circumventing the intent and effectiveness of the wholesaling remedy.

iv. At para. 3.71 of the Condoc, Ofcom raises the very important point that "a further concern arises if Sky has an incentive to use its position as a purchaser of third party content on the DSat platform to influence the availability of that content on DTT." BT has commented on this very real concern in its submissions to Ofcom in the context of its pay TV market inquiry. For present purposes, BT would note that the Sky Proposal does not identify two of the pay TV channels that it proposes to retail, although it does state that they would be a factual channel and a children's channel.

In conclusion, given the significance of this type of programming for the development of pay TV, Sky's shareholdings in important TV channels which provide this type of content (e.g. The History Channel) and, Sky's incentives to foreclose the emergence of rival players on DTT (as noted by Ofcom), Ofcom would need to consider closely whether Sky's arrangements with third party content providers might distort competition (e.g. through MFN clauses or other terms that restrict the ability of competing operators to obtain this content from the third party content provider). Once those as-yet unidentified pay TV channels have been selected, BT requests a proper opportunity to comment on whether these should be included in any possible wholesaling obligation.

Pricing mechanisms for wholesale obligation

59. If a wholesaling requirement were imposed on Sky, it would then be necessary to establish a mechanism for determining the appropriate level of wholesale prices. Ofcom suggests that "one approach would be to require the adoption of a 'retail-minus' approach or 'ex ante margin squeeze' rule to help ensure that retail competitors can compete at the retail price level while still recovering efficiently incurred costs, including retail distribution costs."[34]

60. In BT's view, any framework for establishing the appropriate level of wholesale prices would have to be thought through very carefully, given the risk that they might not be set at a level to sustain efficient competitors to Sky and that, in such a situation, the damage done to the competitiveness of retail markets would be virtually impossible to reverse.

[34] Condoc., para. 5.22.

61. The issue of 'retail-minus' approach, also known as an ECPR rule, was discussed in some detail in a recent judgement of the Competition Appeal Tribunal[35]; this judgement highlighted a number of concerns with ECPR. In particular:

i. There is a risk that the retail price, which forms the basis for the retail-minus calculation, may be set at too high a level and reflect excessive profits; the 'monopolistic' consequences of these high prices would simply be perpetuated in the retail-minus price charged.

ii. Much will depend on the relevant retail costs that represent the 'minus' in the retail-minus calculation. To the extent that Sky benefits from economies of scale and scope, or the calculation excludes fixed costs that would have to be borne by the competing DTT pay TV provider, there is a real risk that the latter may have to be 'super-efficient' in order to compete with Sky on the basis of a retail-minus wholesale price.

62. Indeed, the Tribunal noted that:

"It seems to us that there is a potential clash between the narrow short run productive efficiency sought in theory through ECPR, and the wider dynamic competition benefits and level playing field which the Chapter II prohibition is designed to safeguard."[36]

63. The issue of an appropriate framework for establishing the appropriate level of wholesale prices is highly complex and BT submits should be the subject of a separate consultation exercise by Ofcom if/when the concept of a wholesaling requirement has been established in the first place. BT would be happy to assist Ofcom in this exercise and we are to provide assistance in this matter with a separate submission.

c. <u>The issue of conditional access systems</u>

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[35] *Albion Water v. Water Services Regulatory* Authority, *judgement* of 6 October 2006; in particular, pp. 187-248; http://www.catribunal.org.uk/documents/Judge1046Albion061006.pdf

[36] Ibid., at para. 803.

64. Broadcast pay TV content on DTT is protected from piracy using conditional access ("CA") technology. BT understands that all current providers of pay TV on DTT rely on systems that are compatible with the "Mediaguard" conditional access system (which is licensed by Nagra). According to Ofcom, there are currently in excess of a million DTT set top boxes ("STBs") incorporating Mediaguard CA technology in the UK, including legacy ONDigital STBs, TUTV STBs, BT Vision STBs and CA modules that subscribers have installed in IDTVs and STBs.[37]

65. Sky, however, proposes to rely on a different CA system, supplied by NDS (which is controlled by Sky's largest shareholder, News Corporation), for its proposed DTT pay TV services. This is despite the obvious convenience to consumers if it were to rely on a Mediaguard CA system being used by all other operators on DTT and the fact that Sky relies on Mediaguard to protect the security of its content on the cable platform.

66. Ofcom has identified a number of important issues relating to the use of different CA systems on DTT.

67. First, the DTT platform is capacity constrained and it may therefore be impractical and an inefficient use of spectrum to have multiple versions of a TV channel broadcast simply in order to make it available via STBs supporting different CA systems.

68. Second, there is a risk that Sky's NDS CA system could become the prevailing CA technology and thereby Sky would control access "not necessarily as a result of the efficacy of the NDS CA system but due to the ownership of key content"[38].

69. Third, Sky could use its economies of scale and scope advantages, and engage in various marketing activities to influence the market in such a way as to distort competition.[39]

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[37] Condoc., para. 2.39.
[38] Condoc., para. 5.24.

70. In BT's view, all of these concerns that have been identified by Ofcom are very real concerns and need to be addressed.

71. Sky has indicated that any STB manufacturer that can meet its technical requirements can incorporate the NDS CA system in their STB (this includes the capability to receive both MPEG 2 and MPEG 4-based signals); this would enable the manufacturers to incorporate more than one CA system in their STBs. Sky has also stated that "Picnic does not intend to maintain or impose any link between the availability or price of such reception equipment and the need to take out a Picnic subscription."[40]

72. This indication from Sky does not at all address the very real competition concerns referred to above. In particular:

i. There is no reason to believe that STB manufacturers would actually produce STBs containing more than one CA system, given that this would be a more expensive and complicated option than producing a STB with only one CA system;

ii. Sky is not suggesting that it will ensure that the STBs it relies on will have to contain more than one CA system. If Sky has no incentive to acquire STBs containing the CA system relied on by its competitors and its competitors have no incentive to acquire any such more expensive and complicated STBs, there does not seem much likelihood that many such STBs would be manufactured;

iii. In its press release, Sky states that, whilst STB manufacturers could produce STBs with more than one CA system, it "would expect manufacturers to ensure that any such equipment is secure in order to minimise/prevent signal theft and internet redistribution of Sky

[39] Condoc. Paras. 3.59-3.62.

[40] http://media.corporate-ir.net/media_files/irol/10/104016/press/PR011007_background_Document.pdf, at para. 3.10.

programming, and will work with them accordingly"[41]. This caveat, whilst legitimate in principle, also provides Sky with every opportunity to undermine whatever limited incentive STM manufacturers may have to manufacture STBs with more than one CA system. Thus, for example, any manufacturer that might be tempted to produce such STBs may well find themselves involved in protracted discussions with Sky over issues such as signal security and the appropriate MPEG 4 profile[42]. STB manufacturers which already have an established relationship with Sky and which would intend to maintain that relationship are, of course, unlikely to be tempted to seek to manufacture such STBs in the first place.

iii. Sky retains its ability strongly to encourage STB manufacturers (including its own related companies) to manufacture STBs containing only the NDS CA system e.g. by way of financial inducement.

73. BT notes that Ofcom's aim, if it is to impose conditions, is to impose those that are "the least intrusive necessary to achieve the policy objectives effectively"[43]. Also, presumably, any Ofcom intervention should aim, so far as is feasible, to be technologically neutral.

74. At para. 5.26 of the Condoc, Ofcom suggests four possible alternative solutions.

75. The first suggested option is a requirement on Sky to simulcrypt its videostreams, so that any channels that are to be provided on a wholesale basis are compatible with STBs of other pay TV providers on DTT. In BT's view, this may well be a practicable solution to the competition problem. As Ofcom notes, this solution is used by, for example, MTV to supply its channel via five different CA systems. BT would, however, need to look very closely at the details of any simulcrypting option, to ensure that it does not provide Sky with the ability to discriminate against operators such as BT Vision.

[41] http://media.corporate-ir.net/media_files/irol/10/104016/press/PR011007_background_Document.pdf, at fn 3.
[42] Condoc, para. 4.10.
[43] Condoc., para. 5.11.

76. Ofcom notes that there might be a signal security issue with simulcrypting: "one disadvantage is that the protection afforded to a TV channel using simulcrypt is only as good as the least secure CA system in use."[44] Also, Sky has, apparently raised security concerns about the Mediaguard CA system. Interestingly, however, we understand that Sky's affiliated company, Fox Entertainment Group, actually relies on the Mediaguard CA system in the US.

77. The second option suggested by Ofcom would be a requirement on Sky to stipulate to STB manufacturers that all STBs which are capable of receiving Sky's proposed service must also be compatible with existing Mediaguard-encrypted pay TV services. Ofcom notes that such an option "is likely to have significant implications for the complexity, development timescales and resulting retail price of such STBs"[45]. This, of course, suggests that STB manufacturers have no incentive whatsoever to manufacture such STBs, absent this condition on Sky i.e., the Sky proposal above to deal with the competition issue will not actually deal with it. In any event, BT fully shares Ofcom's reservations about this option.

78. Under the third option suggested by Ofcom, Sky would be required to use the same variant of the Mediaguard CA system which TUTV and Setanta currently use. BT acknowledges that this effective mandating of a CA standard for DTT could undermine Ofcom's duty of technological neutrality. Also, such an approach might complicate efforts by CA systems producers to introduce innovations and improvements to CA systems.

79. The forth option suggested by Ofcom is that Sky could be prohibited from operating a CA system on DTT. This option may simply be a variant of the third option, as it may force Sky to rely on the Mediaguard CA system.

d. <u>Sky's advantages in the marketing of triple-play offerings</u>

80. In its latest annual Communications Market Report, Ofcom noted the increasing importance of bundles of communications services in the market:

[44] Condoc., para. 2.50.
[45] Condoc., para. 5.26.

"Bundled communications services are increasingly popular with consumers, with 40% of households now taking more than one communications service from the same provider (up a third on last year). A majority of broadband customers take it as part of a bundle"[46].

81. Sky has been particularly successful with its "See, Speak Surf" bundled offering of TV, broadband and telephony, which was launched in January 2007. It has done so by being particularly aggressive with its retail pricing. According to Sky: "Our price was much lower than many people thought they would have to pay for just TV, and also much lower than some people were already paying for just broadband."[47]

82. Sky lowest-priced bundled offering is currently merely £19/month. For this price, a customer gets, 4 packages of 'entertainment mixes' channels (i.e., excludes any 'premium' channels), free evening and weekend calls and up to 2MBit/s broadband.

83. Sky has managed to acquire over 1 million broadband customers, in the space of 14 months from launch. According to Sky, it is the fastest growing UK provider of broadband and telephony[48]. Also, the Sky results in the quarter to end-September 2007 noted that almost half a million customers take the Sky triple play offering of TV, broadband and telephony, a 54% increase on the previous quarter.[49]

84. This bundled strategy is at the heart of Sky's future strategic direction. Sky has noted that, whilst it has historically operated in an industry worth £7 billion, by moving into broadband and telephony it is operating in a wider industry worth £20 billion and set to be worth £25 billion by 2010[50]. As stated by Sky's chairman, Rupert Murdoch, in the Sky 2007 Annual Review:

[46] http://www.ofcom.org.uk/research/cm/cmr07/keypoints/
[47] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p.13.
[48] Ibid., at p. 5.
[49] http://media.corporate-ir.net/media_files/irol/10/104016/ResultsRelease011107.pdf, at p.6.
[50] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p.5.

"The convergence of media and telecoms requires companies to innovate and adapt in order to maximise the growth opportunities in a combined sector forecast to be worth £25 billion in the UK alone. The dedication and dynamism of our people ensure that we at Sky are ideally placed to capitalise on these opportunities."[51]

85. The previous section of this submission noted the inherent competitive advantage Sky has over its rivals as a result of its control of key content. It must also be noted that, with regard to the broadband and telephony aspects of triple play bundles, Sky also has an inherent advantage over BT.

86. As to broadband, Sky has invested in local loop unbundled broadband network. This network already covers 70% of UK households and 86% of cabled areas.[52] This network investment enables Sky to retail relatively low-cost broadband offerings. In particular, in 2006 Sky announced a *free* broadband offering, of up to 2Mbit/s[53]. By contrast, BT's retail broadband offerings (along with those of many other broadband providers) rely on the much higher-priced IPStream input and, hence, its retail prices are higher than those of Sky which hampers its ability to compete fairly with Sky. The regulation of broadband is complex. Future regulation of broadband must, however, take account of the fact that BT is competing against lower-cost major players, such as Sky, and needs to be able to compete on the basis of a level playing field.

87. As to calls, whilst Sky is not subject to any ex ante regulation, BT is. In particular, BT is subject to transparency and no undue discrimination requirements, the net effect of which hamper BT's ability to compete against Sky's offerings.

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[51] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p.2.
[52] http://library.corporate-ir.net/library/10/104/104016/items/262498/Annual_Review_07.pdf, at p. 13.
[53] http://media.corporate-ir.net/media_files/irol/10/104016/PR18072006.pdf.

C. Response to Ofcom's consultation questions

This section should be read in the light of and in conjunction with BT's comments in the preceding sections of this response.

Question 1

To what extent do you consider that DTT, DSat, cable and IPTV are in competition with one another for subscribers of pay TV services – either at present or in the future?

88. The principle of Sky retailing pay TV on DTT may benefit consumers and increase choice but only so long as that proposition has meaningful competition from other DTT retailers who are able to offer at least the same "key content" to consumers that Sky proposes without crippling themselves financially. BT agrees with Ofcom that Sky's proposal raises competition concerns and that, as stated by Ofcom, "given the critical stage in the development of Pay TV on DTT, the competition issues need to be considered with great care". Any support for Sky to retail in the DTT market can only be given on the assurance of a fair and equitable framework for competition between DTT retailers and that the concerns identified are resolved in a way which assists the development of a competitive market. Only those conditions will increase consumer choice.

89. In BT's view, DTT, DSat and cable are in competition with one another for subscribers of pay TV services. IPTV, on the other hand, does not impose a material competitive constraint on the other platforms for pay TV services and is unlikely to do so in the near future.

Question 2

To what extent do you consider the Proposal is likely to deliver benefits to the consumer?

90. Ofcom notes that the Sky Proposal, if adopted, would bring new pay TV content onto DTT and thereby increase consumer choice. On the other hand, however, in BT's view choice will, in fact, be reduced for the many DTT consumers who will continue to opt solely for FTA channels on DTT and who would no longer receive Sky's FTA channels.

91. Ofcom also notes that the Sky Proposal would meet any currently unmet demand for the content on the Sky channels in question. In BT's view, however, the issue of unmet demand needs to be considered in a wider context.

92. In BT's view, there is currently significant unmet consumer demand for unbundled pay TV content. BT Vision is aiming to meet this unmet demand by offering consumers the ability to pay only for the specific programmes and/or channels that they want, rather than having to pay for whole channels, or bundles of channels, in order to that specific content. Sky's retail model, on the other hand, results in consumers paying high prices for bundles of content, in order to acquire the content they actually acquire.

.**Question 3**

To what extent do you consider that there is scope for sustainable competition in pay TV on the DTT platform and, more broadly, across all pay TV platforms?

93. In BT's view, there is considerable scope for sustainable competition in pay TV on the DTT platform and, more broadly, across all pay TV platforms. This scope could, however, only be realized if Sky's control over key content is properly regulated and if appropriate remedies are put in place to address Sky's grip over all levels of the content distribution chain. This latter issue is addressed more fully in BTs submissions in the context of its pay TV market inquiry.

Question 4

What are likely to be the key aspects of competition between providers of retail pay TV services on the DTT platform? E.g. what is the role of premium sports and movies content?

94. As outlined in more detail in section C of the present submission, the main factors that affect competition in pay TV services on the DTT platform are:

i. First, Sky's control over key content. This key content is not limited to 'premium' sports and movie content;

ii. Second, Conditional Access Systems;

iii. Third, Sky's advantages over BT, as a result of ex ante regulation imposed on BT.

Question 5

Do you consider that if Sky were to become the only provider of pay TV on the DTT platform it would be likely to have a significant detrimental effect on competition in the long term? How might this affect the development of other platforms for the delivery of pay TV services?

95. In BT's view, for the reasons outlined in the present submission, if Sky were to become the only provider of pay TV on DTT, this would have a clear detrimental effect on competition and would further erode the ability of providers to compete on other platforms.

Question 6

To what extent, if at all, do you consider that the Proposal would be likely to lead to any of the public policy concerns outlined at Section 4?

96. Ofcom mentions in the Condoc certain public policy concerns. BT considers that those risks are real and that the Sky Proposal could result in a conflict of interest between Sky's role as a shareholder in DTV Services Limited, which promotes Freeview, and its role as provider of pay TV services. Sky would be the only shareholder in DTV Services Limited that would provide pay TV services and it would not have the same incentive as the other shareholders in investing in promoting the free-to-air DTT services.

97. BT also considers that the launch of a Sky STB, which is MPEG4 compatible and contains NDS conditional access technology, may well give rise to customer confusion. Whilst it would be preferable for consumers to be able to obtain Sky and existing DTT pay TV content without having separate STBs, BT considers

that the issue of customer confusion could be adequately addressed through appropriate conditions on Sky.

Question 7

Specifically, to what extent do you consider that the Proposal would be likely to lead to consumer confusion?

98. See response to Q6.

Question 8

To what extent do you consider that it is beneficial for consumers to be able to obtain Sky and existing DTT pay TV content without having to purchase separate STBs?

99. See response to Q6.

Question 9

Do you consider that the Proposal might lead to any additional public policy concerns?

100. See response to Q6.

Question 10

If Sky becoming the only provider of pay TV services on the DTT platform were likely to have a significant detrimental effect on competition, do you consider that it is possible to address this through a set of additional conditions and/or directions? If so, what form should those conditions/directions take?

101. In BT's view, if Sky were to become the only provider of pay TV services on DTT, this would be the result of Sky using its market power at various levels of the content distribution chain to exclude or marginalize competitors. Accordingly, it is essential that appropriate conditions be put in place to ensure that this outcome does not arise. Once it has arisen, competition would be irreparably distorted and it would then be too late to seek to control Sky, through the imposition of any conditions and/or directions.