

**RESPONSE OF VIRGIN MEDIA TO OFCOM'S CONSULTATION ON BSKYB'S
PROPOSAL TO OFFER PAY-TV SERVICES ON DIGITAL TERRESTRIAL TV**

DECEMBER 2007

1. INTRODUCTION AND EXECUTIVE SUMMARY

- 1.1 This memorandum comprises the response of Virgin Media to Ofcom's consultation ("**the Consultation**") of 4 October 2007 on the British Sky Broadcasting Limited ("**BSkyB**") proposal to offer pay-TV services on digital terrestrial TV ("**DTT**") ("**the Proposal**"). This memorandum has four sections:
- (a) Introduction and Executive Summary;
 - (b) Background;
 - (c) Observations on Ofcom's analysis of the impact on competition and the consumer interest; and
 - (d) Consideration of Ofcom's options.
- 1.2 Virgin Media's responses to Ofcom's questions as set out in Annex 4 of its consultation paper are included in the main body of this memorandum.
- 1.3 As a preliminary observation, the TV industry is subject to a range of ongoing regulatory initiatives which may materially impact the future regulation of TV broadcasting and conditions of competition in TV broadcasting. In addition, the future development of the DTT platform is currently in a state of flux, especially in light of digital switch over ("**DSO**"). Given the significant future opportunities for pay-TV services on the DTT platform following DSO, and the increase in choice, services and competition that this may allow, Ofcom should be extremely cautious about adopting any measures that may jeopardise those opportunities. As the Proposal has the potential to impact both conditions of competition in the pay-TV sector generally and, in particular, the future development of the DTT platform, Ofcom should exercise extreme caution in deciding how to respond to the Proposal.
- 1.4 Against this background, for the reasons set out below, Virgin Media considers that the only reasonable course for Ofcom is not to consent to the Proposal. In the alternative, Ofcom should refuse to consent to the Proposal until, at least, Ofcom has completed its market investigation into the pay-TV industry.

Adverse effect on intra-platform competition

- 1.5 If Ofcom were to consent to the Proposal unchanged, Virgin Media considers that there is a very high likelihood that BSkyB will, within a short period of time, become the sole supplier of pay-TV on the DTT platform. This is because BSkyB would enjoy overwhelming advantages as compared to other retailers of pay-TV arising from its existing scale, enormous financial and marketing resources, vertical integration (particularly access to superior content on an exclusive basis), influence over third parties (set top box ("**STB**") manufacturers and retailers), brand recognition and, crucially, access to scarce DTT capacity. These advantages cumulatively place BSkyB in a singular position as compared to existing and potential pay-TV retailers on the DTT platform.
- 1.6 BSkyB has an enormous incentive to become the sole supplier of pay-TV on the DTT platform. First, DTT is the largest digital TV platform and has been growing significantly faster than any other platform. While the pay-TV offering on the DTT platform is currently undeveloped, particularly in respect of the availability of conditional access ("**CA**") enabled STBs, there is a real prospect that, following DSO, there will be considerably greater opportunities for pay-TV services on DTT. Such services would pose a considerably greater constraint on BSkyB's existing pay-TV services on the digital satellite ("**DSat**") platform than is currently the case. By ensuring that BSkyB becomes the sole provider of pay-TV services on the DTT platform, or otherwise foreclosing the opportunity for competitor market entry on DTT, this threat is removed.

- 1.7 As a consequence of becoming the sole provider of pay-TV services on the DTT platform, BSkyB will increase its retail pay-TV subscriber base and further entrench its position as the dominant retail provider of pay-TV services in the UK. In turn this will further increase BSkyB's purchasing power in relation to attractive content (as it will be able to spread the cost of that content over an even larger installed retail subscriber base). This will enhance the vicious circle currently operating to BSkyB's advantage and make it even less likely that BSkyB's market power will be successfully challenged at any level of the supply chain by an existing market participant or new entrant. In short, the potential prize for BSkyB: (i) to reinforce its dominant position in pay-TV by becoming the only material supplier of pay-TV services on the two largest digital TV platforms; and (ii) to remove the competitive threat from a viable pay-TV retailer on DTT, is enormous.

Adverse effect on inter-platform competition

- 1.8 BSkyB's existing competitors at all levels of the pay-TV supply chain suffer from a vicious circle brought about by the distinctive features of the pay-TV sector which have enabled BSkyB to secure leading or dominant positions at all levels of the supply chain and the ability to deter new entry and expansion by such limited competitors as do exist. With access to superior content, BSkyB has been able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, achieve a leading position downstream. Further, market forces have been unable to offset this tendency and BSkyB's position has become entrenched. This is because new entrants face inferior investment incentives as a result of having to compete for subscribers with inferior content and to compete for content with fewer subscribers.
- 1.9 Against this background if, as is likely, BSkyB were to become the sole provider of pay-TV on the DTT platform as a consequence of the Proposal, this would further entrench the market position of BSkyB in the supply of pay-TV as a whole, and further enhance the vicious circle. In particular:
- (a) it would limit the constraint on BSkyB's DSat retail offering that the DTT platform might otherwise impose in the future;
 - (b) **[CONFIDENTIAL]** This would:
 - (i) reduce the constraint imposed by those entities on BSkyB's existing retail proposition on the DSat platform;
 - (ii) **[CONFIDENTIAL]** one of the only entities (Setanta) that has been successful in the last few years in bidding against BSkyB for valuable premium sports rights (and, in particular, the rights to Football Association Premier League ("**FAPL**"));
 - (iii) thereby increase BSkyB's purchasing power in relation to premium sports rights, and increase the likelihood of BSkyB continuing to hold the vast majority of attractive sports rights for the foreseeable future; and
 - (iv) leave Virgin Media as the only material retailer of premium sports content other than BSkyB, in circumstances in which Virgin Media's ability effectively to compete with BSkyB is massively constrained due to the uneconomic terms on which BSkyB supplies that content to Virgin Media;
 - (c) it would increase BSkyB's pay-TV subscriber base, thereby allowing it to spread the cost of attractive content over an even larger number of subscribers. This will increase further BSkyB's ability, relative to other bidders, to secure attractive premium content (whether sports, movies or basic content); and

- (d) it would substantially reduce the likelihood of other parties bidding for DTT capacity with the intention of launching a rival pay-TV service, to the long-term detriment of the prospects for competition.

1.10 In short, if Ofcom were to consent to the Proposal, and BSkyB became the sole supplier of pay-TV services on the DTT platform, this would materially strengthen BSkyB's position in relation to (i) the purchase of content; and (ii) the retail supply of pay-TV across all platforms. This would strengthen the vicious circle already operating in BSkyB's favour to such a degree that it is difficult to see the circumstances in which it could ever be challenged (absent strong and direct regulatory intervention).

1.11 As well as harming other participants in the pay-TV industry, such an eventuality would clearly lead to consumer harm through higher prices, restricted choice and reduced innovation.

Benefits of the Proposal do not outweigh the detriments

1.12 Whilst Virgin Media recognises conceptual benefits arising from the Proposal through a potential increase in choice for consumers on the DTT platform, they are marginal. The starting point is that Freeview viewers will definitely lose access to the three existing BSkyB channels without, in most cases, having a STB capable of receiving BSkyB's encrypted pay-TV offering.

1.13 Moreover, the vast majority of viewers in the UK can currently access the content in the Picnic proposition, either from Virgin Media (with the exception of Sky One) or through BSkyB's existing DSat service or Tiscali (currently the only IPTV provider in the UK). Accordingly, the Proposal does not offer products, services or choice that are not already available to the vast majority of customers. It is, instead, limited to offering different choices on the DTT platform. Further, given that BSkyB is likely, as a consequence of the Proposal to become the sole provider of pay-TV services on the DTT platform, there is a real risk that any short-term increase in consumer choice will be short-lived. This is because the Proposal [**CONFIDENTIAL**].

1.14 Accordingly, even considering the DTT platform in isolation, the net consumer benefit is, at best, marginal in the short-term. On the basis that, in the medium to long term, there is a real prospect for attractive pay-TV services on the DTT platform, the adverse effect on competition of the Proposal will be felt outside the DTT platform and across the pay-TV industry as a whole. Accordingly, even if Ofcom were to conclude that the Proposal provided consumer benefits for potential pay-TV subscribers on DTT that outweighed the [**CONFIDENTIAL**] the existing free to air BSkyB channels, Virgin Media does not consider that Ofcom would be acting rationally if it were to conclude that the relevant consumer benefit outweighed the potential adverse effects on the pay-TV industry as a whole.

Conclusion on Options

1.15 There are a number of reasons why Ofcom should be extremely cautious in considering the Proposal:

- (a) the benefits of the Proposal are limited to current and potential DTT viewers (and may, at best, only be marginal and short term);
- (b) the potential detriments arising from the Proposal are extremely severe and will affect the entire pay-TV industry (at all levels), and customers of all platforms;
- (c) as issues that are central to an assessment of the Proposal are also central to the Market Investigation, it will be difficult for Ofcom to reach a definitive position on the Proposal before it reaches a decision on the Market Investigation; and

- (d) the future of the DTT platform is in a state of flux (and the pay-TV offer on DTT is still in its infancy). In particular, consenting to the Proposal may significantly impact investment decisions in connection with the forthcoming auction of digital terrestrial spectrum. Accordingly, decisions taken now which alter the competitive balance have the potential to have very long term effects.
- 1.16 In light of the above, Virgin Media considers that the only reasonable course for Ofcom is not to consent to the Proposal (i.e. Ofcom Option 3). In the alternative, Ofcom should refuse to consent to the Proposal until, at least, Ofcom has completed its Market Investigation into the pay-TV industry.
- 1.17 While Virgin Media considers that the only reasonable course for Ofcom is not to consent to the Proposal, it has considered carefully whether there are conditions that might be attached to the Proposal which would satisfactorily address the potential detriment. In summary:
- (a) even if Ofcom were to impose some form of operational separation requirement on Picnic (assuming this was capable of being implemented), and required BSkyB to wholesale the Picnic channels to other DTT pay-TV retailers on economically viable terms (assuming this was possible) and subject to appropriate technical platform services ("**TPS**") conditions, Virgin Media still does not consider that this would be sufficient to address satisfactorily the competition concerns arising from the Proposal. In short, Virgin Media considers that there are no practical remedies that would address the very significant competition concerns that would arise in the event that BSkyB is permitted to retail the Picnic proposal on the DTT platform. Accordingly, as Ofcom anticipated might be the case, the risk and degree of harm arising from the Proposal to both intra-platform and inter-platform competition is sufficiently high that BSkyB should not be permitted to retail any pay-TV services on the DTT platform; and
- (b) even the wholesale-only supply of the Picnic channels to DTT pay-TV providers will raise concerns by strengthening the position of BSkyB in the supply of pay-TV in the UK. If, however, Ofcom were to consider that the benefits of such an approach were to outweigh the adverse effect on competition across the pay-TV industry and were to permit such an arrangement, it would be necessary, as a minimum, for the wholesale terms of supply to ensure:
- (i) that DTT retailers were not prevented from competing effectively with other platforms (and, in particular the DSat platform) in relation to the retailing of such channels. In other words, any wholesaling remedy would need to offer the DTT pay-TV retailer sufficient margin to compete with BSkyB's DSat retail prices and would need to offer the channels on an equivalent basis to that retailed by BSkyB; and
- (ii) that the arrangement did not distort competition between other platforms (and, in particular, the cable platform) and the DTT platform. This would require Virgin Media (as regards the cable platform) and any other potential retailer of the relevant BSkyB channels on any other platform, to benefit from equivalent terms to those BSkyB is required to offer to DTT pay-TV retailers.
- 1.18 Finally, Virgin Media considers that it would be entirely inappropriate for Ofcom to consent to the Proposal on an unconditional basis on the basis that competition concerns could be addressed under ex post competition powers (i.e. Ofcom Option 1). This is because ex post regulation:
- (a) has, to date, failed to ensure a competitive pay-TV industry;

- (b) takes too long to be effective in fast moving markets such as TV broadcasting;
- (c) is costly for all parties;
- (d) has not afforded any real degree of certainty for all players in the market; and
- (e) in general, is not designed to promote sustainable entry and competition against an incumbent dominant provider.

2. BACKGROUND

2.1 As a preliminary, but important observation, the Proposal is being considered at a time when:

- (a) the TV industry is subject to a range of ongoing regulatory initiatives which may materially impact the future regulation of TV broadcasting and conditions of competition in TV broadcasting; and
- (b) the future development of the DTT platform is in a state of flux, especially in light of DSO.

2.2 Each of these factors create the context for, and have a direct impact on, Ofcom's consideration of the Proposal and are considered below in more detail.

Regulatory Reviews

2.3 There are a number of ongoing regulatory initiatives that may have a material impact on different aspects of the TV broadcasting environment in the UK. These include:

- (a) Ofcom's market review into wholesale digital TV broadcasting platforms;
- (b) Ofcom's consultation on the future of digital terrestrial TV;
- (c) Ofcom's market investigation into the pay-TV industry ("**Market Investigation**"); and
- (d) the Competition Commission ("**CC**") investigation of BSkyB's acquisition of a 17.9 per cent stake in ITV.

2.4 Of particular importance to the Consultation is the Market Investigation. The Market Investigation was, at least in part, prompted by the submission of BT, Setanta, Top Up TV and Virgin Media of 3 July 2007 (the "**Submission**") which set out why the structure of the pay-TV industry has enabled BSkyB to achieve market power at all significant levels of the pay-TV supply chain thereby creating a vicious circle for other market participants. For the reasons set out below, Virgin Media considers that approval of the Proposal will afford BSkyB the ability to extend the effect of the vicious circle to the DTT platform leading to adverse and irreversible effects for both intra-platform and inter-platform competition.

2.5 As many of the concerns raised in the Submission will be exacerbated by the Proposal, Ofcom should be very cautious about reaching any definitive conclusions in relation to the Proposal until it has reached its conclusions in the Market Investigation.

DTT platform and DSO

2.6 As recognised by Ofcom in the Consultation, the DTT platform is still in its infancy. Although launched in 1998, the DTT platform has only operated as a long-term viable business proposition since the launch of Freeview in October 2002. Since that time, the success of the DTT platform has been rapid and it is now the largest digital TV platform in

the UK with around 9.1 million UK households; more households than BSkyB's DSat service¹. DTT's rapid and exponential growth is expected to continue, especially given that DSO will be completed in 2012 and will result in DTT being the primary and entry-level means to access TV in the UK for remaining analogue viewers.

- 2.7 Notwithstanding the success of the DTT platform, absent the Proposal, Virgin Media does not in the short term expect there to be rapid development of pay-TV services on the DTT platform [**CONFIDENTIAL**]. This view primarily reflects the lack of available digital terrestrial spectrum, the limited unique reach of pay-TV DTT services (see paragraph 3.43(b)) and the limited penetration of CA capable DTT boxes. This is in addition to the wider challenges facing competing pay-TV operators as a consequence of BSkyB's control of access to premium sports and movies content (as discussed more fully in the Submission).
- 2.8 Post-DSO the operation of the DTT platform could be very different to the current position. In Ofcom's consultation on the future of DTT (dated 21 November 2007), Ofcom notes that DSO will result in an increase of coverage from 73 per cent of the UK to 98.5 per cent of the UK and will enable all remaining 16QAM multiplexes to be converted to 64QAM, resulting in an overall capacity increase of 20 per cent. Capacity could also be very significantly increased by technological advancements including in relation to video and audio coding compression standards and new transmission standards. Together these technological improvements could increase DTT capacity by an additional 160 per cent on upgraded multiplexes. This extra capacity could enable a number of new services and technologies onto the DTT platform; including a larger range of channels, high definition ("**HD**") channels and more interactivity.
- 2.9 Virgin Media believes that while pay-TV services on DTT will be limited in the short-term, there are likely in the future to be increased commercial opportunities for broader DTT pay-TV offerings [**CONFIDENTIAL**]. This view reflects a number of potential changes in the market;
- (a) firstly, the opportunity presented by the potential expansion in available DTT channels as a result of the DDR. This potentially creates the opportunity to gain access to capacity sufficient to launch a viable mini-bouquet of pay-TV channels at economic rates;
 - (b) secondly, the potential availability of BSkyB premium content on wholesale terms on more economic rates, whether as a result of regulatory intervention or a change in strategy by BSkyB;
 - (c) thirdly, the continued survival of at least one of the existing pay-TV DTT operators to ensure a continued basis for the deployment of CA capable STBs; and
 - (d) fourthly, the potential for the emergence of a new generation of CA capable DTT set-top hardware thereby expanding the base of homes able to receive a pay-TV offer. This will, potentially, be driven by the HD services enabled by the DVB-T2 standard.
- 2.10 [**CONFIDENTIAL**] the ability of any operator to pursue this opportunity is far from certain and highly sensitive to changes in market structure. In addition, operators (either by themselves or in coalition) must be willing to take the significant risk to invest substantially to secure sufficient DTT capacity. Ofcom should be extremely cautious about adopting any measures that may undermine the willingness of operators to make such investments. In this respect, the entry of BSkyB into the DTT market as a retailer would introduce a range of significant additional risks which are very likely to impact negatively the willingness and ability of third parties to make the necessary investment.

¹ Ofcom Proposed BSkyB digital terrestrial television services consultation, 4 October 2007, page 10.

- 2.11 In summary, the TV industry is subject to a range of ongoing regulatory initiatives which may materially impact the future regulation of TV broadcasting and conditions of competition in TV broadcasting. In addition, the future development of the DTT platform is currently in a state of flux, especially in light of DSO. As the Proposal has the potential to impact both conditions of competition in the pay-TV sector generally and, in particular, the future development of the DTT platform, Ofcom should exercise extreme caution in deciding how to respond to the Proposal. In short, the risk of making the wrong decision in a rapidly changing market could very significantly outweigh any short term benefits Ofcom may consider will arise from the Proposal.

3. **OBSERVATIONS ON OFCOM'S ANALYSIS OF THE IMPACT ON COMPETITION AND THE CONSUMER INTEREST**

- 3.1 Virgin Media considers below, in turn, the potential implications of the Proposal on:
- (a) competition on the DTT platform, in particular as regards the provision of pay-TV (referred to as intra-platform competition); and
 - (b) competition between DTT and other digital TV platforms (referred to as inter-platform competition).
- 3.2 In addition, although Virgin Media notes that Ofcom has not, at this stage, been able to carry out a detailed market definition exercise and that it may not, ultimately, be necessary to reach final conclusions on market definition, Virgin Media sets out in Annex 1 some preliminary observations on the alternative approaches to market definition highlighted by Ofcom in the Consultation in relation to retail service provision and supply at the wholesale level.

Analysis of impact on intra-platform competition

- 3.3 As discussed in the Consultation, competition on the DTT platform is undergoing a significant period of upheaval and there is considerable uncertainty in how competition will evolve in the long term. Ofcom considers that, as regards DTT, there are a number of potential outcomes:
- (a) a single CA technology which supports multiple retailers;
 - (b) competing CA technologies with competing retailers; and
 - (c) a single CA technology with a single retailer.
- 3.4 If Ofcom were to consent to the Proposal unchanged, Virgin Media considers that there is a very high likelihood that, as regards the supply of pay-TV on the DTT platform, it will lead [**CONFIDENTIAL**]. This is because BSkyB would enjoy overwhelming advantages as compared to other retailers of pay-TV arising from its existing scale, enormous financial and marketing resources, vertical integration (particularly access to superior content on an exclusive license basis), influence over third parties, brand recognition and, crucially, access to scarce DTT capacity.

BSkyB's existing competitive advantages

- 3.5 BSkyB is a vertically integrated supplier of pay-TV, operating at the three main tiers of the pay-TV supply chain: it produces and acquires content; it wholesale supplies channels; and it distributes those channels on the DSat platform. BSkyB already enjoys a leading position in each of the three levels of the supply chain and, further, these substantial market positions have endured over a significant period of time and are now well-entrenched:

- (a) BSkyB has a leading position in the acquisition of content, specifically sports rights and movie rights. In relation to sports rights, BSkyB is particularly strong with a share by value of 79.7 per cent of sports events shown on pay-TV². BSkyB also has exclusive pay-TV subscription contracts with all of the major US movie studios (Disney, Columbia, Fox, Sony, Paramount, Universal, Dreamworks and Warner Brothers) meaning that it has a 100 per cent share of premium subscription movie rights (whilst pay-per-view rights are held more widely, these make up a relatively small proportion of pay-TV revenues in the UK). As described in paragraph 3.9, both premium sports and movie content are considered to be the key drivers of pay-TV;
- (b) BSkyB has a dominant position in the wholesale supply of sports and movie channels. BSkyB holds a near monopoly share of approximately 96 per cent in relation to the wholesale supply of sports channels³ and is the sole provider of premium subscription movie channels in the UK; and
- (c) BSkyB has a dominant position in the distribution and retailing of pay-TV content with a 67.6 per cent share pay-TV subscribers⁴.

3.6 BSkyB's ability to build these leading positions has been facilitated by a range of specific features of the pay-TV industry described in detail in the Submission and summarised below:

- (a) there is a finite pool of key content;
- (b) certain contracts for key content are for a limited duration;
- (c) key content is only available on a staggered basis;
- (d) key content is supplied on an exclusive license basis and is selectively distributed;
- (e) the distribution of content benefits from economies of scale; and
- (f) the pay-TV industry is also characterised by significant feedback effects along its vertical supply chain.

3.7 As a consequence of the above features, the pay-TV industry exhibits a tendency for concentration and "increasing dominance" (i.e. leading market positions become entrenched). A firm with access to superior content is able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, achieve a leading position downstream. These features distinguish the pay-TV industry from other industries with "feedback effects" and have already resulted in market failure in the supply of pay-TV in the UK by enabling BSkyB to develop and entrench its leading market positions at the key levels of the supply chain and, in particular, control of the most attractive pay-TV content. This has resulted in a vicious circle for its competitors that prevents them being able effectively to compete. The result of this is that BSkyB does not currently face effective competition in the supply of pay-TV at any level of the supply chain.

3.8 Against the above background Virgin Media considers that, if Ofcom were to consent to the Proposal, BSkyB will be able to utilise its existing market power to ensure that BSkyB

² *Submission to Ofcom on the need for a market investigation into the pay-TV industry* by British Telecommunications plc, Setanta Sport Holding Limited, Top Up TV Europe Limited and Virgin Media Limited of 3 July 2007, page 7.

³ *Submission to Ofcom on the need for a market investigation into the pay-TV industry* by British Telecommunications plc, Setanta Sport Holding Limited, Top Up TV Europe Limited and Virgin Media Limited of 3 July 2007, page 8.

⁴ *Submission to Ofcom on the need for a market investigation into the pay-TV industry* by British Telecommunications plc, Setanta Sport Holding Limited, Top Up TV Europe Limited and Virgin Media Limited of 3 July 2007, page 8.

becomes the sole retailer of pay-TV on the DTT platform. The specific advantages enjoyed by BSkyB that will enable it to achieve this outcome are addressed in more detail below:

Control of attractive content

- 3.9 In previous investigations, the UK and EU competition authorities have consistently identified high quality sports and movies as being key content for entry into and competition in pay-TV and, in particular, the provision of premium pay-TV services. As indicated above, BSkyB holds the vast majority of all sports rights available for pay-TV (a share by value of 79.7 per cent of sports events shown on pay-TV) and exclusive pay-TV subscription contracts with all of the major US movie studios (Disney, Columbia, Fox, Sony, Paramount, Universal, Dreamworks and Warner Brothers) meaning that it has a 100 per cent share of premium subscription movie rights. Further, the features of the markets described above (at paragraph 3.6) mean that, absent regulation, that position is unlikely ever to be challenged. In particular, Virgin Media considers that, as a consequence of its very large base of pay-TV subscribers, BSkyB will continue to have an overwhelming enduring advantage in bidding for attractive sports and movie rights.
- 3.10 In short, BSkyB controls, and will continue to control, on an exclusive basis, the overwhelming majority of the attractive content that has been shown to drive pay-TV subscription in the UK. Although Setanta has, following regulatory intervention, been successful in securing two out of the six available packages of live FAPL rights in the most recent auction, it is generally considered to have acquired the least attractive of the six packages. Further, as compared to BSkyB, Setanta does not have the range or quality of additional sport rights necessary to supplement its FAPL content.
- 3.11 In addition to very attractive sports and movie content, BSkyB also controls a range of attractive basic channel content, much of which is broadcast on Sky One. In consequence, Virgin Media considers that if Ofcom consents to the Proposal, the channels offered in the Picnic proposition will be very much more attractive to potential (and existing) pay-TV subscribers on the DTT platform than anything that can be offered by Setanta or Top Up TV or, indeed, any potential entrant to the supply of pay-TV on DTT. This is likely to cause new and existing pay-TV subscribers on the DTT platform to opt for the Picnic proposition instead of the offerings of Setanta or Top Up TV.

Enormous financial resources

- 3.12 As by far the largest retailer of pay-TV services in the UK, BSkyB has very significant financial resources with which to support Picnic. These resources could be used:
- (a) to support a significant marketing campaign (using both above the line and below the line advertising) on the launch of Picnic and on an ongoing basis. Neither Setanta nor Top Up TV (nor indeed any other pay-TV retailer in the UK) has access to anything like the marketing resources of BSkyB. BSkyB recorded in its 2007 annual report an annual marketing spend of £734 million for the year ended June 2007. This marketing spend is also increasing; in its quarterly results for the three months ended September 2007, BSkyB reported that its marketing costs increased by £35 million to £196 million;
- (b) to underwrite the investment risk a manufacturer would otherwise incur in developing and manufacturing a new STB for BSkyB, either directly or by combining DTT and other DSat box orders. This is important because the widespread availability of Picnic STBs will be key in ensuring rapid uptake of subscribers. BSkyB could, for example use its financial resources to underwrite the research and development costs of its preferred manufacturers and to manage after-sales support on behalf of manufacturers. Again, neither Setanta nor Top Up

TV (nor indeed any other pay-TV broadcaster in the UK) would be able to replicate this support for manufacturers;

- (c) to subsidise the retail cost of STBs. Again, this is important as the upfront capital cost of acquiring the relevant hardware has been shown in the past to be key to a subscriber's choice of offering. While BSkyB has indicated it does not intend to subsidise Picnic STBs, it has historically always subsidised satellite STBs and could easily change its decision and subsidise the boxes in either a direct or indirect fashion. Direct subsidy could be used by BSkyB to reduce the retail price of the STB in the same fashion as has been utilised in relation to BSkyB's satellite STBs and the Sky+ product. BSkyB might also indirectly subsidise boxes, increase their perceived values (i.e. introduce an integrated personal video recording function), or otherwise bring about a reduction in the retail price paid by customers (e.g., as indicated above, by underwriting research and development and other capital investment costs incurred by manufacturers thereby reducing the manufacturing cost and the ex-factory price of STBs); and
- (d) to incentivise retailers to market the Picnic proposition over other rival DTT pay-TV services. In this regard, one of the key determinants in customers' choice of offering (including choice of STB) is the advice and guidance given by retailers (e.g. DSG, formerly Dixons). BSkyB has historically adopted a range of initiatives that have been very successful in persuading retailers to promote their products and services. These include:
 - (i) market leading financial incentives (in the form of commissions and bonuses to both the retailer and the sales person) for selling BSkyB's products. These incentives are very powerful in inducing retailers to promote BSkyB's service and also provide a further margin allowing retailers to reduce STB prices; and
 - (ii) advertising or co-marketing support for retailers that promote their product, whether in-store or in other forms of marketing. This is of considerable value to those retailers.

3.13 In summary, BSkyB's enormous financial resources would provide it with a very significant advantage over Setanta and Top Up TV, and any other retailer of pay-TV, in successfully marketing a new DTT service.

Relationships with third parties: STB manufacturers

3.14 In addition to advantages arising from its control of content and enormous financial resources, BSkyB is also uniquely well placed as regards its existing relationships with third parties (in particular manufacturers of STBs and retailers).

3.15 As regards manufacturers of STBs, BSkyB has a long history of working with such manufacturers and is well placed to persuade them to develop and deploy Picnic-specific STBs to the potential detriment of existing pay-TV providers Top Up TV and Setanta. In particular, BSkyB could increase the incentive of manufacturers of STBs to adopt the preferred technology of BSkyB by linking orders of Picnic STBs together with orders for DSat STBs. This will provide relevant manufacturers with order volumes that could not be matched by other pay-TV retailers on the DTT platform. Virgin Media notes that these incentives would not necessarily be expressed formally, or capable of effective prohibition.

3.16 BSkyB has indicated that its STBs will use NDS CA technology, which is controlled by BSkyB's largest shareholder News Corporation, and not the MediaGuard CA technology of Top Up TV. This means that STBs currently used to receive Top Up TV and Setanta will not be able to receive the Picnic service. In order to access pay-TV services on the DTT platform, DTT viewers will either have to choose between a Picnic STB, a Top Up

TV/Setanta-enabled STB (which currently use MediaGuard CA technology), or purchase a STB that supports both technologies (subject to BSkyB/News Corporation's willingness to license NDS to a STB not under its control).

- 3.17 In this respect, Virgin Media is concerned that there are a number of ways that BSkyB might further disincentivise STB manufacturers from developing boxes other than a Picnic STB, e.g. informal incentives to remain "NDS exclusive" and/or clear signals that NDS technology support will be prioritised for Picnic and DSat-only boxes.

Relationships with third parties: Content providers

- 3.18 BSkyB routinely secures DSat exclusivity in its contractual arrangements with third party content providers, both basic and premium. Virgin Media has noted in the Submission that this approach effectively prevents the emergence of a competitive basic channel offer on DSat, given that these contracts are staggered.
- 3.19 By the same token, Virgin Media considers that BSkyB is already likely to be securing DTT exclusivity in the agreements it has secured and is securing for DTT. BSkyB could take the same approach as it takes in DSat contracts – in other words, the content provider agrees to be DTT exclusive to BSkyB or Picnic. Equally, BSkyB could attempt to secure *de facto* DTT exclusivity by, for example, requiring exclusivity to its wholly-controlled CA technology, NDS.

Access to scarce DTT capacity

- 3.20 One of the most important advantages that would be enjoyed by BSkyB if Ofcom were to consent to the Proposal, would be access to significant capacity purchased at low rates on the DTT platform on which to broadcast pay-TV services. This would place BSkyB at a material advantage relative to existing pay-TV operators on the DTT platform and would also place it in an advantageous position as regards any future retailers of pay-TV on the DTT platform.
- 3.21 Access to sufficient broadcasting capacity is a prerequisite to being able to offer an attractive bouquet of pay-TV services on the DTT platform. Capacity on the DTT platform is currently extremely limited. Such capacity as has become available (or has been offered to broadcasters) in the recent past has attracted very considerable sums. Virgin Media believes that the most recent 24 hour channel slot to be sold was acquired for some £12 million per annum, [**CONFIDENTIAL**] a year.
- 3.22 Accordingly, while limited DTT capacity will become available on DSO as a result of the migration of the remaining multiplexes to 64QAM, and it is possible that further capacity may be released from the migration of multiplexes other than B to DVB-T2 (clearly, multiplex B offers no potential capacity to a pay-TV offering given its continued PSB designation), such capacity is likely to attract a high price.
- 3.23 The most likely source of significant capacity is from the acquisition of further capacity for TV broadcasting as part of the DDR auction process. However, it is Virgin Media's expectation that any such capacity will, again, attract a significant price, given the wide range of potential competition, and the capacity required to offer a material pay-TV offering (say, three 24 hour channels).
- 3.24 In summary, there is currently almost no capacity available on the DTT platform for the launch of pay-TV services and that capacity which has been made available attracts a very significant price. Whilst it may be expected that further capacity on the DTT platform will become available either as a consequence of technical developments within existing capacity, or as a consequence of the DDR, this capacity will either not be available to pay-TV operators on a DTT platform or, if available, will again require very significant capital expenditure.

- 3.25 In contrast, BSkyB currently has access to three full broadcast streams (on which it proposes to offer up to five services as part of the Picnic proposition). Given that this capacity was acquired by BSkyB at an early stage in Freeview's evolution – at a similar time to Virgin Media's own lease – Virgin Media believes that the prices paid by BSkyB will be less than [CONFIDENTIAL] per annum per channel. In other words, if Ofcom were to consent to the Proposal, BSkyB would have immediate access to very scarce capacity and a material cost advantage over any future operator that managed to secure sufficient capacity on the open market to offer a pay-TV service.
- 3.26 This cost advantage would put any third party wishing to compete with BSkyB at a material competitive disadvantage and it is, therefore, likely that if Ofcom were to consent to the Proposal, any potential rival operator would be considerably less willing to bid the substantial sums required to secure the capacity necessary to compete with BSkyB. Given that DSO is a "one off" opportunity to secure the UHF spectrum, this would be likely to have the permanent effect of eliminating the potential for alternative pay-TV operators on the DTT platform.

BSkyB has the incentive become the sole pay-TV provider on DTT

- 3.27 During a meeting on 5 December with Ofcom, Ofcom sought to distinguish between, on the one hand, advantages that are unique to BSkyB (i.e. could not be replicated by other large companies – in relation to which Ofcom referred to control of content) and those advantages that are not unique to BSkyB (i.e. could be replicated by other large customers – in relation to which Ofcom identified large financial resources as an example).
- 3.28 Virgin Media assumes that the reason Ofcom has sought to draw such a distinction is that it considers advantages that are unique to BSkyB to be somehow more "problematic" from a competition perspective than those advantages that are not unique to BSkyB. Virgin Media considers that, even if it were possible to draw the distinction proposed by Ofcom, it has little or no value in assessing the Proposal. This is because in assessing the competitive impact of the Proposal, it is necessary not only to consider the advantages enjoyed by BSkyB (and consequent ability to foreclose competitors), but also BSkyB's incentives. Put simply, even if, for example, there are thought to be companies with similar financial resources as BSkyB, this could only be relevant to Ofcom's analysis if those companies might be expected to launch a pay-TV service on the DTT platform such that BSkyB's financial advantages should not be considered "unique". In practice however, even if those companies existed, none have the same incentives to launch a pay-TV service on the DTT platform.
- 3.29 In this regard, BSkyB has a very clear incentive to become the sole pay-TV provider on the DTT platform. First, as discussed above, DTT is the largest digital TV platform and has been growing significantly faster than any other platform. Further, following DSO and further changes in the market, there may be expected to be scope to offer an improved range of pay-TV channels and services as a consequence of a significant increase in broadcasting capacity (although securing this additional capacity will come at a market price). While the free to air Freeview offering currently offers a limited competitive constraint on BSkyB's retail packages (and primarily only in relation to lower value entry packages), and the pay-TV offering on the DTT platform is currently undeveloped⁵, there is a real prospect that if the pay-TV proposition on the DTT platform were to be developed in combination with other factors; for example, the acquisition of significant DTT capacity and the emergence of an open CA environment, this would pose a considerably greater constraint on BSkyB's existing DSat business. By ensuring that BSkyB becomes the sole

⁵ Notwithstanding the undeveloped nature of the pay-TV proposition on the DTT platform, the CC still concluded that the services of Setanta and Top Up TV still impose a competitive constraint on BSkyB's offering (see *Acquisition by British Broadcasting plc of 17.9 per cent of the shares in ITV plc; Provisional findings reports* 4 October 2007 at paragraph 4.71).

provider of pay-TV services on the DTT platform, this threat is removed while also creating the opportunity to stifle both Top-Up TV and Setanta's pay-DTT businesses.

- 3.30 Second, and related to the above point, as a consequence of becoming the sole provider of pay-TV services on the DTT platform, BSkyB will increase its retail pay-TV subscriber base and further entrench its position as the dominant retail provider of pay-TV services in the UK. This will enable BSkyB to avoid a scenario where a third party – e.g. Setanta could, by combining a pay-DTT environment with TPS access to the DSat platform and carriage on the cable platform, create over time a critical mass of subscribers sufficient to enable it to profitably compete with BSkyB for premium rights. In turn this will further increase BSkyB's purchasing power in relation to attractive content (as it will be able to spread the cost of that content over an even larger installed retail subscriber base). This will further enhance the vicious circle referred to in the Submission and make it even less likely that BSkyB's market power will be successfully challenged at any level of the supply chain by an existing market participant or new entrant. In short, BSkyB has a very considerable incentive to take whatever steps are necessary to become the sole provider of pay-TV services on the DTT platform
- 3.31 Third, once BSkyB is the sole provider of pay-TV on DTT, it will be able to "manage" competition between the DSat and DTT platforms. By way of example, it seems likely that due to capacity constraints on the DTT platform, BSkyB will be able to generate greater revenues from the DSat platform. If this is the case, BSkyB will have an incentive to seek to ensure that DTT does not cannibalise DSat subscribers. BSkyB might achieve this objective by choosing to curb or delay innovation on the DTT platform or otherwise reduce the attractiveness of the DTT pay-TV service. This would be to the detriment of DTT viewers.
- 3.32 No other potential entrants, whether broadcasters or otherwise have the same strong incentives as BSkyB to become the sole provider of pay-TV services on the DTT platform (nor to withhold innovation). This is either because the DTT platform does not offer the same threat to them as to BSkyB (and launching a service on DTT would have no "defensive benefit") or because they are not vertically integrated and will not benefit from the positive "feedback effects" BSkyB would enjoy as a consequence of growing its retail subscriber base.
- 3.33 It should also be emphasised that any other potential entrant would face the very considerable entry barrier posed by BSkyB as the dominant incumbent. In other words, in considering whether to make the investment necessary to launch or expand a pay-TV service on the DTT platform any new entrant will be forced to consider very carefully the potential reaction of BSkyB as the dominant provider of pay-TV in the UK to such entry. In this context, BSkyB has a reputation for aggressively protecting its market position. In contrast, BSkyB does not have to worry about the impact on its business model of aggressive competition (whether legitimate or otherwise) from a dominant incumbent because it is the dominant incumbent.
- 3.34 In summary, if Ofcom were to consent to the Proposal:
- (a) BSkyB would enjoy overwhelming advantages as compared to other retailers of pay-TV arising from its existing scale, enormous resources, vertical integration (particularly access to superior content on an exclusive basis), influence over third parties, brand recognition and, crucially, access to scarce DTT capacity;
 - (b) BSkyB has very considerable, and unique, incentives to seek to become the sole provider of pay-TV services on the DTT platform; and
 - (c) the presence of BSkyB as a retailer of pay-TV channels on the DTT platform would act as a very material entry barrier for any potential third party considering making

the significant investments necessary to commence the supply of pay-TV services on the DTT platform.

- 3.35 These factors make it almost inevitable that if Ofcom were to consent to the Proposal, BSkyB would, within a short period, become the sole retailer of pay-TV services on the DTT platform.

Analysis of impact on inter-platform competition

- 3.36 If BSkyB were to become the sole provider of pay-TV on DTT, this would not only adversely affect competition on the DTT platform, it will also have a very material adverse impact on competition at all levels of the pay-TV landscape in the UK.
- 3.37 As set out in the Submission, BSkyB's existing competitors at all levels of the pay-TV supply chain suffer from a vicious circle brought about by the distinctive features of the pay-TV sector. This vicious circle has enabled BSkyB to secure leading or dominant positions at all levels of the supply chain and to deter new entry and expansion by the limited competitors that do exist.
- 3.38 As indicated above, the pay-TV industry has exhibited a tendency for concentration and "increasing dominance". BSkyB, with access to superior content, has been able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, achieve a leading position downstream. Further, market forces have been unable to offset this tendency. BSkyB's position has become entrenched because consumers have not subscribed (or switched) to new entrants in any material numbers. This is because new entrants face the handicap of having to compete for subscribers with inferior content and to compete for content with fewer subscribers.
- 3.39 Against this background, if BSkyB were to become the sole provider of pay-TV on the DTT platform which, for the reasons set out above, is likely if the Proposal were to be approved, it would further entrench the market position of BSkyB in the supply of pay-TV as a whole, and further enhance the vicious circle. In particular:
- (a) it would limit the constraint on BSkyB's DSat offering that the DTT platform might otherwise impose in the future (and, in particular, after DSO). This will give BSkyB even greater pricing and general decision-making freedom across its entire business, clearly impacting inter-platform competition;
 - (b) **[CONFIDENTIAL]**. This would:
 - (i) reduce (the admittedly limited) constraint imposed by those entities on BSkyB's existing retail proposition on the DSat platform;
 - (ii) **[CONFIDENTIAL]** one of the only entities (Setanta) that has been successful in the last few years in bidding against BSkyB for valuable premium sports rights (and, in particular, the rights to FAPL);
 - (iii) thereby increase BSkyB's purchasing power in relation to premium sports rights, and increase the likelihood of BSkyB continuing to hold the vast majority of attractive sports rights for the foreseeable future; and
 - (iv) leave Virgin Media as the only material retailer of premium sports content other than BSkyB, in circumstances in which Virgin Media's ability effectively to compete with BSkyB is removed due to the uneconomic terms on which BSkyB supplies that content to Virgin Media;
 - (c) it would increase BSkyB's pay-TV subscriber base, thereby allowing it to spread the cost of attractive content over an even larger number of subscribers. This will

increase further BSkyB's ability, relative to other bidders, to secure attractive premium content (whether sports, movies or basic content); and

- (d) it would substantially reduce the likelihood of other parties bidding for DTT capacity with the intention of launching a rival pay-TV service, to the long-term detriment of the prospects for competition.

3.40 In short, if Ofcom were to consent to the Proposal, and BSkyB became the sole supplier of pay-TV services on the DTT platform, this would materially strengthen BSkyB's position in relation to (i) the purchase of content and (ii) the retail supply of pay-TV across all platforms. This would strengthen the vicious circle already operating in BSkyB's favour to such a degree that it is difficult to see the circumstances in which it could ever be challenged (absent strong and direct regulatory intervention).

3.41 As well as harming other participants in the pay-TV industry, such an eventuality would clearly lead to consumer harm through higher prices, restricted choice and reduced innovation.

Benefits of the Proposal do not outweigh the detriments

3.42 Ofcom has identified one key potential benefit arising from the Proposal: the increase in choice for consumers on the DTT platform, i.e. greater choice in relation to sports, movie, childrens and factual content. In addition Ofcom notes that BSkyB may also contribute to innovation on the DTT platform. Whilst Virgin Media recognises that conceptual benefits exist, they are, at best, marginal and clearly do not outweigh the resulting detriment.

3.43 First, in the short term, Ofcom should be wary about assigning too much importance to the argued increase in consumer choice. The first factor to take into account is the diminution in viewer choice resulting from the removal of Sky News, Sky Sports News and Sky Three from Freeview. The second factor is that the vast majority of viewers in the UK could currently access the content in the proposed Picnic pack, either from Virgin Media (with the exception of Sky One), through BSkyB's existing satellite service or via Tiscali. Current industry estimates are that approximately two million homes are unable to receive digital satellite. However, Virgin Media considers that this overestimates the number of households that are currently unable to receive the channels proposed to be included in the Picnic proposition in two ways:

- (a) first, BSkyB's DSat platform provides 98% coverage of the UK⁶ which suggests that only 500,000 homes fall outside the DSat footprint.
- (b) second, those households that, whilst falling within the DSat footprint, are unable to access BSkyB's services, usually for planning and satellite consent reasons, tend to be in metropolitan locations where an alternative provider is, in the vast majority of cases, able to provide pay-TV including BSkyB's premium channels and the relevant basic channels (though with the exception of the BSkyB basic channels in the case of Virgin Media-only areas). Examples are the London Boroughs of Westminster and Hackney, where planning issues makes satellite installation difficult, but are today serviced by Virgin Media and, in some cases, Tiscali.

3.44 Accordingly, Virgin Media considers that the number of UK homes currently unable to access the Picnic channels is probably no more than one million. Further, the very limited number of homes unable to receive cable, IPTV or DSat services will nonetheless need to acquire a Picnic STB to receive these services unless Simulcrypt is mandated. In consequence, absent the Proposal, most viewers would still be able to obtain Picnic content if they choose to. In short, the Proposal does not offer products, services or choices that are not already widely available and is, instead, limited to offering a different

⁶ Ofcom *The Communications Market 2007* 23 August 2007, page 153.

means of receiving similar content over the DTT platform – though nonetheless requiring a TPS solution.

- 3.45 Second, given that BSkyB is likely, as a consequence of the Proposal to become the main or even sole provider of pay-TV services on the DTT platform, there is a real risk that this short-term increase in consumer choice will be short-lived. **[CONFIDENTIAL]**
- 3.46 Third, as indicated above, once BSkyB is the main or even sole provider of pay-TV services on the DTT platform it will have less incentive than other retailers to innovate and compete aggressively with pay-TV services on other platforms, in particular with BSkyB's DSat service.
- 3.47 Accordingly, even considering the DTT platform in isolation, in order to conclude that there is a net consumer benefit in terms of choice, Ofcom would have to conclude that the Picnic proposal would provide greater consumer choice in the medium to long term by providing an additional means of receiving a selection of pay-TV content available on, inter alia, the DSat platform than would otherwise be offered by Top Up TV, Setanta and the current free to air BSkyB channels.
- 3.48 In practice, however, for the reasons set out above, the adverse effect on competition of the Proposal will be felt outside the DTT platform and across the pay-TV industry as a whole. Accordingly, even if Ofcom were to conclude that the Picnic proposal provided consumer benefits for potential DTT viewers that outweighed **[CONFIDENTIAL]** the existing free to air BSkyB channels, Virgin Media does not consider that Ofcom would be acting rationally if it were to conclude that the relevant consumer benefit outweighed the potential adverse effects on the pay-TV industry as a whole.

4. **CONSIDERATION OF OFCOM'S OPTIONS**

4.1 In this section, Virgin Media addresses in turn:

- (a) why the only viable option that is open to Ofcom is not to consent to the Proposal;
- (b) whether, in the event that Ofcom did not adopt that course, there are conditions that might be attached to the Proposal which would satisfactorily address the potential detriments; and
- (c) finally, why it would be inappropriate for Ofcom to consent outright to the Proposal (i.e. on the basis that ex post regulation would be sufficient to regulate BSkyB's behaviour).

Ofcom should not to consent to the Proposal

4.2 There are a number of reasons why Ofcom should be extremely cautious in considering the Proposal:

- (a) the benefits of the Proposal are limited to current and potential DTT consumers (and may only be, at best, marginal and short term);
- (b) the detriments arising from the Proposal are potentially extremely severe and will affect the entire pay-TV industry (at all levels), and customers of all platforms;
- (c) as issues that are central to an assessment of the Proposal are also central to the Market Investigation, it will be difficult for Ofcom to reach a definitive position on the Proposal before it reaches a decision on the Market Investigation;
- (d) the future of the DTT platform is in a state of flux (and the pay-TV offer on DTT is still in its infancy). Accordingly, decisions taken now which alter the competitive balance have the potential to have very long term affects.

- 4.3 In light of the above, Virgin Media considers that the only reasonable course for Ofcom is not to consent to the Proposal (i.e. Ofcom Option 3). In the alternative, Ofcom should refuse to consent to the Proposal until, at least, Ofcom has completed its Market Investigation into the pay-TV industry.

Potential remedies

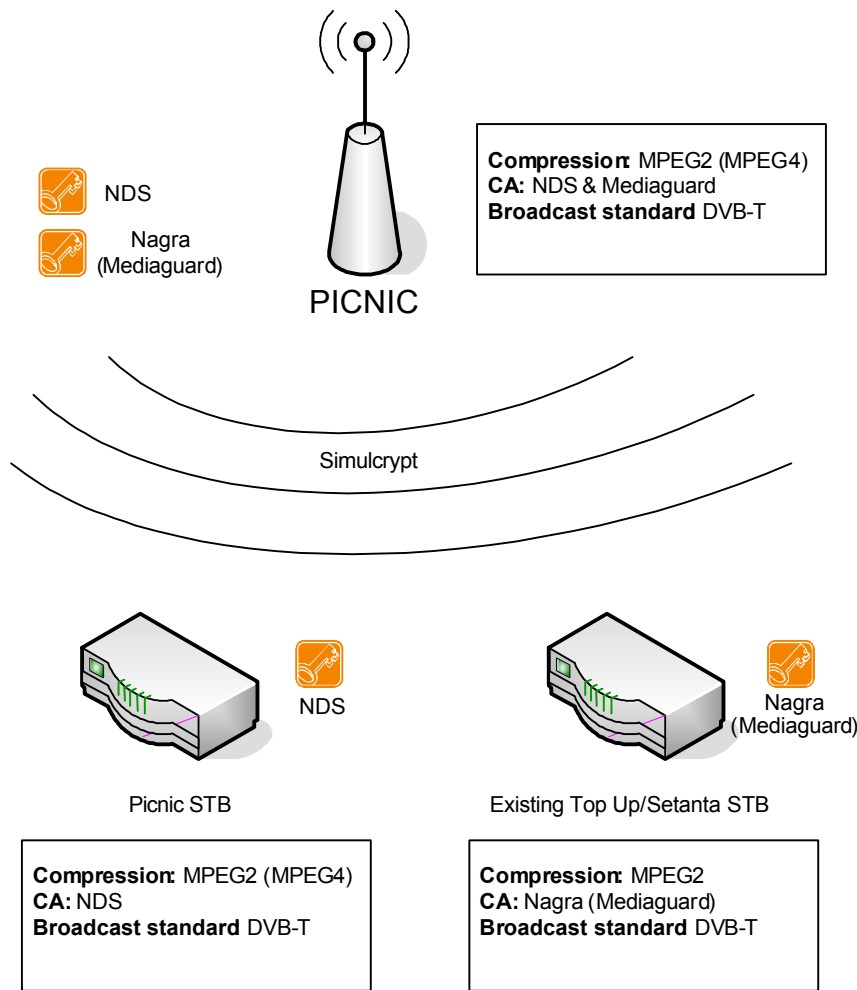
- 4.4 While Virgin Media considers that the only reasonable course for Ofcom is not to consent to the Proposal, it has considered carefully whether there are conditions that might be attached to the Proposal which could potentially satisfactorily address the potential detriment (i.e. Ofcom Option 2). Virgin Media has, therefore, considered in turn:
- (a) whether there are any conditions under which BSkyB might be permitted to retail the Picnic proposal on the DTT platform; and
 - (b) whether there are any conditions under which BSkyB might be permitted to wholesale the channels included in the Picnic proposal to other retailers on the DTT platform.

Remedies to allow BSkyB to retail Picnic

- 4.5 As set out in section 3, Virgin Media considers that if BSkyB were to be permitted to retail the Picnic proposition on the DTT platform, it would very soon become the sole supplier of pay-TV services on the DTT platform. This would have very grave consequences for both intra-platform competition and inter-platform competition. That outcome is likely to occur as a result of the fact that BSkyB already holds market power, or dominance at all levels of the pay-TV supply chain. In particular, BSkyB's existing scale, enormous financial and marketing resources, vertical integration (particularly access to superior content on an exclusive license basis), influence over third parties (manufacturers, third party content owners), brand recognition and access to scarce DTT capacity will confer on BSkyB an enormous advantage over existing DTT pay-TV retailers. In short, again as described in section 3, BSkyB has both the unique ability and unique incentive to leverage its market power and become the sole retailer of pay-TV on the DTT platform.
- 4.6 Theoretically, Ofcom might seek to insulate Picnic from the inherent advantages enjoyed by BSkyB, perhaps through some form of operational separation. It might be argued that such an approach would ensure that Picnic must stand alone from BSkyB, by for example:
- (a) preventing Picnic from using BSkyB's existing STB manufacturers;
 - (b) preventing Picnic from using BSkyB's existing relationships with third party content providers;
 - (c) preventing Picnic from utilising BSkyB's existing relationships with retailers;
 - (d) placing limits on Picnic's marketing expenditure;
 - (e) limiting the capital sum BSkyB might invest in Picnic;
 - (f) ensuring that Picnic's management is entirely independent of BSkyB; and
 - (g) ensuring that Picnic has entirely separate accounts.
- 4.7 All of these requirements (and very probably others) would be necessary to seek to ensure that Picnic did not benefit from the inherent advantages enjoyed by BSkyB that would otherwise cause BSkyB to become the sole retailer of pay-TV on the DTT platform. However, it is not clear whether a number of these requirements would be capable of practical implementation and, even if they could be, they would require a high level of ongoing monitoring by Ofcom.

- 4.8 In practice, however, Virgin Media considers that any such approach would be inherently flawed, as Picnic would still be an entity within the BSkyB Group, and BSkyB's incentives as regards the DTT platform would be unchanged. Experience suggests that it would be almost impossible to regulate BSkyB (and Picnic) against its commercial incentives in this way. Such is the prize on offer (i.e. becoming effectively the sole provider of pay-TV services on the two largest TV platforms and removing the competitive threat from a viable pay-TV retailer on DTT) that BSkyB can be expected to devise a myriad of ways in which to circumvent such regulation. Moreover, this approach would not address the detriment that would arise as a consequence of the fact that other DTT pay-TV retailers would not have access to content of equivalent value to subscribers.
- 4.9 One theoretical approach to address the concerns arising from access to content would be to impose a requirement on BSkyB to wholesale the relevant channels to other pay-TV retailers on the DTT platform. It might be argued that such a condition would protect the position of other retailers on the DTT platform by removing the upstream advantage enjoyed by BSkyB as a consequence of its ownership of highly attractive content.
- 4.10 Such a condition would certainly need to be combined with conditions relating to TPS (as envisaged by Ofcom) for otherwise, even if the Picnic channels were made available to Top Up TV and Setanta, they would not be capable of being viewed by existing DTT viewers. Virgin Media has identified three scenarios for the technical delivery of Picnic on DTT in circumstances in which BSkyB is obliged also to wholesale the channel to other pay-TV retailers:
- (a) Scenario 1: Current Picnic STB specification with BSkyB obligation to simulcrypt (i.e. BSkyB "Picnic spec" DTT STB with NDS CA but a simulcrypt broadcast method);
 - (b) Scenario 2: Picnic STB with dual CA (i.e. STB with dual CA: Nagra (Mediaguard); and NDS, with the broadcast stream NDS encrypted);
 - (c) Scenario 3: Picnic STB uses Nagra only (i.e. Picnic STB with Nagra CA and with the broadcast stream Nagra encrypted).
- 4.11 All of the above options are technically possible, but each raises issues which would need to be addressed before any implementation.

Scenario 1: Current Picnic STB specification with BSkyB obligation to simulcrypt

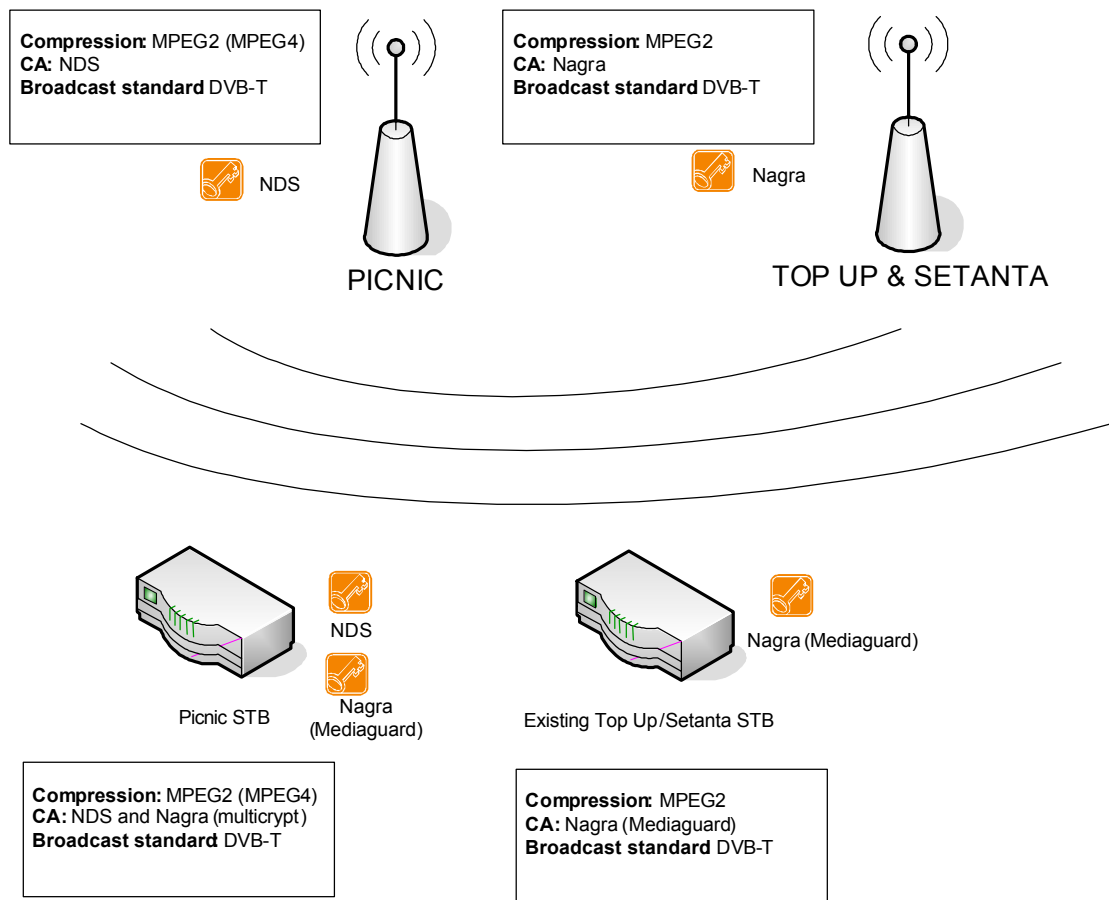


4.12 Simulcrypting the Picnic channels involves the broadcast of the Picnic content using multiple CA systems without the need to replicate each broadcast stream for each supported CA system. This would be a bandwidth-efficient way to allow existing Top Up TV and Setanta subscribers (with CA enabled STBs) to access Picnic content using their existing STBs (with Nagra Mediaguard CA systems), without the need for a replacement STB⁷. The main problems associated with this approach are as follows:

- (a) as recognised by Ofcom in the Consultation, a CA system is only as good as the least secure CA system in use. This is because the "key" to view the video stream is (clearly) possessed by any of the CA systems in the simulcrypt. A weakness in any one of the participating CA systems in the simulcrypt cluster will therefore compromise security of the video stream as a whole; and
- (b) BSkyB may need to seek permission from content rights holders in order to simulcrypt, and may also require extra equipment to play out Picnic content in both CA formats.

⁷ Note that existing Top Up and Setanta set top boxes would not be able to access Picnic services if Sky used MPEG4 in transmission, since their current set top box specification is MPEG2.

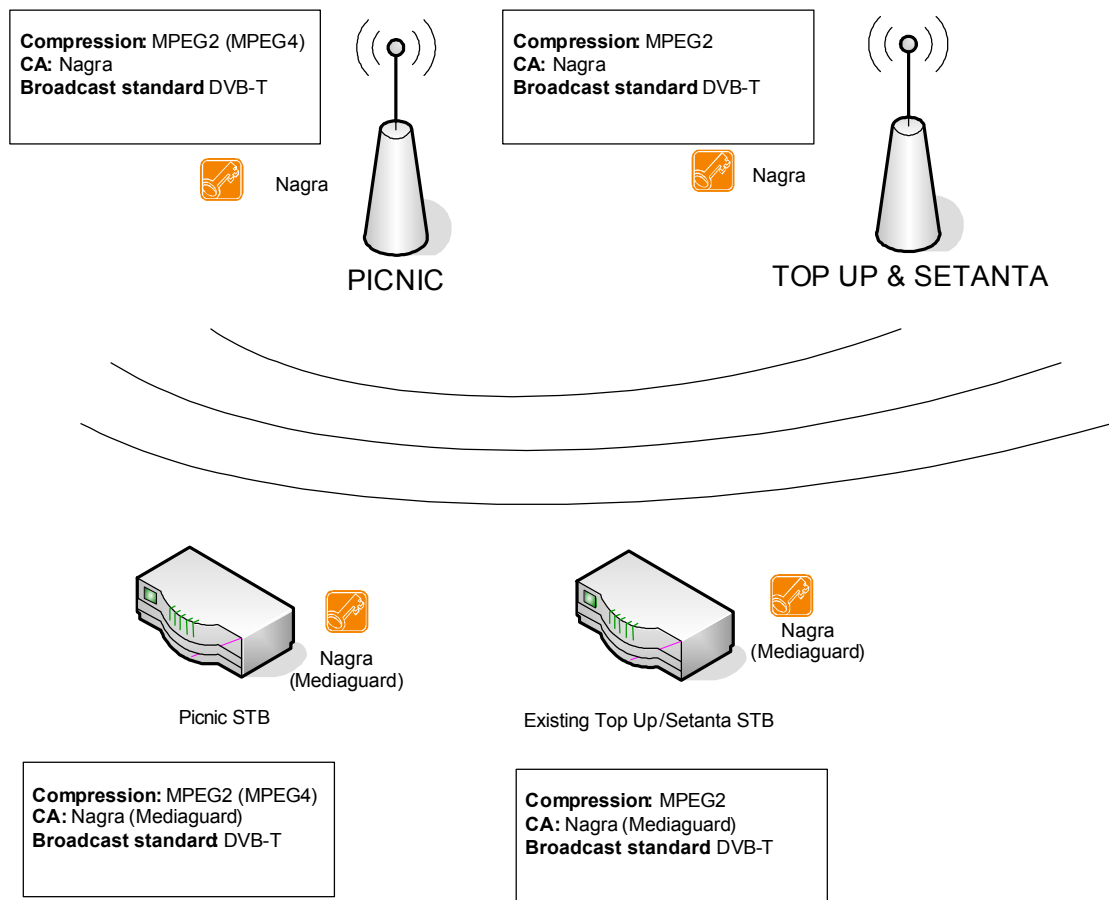
Scenario 2: Picnic STB with dual CA built in (multicrypt)



4.13 In this scenario, Picnic STBs would be equipped with two CA systems (NDS and Nagra), providing Picnic customers with the flexibility to access Picnic and/or Top Up/Setanta services. The main problems associated with this approach are as follows:

- (a) cost: implementing two CA modules on a single STB would be likely to be costly, even considering economies of scale;
- (b) complexity: ensuring that both CA systems work and do not conflict with each other would be a significant engineering challenge. Not all CA vendors necessarily support the use of "plug-in" CA, (i.e. Conditional Access Modules), and therefore could mandate that CA functionality be directly integrated into the STB electronics;
- (c) speed to market: development timescales are likely to be considerably longer for a multicrypt STB as opposed to a STB with a single CA system. This can mainly be attributed to increased test cycles as a result of increased complexity; and
- (d) perhaps the greatest problem associated with this approach is that as the Picnic channels would broadcast with NDS CA, only new multicrypt STBs would be able to receive Picnic content. In consequence, existing Top Up TV and Setanta customers would not be able to access Picnic transmissions since existing CA enabled STBs do not contain NDS CA technology.

Scenario 3: Picnic STB uses Nagra only



4.14 In this scenario, the Picnic channels would be broadcast with Nagra CA, allowing existing Top Up TV and Setanta customers to access Picnic content. The main problems associated with this approach are as follows:

- (a) such an approach would effectively [**CONFIDENTIAL**]; and
- (b) BSkyB may need to seek consent from content rights holders to use Nagra CA technology for DTT broadcasts.

4.15 In summary, whilst feasible, none of the technological solutions that would need to be implemented to facilitate a requirement on BSkyB to wholesale the Picnic channels to other retailers of pay-TV services on the DTT platform are straightforward and all raise practical difficulties of varying degrees.

4.16 Even assuming these technological difficulties could be overcome, the fundamental prerequisite for any wholesale arrangement in relation to Picnic channels is that the channels are made available by BSkyB on terms that are economically viable. In this respect, Virgin Media draws Ofcom's attention to the numerous difficulties faced by Virgin Media in securing content on viable economic terms from BSkyB. These are set out in detail in Annex 6 of the Submission but, in summary:

- (a) BSkyB's supplies premium channels to Virgin Media on the basis of a unilaterally imposed wholesale ratecard and there is no contractual commitment on BSkyB's behalf. Accordingly, Virgin Media has no contractual certainty in its relationship with BSkyB and this makes it very difficult to adopt any strategy beyond the short term in relation to retailing premium channels;

- (b) BSkyB's premium channels are wholesaled to Virgin Media at uneconomic rates. Given the wholesale rates charged by BSkyB for its premium channels, it makes no commercial sense for Virgin Media to compete aggressively with BSkyB on retail pricing in order to win additional premium channel viewers. This is because each customer to Virgin Media's largest package of basic channels that takes one or more premium channels generates a lower margin for Virgin Media than a similar customer not taking premium content;
 - (c) BSkyB refuses to supply enhanced and interactive services to Virgin Media resulting in a less attractive product than the equivalent BSkyB product on the DSat platform;
 - (d) BSkyB also refuses to supply HD channels to Virgin Media despite Virgin Media being technically able to provide HD channels; and
 - (e) BSkyB has constructively refused to supply its pay basic channels to Virgin Media by demanding an uneconomic price.
- 4.17 Accordingly, in contrast to the terms on which BSkyB supplies its premium channels to Virgin Media, any wholesaling remedy would need to offer sufficient margin and certainty to compete substantially with Picnic's retail prices and would need to offer the channels on an equivalent basis to that retailed by BSkyB. Further detail on what would be required for the economic wholesale supply of those Picnic channels is set out in paragraphs 4.24 to 4.25 below.
- 4.18 Again, however, Virgin Media does not consider that an obligation on BSkyB to wholesale the relevant channels, even if on economic terms and combined with workable TPS conditions, would remove the detriment arising from BSkyB being permitted to retail the Picnic proposition in the DTT platform. This is because:
- (a) first, it would address only the detriment arising from lack of access to attractive content and would not address the range of other advantages from which BSkyB benefits (including its existing scale, enormous financial resources, influence over third parties (e.g. STB manufacturers and retailers) and brand recognition). Even with access to BSkyB's content, these advantages [**CONFIDENTIAL**]; and
 - (b) it would do nothing to address the adverse impact on the pay-TV industry as a whole of BSkyB being able to expand its subscriber base through the DTT platform and the strengthening of the existing vicious circle that would result.
- 4.19 In conclusion, even if Ofcom were to impose some form of operational separation requirement on Picnic (assuming this was capable of being implemented), and required BSkyB to wholesale the Picnic channels to other DTT pay-TV retailers on economically viable terms, and subject to appropriate TPS conditions, Virgin Media still does not consider that this would be sufficient satisfactorily to address the competition concerns arising from the Proposal. In short, Virgin Media considers that there are no practical remedies that would address the very significant competition concerns that would arise in the event that BSkyB were permitted to retail the Picnic proposal on the DTT platform. Accordingly, as anticipated by Ofcom might be the case⁸, the risk and degree of harm arising from the Proposal to both intra-platform and inter-platform competition is sufficiently high that BSkyB should not be permitted to retail any pay-TV services on the DTT platform.
- 4.20 [**CONFIDENTIAL**]

⁸ See paragraph 5.30 of the Consultation.

BSkyB supplies Picnic channels on a wholesale basis

- 4.21 Assuming BSkyB is not permitted to retail the Picnic proposition on DTT, Virgin Media has considered whether it should be permitted to supply the relevant channels at wholesale to other DTT pay-TV retailers (i.e. on a wholesale only basis).
- 4.22 As a preliminary observation, Virgin Media considers that even the wholesale supply of the Picnic channels to DTT pay-TV providers will raise concerns by strengthening the position of BSkyB in the supply of pay-TV in the UK. This is because, on the largest digital platform in the UK, such wholesale supply may, particularly post DSO, be expected to generate considerable additional revenue for BSkyB that will, in turn, strengthen the ability of BSkyB to bid for and win attractive premium content rights. In other words, even this approach would tend to strengthen the existing vicious circle in favour of BSkyB.
- 4.23 If, however, Ofcom were to consider that the benefits of such an approach were to outweigh the adverse effect on competition across the pay-TV industry and were to permit such an arrangement, it would be necessary to ensure that the terms on which the channels were supplied did not distort inter-platform competition. This requires two conditions to be fulfilled: (i) that DTT retailers are not prevented from competing effectively with other platforms (and, in particular the DSat platform) in relation to the retailing of such channels and (ii) that the terms of the wholesale arrangement do not distort competition between other platforms (and, in particular, the cable platform) and the DTT platform.

DTT retailers not prevented from competing effectively

- 4.24 In order to ensure that DTT retailers are not prevented from competing effectively with the DSat service, it would be necessary to ensure that the channels are made available to DTT pay-TV retailers on terms that are economically viable and allow those retailers to compete effectively with BSkyB's DSat service. Accordingly, in contrast to the current terms on which BSkyB supplies its premium channels to Virgin Media (see paragraph 4.16 above and the Submission), any wholesaling remedy would need to:
- (a) offer DTT pay-TV retailers a sufficient margin to compete with BSkyB's DSat retail prices. Virgin Media considers it is imperative that the price at which content is made available to DTT pay-TV retailers actually presents an incentive for the retailer to compete profitably with BSkyB's DSat service for example, at the level of retailer commission;
 - (b) offer DTT pay-TV retailers the channels on an equivalent basis to that retailed by BSkyB on DSat including, for example, interactive services and HD channels. Where there are technological difficulties, BSkyB must be obliged to work with the retailer/platform operator in order to address any technical limitations in a timely fashion to enable efficient roll out of these services; and
 - (c) offer the DTT pay-TV retailer a sufficient certainty of supply in order to enable those retailers to plan and invest in long-term retail strategies. [**CONFIDENTIAL**]
- 4.25 While any wholesaling regime would need to address the above issues with clarity and certainty, Virgin Media recognises that it would be unrealistic for Ofcom to be expected to mandate the detailed terms of every wholesaling arrangement between BSkyB and third party retailers. Accordingly, Virgin Media envisages that any workable wholesaling regime would need to set out a viable managed framework under which BSkyB would fulfil its wholesale obligations. In order for this approach to be effective, the following guiding principles would be required:
- (a) first, BSkyB and DTT pay-TV retailers would be expected to negotiate and reach mutually agreed wholesale terms;

- (b) second, any negotiation must be entered into on a bi-lateral good faith basis. No progress will be capable of being made if BSkyB is permitted, as now, to present a unilaterally determined ratecard on a "take it or leave it basis";
- (c) third, parameters identifying the fundamental principles for a meaningful wholesale arrangement (along the lines set out at paragraph 4.24 above) would need to be set out. By way of example those parameters would need to specify an acceptable approach to margin, equivalence and certainty of supply. At this stage it is impossible for Virgin Media to speculate as to the precise detail of these "parameters" (e.g. as regards the appropriate margin) as they will be heavily dependent on the overall form of the wholesale arrangements and the resulting market structure; and
- (d) finally, and linked to the above point, the incentive for BSkyB to stall, prevaricate, and fail to reach agreement must be removed. This can be achieved by providing that if agreement is not reached within a defined period of time, the wholesale terms will be determined by an independent arbiter on the basis of the key parameters described above. The findings of the arbiter must be binding on each party.

4.26 It is worth noting that these principles are not novel. Principles similar to these have been enshrined by the 1996 Telecommunications Act in the US in relation to a specific telecommunications wholesaling regime. However, in order for these principles to work in the UK in relation to the wholesale of pay-TV content on DTT, considerable thought will need to go into the detailed mechanics of these principles and the specific dynamics of the UK pay-TV industry. While Virgin Media has not progressed its analysis of the detailed working of these principles, based on its extensive experience in acquiring wholesale content, Virgin Media considers that these broad principles are manifestly essential to an effective wholesaling regime for pay-TV content in the UK.

Competition between other platforms is not distorted

4.27 In order to ensure that a wholesaling arrangement does not distort competition between other platforms (and, in particular, the cable platform) and the DTT platform, it would be necessary to ensure that Virgin Media, as regards the cable platform, and any other potential retailer of the relevant BSkyB channels on any other platform, benefit from equivalent terms to those BSkyB is required to offer DTT pay-TV retailers. In this context, Virgin Media supports the observation of Ofcom (at paragraph 5.21 of the Consultation) that it would be necessary to consider the role of any wholesaling requirement across all pay-TV markets.

Ex post regulation is not viable

4.28 Finally, Virgin Media reiterates that it is not appropriate for Ofcom to consent to the Proposal unconditionally on the basis that competition concerns could be addressed under ex post competition powers (i.e. Ofcom Option 1). In this connection, this section first discusses why Virgin Media considers that ex post competition powers are not appropriate and second details the advantages of an ex ante approach.

Inappropriate to rely on ex post competition powers

4.29 It is inappropriate to rely on ex post competition powers to govern BSkyB's behaviour, specifically in relation to the Proposal, because ex post regulation:

- (a) has, to date, failed to ensure a competitive pay-TV industry;
- (b) takes a long time to reach conclusion;
- (c) is costly for all parties;

- (d) has not afforded any real degree of certainty for all players in the market; and
- (e) in general, is not designed to promote sustainable entry and competition against an incumbent dominant provider.

Each of these concerns are considered below.

- 4.30 First, ex post competition powers have shown themselves to be entirely ineffective in controlling the pay-TV industry in the UK. Despite Articles 81 and 82 of the EC Treaty, and the equivalent powers of the Competition Act 1998, BSkyB has been able, over the last decade, to create and entrench leading and dominant positions across the pay-TV industry.
- 4.31 Second, as Ofcom will be aware, investigations under ex post competition powers can be very lengthy (even before any appeal of any decision). By way of example:
- (a) the OFT's investigation of BSkyB under the Chapter II prohibition of the Competition Act took nearly three years to conclude (March 2000 to December 2002), excluding applications from third parties to the OFT to vary its final decision; and
 - (b) in relation to the ongoing BSkyB/Virgin Media carriage issues litigation, the dispute arose in September 2006 and the trial is not scheduled to start until February 2009 (and then in respect of liability issues only, with any hearing on the quantum of any resulting damages to be heard at a later date), i.e. two and a half years to resolve, excluding any appeal.
- 4.32 In this respect, in fast moving markets, such as TV broadcasting, the delay in reaching a decision under ex post competition powers will prevent such powers being either an effective deterrent or an appropriate means of obtaining satisfactory redress.
- 4.33 Third, the length of proceedings adds to the total cost to the complainant (both the management time and external advisor fees incurred, and the cost of the alleged anti-competitive practice continuing until the conclusion of proceedings). It can also add to the total cost to the company complained about (management time and external advisor fees). This is true of many types of private actions and regulatory investigations, however it is particularly acute in competition cases because of the factual and economic complexities involved, including the importance of detailed, fact-based, economic analysis.
- 4.34 Fourth, ex post regulation can create uncertainty for firms in a market, i.e. both firms with market power and their competitors, suppliers and customers. In this respect, it can be very difficult for market participants to judge the line between aggressively competitive behaviour and anti-competitive use of market power. Potential complainants can be discouraged from complaining or issuing private actions in relation to conduct because of the large cost, lengthy time frame and difficulties in gathering suitable factual evidence to support their case (this evidence is often held by the firm with market power (i.e. margin/costs breakdown data)).
- 4.35 Fifth and lastly, where a decision not to engage in ex ante regulation has enabled a provider to achieve market power at various levels of the supply chain, such as BSkyB in pay-TV, ex post regulation will not be able to reverse that position. That is because ex post regulation typically seeks to regulate the behaviour of the incumbent but cannot create the incentives for expansion and entry that would have existed prior to the incumbent achieving market power. In short, history has shown that ex post regulation has not been successful in encouraging competition to a dominant incumbent.

Advantages of ex ante

4.36 It is worth noting that there can be some very real advantages to adopting an ex ante approach to regulating a market. The following advantages are particularly relevant to the pay-TV industry and the Proposal specifically:

- (a) ex ante regulation can provide certainty and transparency for participants by setting out clear rules in advance. Market participants are then able to concentrate of healthy competition and innovation to the benefit of consumers;
- (b) anti-competitive harm can be actively prevented, which is particularly important for new and smaller pay-TV providers such as Top Up TV and Setanta. In contrast, harm is generally only ameliorated through the use of ex post competition powers; and
- (c) dispute resolution can be streamlined and fast-tracked, avoiding lengthy, costly and complex investigations and legal actions.

Conclusion on Options

4.37 For the reasons set out above, the only reasonable and proportionate option for Ofcom is not to consent to the Proposal.

4.38 If Ofcom does consent to the Proposal subject to satisfactory conditions, the only conditions under which intra-platform and inter-platform competition might not be materially distorted are:

- (a) BSkyB must not be permitted to retail the Picnic proposition on DTT;
- (b) If BSkyB is permitted to supply a pay-TV service on DTT on a wholesale basis (i.e. on a wholesale basis only) the following broad conditions must be imposed:
 - (i) the channels must be made available to DTT pay-TV retailers on terms that are economically viable and allow those retailers to compete effectively with the terms on which BSkyB offers those channels on the DSat platform. In other words, any wholesaling remedy would need to offer the DTT pay-TV retailer sufficient margin to compete with BSkyB's retail prices and would need to offer the channels on an equivalent basis to that retailed by BSkyB; and
 - (ii) in order to ensure that a wholesaling arrangement does not distort competition between other platforms (and, in particular, the cable platform) and the DTT platform, it would be necessary to ensure that Virgin Media, as regards the cable platform, and any other potential retailer of the relevant BSkyB channels on any other platform, benefit from equivalent terms to those BSkyB is required to offer to DTT pay-TV retailers.

ANNEX 1

OBSERVATIONS ON MARKET DEFINITION

Introduction

1. Virgin Media notes that Ofcom has not, at this stage, been able to carry out a detailed market definition exercise and that it considers that it may not, ultimately, be necessary to reach final conclusions on market definition. Nevertheless, Virgin Media sets out below some preliminary observations on the alternative approaches to market definition highlighted by Ofcom in the Consultation in relation to retail service provision and supply at the wholesale level.

Retail Service Provision

2. Ofcom has identified four alternative possible markets/sets of retail markets against which to assess the proposal. They are: (i) all TV; (ii) all pay-TV; (iii) premium and basic pay-TV markets; and (iv) DTT specific markets.
3. As a preliminary observation Virgin Media would emphasise that market definition should be considered in the context of the competition issues that are being addressed, with the consequence that different approaches to market definition can be appropriate in different competition contexts. Against that background, Virgin Media considers that in addressing the Proposal, a market for the retail provision of all free to air ("**FTA**") and pay-TV channels across all TV platforms is too broad.
4. In practice, without addressing the subject of market definition in detail, Virgin Media considers that, in considering the Proposal, the relevant market should be considered to be no wider than all pay-TV (i.e. a market for the retail provision of all pay-TV channels across all platforms). This is for the following reasons:
 - (a) the existence of FTA TV does not provide a sufficient competitive constraint on pay-TV operators and, in particular, on BSkyB so as to form the part of the relevant market for the purposes of the hypothetical monopolist test ("**SSNIP test**"). The very fact that large numbers of households (in excess of 11 million) are prepared to pay significant monthly subscriptions, when the multi-channel offers of FTA operators are available to many of them at little or no cost, is itself strongly indicative of the fact that two types of TV are not effective substitutes and are in separate economic markets. In particular, although Freeview has experienced rapid growth from 2003 to the fourth quarter of 2007:
 - (i) the rate of growth and subscription to BSkyB (and by Virgin Media, or its predecessor companies), has remained approximately the same over that period;
 - (ii) the Average Revenue Per User ("**ARPU**") achieved by BSkyB (and by Virgin Media or its predecessor companies), has remained stable, if not slightly increased over the period;
 - (iii) BSkyB has not reduced the price of even its cheapest basic pay-TV offering over that period;
 - (b) it is clear that a separate pay-TV retail market is consistent with settled precedent. The existence of a separate pay-TV retail market (as distinct from FTA TV market and hence from a "multi-channel TV retail market") has consistently been recognised by competition authorities and courts in the European Union. In particular, the European Commission has consistently identified a separate pay-TV market in European countries, inter alia, in:

- (i) Decision IV/36.539 British Interactive Broadcasting / Open (in the United Kingdom);
 - (ii) Decision COMP/M.2786 Newscorp / Telepiù (02/04/2003) (in Italy);
 - (iii) Decision COMP/M.4519 Lagardère / Sportive (18/01/2007); and
 - (iv) Decision COMP/M.4547 KKR / Permira / Prosiebensat.1 (22/02/2007) (in Germany);
- (c) the French courts and competition authorities have also consistently identified a separate pay-TV market, inter alia, in:
- (i) Opinion of the Conseil supérieur de l'Audiovisuel relating to the request for an opinion from the Competition Council concerning the taking of exclusive control of TPS and Canal Satellite by Vivendi Universal / Groupe Canal + (23/05/2006);
 - (ii) Opinion no. 06-A-13 of the Conseil de la concurrence relating to the purchase of the companies TPS and CanalSatellite by Vivendi Universal and Groupe Canal Plus (13/07/2006);
 - (iii) Judgment no. 05-D-13 of the Conseil de la concurrence relating to practices implemented by the Canal Plus group in the pay TV sector (18/03/2005);
- (d) the Spanish courts and competition authorities have also consistently identified a separate pay-TV market, inter alia in:
- (i) Decision C74/02 Sogecable / Via Digital (Tribunal de Defensa de la Competencia, 13/11/2002);
 - (ii) Decision C102/06 Sogecable / AVS (Tribunal de Defensa de la Competencia, 26/02/2007);
- (e) the Italian courts and competition authorities have also consistently identified a separate pay-TV market, inter alia, in RTI and others v. Sky and others (L'autorità garante della concorrenza e del mercato, 28/06/2006); and
- (f) the German courts and competition authorities have also consistently identified a separate pay-TV market, inter alia, in Takeover of Premiere's Digital Playout Center by SES Astra (Bundeskartellamt, 30/12/2004).
5. For the reasons given above, Virgin Media considers that the relevant market against which to assess the proposal is no wider than all pay-TV.
6. The only recent case of which Virgin Media is aware in which a wider approach to market definition has been adopted is the CC investigation of BSkyB's acquisition of a 17.9 per cent stake in ITV. The circumstances in that case were, however, unusual. On the one hand BSkyB is the largest pay-TV operator by a substantial margin, whose dominant position in the market for the retail supply of pay-TV is reinforced by its position as the largest wholesaler and purchaser of pay-TV channels and its position in purchasing sport and movie content rights. On the other hand, ITV is the largest commercial FTA broadcaster and has made a major contribution to the success of Freeview.
7. Given BSkyB's dominance in pay-TV markets (including viewing, wholesale channel supply and procurement) and in circumstances where existing pay-TV providers are unable to provide an effective competitive constraint on BSkyB, it becomes increasingly important to preserve whatever limited competition remains in the market. In this regard, Virgin Media agrees with the CC that FTA services do pose a constraint on BSkyB's offer. It was,

therefore, extremely important for the CC to consider the effects of the transaction on the TV sector as a whole as only by doing so would the CC capture the full extent of the reduction in strategic rivalry that would arise from the transaction.

8. Nevertheless, Virgin Media does not consider that the constraints between pay-TV and FTA TV are sufficiently strong for pay-TV and FTA TV to be considered to be in the same economic market. Whilst FTA may act as a constraint on pay-TV prices, the constraint is only likely to be effective once prices have already been raised above the competitive level. Whilst it is important not to ignore such a constraint (particularly in a context where the key issue is preserving what little competition exists), it is not appropriate for the purpose of defining a relevant market based on economic principles. This was the view of the Director General of Fair Trading in the BSkyB Chapter II Prohibition decision⁹, i.e. that whilst FTA channels constrain the prices of pay-TV packages *"to some extent"*, this was not sufficient to prevent the prices of *"packages containing unique to premium pay TV channels"* being raised above competitive levels.
9. In this regard Virgin Media agrees with Ofcom's observation that the CC's Provisional Findings do not elaborate on the nature or the extent of the constraint posed by FTA on BSkyB's offer.
10. In summary, Virgin Media considers that the approach adopted by the CC in assessing market definition for the purposes of its investigation of BSkyB's acquisition of a stake in ITV is a clear example of the approach to market definition being determined by the specific circumstances being considered. Virgin Media does not consider that, even if Ofcom ultimately considers it necessary to define the relevant markets, that it would be appropriate to conclude that there is an economically justified market for the retail provision of all FTA and pay-TV channels across all pay-TV platforms.
11. While Virgin Media considers that the relevant market against which to assess the proposal is no wider than all pay-TV, on full consideration of the appropriate principles for defining relevant markets, it is likely the relevant markets are narrower. In previous investigations, the UK and EU competition authorities have identified premium pay-TV services (and, in particular, high quality sports and movies) as being the driver of subscription to pay-TV. For example:
 - (a) in its Review of BSkyB's position in the wholesale pay-TV market in December 1996, the OFT found that *"premium sports and movie channels were the main drivers of subscription to pay-TV"*¹⁰;
 - (b) in its Decision on Bertelsmann/Kirch/Premiere in 1998 the European Commission stated that: *"Access to programme rights is even more important in the case of pay TV than it is in the case of free TV since, in order to entice the consumer to subscribe or to take particular productions on a pay per view basis, certain specific types of content are required. Experience of pay-TV in Europe so far shows that in order to be sufficiently attractive, a pay-TV bouquet must include a combination of premium rights for the first broadcast of films produced at the major Hollywood studios and for popular sporting events"*¹¹;
 - (c) in its Decision in respect of TPS in 1999, the European Commission noted that: *"It is universally acknowledged that films and sporting events are the two most popular pay-TV products. It is necessary to have the corresponding rights in order*

⁹ Decision of the Director General of Fair Trading, Case No. CA98/20/2002, BSkyB Investigation: Alleged Infringement of the Chapter II Prohibition – 17 December 2002.

¹⁰ See paragraph 1.4 of the 1996 Review.

¹¹ See paragraph 48 of Commission Decision of 27 May 1998 in Case No IV/M.993 Bertelsmann/Kirch/Premiere. [1999] OJ L 53/1.

to put together programmes that are sufficiently attractive to persuade potential subscribers to pay for receiving television services"¹²;

- (d) in its Decision in respect of British Interactive Broadcasting in 1999, the European Commission stated that: *"experience has shown that, to be successful as a pay television operator, it is essential to include film and sports channels as part of the service. BSkyB itself identified "movies and sports as key sales drivers".*"¹³ The Commission also noted that premium film and sports channels: *"are the basics around which other channels can be offered to subscribers"*¹⁴;
- (e) in its Report on NTL/Cable & Wireless Communications, the CC noted that televised sports, especially football, are a key driver of demand for pay-TV services.¹⁵ In addition, the CC recognised that premium movies are a key driver and an important value component of pay-TV¹⁶; and
- (f) in its Decision on BSkyB/Kirch, the European Commission noted that: *"It is universally accepted that films and sporting events are the two most popular pay-TV products. It has been acknowledged by the Commission in a previous decision that it is necessary to have the corresponding rights in order to put together programmes that are sufficiently attractive to persuade potential subscribers to pay for receiving television services. Films and sport are therefore pay-TV's drivers."*¹⁷
12. The value of premium channels in driving subscription reflects the value attributed to those channels by subscribers. In this regard, basic channels are not generally considered by subscribers to be substitutes for premium channels. Accordingly, Virgin Media considers that there are very likely to be separate markets for the retail provision of premium pay-TV and the retail provision of basic pay-TV.
13. Further, on the basis of a proper economic analysis, there is also likely to be narrower markets within the premium segment for each of premium sport and premium movies. In this respect, although the "buy through" relationship between basic and premium pay-TV does not exclude, in principle, the ability of basic pay-TV channels to constrain premium channel pricing to some extent, however, premium prices are unlikely to be constrained to competitive levels (i.e. basic pay-TV prices are unlikely to constrain premium pay-TV prices from rising between 5 and 10 per cent above the competitive level). To this end, in its investigation into alleged infringements by BSkyB of the Chapter II Prohibition¹⁸, the Director General of Fair Trading concluded that there were relevant retail markets for the supply of channels containing sports content that was unique to pay-TV (which he identified as being live FAPL football) and, separately, the retail provision of packages containing premium film channels as defined by first run category A and category B films shown in the pay-TV window. Although, as Ofcom recognises there have been minor changes in the structure of the market and, in particular, the introduction of a remedy as regards the sale of FAPL rights, Virgin Media does not consider that the relevant changes impact materially on the approach to market definition.

¹² See paragraph 34 of Commission Decision of 3 March 1999 in Case No IV/36.237 TPS. [1999] OJ L 90/6.

¹³ See paragraph 28 of Commission Decision of 15 September 1999 in case IV/36.539 British Interactive Broadcasting/Open.

¹⁴ See paragraph 28 of Commission Decision of 15 September 1999 in case IV/36.539 British Interactive Broadcasting/Open.

¹⁵ See paragraph 1 of Appendix 4.4 of the Competition Commission's report on the proposed acquisition by NTL Incorporated of the cable business of Cable and Wireless Communications plc, March 2000.

¹⁶ See paragraph 1 of Appendix 4.5 of the Competition Commission's report on the proposed acquisition by NTL Incorporated of the cable business of Cable and Wireless Communications plc, March 2000.

¹⁷ See paragraph 42 of Commission Decision of 21 March 2000 in Case No COMP/JV.37 BSkyB/KirchPayTV.

¹⁸ Decision of the Director General of Fair Trading, Case No. CA98/20/2002, BSkyB Investigation: Alleged Infringement of the Chapter II Prohibition – 17 December 2002.

14. Finally, for the reasons set out by Ofcom, Virgin Media does not consider that it would be appropriate to define relevant retail markets by relevant DTT specific markets.
15. In summary, as regards retail service provision, Virgin Media considers that the relevant market against which to assess the proposal is certainly no wider than all pay-TV. In practice, however, on the basis of a proper economic analysis, there is very likely to be separate markets for the retail provision of (i) premium pay-TV sports channels, (ii) premium pay-TV movie channels and (iii) basic pay-TV channels.

Wholesale Layers

Wholesale channel provision

16. As wholesale demand is derived from retail/consumer demand, the relevant wholesale markets are likely to follow very closely the relevant retail markets. Accordingly, Virgin Media considers that the relevant market could be no wider than a market for the wholesale provision of all pay-TV channels across all platforms. In practice, however, Virgin Media considers it likely that there are economically separate markets for the wholesale provision of, separately, premium and basic pay-TV channels across all platforms and that it is also likely that there are narrower wholesale markets within the premium segment for each of premium sport and premium movies.
17. In this regard Virgin Media would note that in its 2002 investigation the Director General of Fair Trading concluded that there was a relevant market for the wholesale supply of channels containing sports content that is unique to pay-TV (in that case limited to live FAPL football) and a separate relevant market in relation to the wholesale supply of premium film channels, characterised by first run category A and category B films shown on the pay-TV window. In this context, Virgin Media agrees with the observation of Ofcom that whilst the FAPL remedy introduced in 2006 is of some relevance to market power assessment (albeit Virgin Media considers its relevance to be very limited), it has no material impact on market definition.

Wholesale provision of technical platform services

18. Virgin Media has considered the question of market definition (and market power) as regards the wholesale provision of retail carriage and open access services (using TPS) as part of its contribution to Ofcom's review of wholesale digital TV broadcasting platforms.
19. Virgin Media considers that it operates as a platform provider in a wholesale market which includes the satellite platform, but that access to retail carriage and open access services on BSkyB's DSat satellite platform should be treated as a separate relevant market in relation to which BSkyB has significant market power.
20. This view is based on the asymmetric position of the cable platform and BSkyB's DSat satellite platform, and their relative commercial importance to channel providers. In particular, a basic pay-TV channel which is only distributed on BSkyB's DSat platform could not viably switch to being distributed only on the cable platform because it would not be able to generate adequate subscription and advertising revenues given the cable platform's much smaller subscriber base. Access to the BSkyB subscriber base is an absolute necessity for providers of basic pay channels in order to be commercially viable. As a consequence, BSkyB's ability to price is not constrained by the ability of basic channel providers to switch to alternative platforms.
21. Equally, BSkyB is not constrained by the ability of basic channel providers to switch between retail carriage and open access arrangements with BSkyB. Purchasing open

access services from BSkyB (i.e. selling basic channels direct to consumers in competition with BSkyB) is wholly uneconomic¹⁹.

22. In contrast, channel providers can readily switch from being distributed only on the cable platform to the satellite platform thereby gaining access to the large subscriber base outlined above. Accordingly, Virgin Media is constrained in its ability to profitably reduce carriage fees on the cable platform by the ability of channel providers to "walk away" to the satellite platform and remain viable.
23. As regards the comment in paragraph 3.40 of the consultation that "*the limited nature of close substitutes could mean that there are relatively narrow markets for the provision of TPS services*", Virgin Media considers that, whilst this is certainly the case as regards the satellite platforms, it is not the case for cable where satellite provides a very close substitute and thereby exerts a strong competitive constraint on Virgin Media.
24. Finally, as regards the cable platform, Virgin Media agrees with Ofcom's observation (at paragraph 3.40) that:

"the competitive conditions for the provision of TPS are likely to be strongly influenced by the nature of competition in the relevant wholesale channel and retail content markets and these "indirect constraints" could have a bearing on market definition".
25. Virgin Media's negotiating power with channel providers is very materially tempered by competition between pay-TV providers at the retail level. In particular, as a result of intense competition with BSkyB and other digital pay-TV providers, and to some extent with Freeview, at the retail level, Virgin Media is compelled to carry those channels which are valued by current and potential subscribers. This constrains its ability to exercise any buyer power in its negotiations with channel providers.

¹⁹ The reasons for this are set out in detail in Virgin Media's submission to Ofcom of 5 February entitled "Submission of ntl:Telewest to Ofcom in connection with Ofcom's review of wholesale digital television broadcasting platforms". In short, open access arrangements on DSat are considered to be uneconomic for basic channel providers because of (i) the adverse impact on advertising revenues of a materially reduced subscriber base (ii) the impossibility of compiling a critical mass of basic channels due to BSkyB's staggered channel carriage arrangements (iii) BSkyB's ability to enforce "buy through" of its basic package(s) to access its premium content (iv) the huge costs of marketing and selling a competitive channel package and (v) the level of BSkyB's TPS charges.