

**NON-CONFIDENTIAL VERSION**



**OFCOM'S PAY TV MARKET INVESTIGATION :**

**BT GROUP PLC SUBMISSION ON WHY A REFERENCE TO  
THE COMPETITION COMMISSION IS FULLY JUSTIFIED**

**6 August 2008**

## A. Introduction and summary

The purpose of the present BT Group plc ('BT') submission is to explain in brief why, in the view of BT Group plc ('BT'), a market investigation reference of pay TV to the Competition Commission ('CC') is fully justified.

The present submission will seek, wherever practicable, to avoid repetition of points made in previous BT individual or joint submissions to Ofcom.

BT's view, that a reference of pay TV to the CC is fully justified, is based on :

- the guidelines set out in the OFT's 2006 Guidance on Market Investigation references (the "OFT Guidance");
- relevant case-law, in particular, the CAT's judgment in the *Association of Convenience Stores* case<sup>1</sup>;
- precedent market investigation references, in particular by a sectoral regulator, the ORR;
- Government policy, as set out in the Government's response to the recent House of Lords Regulators Committee report.

BT would wish to emphasise, in particular, the following points :

### Legal obligations on Ofcom

Whilst Ofcom has a discretion to refer pay TV to the CC, the CAT has pointed out that this discretion must be "exercised according to law" :

- Ofcom is required to make a decision on whether to refer within a 'reasonable' time. Ofcom has already spent more than 16 months on its preliminary investigation. The CAT recently held that a period of approximately 16 months to decide on whether to refer was not 'reasonable'. Also, it is questionable whether it would be in line with the legislative intent of the Enterprise Act if an Ofcom investigation, to determine whether an in-depth 2-year investigation by the CC would be appropriate, itself takes around two years.
- The OFT Guidance clearly states that it would be 'inappropriate' for it to engage in extensive research when deciding whether or not to make a CC reference.
- The fact that Ofcom is a sectoral regulator, with specialized industry knowledge and sectoral powers, does not justify departing from the OFT Guidance. As Ofcom will be aware, the OFT Guidance also applies to the sectoral regulators, including Ofcom<sup>2</sup>. Any departure from the OFT Guidance would be inappropriate and inconsistent with established practice of the OFT the one referral decision made to date by a sectoral regulator, the Office of the Rail Regulator ('ORR').

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<sup>1</sup> Competition Appeal Tribunal, "The Association of Convenience Stores v The Office of Fair Trading" (2005); Case No: 1052/6/1/05.

<sup>2</sup> OFT Guidance, para. 1.2.

## Evidence of competition problems

BT, in its previous individual and joint submissions, has outlined a number of significant competition concerns in pay TV and has provided evidence to support its arguments. The range of competition problems that have been identified can not, in BT's view, adequately be addressed on the basis of Art 82/Chapter II or on the basis of Ofcom's regulatory powers.

One of the competition concerns, that was identified in Ofcom's December 2007 Condoc, is the possible leveraging of upstream market power into retail markets. In this regard, the Condoc focuses particular attention on whether Sky has sufficient incentives to supply its wholesale content to retail competitors. The evidence already available to Ofcom clearly indicates that there are very real concerns about this issue, that would warrant further investigation by the CC. In particular, in addition to the points already made in previous BT submissions, Sky's submissions to Ofcom show that :

- Sky has provided Ofcom with contradictory evidence of relevance to its incentives to supply retail rivals (in particular, relating to the question of switching costs);
- The academic analysis Sky selectively relies on (the Harbord and Ottaviani paper) to claim that it has incentives to supply retail rivals actually highlights the need for regulatory intervention to address the competition problems;
- The financial analysis Sky relies on (its 'vertical arithmetic' exercise) actually indicates that Sky is already foreclosing retail rivals.

This particular competition issue (which is one of many raised by BT), regarding incentives to supply, is not simply a narrow Art 82/Chapter II issue, as it also raises the wider question of the incentives of *any* operator in Sky's position to supply content to retail rivals – the evidence is indicative of problems with the structure of competition in pay TV.

Furthermore, the Condoc (at para. 6.71) makes the point about possible incentives not to supply newer platforms (such as IPTV) with lower switching barriers. The lack of incentives to supply is NOT simply because these are new entrants. It is because of the relatively low barriers to switching; also, these operators may challenge the rent extraction models of Sky. Furthermore, uncertainty about the future development of these new platforms may also reduce Sky's incentives to supply.

It is noteworthy that Sky's response to the Condoc seeks to make tangential arguments about dynamic foreclosure and the *Microsoft* case, but ignores the more direct and clear-cut concern arising from a straightforward analysis of trade-offs for supply/non-supply.

## Consumer harm

In its Condoc, Ofcom specifies a number of criteria against which it will judge whether pay TV is functioning effectively for consumers. The first of these identified criteria is 'choice of platform and content'. It is immediately apparent that Sky's lack of incentives to supply its content to rival retail operators results in a material

reduction of consumer choice. This leveraging of Sky's upstream market power into retail pay TV is also likely to give rise to retail prices above the competitive level.

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Section B below comments on the legal parameters relating to the nature and extent of the investigatory role for the OFT/Ofcom in the market investigation process.

Section C below explains that a reference of pay TV to the CC is fully justified, in BT's view, on the basis of the criteria set out in Chapters 4-6 of the OFT Guidance for identifying whether there are reasonable grounds for suspecting that competition is being prevented, restricted or distorted.

Section D below explains that, in BT's view, a reference to the CC is fully justified, by reference to the criteria set out in Chapter 2 of the OFT Guidance for the appropriateness of a CC reference, given the scale of the identified competition issues and the significance of pay TV; the fact that these issues cannot adequately be addressed under the Competition Act or sectoral regulation and that appropriate remedies would be available to the CC.

## **B. The nature and extent of investigation required at OFT/Ofcom level**

1. The evidential threshold, of 'reasonable grounds to suspect' prevention, restriction or distortion of competition

The OFT Guidance states that, whilst it will carry out an appropriate competition assessment, it :

“is not required to reach firm conclusions before making references *and it would be inappropriate for it to engage in extensive research*. Provided it has reasonable grounds for suspecting that there are market features that adversely affect competition, the reference test has been met and further investigation can be left to the Competition Commission.” (emphasis added; para. 4.7)

Thus, for example, in its paper setting out its reasons for the BAA reference, the OFT stated :

“We recognise that our preliminary analysis has not reached firm views on these matters, but consider the analysis appropriate for the first phase and look forward to the outcome of the Competition Commission's investigation of these significant issues.” (para. 1.15; [http://www.ofcom.gov.uk/shared\\_ofcom/reports/transport/of912ex.pdf](http://www.ofcom.gov.uk/shared_ofcom/reports/transport/of912ex.pdf))

Whilst Ofcom might consider that it has a specialist sectoral role and expertise that should be utilised, this must be considered within the statutory framework of the market investigation process.

In this regard, the April 2007 market investigation reference of the leasing of rolling stock to the CC by the Office of the Rail Regulator (“ORR”) provides a very important precedent. This was the first and, to date, only market investigation reference to the CC under the Enterprise Act by a sectoral regulator. This ORR reference is significant, as it sets out what BT considers to be important principles for determining the circumstances in which it is appropriate for a sectoral regulator to make a market investigation reference to the CC.

The ORR emphasised that, whilst it had carried out a thorough analysis, its role was not to reach definitive views on the relevant issues (para. 5.28). In particular, it cited the CAT in the *Association of Convenience Stores* case :

“There is, if we may say so, some risk that one may mistake the height of the hurdle...It is a ‘reasonable ground to suspect’ test. The scheme of the Act is that a full investigation is carried out at the stage of the Competition Commission” (para. 5.28)

Furthermore, in response to arguments by affected parties that, as the ORR was the specialist sectoral regulator and therefore would be better placed to address the relevant issues, the ORR stated :

“A more detailed examination of the relevant issues would, in our view, be necessary in order to give robust recommendations on changes to the franchise system to introduce more competition into the leasing of rolling stock. The Competition Commission is a specialist second stage investigatory body and so is best placed to carry out a detailed investigation of this sort. Moreover, our sectoral expertise will be available to the Competition Commission during the course of its investigation.”

Further, whilst the Competition Commission has powers to impose behavioural remedies we can only take undertakings that have been offered voluntarily.” (paras. 37, 38; <http://www.rail-reg.gov.uk/upload/pdf/325.pdf>)

In BT’s view, Ofcom’s approach to determining whether to refer pay TV to the CC for a market investigation should not be inconsistent with the above-outlined legal principles.

## 2. Duration of the first-stage investigation by Ofcom

The CAT, in its judgement in the *Association of Convenience Stores* case, set out some very clear guidelines on this issue. It stated that :

- All discretions, including the discretion by the regulator to make a market investigation reference, “have to be exercised according to law” (para. 4).
- A failure by the regulator to make a decision, on whether or not to refer, within a ‘reasonable’ timescale is reviewable by the CAT (para. 12).

- In the circumstances of that case, the envisaged OFT timescale of approximately 16 months for determining whether to make a reference to the CC was not ‘reasonable’ (para. 8).

The CAT was particularly critical of the OFT’s envisaged timescales for reaching a decision on whether to refer :

"If we may say so the competition authorities must equip themselves in a way that enables them to address the kinds of issues that arise in a case like this within a reasonable timescale” (para. 8).

The CAT suggested that the potential for harm underscored the need to reach a reference decision within a reasonable timescale. It noted that unreasonable timetables “involve some risk (if the Applicants are right) of shutting the stable door after the horse has gone.” (para 7). The CAT also stated that the timescale envisaged by the OFT was unduly long, “particularly considering the background that we have just indicated and the general public interest in this sector which potentially affects every consumer in the country.” (para 8).

The CAT’s concerns regarding potentially irreparable harm and the general public interest are of particular relevance in the context of pay TV.

There is no reason why the particular position of a sectoral regulator should justify that regulator in taking longer to determine whether to make a market investigation reference. A factor that affected the CAT’s conclusions on timescales in the above case was that the OFT already had a familiarity with the market in question before commencing its investigation (para. 7) – sectoral regulators are, of course, even better placed to understand the markets in question, given their sectoral expertise and statutory functions.

Also, this issue was specifically addressed as follows by the ORR, in the context of its recent reference :

“We have taken into account the concerns of the CAT that a first stage investigation should not be unduly long. Accordingly, we have taken care not to carry out analysis to a level of detail that would be disproportionate given that this is a first stage investigation.” (para. 5.29)

The ORR carried out its investigation within a period of 9 ½ months. This compares very favourably to the over 16 months to date that Ofcom has already spent on the pay TV investigation, with no conclusions likely to emerge in the near future.

Indeed, it would be somewhat incongruous, and probably reviewable by the CAT as being ‘unreasonable’, if the initial investigation to determine whether to make a reference purported to be particularly extensive or, say, took around two years, given

that the statutory function of the CC is to carry out in-depth investigations within a 2-year period.

It is useful to note that, to date, there have been 9 market investigation references to the Competition Commission under the EA. BT estimates that, for these 9 references, the average duration of the initial investigation to determine whether to make a reference was approximately 7 months (see further details attached in Annex 2 to the present paper).

Also, the OFT issued specific guidance in November 2004 regarding the market studies it conducts, an outcome of which can be a reference to the Competition Commission. This guidance sets out indicative timelines of 3-6 months for a "short study" and around one year for a "full study". The guidance also emphasises that anticipation of a reference to the CC should be a factor in shortening the length of the period spent by the OFT studying the market, making the use of "short studies" more likely. Whilst this guidance does not formally apply to Ofcom (unlike to OFT Guidance relating to market investigation references discussed above), BT nevertheless considers that its principles provide important indicators for Ofcom.

### 3. Government policy on market investigation references by sectoral regulators

It is worth noting that a detailed October 2007 House of Lords Regulators Committee report recommended that :

“where possible, utility regulators should look to bring more cases to the competition authorities and that the regulators should work to ensure that the cases most likely to establish useful precedents are brought to the Competition Commission” (para. 6.26)  
<http://www.publications.parliament.uk/pa/ld200607/ldselect/ldrgltrs/189/18902.htm>

The Government response to this report stated :

“the Government agrees with the Committee that regulators should be encouraged to think about whether they can be more pro-active in using competition law, including market investigation references to the Competition Commission.” (p.13; <http://www.parliament.uk/documents/upload/GovRespRegulators.pdf>)

### C. **Reasonable grounds to suspect that competition in pay TV is prevented, restricted or distorted?**

The following paragraphs discuss each of the relevant criteria identified in the OFT Guidance, in the order identified in this Guidance.

#### 1. Performance indicators

Whilst acknowledging the limitations of performance indicators, such as prices and profitability, the OFT Guidance states that “evidence on prices and profitability might be the beginning of the OFT’s interest in a particular market” (para. 4.5).

- Prices above the competitive level : The ALMR response to Ofcom’s Condoc, together with various responses from representatives of pubs, provides significant *prima facie* evidence of pricing by Sky above the competitive level. Thus, for example :
  - On the basis of those submissions, it appears that Sky has used its position as sole supplier of premium sports content to pubs and clubs to price to them at a level that appears to be significantly above the competitive level;
  - it is not apparent that the very significant differences in the prices Sky charges to pubs/clubs and to residential homes can be justified by differences in the services being provided;
  - it appears that Sky can recover a very material portion of its overall content acquisition costs through its supply arrangements with the pubs and clubs. This suggests that Sky cannot use the high cost of premium content acquisition to justify the high retail prices it charges to residential customers.

Furthermore, it is significant that, very shortly after Setanta started to broadcast FAPL matches and decreased its residential retail price from £14.99 per month to £9.99 per month, Sky actually increased its retail prices for some of its premium sports channels. This suggests that Sky’s retail pricing is not subject to any effective competitive constraint.

As part of its response to Ofcom’s Condoc, Sky annexed a report from PwC. Sky claims that one of the ‘key findings’ of this report is that : “when evaluated properly, charges for pay TV services in the UK cannot be said to be ‘high compared to other countries’” (para. 4.4 Sky response). Annex 3 of the present paper explains that, in BT’s view, this argument by Sky is not valid.

- Profitability : It is useful to refer to the precedent of the recent ORR reference. An important aspect of the ORR’s analysis was its assessment of the profitability of the rolling stock leasing companies. The ORR made clear that it did not propose to reach definitive views on profitability, but that it had “identified plausible profitability analyses which indicate excess profits of a level that, in our view, warrants a Competition Commission reference.” (para. 5.41). In BT’s view, this ‘plausibility’ threshold is met in the case of pay TV, given, in particular :
  - The evidence from the pubs and clubs of very high Sky prices;
  - The evidence in Annex 1 of BT’s March 2008 response, which suggests Sky has a very high level of profitability;
  - Ofcom’s own profitability analysis of Sky, based on a Total Return to Shareholders assessment since Sky’s flotation, which does not take account of the strong evidence from the OFT that the flotation price



already incorporated excessive profits (as discussed in Annex 1 of BT's March 2008 response).

It BT's view, the evidence already available to Ofcom regarding pricing and profitability gives sufficient cause for concern and that these issues do not require any further investigation by Ofcom to justify a reference.

## 2. Structural features

The OFT Guidance notes that :

“A wider range of structural features can give rise to concern under the market investigation reference provisions of the Act than would normally arise in considering whether a firm or firms had infringed one of the CA98 prohibitions.” (para. 5.1)

(i) Market concentration : The first structural feature the OFT Guidance identifies is market concentration. The Condoc establishes that Sky has considerable market power, in particular in relation to the supply, at the wholesale and retail levels, of premium sports and movies channels.

The OFT Guidance also notes that :

“A firm may have market power, and the capacity to act in ways that may prevent, restrict or distort competition, with a market share below that usually regarded as necessary to suggest dominance for the purposes of CA98”. (para. 5.4)

Accordingly, for example, even if Ofcom does not consider that Sky has dominance in any market for 'basic' channels, Sky may nevertheless have sufficient market power to justify inclusion of 'basic' pay TV content in a reference to the Competition Commission. Indeed, Sky's influence may extend beyond its wholly owned channels due to the set of partial ownership stakes it holds, as well as the buyer power it wields; this may well give it wider influence over channel distribution and allow it extract or obtain favourable contractual provisions (exclusivity arrangements, MFN clauses and other such restrictions).

(ii) Vertical integration : The next structural feature the OFT Guidance considers is vertical integration. It notes that a vertically-integrated firm may give rise to adverse effects on competition “if it can foreclose non-integrated competitors from a significant part of their market either by refusing to supply or to deal with them or by discriminating against them in its pricing.” (para. 5.8). Sky is, of course, vertically integrated. Also, BT has provided Ofcom with various submissions which establish Sky's incentives to foreclose competition.

In assessing Sky's incentives to foreclose competition, BT believes that particular weight should be attached to the various Sky submissions which, as BT has shown in its submissions, show Sky's incentives to foreclose. Thus, for example :

- Sky accepts that it has no incentive to supply its channels to third parties on the same platform<sup>3</sup>;
- The logic of Sky's reasoning equally applies in respect of supply to a third party on any other platform where barriers to switching from Sky's platform to that platform are low;
- Sky now argues strongly that the costs of switching between platforms are low, having made inconsistent claims regarding this issue<sup>4</sup>.
- This direct evidence from Sky of its lack of incentives to supply third parties is particularly powerful. It is directly relevant to the question in hand and arguably more so than any 'objective evidence' that Ofcom may seek to gather about switching costs. Sky will, after all, act on the basis of its own assessment of switching costs, not on the basis of any 'objective evidence' of switching costs gathered by Ofcom.
- Furthermore, the fact that Sky presents conflicting arguments regarding switching costs simply undermines Sky's credibility and should reinforce concerns about Sky's incentives to foreclose.
- In addition, Sky and CRA submitted a "vertical arithmetic" empirical exercise on the basis of actual margin data from Sky which, when correctly interpreted, shows that Sky has actually already engaged in foreclosure, and has done so beyond the statically optimal level.<sup>5</sup>

(iii) Barriers to market entry, exit and expansion : The OFT Guidance then considers barriers to market entry, exit and expansion. It notes that "entry conditions are always a crucial part of any competition assessment" (para. 5.10).

The Condoc convincingly argues that Sky has inherent advantages in contests for the supply of premium content. Accordingly, and given Sky's lack of incentive to supply content to competing retailers, there are fundamental barriers to market entry.

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<sup>3</sup> See, for instance, Annex 4 of Sky's submission, prepared by CRA International. At paragraph 89: "*To summarise, we would anticipate that if competition downstream is fierce (and there are low switching costs which is the case for intra-platform competition), in practice multi-retailer licensing would not occur*". It is however not completely clear how Sky/CRA reconcile this position with their presentation of the Harbord and Ottaviani (2001) paper.

<sup>4</sup> In its latest submission, Sky argues that the costs of switching between platforms are "modest" and "Sky considers that Ofcom's assertion that the costs of switching between pay TV services provided by different pay TV retailers are "high" cannot be supported." (Annex 2, para. 3.47 Sky response). BT certainly agrees with this assessment, with regard to switching towards IPTV platforms in particular. Sky's position on the matter may now have settled, after having made claims of both high and low switching costs previously. For previous contradictions, see for instance: "Sky's "Incentives" to Foreclose Competition in the UK Pay TV Industry", prepared by CRA and submitted as Annex 4 of Sky's original response to the complaint (October 2007), at paragraphs 98 (low switching costs) and paragraph 64 (high switching costs – CRA refers to factors "which discourage switching to Sky, and in some cases render it impossible").

<sup>5</sup> Reference is made to Annex 2 of BT's submission in response to the Condoc, prepared by NERA Economic Consulting, Section 3.3.

Sky's arguments in its submissions actually underline the problem of barriers to market entry. Sky argues that Ofcom's "implicit model of entry sets an unreasonable benchmark for what counts as 'entry'". The most likely form of entry, it argues, is gradual. There is "an obvious opportunity for channels focusing on a specific sport or category of sports to target a smaller audience – a strategy pursued by the likes of Attheraces, Setanta Golf, MUTV, Chelsea TV and NASN" (Sky, Annex 3, paras. 3.1, 3.9). However, the specific market entry examples it identifies :

- do not involve entry to any premium content market, as defined by Ofcom;
- actually suggest that (with the exception of Setanta Golf) market entry opportunities essentially depend on Sky. Thus, the success of Attheraces presumably depends, to an important extent, on its inclusion in Sky's retail offering. Also, Sky has significant shareholdings in both MUTV (33.33%) and in Chelsea TV (35%);
- also suggest that entry opportunities are very limited and operators will be severely constrained. In the case of Setanta Golf, for example, it is useful to note that the most popular golf events are the Open (which is a listed event) and the Ryder Cup (which was a listed event and for which Sky now holds exclusive rights).

Sky/CRA seek to dismiss the notion that barriers to entry in the UK pay TV industry may depend on interactions between the outcomes at several levels of the value chain. In this context, it is worthwhile noting that such linkages were taken very seriously by the European Commission in its examination of the SFR/Télé2 merger, and formed part of the theory of harm it advanced.<sup>6</sup>

*"100. Given the high barriers to entry and expansion that result from the difficulty of access to content (channels and broadcasting rights) controlled by Vivendi, the discriminatory measures described in this section would have an appreciable effect on competition. The measures would directly or indirectly bring about a substantial increase in the attractiveness of Télé 2's offerings, and consequently of its subscriber base, while competing DSL operators would have no real access to equivalent content. The position of DSL operators on the downstream market in the distribution of pay TV would be significantly weakened, and this would also weaken their position as potential buyers of rights for the distribution of channels or the broadcast of television programmes. Vivendi's negotiating position on the upstream and intermediate markets would be greatly reinforced by the broadening of its subscriber base, which already consists of over 8.5 million subscribers.*

*101. In conclusion, the transaction notified might weaken the emerging competitive pressure exerted by DSL operators on the downstream market in the distribution of pay TV, which is already fragile as a result of the very strong position held by Vivendi on all markets for pay TV in France. It is clear from the above that the weakening of potential competition from DSL*

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<sup>6</sup> European Commission, Case No COMP/M.4504 - SFR/Télé 2 France.

*operators on the downstream market would produce a corresponding reinforcement of the very strong positions held by Vivendi on the upstream and intermediate markets, and vice versa: the strengthening of Vivendi's position on one market has a direct impact on the other sectors of the market for pay TV, because of the high degree of vertical integration of the group."*

(iv) Buyer power : The OFT Guidance identifies countervailing buyer power as a relevant factor. In the present case, there is clearly no countervailing buyer power at the retail level. BT would note, however, that Sky's buyer power must also be considered as an important structural issue affecting competition. Thus, for example, the Condoc notes that Sky may have "a degree of buyer power when negotiating with third party wholesale channel providers" (para. 5.55), even for 'basic' content. This Sky buyer power has a material impact on conditions of competition at the retail level. As noted above, this may give Sky influence over the conditions of channel distribution, and in particular allow it obtain favourable contractual provisions (exclusivity arrangements, MFN clauses and other such restrictions), thereby raising barriers to entry for other (especially newer) operators.

The OFT Guidance also discusses the following further structural issues : regulations and government policies; information asymmetries; high switching costs. These issues are of less importance in the current context.

### 3. Firms' conduct

The OFT Guidance states :

"A significant part of the evidence on which the OFT will base its case for a market investigation reference will normally concern the conduct of firms (as sellers or buyers) who, because of structural or other features of the market, are in a position to exercise a degree of market power."

The various submissions to Ofcom, including BT's submissions, have provided a wide range of examples of conduct that would justify a reference to the Competition Commission. These include :

- Pricing above the competitive level;
- Not providing content, particularly premium content, to third parties. Whilst Sky may argue that its conduct does not amount to an abusive refusal to supply, for the purposes of any Chapter II/Art 82 analysis, this is not directly relevant for present purposes. The fact remains that Sky continues not to supply its content to most third parties and this continuing failure warrants investigation by the Competition Commission, particularly in light of Sky's incentives not to supply its content to third parties. The Competition Commission would have the powers to impose a detailed supply obligation on Sky, whether or not such an obligation would be appropriate in the context of a Chapter II/Art 82 investigation.

- A web of contractual provisions and industry practices, the net effect of which is that innovation and product differentiation by IPTV operators, in particular, is inhibited. It is worth noting that this concern was raised by the European Commission in its decision in SFR/Télé2:<sup>7</sup>

*"62. DSL operators may, for example, wish to differentiate their offerings, or to make them more attractive than those of their competitors, by centring their packages of channels around a particular theme; but any such differentiation will be very limited, because it has to work on the basis of channels that are marginal in terms of attractiveness and recognition. It is very difficult, therefore, to achieve real differentiation, and to increase the attractiveness of proprietary offerings, because channel producers will deny DSL operators access to their channels even if they do not belong to the Vivendi group, in view of the exclusive contracts they have with the group. It was pointed out earlier that when television offerings by DSL were being designed the Vivendi group already had some exclusive rights for satellite, and decided to extend these exclusive rights to DSL (and in some cases to mobile telephone services). And some channels that were initially included in DSL operators' packages were subsequently withdrawn in view of exclusive contracts concluded with the Vivendi group."*

- The evidence submitted by Sky and CRA themselves in the form of a "vertical arithmetic" empirical exercise raises serious questions about the actual conduct of Sky, as a proper interpretation of the results presented suggest that Sky has actually already engaged in foreclosure, and has done so beyond the statically optimal level.
- Inhibiting the development of SVOD (as noted in the Screendigest report; attached as Annex 11 to the Condoc; para. 432).
- The agreement between Sky and Setanta, leading to a situation in which Setanta content is not supplied to pubs and clubs, other than on the basis of a buy-through arrangement with Sky; together with arrangements under which Sky is effectively the gatekeeper for potential customers who wish to sign-up to Setanta. Whilst Setanta may need to have some form of distribution arrangement with Sky in order to distribute its channels to the pubs and clubs, it seems somewhat unlikely that this would justify the buy-through and gatekeeping arrangements.
- Inhibiting innovation, by not providing HDTV or interactive versions of premium content to third party retailers.

#### **D. The appropriateness of a reference to the CC**

The following paragraphs address this issue, by reference to the criteria set out in the OFT Guidance.

1. It would not be appropriate to deal with the competition issues identified by applying the Competition Act or by using sectoral powers

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<sup>7</sup> European Commission, Case No COMP/M.4504 - SFR/Télé 2 France.

The OFT Guidance states that its policy is to consider whether a competition problem can be addressed under the Competition Act; it will only go on to consider a reference to the CC in one of two circumstances :

- First, where it has reasonable grounds to suspect that there are market features that restrict competition but do not establish an infringement of the Competition Act prohibitions. Barriers to entry are identified as a specific example of such market features.

In the present case, the significant barriers to market entry at the wholesale level, which Ofcom has already identified and which go to the heart of the competition problems in pay TV, may very well not be caused by any specific conduct that would fall within the prohibitions of the Competition Act.

Similarly, the various other factors that give rise to potential competition concerns, such as aggregation of content at various levels of the supply chain, may well not fall within the Competition Act prohibitions.

- Second, “when action under the CA98 has been or is likely to be ineffective for dealing with the adverse effect on competition identified” (para. 2.3 of the OFT Guidance).

In the present case, a wide range of conduct has been identified (eg, in section C.3. above) that raises competition concerns. It would not be practical to address each of these competition concerns in separate Competition Act investigations. This process would be excessively time-consuming and, more importantly, would not tackle the underlying competition problems, as opposed to individual manifestations of these underlying problems. Furthermore, this process would potentially not address problematic market features altogether, as they may not amount to ‘abuses’ under CA98.

In this regard, it is useful to note that, when referring liquid petroleum gas supply to the CC under the market investigation procedure, the OFT stated :

“Given the breadth of issues arising in relation to domestic bulk LPG, the OFT does not currently consider that action taken under the Competition Act, or under Articles 81 or 82 of the EC Treaty, as appropriate, if a breach of one or more of the relevant provisions were established, would be effective in resolving all the adverse effects on competition which it has identified”. (para. 20. [http://www.offt.gov.uk/shared\\_offt/press\\_release\\_attachments/lpg.pdf](http://www.offt.gov.uk/shared_offt/press_release_attachments/lpg.pdf))

Also, it is important to stress that, in BT’s view, a Competition Act investigation into whether Sky is under an obligation to wholesale its premium content to third parties would be inadequate. As stated in BT’s March 2008 submission, any such approach would not tackle the underlying problems for consumers of high prices

derived *inter alia* from upstream market power and reduced choice as a result of upstream content aggregation.

The OFT Guidance states that the OFT does not intend to make market references based on the conduct of a single firm, where there are no other features of a market that adversely affect competition (para. 2.7 of the OFT Guidance). The OFT Guidance goes on to state that this general principle is subject to a number of qualifications.

One such qualification arises where the conduct of an individual firm is associated with structural features of the market, such as barriers to entry (which is clearly the case with pay TV). In such a case :

“a market investigation reference may be more appropriate than action under the CA98 even though only a single firm appears to be conducting itself anti-competitively” (para. 2.8 of the OFT Guidance)

In any event, in the present case the competition problems that have already been identified are not necessarily caused solely by Sky – a number are the result of structural concerns at various levels of the pay TV supply chain, involving not only Sky.

The above factors are also sufficient to rule out reliance on sectoral powers, in particular, s316 Communications Act 2003, to deal with the relevant competition concerns. This provision of the Communications Act is aimed at addressing conduct by the provider of a licensed service, which cannot more appropriately be dealt with under the Competition Act; in the present case, the competition concerns do not necessarily derive from the actions of individual providers of a licensed service.

2. It would not be more appropriate to address the problems identified by means of undertakings in lieu of a reference

It seems highly unlikely, in the present case, that appropriate undertakings would be agreed that would achieve the necessary comprehensive solution to the various competition problems.

3. The scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it

There can be no doubt that, given the size and importance of the pay TV market, together with the scale of the suspected competition problems, this OFT criterion for a CC reference is met.

According to the Condoc, there were close to 12m UK households subscribing to pay TV services.<sup>8</sup> It is also an industry that is economically significant; the Condoc

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<sup>8</sup> See Condoc Annex 8, Figure 1.

appropriately puts this into perspective by noting: "*Since 2003, subscriptions have made up the largest revenue stream within total TV industry revenue. In 2006, subscriptions totalled just over £4 billion, exceeding the revenue generated by TV advertising (£3.5 billion) and the level of public funding (£2.5 billion)*".<sup>9</sup>

In addition, as noted by Ofcom in the Condoc, the present situation represents a significant crossroads for the UK pay TV industry, with an important opportunity for new entry to increase the level of competition and provide more value to consumers:

*"In particular, the possibility of new market entry or the exit of existing players is important, since whilst it might be possible to characterise the last decade or so as being a process of competition between two established pay TV providers, one on cable and one on satellite, we are now at a point in time where new market entry is becoming possible, based on new distribution technologies (IPTV, DTT, Internet, mobile TV). We therefore need to be particularly alert to the risks associated with dynamic foreclosure, i.e. the risk that firms already present in the market might either exploit or benefit from certain dynamic characteristics of the market to foreclose entry by new providers (or – analogously – to drive out firms that have recently entered)."*

The European Commission expressed very similar views in its SFR/Télé2 decision:<sup>10</sup>

*"70. The market survey carried out during the second stage of the proceedings has confirmed two things. First, the DSL segment is the main vector of growth in the market for the distribution of pay TV by operators independent of Vivendi in France. Second, the DSL operators are the main competitors capable of exerting growing competitive pressure in the markets in pay TV in France. But at present, pre-merger, the development of the competitive pressure exerted by the DSL operators is limited, mainly because they do not have sufficient access to television programmes and channels currently held by Vivendi either directly or indirectly via exclusive broadcasting, exploitation or distribution rights."*

In light of all these factors, a reference of the pay TV market to the Competition Commission stands out as an appropriate and proportionate response to the very serious concerns which have emerged during Ofcom's market investigation.

4. There is a reasonable chance that appropriate remedies will be available

There is no reason to believe that appropriate remedies would not be available to the CC to deal with any identified competition problem. BT, in its previous individual and joint submissions, has outlined in some detail a number of possible remedies that may be appropriate.

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<sup>9</sup> See Condoc Annex 8, para 2.50.

<sup>10</sup> European Commission, Case No COMP/M.4504 - SFR/Télé 2 France.



**6 August 2008**

ANNEX 1

[CONFIDENTIAL]

## ANNEX 2

### Market references to date under the Enterprise Act

The following is a list of all market investigation references to the Competition Commission, under the Enterprise Act, and an indication of the period the referring authority took to investigate the sector in question before referring :

- The first market investigation reference to the Competition Commission was *storecards*. The OFT launched a study into this sector on 17 September 2003 and referred the matter to the CC on 18 March 2004 ie, **6 months** later.  
(<http://www.offt.gov.uk/news/press/2004/47-04>)
- *Domestic bulk liquefied petroleum gas*. Reference made July 2004, following a period of consultation with the parties, which began on 13 May 2004. Unclear when OFT consultation process started.  
<http://www.offt.gov.uk/news/press/2004/103-04>
- *Home credit*. Reference made 20 December 2004. The reference resulted from a super-complaint that was lodged with the OFT on 14 June 2004 ie, an investigation period of **6 months**.  
[http://www.offt.gov.uk/shared\\_offt/reports/financial\\_products/offt769.pdf](http://www.offt.gov.uk/shared_offt/reports/financial_products/offt769.pdf)
- *Classified directory advertising*. Reference made in April 2005, following **7-month** OFT study. <http://www.offt.gov.uk/news/press/2005/63-05>
- *Northern Irish personal banking*. Reference made on 26 May 2005. Resulted from super-complaint lodged on 15 November 2004 ie, an investigation period of **just over 6 months**.  
[http://www.offt.gov.uk/advice\\_and\\_resources/resource\\_base/references/Northern-Ireland-banking](http://www.offt.gov.uk/advice_and_resources/resource_base/references/Northern-Ireland-banking)
- *Groceries market*. Reference made on 9 May 2006. The OFT had carried out a 9-month investigation between November 2004 and August 2005, before reaching a decision not to make a market investigation reference to the Competition Commission. This decision was appealed. During the appeal process, the OFT indicated its intention to withdraw the decision and reconsider. The OFT commenced a “fresh inquiry” (para. 1.2 OFT statement of reasons) on 1 November 2005 (ie, new investigation period of **just over 6 months**) . In its statement of reasons for making the reference, the OFT noted:  
“The OFT had not sought to carry out a detailed analysis of competition in the market , nor to reach firm conclusions as to whether or not competition is being harmed. However, in the OFT’s view, the evidence it collected provided appropriate grounds for a reference to the CC”.  
([http://www.offt.gov.uk/shared\\_offt/reports/comp\\_policy/offt845.pdf](http://www.offt.gov.uk/shared_offt/reports/comp_policy/offt845.pdf). see para. 1.2)
- *Payment protection insurance*. Reference made on 7 February 2007. Resulted from super-complaint lodged on 13 September 2005. On 8 December 2005 announced that it would commence a market study during 2006; “The precise timing and scope of the market study will be decided in early 2006 after the Competition Commission has reported on store cards and associated PPI” (<http://www.offt.gov.uk/news/press/2005/226-05>). The OFT eventually launched

its market study on 4 April 2006 (ie, investigation period of **just over 10 months**).

<http://www.ofst.gov.uk/news/press/2007/15-07>

- *BAA airports*. Reference made 30 March 2007. Resulted from 30 June 2006 OFT market study (ie, investigation period of **9 months**).

<http://www.ofst.gov.uk/news/press/2007/55-07>

- *Rolling stock leasing*. Reference made on 26 April 2007 by ORR, which commenced its investigation on 7 July 2006 (ie, investigation period of 9 ½ months) . <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8658>

**ANNEX 3**  
**PwC international “price comparison” on behalf of Sky**

**A. Introduction**

As part of its response to Ofcom’s Condoc, Sky commissioned a report from PricewaterhouseCoopers, entitled “The outcomes for consumers in relation to pay TV in Europe” (the “PwC Report”). The PwC Report is attached as Annex 1 to Sky’s response to the Condoc.

Sky claims that this report “demonstrates that the UK performs well against 14 other European countries in terms of digital pay TV penetration, choice and value from pay TV and innovation in pay TV” (para. 7 Sky response). On the issue of prices, Sky claims that one of the ‘key findings’ of the PwC Report is that

“when evaluated properly, charges for pay TV services in the UK cannot be said to be ‘high compared to other countries’” (para. 4.4 Sky response)

The present note is intended to show that the PwC Report does not actually support this claim.

**B. The PwC Report**

The PwC report emphasises the difficulties of carrying out any international price comparison of pay TV and about the limitations of its report.

Heterogenous nature of pay TV across countries : The PwC Report identifies in particular the following major factors that affect a cross-country comparison and accepts that “these country-specific factors should be taken into account in forming a reasonable view of comparisons across countries” (para. 2.2 of the PwC Report) :

- Economic prosperity.
- The historic nature of TV provision in the country.
- Size, as measured by the number of TV households. PwC notes that this will have an impact on revenues and costs for pay TV providers.
- TV viewing preferences.
- Public policy (including regulation and competition policy) vis a vis broadcasting. PwC accepted that these factors could be of “critical importance”.

PwC notes that “although it was outside the scope of this study to assess all of these factors on a country by country basis, each factor is likely to have had an impact on the development of each country’s pay TV sector and the observed outcomes in terms of consumer choice and price and innovation” (para 2.2).

Identifying “genuine” pay TV : PwC excludes from its pricing comparison a wide array of lower-priced cable pay TV packages, in many countries. Specifically, it excludes any such pay TV packages which include only channels which are also available in the country in question on a FTA basis. PwC claims that “we can infer that the fees paid by consumers for such services must include only a small or no element related to the content provided” (para. 2.1.3 of the PwC Report) and

“To make a fair comparison between subscription fees for pay TV services across Europe, therefore, we believe that it is important to recognize this distinction – we would expect consumer fees for cable access/mini-pay TV services to be lower than those for ‘genuine’ pay TV services as the latter provide both an access element and a content element” (para. 2.1.3 of the PwC Report)

This subjective PwC assumption of what is “genuine” pay TV, which has a very material effect on its data (c.f Figure 3 of the PwC Report), is highly questionable.

Comparing pay TV channel packages : PwC identified the following 4 types of pay TV package, which it relies on for the purposes of its comparison :

- a “most inclusive” package, “containing all the important/key content available from the pay TV retailer”;
- an “inclusive of important sports” package, which comprises the lowest-priced package, typically including live domestic football league;
- an “inclusive of important movies” package, which comprises the lowest-priced package “that includes a significant amount of the important movies content to the extent available through the pay TV retailer”;
- an “inclusive of important sports and important movies” package, which is generally the lowest-priced package combining the previous two categories of package.

PwC accepts that “straightforward price comparisons of pay TV services across countries are not appropriate : price cannot be disentangled from the content offered” (para. 2.1.5 of the PwC Report).

In the first place, there is the issue of identifying, even in the broadest of terms, comparable packages of content. PwC stated that, in order to address this, “in some cases our package selection has required the aggregation of more than one retailer’s package offering in order to build up comparable packages” (para. 3.3.3 of the PwC Report). This, PwC accepts, gives rise to “unavoidably a degree of subjectivity” (para. 3.3.3).

The subjectivity involved in the selection of ‘comparable’ packages of content necessarily undermines any claim that Sky may wish to make about the objectivity of PwC’s findings.

Second, there is the all-important issue, in a meaningful like-for-like price comparison, of comparing equivalent quality of the content. PwC states :

“We have attempted to account for the quality of pay TV service offerings by considering indicative quality based on the number, category and range of pay TV channels. Clearly and ultimately, what constitutes quality can only be assessed, with some difficulties, by asking consumers. However, this was outside the scope of the study.” (para. 2.1.5)

Whilst relying on volume of channels as one of the factors for this ‘indicative quality’ comparison, the PwC Report actually shows that volume of channels is not a useful comparator. This is clear from Figure 5 of the Report, which charts the PPP price for the ‘most inclusive’ package against the number of channels in the packages. This shows that, whilst there is ‘an apparent positive correlation’ between PPP price and volume of channels, the data points “are widely scattered”. “This implies that a variety of unobserved variables are important and hence care should be taken in drawing conclusions from these data” (para. 3.4.1).

Also, in its Concluding Remarks section, PwC states :

“A price comparison in the absence of what the price buys is therefore not meaningful.....package offerings vary significantly. Ideally prices should be adjusted to take into account any differences in quality of service in order to conduct a proper assessment of value for money, although this is outside the scope of this study” (para. 5.2)

The reality is that ‘quality’ is highly subjective. Comparing retail prices of packages of content, where the content in the packages may be very different (eg FAPL in the UK and Bundesliga in Germany) and consumer preferences for even the same content may be very different (eg US movie content in the UK and dubbed versions of the same content in France) means that like-for-like price comparisons are very complex.

PwC’s proxy for a ‘quality’ comparison, namely a direct comparison based on the “number, category and range of pay TV channels” does not take any meaningful account of these all-important quality differentials.

Third, there is the issue of the costs other than subscription costs, that need to be taken into account in any pricing comparison. The PwC report acknowledges that “the price of receiving a package may have different elements : for example, hardware costs (one-time and/or rental) and other set-up costs such as installation costs”; PwC states that “wherever the information is available” (para. 3.3.4), it separately identifies these costs. The separate identification of these costs, however, simply underlines the fact that PwC’s pricing comparison tables (and its summary of findings in para 5.4 of the Report) does not include these important costs.

## **C. Conclusions**

Sky claims that one of the 'key findings' of the PwC Report is that charges for pay TV services in the UK cannot be said to be 'high compared to other countries'. It will be clear from the above, however, that that PwC Report does not actually make this claim.

PwC merely seeks to carry out what "we consider to be valid comparisons" (para. 2.1.5). Also, it states that, subject to caveats "we have conducted a transparent comparable assessment that demonstrates what consumers actually experience, in terms of prices, number and types of channels, based on our analysis of selected channels" (para. 5.2).

The significant caveats attached by PwC to its analysis, together with the subjective nature of a number of the key assumptions in its analysis, however, mean that it could not support a conclusion that UK pay TV prices are not high compared to those of other countries.