OFCOM

BRIEFING FOR ANALYSTS:

BROADCASTING & MEDIA

Tuesday, 22 September 2009

ED RICHARDS
CHIEF EXECUTIVE
Ed Richards (Chief Executive): Good morning everybody. Let us get straight into it this morning, I don’t want to keep you for any more time than you need to be here for, very welcome as you are. We are going to cover three main things this morning, so let me introduce those and say who is here, and then I’ll hand over to our first speaker.

We are going to cover the media ownership rules, which is something that we published fairly recently and which you may be familiar with, but we want to cover exactly what we have said in that, and what we believe the next steps are. Jonathan Thompson, our Director of Strategy, will do that section. We shall then turn to what we have broadly termed TV Advertising, but in that area we shall also pick up the area of Product Placement and race and broader issues around sponsorship. That will be led by Kate Stross and Chris Banatvala from our Content Team. Thirdly, we shall talk about Pay TV and Steve Unger, whom you will know and who has been leading the work in that area, will pick up that area.

We shall pause briefly after each section to see if there are any questions and then there will be an opportunity for any more general questions at the end of the session. With that, I’ll hand straight over to Jonathan.

MEDIA OWNERSHIP RULES REVIEW
Jonathan Thompson

As Ed said, I’m going to do a brief summary of Ofcom’s review of media ownership rules on which we published our proposals on 31 July, and for which the consultation period closed last week.

The Media Ownership Rules help protect plurality in TV, newspapers & radio

As I am sure you are all aware, the media ownership rules are set out in legislation and are designed to ensure plurality and diversity of media, so that consumers have access to a range of news, information and sources of opinion. They focus on media ownership at both a local and national level and across television, radio and newspapers.

Ofcom has a statutory duty to review the operations of the media ownership rules at least every three years, and to report its findings and recommend any changes to the
Secretary of State for Culture, Media and Sport. The aim of our review is to examine whether the rules continue to deliver the purposes which Parliament originally intended, which are to protect plurality of viewpoints in the media, and to give citizens access to a variety of sources of news. As the chart highlights, the media ownership rules include seven main areas: local radio ownership; local cross-media ownership across television, newspapers and radio; national cross-media ownership, across Channel 3 and the national newspapers; national radio ownership, and restrictions on holding broadcast licences; the rules around the appointed news provider for the Channel 3 licences, and the public interest test which can be implemented by the Secretary of State for Business.

Our approach to reviewing these rules is to consider two main factors, the first of which is changes in consumer behaviour and attitudes towards local and national media. We have also looked at whether the rules are in any way restricting the ability of the industry to respond to economic pressures.

In local media consumers still rely on television, radio and newspapers as sources of news

The Government's Digital Britain report in particular asked Ofcom to consider the impact of the media ownership rules at a local level, particularly looking at sustainability of local media, which I'll turn to first. What this chart shows is the primary source of news for consumers at a local level, and it demonstrates that, since 2003 when the media ownership rules were last reviewed, television, press and radio have remained the most important sources of news for consumers at a local level.

As you can see, television has increased its importance while local newspapers have declined slightly. Despite significant growth in take-up and usage of the Internet, it has not yet become a primary source of news for consumers at a local level.

We propose changing the radio and local cross-media rules

At a local level, our research has shown that television, radio and newspapers remain important sources of news and information. However, clearly the local media sector and, particularly, radio and newspapers, is facing significant economic pressures as a result of both structural and cyclical changes. As a consequence, we believe that removing local radio ownership rules might enable local radio stations to come together under common ownership and make operational efficiencies. Our research found that consumers do not have significant concerns about common ownership given the alternative sources of news available.

We also believe that liberalising the local cross-media ownership rules could allow companies greater flexibility to respond to economic pressures. We, therefore, propose
recommending the liberalisation of the local cross-media ownership rules. This will mean that the only restriction would be on the ownership of all three of local newspapers, regional television and local radio. However, we believe that the complete remove of the cross-media ownership rules at a local level could risk compromising plurality of media. These two proposed changes at a local level are subject to the findings of our consultation which closed last week.

**At a national level, television remains consumers’ main source of news**

At a national level, as the chart shows, our research illustrates that television remains the most important medium for news and information, particularly news from the BBC and ITV, and its importance has grown since 2003. Newspapers also continue to play an important role, particularly in setting the national agenda, and, as we saw with the local research, despite significant growth in take-up and usage of the Internet, it remains the primary news source for a small minority of consumers.

**We don’t recommend changing the media ownership rules at a national level**

It is worth stressing that the national ownership rules are different to those at a local level, and have been significantly more liberalised than those at a local level. Given this and given our research has suggested that neither consumer behaviour nor market trends have changed the effectiveness or relevance of the national media ownership rules, we do not propose to make significant changes. We intend to leave in place the national cross-media ownership rules, given the significant influence of the national newspapers and Channel 3 broadcasters, to retain the broadcasting licence restrictions which guard against undue influence, to retain the appointed news provider provisions which help to ensure an independent provider of national news for the Channel 3 licences, and to retain the media public interest test, which continues to provide a backstop for the Secretary of State to protect plurality and diversity in media. Again, all of this is subject to the findings of the current consultation.

**Next steps**

To wrap up, as I said the consultation was published in late July, it closed last week and we are now in the process of reviewing the responses we have received, and all non-confidential responses are up on the Ofcom website, to which the link is provided. As far as our next steps, in order to meet our statutory deadline we shall report to the Secretary of State for the department of Culture, Media and Sport by 13 November this year. It is then up to his discretion whether or not to accept our proposals and, if he should, any changes can be implemented via secondary legislation. So that was a very brief summary, and we will now take any questions.
Ed Richards: Are there any questions on that topic before we move on to the advertising sponsorship issues? [No questions] I thought that might be the one to provoke the least interest, and we shall warm up from here on in.

COMMERCIAL PUBLIC SERVICE BROADCASTERS
Kate Stross
Director of Content

Good morning. I’m Kate Stross, the Director of Content.

Current issues

I shall focus on three main issues that are of particular relevance to the commercial public service broadcasters. I shall talk a little about the sustainability of regional news on Channel 3, about the licence revaluation process for both the Channel 3 and Channel 5 licensees and give you an update on issues around advertising regulation for the commercial public service broadcasters.

Regional news on Channel 3

We published two documents this morning which those of you who are early risers might have had a chance to look at before you came here. The first is a response to a DCMS consultation on sustainable independent and impartial news in the nations locally and in the regions. It was published by the DCMS following on from the Digital Britain final report. It seeks views on the importance of maintaining plurality in regional news, that is television news, between the BBC and Channel 3 and, if plurality is considered to be important, how should that regional news provision on Channel 3 be funded. The DCMS have proposed creating what they call a “containable, contestable element” of the licence fee, about 3.5% of the licence fee or £130 million a year, and that might be used to fund public service content on other channels than the BBC, and notably potentially to fund regional news on ITV. The reason why they have done that follows on from the conclusions in our final statement of the PSB review, where we said that the existing regulatory obligations on the Channel 3 licensees were not sustainable, and that external funding for regional news on Channel 3 would be needed. This proposal is a response to that view from Ofcom.

We have also published today a report on local and regional media in the UK, which is intended to provide an evidence base on the local and regional media sectors, and to provide some supporting evidence for our response to the DCMS consultation. The DCMS response really draws together in one place a lot of evidence that we developed during the
course of the PSB review, and it draws out some new evidence from the local and regional media report. The links to the two documents are on the screen there.

I believe the most interesting conclusion that we arrive at from your perspective is on the following slide, where we look at the costs and the benefits of public service broadcaster status for the regional Channel 3 licensees as a network.

**Our analysis shows that the regional Channel 3 licences could face a deficit of £38-64 million in 2012**

We say in our response that, without a change in the regulatory obligations that the regional Channel 3 licensees face, they will see a deficit on their licences in the region of £38-64 million a year by 2012, so the red lines on that chart represent the costs of their regulatory obligations absent any change in those obligations, and the blue lines represent the benefits of PSB status. You can see the deficit arising as digital switchover progresses. This is not a P&L loss on the licences. The deficit is an opportunity cost of public service broadcaster status, and the way we get to it is by looking at the value of the PSB benefits that the licensees get such as analogue spectrum, the ‘gifted’ DTT spectrum, EPG due prominence and so on. Then we look at the costs of their PSB obligations, notably regional news production but also all the other programme quotas that they have to meet as PSBs. In both cases, we are looking at those benefits and costs against a non-public service broadcaster counterfactual. So the deficit is the difference between the two, and it comes about because of the decline in the value of gifted analogue spectrum that the licensees see while their costs are relatively fixed.

We have put ranges on the graph because there isn’t an absolutely precise point answer to the question ‘what is the opportunity cost of being a public service broadcaster?’. You have to look at a hypothetical counterfactual, so we have built some ranges into our analysis. But we do think that the general conclusion we arrive at that there will be a deficit across the network before digital switchover is a reasonable figure, as is the timing. The deficit arises before digital switchover completes, and these conclusions are consistent with the conclusions that we set out in the PSB review statement based on which we changed and reduced the regional news regulatory obligations on the Channel 3 licensees. Therefore, we have updated the analysis behind the PSB review.

It is also worth noting that the size of that deficit once you get beyond digital switchover approximates to what the licensees spend on regional news provision, which is about £68 million a year from 2010, so it is really regional news provision that creates the deficit.

**The Government has proposed new model for delivering regional news on Channel 3**
In response to the conclusions that we published in the PSB review, the Government in Digital Britain proposed a new model for regional news provision on Channel 3. Under this model, independently funded news consortia would bid for funds to provide regional news in each of the licensed regions. The news would be provided to the incumbent Channel 3 licensees and they would show it in the existing slots in their schedule as a means of meeting their statutory obligations.

The bidding consortia could include news providers, regional newspapers, regional radio companies, TV production companies, and there is nothing to prevent an incumbent Channel 3 licensee bidding for these funds as STV has indicated, for example, that it intends to do. It would be a competitive bidding process and the funding would be awarded based on a number of criteria around the reach and the impact of the news that you offer, offering high production editorial standards. You might look at the contribution to training that the consortium would make in there area and, of course, the financial strength of the consortium. Therefore, it is not just a case of the lowest bidder wins the funding.

In the Digital Britain report, the Government proposed launching three pilot areas in Wales and in Scotland and in one English region – yet to be decided which - , and the pilots would launch in late 2010. Then, potentially, if the licence fee is used as the source of funding, you could get full roll-out from early 2013 onwards, so news provision across the network.

Phased funding for news consortia could balance costs & benefits over 5 years

This is a hypothetical graphic that shows that, if the pilots and the full funding for regional news are rolled out according to that Digital Britain suggested timetable, this is what the cost/benefit analysis for the Channel 3 licensees looks like. You can see that the effect of external funding of regional news is to bring the licences much more nearly into balance. The DCMS consultation closes today, so we have submitted our response to it, and I would have thought that the Government will arrive at a decision on whether to create this contained, contestable element over the course of the next couple of months, and any legislative change that is needed will go into the Digital Economy Bill when it comes before Parliament in the Autumn.

Licence revaluation for Channels 3 and 5

I’m just going to touch on licence revaluation for the Channel 3 and the Channel 5 licences. This is something, again, that was flagged in the Digital Britain final report, which said that the Government would enact two clauses of the Communications Act which have two effects. One is to make sure that the Channel 3 and the Channel 5 services are available on all platforms until the end of their licence period. The second effect of the
enactment of these clauses is to enable the licensees to apply for a revaluation of their licences a year earlier than they might have done. They were already able to apply for a revaluation from the start of 2011 but, because of this change in legislation, they can apply for a revaluation from 2010.

All it required to make this happen legislatively was a commencement order, which has already been laid by the DCMS, so this process is now in train. It allows all of the ITV licensees and GMTV and Five to apply for that revaluation.

**Licence revaluation – next steps**

What that means in practical terms for us is that the licensees have until 31 December to make their application if they want a 2010 revaluation and before they apply, we would expect to consult on a methodology for the revaluation process. The link that I put on the slide there is one that details the revaluation process that we used last time we did this exercise back in 2005. I think it is worth pointing out that it is not likely that all the licensees will apply, because some of them are already paying a purely nominal amount for their licences. However, I would have thought that the higher payers might see it as being in their interest to apply and, once they have done so, we will do the work on the revaluation early next year, I would think.

**CRR – Competition Commission’s provisional findings**

This slide is really just reminding you of the CC’s findings on the CRR remedy which were published last week. There is no news here, this is all in the public domain but, as you will know, the CC concluded that there had been a decline in ITV1’s market power but that it still has all the big audience programmes, so an advantage in delivering large audiences. They recognise, though, that, while ITV still has this power, there may be unintended consequences of the CRR remedy. Notably, this is in circumstances where what ITV1 is looking to do is to launch services which provide the same programmes to viewers in a different form, so ITVs Plus 1 which has been talked about or the ITV HD service. Those services at the moment do not count under the CRR remedy, and this is a bar to innovation on ITV. Therefore, the CC’s conclusion was that the remedy broadly speaking should not be lifted but there may be arguments for some modifications, and it is now in a consultation process over what those modifications might be.

**Advertising restrictions**

Looking at the advertising restrictions where Ofcom controls regulation, I want to touch on one other area which is the issue of advertising minutage and the airtime sales rules for the commercial public service broadcasters. Under our code for the sale of
television advertising, public service broadcasters are allowed an average of seven minutes
an hour of advertising, and a maximum of 12 minutes in any one clock hour. There is a
further restriction on them in that across the hours of peak, so between six and eleven
o’clock in the evening, they can schedule only 40 minutes of advertising. Those are quite
tight restrictions, much tighter than required by the European Directive. By contrast, all the
other commercial broadcasters in this country can schedule nine minutes of advertising an
hour, and up to 12 minutes in any one single clock hour.

We did an update last year of our general rules on advertising in order to make sure
they complied with the AVMS Directive which comes into force at the end of this year. When
we published the final statement on that this Spring, we said we would conduct a further
review looking at the issue of minutage and also the airtime sales rules, which are another
rule that affects just the commercial public service broadcasters. That rule requires the
commercial PSBs to sell all of the airtime, so all of that seven minutes per hour, whereas a
purely commercial broadcaster can make its own commercial decision as to whether to sell
all the nine minutes or not.

We are coming to the view that with digital switchover upon us, there is really less
and less reason to maintain differential regulation as between the public service
broadcasters and the other commercial broadcasters. And so we’re going to be looking at
whether the playing field between the two should be levelled and, if so, how: do you level up,
do you level down or meet somewhere in the middle? Depending on what happens on
minutage, one will also need to think about whether the airtime sales rules should be
amended in line with that. We shall publish a consultation on that in the Spring of next year
and, in practical terms, that means that any changes which occur as a result of our decisions
will happen from 2011 onwards. Thank you very much.

PRODUCT PLACEMENT
Chris Banatvala
Director of Standards

I shall talk about the one other area of funding that has reared its head in the last
week – product placement.

Product placement – the process

Let me tell you a little about the story of product placement. Up to the last European
law, product placement was illegal in Europe. It was not allowed under the old Television
Without Frontiers Directive. However, a couple of years ago, Europe decided that it should
lift the ban but it left the actual decision to each individual member state. All member states
bar us and one other country decided to lift the ban. Back in March last year, the then Secretary of State, Andy Burnham, said that he would continue the prohibition. However, as you know, as of last week, the Government is now going to look at that again.

What does that mean in terms of the story going forward? The DCMS is likely to consult within the next few weeks, it is announced. Following that, it will have to enact regulations, it can’t just do it. At the moment, there are regulations ready to go onto the statute book but with a prohibition on product placement in place. They obviously need to lift that out and replace it. The likelihood is that the regulations will go forward without the product placement regulations that will be introduced later because of the slight delay.

Following the consultation, if the Government decide that they will allow product placement, it is likely to ask us to create a code around possible rules. We’d obviously have to consult on that and they will be in place in around Summer 2010. Having said that, it all depends on how long the Government consult for, though we note that all the political parties – the Liberal Democrats and the Conservatives – are in favour of product placement.

Product placement – European law

I’m going to look at three different areas: what Europe says about it, what our Government will look at and what we are likely to look at.

This is the European law, which is non-negotiable, it has already been passed and it is what we have to comply with. The first issue is, where are you allowed to do it? Films, series, sports and light entertainment. Even that list raises questions as to what is light entertainment, what is a series. A series means soaps and dramas; films mean films and made for TV films, and light entertainment is possibly the most difficult and controversial area to work out and we shall come to that later.

One of the stipulations is that it must not be in kids’ programmes. Another area that is very important is that it must not affect the editorial independence of a programme, so you can’t skew the storyline based on a product that has been placed. All broadcasters must signal that product placement has taken place, how we do that will be a matter for consultation but there must be some sort of signalling: it could be the logo of what has been placed, it could be a P, it could be a PP.

What are the other no-nos? No undue prominence, no promotion which is quite important. I am sure that many brands are getting quite excited about the possibility of being able to go into Coronation Street, asking for a pint and then saying, ‘that was a gorgeous drop of Tetley’s’. That is not allowed. It is purely the placement of products. Tobacco
products and prescribed medicines are prohibited, as is alcohol in programmes aimed at children, which stands to reason.

Encouragement of harmful activities as well: you must make sure that your treatment does not encourage harmful activities that include products that are placed. Again, themes, this is the idea that makes it different from America. You cannot have whole programmes based around a product. In America, you might remember that in Sex and the City they had a whole programme based around Jaeger, Prada etc. That would not be permitted under European law.

**Product placement – the Government**

What are the Government going to consider? Those things I have described just now are the minimum requirements which we have to ensure. Each member state, depending on its cultural outlook and perspective, can then decide title rules because of the way society is, and the Government will look at a number of areas on which I am sure it will consult. It will look at what other prohibitions it might want. There is restriction of alcohol in kids’ programmes, so will it want, for instance, to restrict all alcohol? As far as foods that are high in fat, sugar and salt, it might want to consider whether there need to be some restrictions around product placement as there is currently in advertising.

Scheduling: currently there are restrictions for certain products around scheduling. You probably don’t know but condoms are not allowed to be advertised in and around children’s programmes. Would you have that for placed products? That begs the question as to why you might want to place a condom in CBeebies?

Programme genre: I shall discuss this later. Kids are definitely not allowed to have products placed. It doesn’t mention news, current affairs and documentaries. Will the Government want to consider banning products placed in documentaries, news and current affairs, and what is a documentary? What is Jamie Oliver on Channel 4? Is it light entertainment or is it a documentary? You can see where it can be a little grey, and that is no doubt where Ofcom will come into play.

**Product placement – Ofcom and further implications**

Once the Government decides to allow product placement, if they do, they will likely pass us the code to look at and decide how we would implement it. These are the areas we are likely to be consulting on: signalling – how do we let people know?; what does a documentary or light entertainment programme mean and where can you place it?; what does ‘no treatments, no themes’ mean? Finally, what is promotion? “That was a lovely pint
of Tetley, you can get it at £1.99 at your local pub", probably quite obviously not a promotion, but there are other grey areas at which we need to look.

The future. The Government’s announcement is quite significant in terms of commercial funding of television programmes. It has raised the prospect that you can now pay for references in programmes, which is currently prohibited, and that has a huge effect on a number of commercial areas such as sponsorship. It says that the separation rule that was traditional in all broadcasting has now gone. You can pay for your references, it is limited but you can do so. Consequently, Ofcom, as that public policy changes, will have to look at the whole area of commercial references in programmes.

Sponsorship. The old rules used to say, for instance, that if you sponsored a programme, you cannot have your product within that programme, which maintained separation and was a backdoor way of prohibiting product placement. If you sponsor it and you have your product, you are effectively product placing. Now you are allowed to place products but the question is what liberties do people who sponsor programmes have within the programme, so we’ll have to look at that. We shall also have to look at what does undue prominence now mean, given the fact that you can pay for references. Therefore, it raises a number of very interesting and challenging issues.

Ed Richards: Thanks, Kate and Chris. We thought product placement was just a case of you can do it or you can’t do it, but it is a lot more complicated. The key point that we want to get across this morning in relation to that was not just the complexity of some of the issues around product placement if the Government decide to go ahead, but the relationship between that and the broader set of commercial opportunities around sponsorship. This has not been discussed very much so far but it does change those principles in such a way that we shall reconsider how sponsorship control is embedded in the code as well as product placement in due course. Therefore, it is a broader set of issues rather than just product placement. Any questions on what we have just covered?
Marc Sugarman, Citigroup: I have two questions. The first is on PSB .... and it looks from your graph that there is a chance that ITV could lose £30-50 million a year, or could have a deficit of £30-50 million a year between now and 2013. Is there any provision to make good that deficit in the meantime?

Ed Richards: No. Do you want to address them through me and I'll hand them over if we need to. The licence is for the licence period so we have to look at it across the whole period. It is also an opportunity cost measure, as Kate said, it is not a P&L measure, so what we are doing is highlighting the fact that it does go into deficit at that point and, if nothing changes, that is what we would expect to happen. That is precisely why, as many of you who have been here before will know, we have been flagging this consistently for some time now.

The key point at the heart of this is the observation that Kate made about regional news. You can adapt the obligations here and there, a little bit up, a little bit down, but the key factor which is absolutely determinative is the presence of regional news. That is the tens of millions of pounds obligation that pushes it into deficit. So that is the reason that we have tried to ensure that people concentrate on that question and whether or not there is an alternative approach to that over the next few years.

As far as some of the other obligations, we have a difference of view with ITV: they think that they have higher costs than we do but, self-evidently, high levels of UK origination, the independent quota of 25%, these are all obligations. In some cases, they believe they have significant costs, and in other cases we agree with them. That is how it looks but the key thing is the regional news obligation.

Marc Sugarman, Citigroup: I also have a question on advertising and CRR. I think that ITV1 made a loss in the first half of the year and will probably make a loss for the full year this year. Isn't it pretty obvious that, in order for them to support the level of investment they need to create the peak time programming, they need some kind of pricing power? In no other market in the world do we see the sort of constraint that ITV is under. In the past, you have talked about trying to make sure there is a third leg and trying to make sure that the commercial sector does not fail, but isn't what is happening with CRR and the fact that you can't do anything about advertising rules until 2011 making it likely that the commercial sector does fail?
Ed Richards: First, I don’t think that it is failing, so it is a question of how strong it is. Secondly, the Competition Commission is the final authority on this, so we’re not get into the position where we are arguing in public with another competition authority. We have to respect their view, we have talked to them about these issues. However, I do not believe it is as obvious as you suggest in the sense that it is not as if it is a policy. Conferring or agreeing to pricing power for ITV is not something that has no consequences. The consequences are for advertisers and, therefore, consumers, so you are trying to think about two things here. One is whether that is legitimate pricing power or not, whether that pricing power would take place, the consequences for advertisers and consumers, so competition in the more conventional sense. On the other side, you raise the issue as to whether there are broader consumer benefits that you can attribute to the ability of a company like ITV to fund an expensive peak-time and indeed non-peak schedule. That is the tension but it is a balancing act and it is a complicated question, and I don’t think it is as simple as surely they should be given pricing power. You would not say that in any other market.

Question: When you talk about the increase in advertising minutage, we have seen levels of price inflation in the UK TV market of up to 30% since 2002. By increasing advertising minutage or the rules, the restrictions around advertising minutage, is there a risk that you might accentuate that pricing deflation within the UK TV market further if you do make these changes to increase the overall level of minutage permitted by the PSBs?

The second question is around the airtime pricing review. You have previously talked about a full market review of airtime pricing, which I believe was withdrawn some years back. Is there any consideration to revisit that full market review of the way that TV airtime is sold in the UK?

Ed Richards: In relation to the first question, there might be that risk if that is what we are proposing but, if you listen carefully to what we were saying and look at the slides carefully, that isn’t necessarily what we are proposing at all. We are saying that we are going to look at the rules. The rules clearly have a ceiling on the amount of airtime that can be sold and, if you remove that, there would be scope for an increasing supply of the kind. But the rules also have a floor which says that the PSBs must sell out a certain amount of advertising and Kate was saying that we would look at both of those, and we would look at the consequences and impacts and the case for keeping any of those rules. Therefore, one side of that could end up in increased supply, and the other side of it could
end up in reduced supply. We have not made our view clear on that but it is important not to assume that looking at the advertising rules on minutage assumes increased supply; it could result in the exact opposite. It is the same with the nine to seven: you could bring the nine down to the seven rather than taking the seven up to the nine, so this could work both ways.

As far as the market review, we have in the past talked about a market review, that is absolutely true, though not particularly publicly. We have discussed it with stakeholders and on both previous occasions when we have done this, people have shown a distinct lack of interest in it and have not thought that was a sensible way forward. That may change in due course. From our perspective, we want to see the outcome of the Competition Commission’s considerations on CRR, so we shall see where that gets to, what the outcome is and where we all are. At that point, we will certainly cover the issues that Kate discussed in terms of the advertising minutage rules, and we shall consider whether there is a case for anything broader and listen to what other people have to say: advertisers, broadcasters and so on. We’ll have a look at that. We won’t be launching a major market review without having that informal dialogue first. A market review of that kind is a very substantial endeavour. It takes a lot of time and unearths all sorts of things, so we shall want to assess the case for anything like that before we embark on it.

**Matthew Walker, Nomura:** I have two questions. One is on the advertising rules. Does changing the rule on having to sell all the airtime for the PSBs necessitate a change in the station average price to a different system? Secondly, if the Conservatives do get in, which is still an ‘if’ at the moment, and they have talked about abolishing Ofcom, how will these consultations, programmes, rule changes be taken forward, or will they all just be dropped?

**Ed Richards:** To the first question, the answer is I don’t know but let me be very clear. We are not signalling whether we are or are not going to change those minutage rules. We are saying that we are going to look at them and ask ourselves the fundamental questions about them: is there a compelling public interest competition reason for having them? If we conclude that the answer is no, we’ll get rid of them, within the European framework obviously, which has to be a given. Whether that affects station average price, I don’t know. We’ll have to look at that in due course. One of the challenges for everybody in this area is that the whole station average price approach, the whole system is relatively opaque and quite difficult for people to understand. Therefore, we’ll have a look at that as part of that review.
As far as the question about a change in Government is concerned, you will probably have to ask them, but we plan to get on with all of this work in the way we always have. We only do things that are statutory obligations, we don't do things which we have no powers to do, we shall carry on doing them and have sensible discussions in private with the Conservative party in case they win the election.

**Andrea O'Keefe, JP Morgan:** Can you talk about how a possible reduction in minutage might impinge upon CRR? In a reduced minutage environment, potentially that could force prices up and yet CRR is effectively price-setting. How would you manage the balance?

**Ed Richards:** That is exactly why we want to wait to see where we are with CRR for precisely that reason. We have to see what final conclusion the CC comes to and it is important to say that the CC has not reached a conclusion. There is scope in what they have said for a very significant dialogue with them, which I am sure ITV and others will have, and I am sure we'll talk to them as well. That discussion is far from concluded and once we know where that is, and I believe we are expecting it by Christmas, we shall be in a position with a firm framework to know how best to approach these advertising issues. What we want to signal clearly today very clearly is that there are some issues which need to be looked at. We recognise the pressure that the commercial broadcasters are under here, and I think it is absolutely the right time for us to ask those fundamental questions about whether any of these rules actually has enduring, compelling competition reasons for keeping them and, if not, we won't want to keep them.

**Julien Roch, Barclays Capital:** I have a question on regional news. What would happen to the revenue on ITV3 during regional news even if ITV claims there is very little advertising – there is a little bit?

**Ed Richards:** I believe I am right in saying, Kate, that there is no revenue. What they do is optimise the schedule and, because in relative terms the viewing, although substantial, is lower there than, say, for *Coronation Street*, all the advertising minutes that they are able to schedule in line with our rules and European law are placed around *Coronation Street*, *Emmerdale* and so on. Therefore, there is currently no revenue associated with that slot.

**Julien Roch, Barclays Capital:** But that assumes that the one before and after is linked to the next programme.
**Kate Stross:** On ITV at the moment, there is a short break at 6 but there is not another break until probably 6.45, which is half way through the national news. There is no break at all in the middle of the regional news or between the regional news and the national news. There is only a very small amount of advertising ahead of the regional news but audiences are relatively low, as Ed says.

**Ed Richards:** We have looked at that and we just do not think it is a big issue. In fact, it is a dangerous issue in the sense that, if you started saying we have to push minutage in and around that, you would be imposing a sub-optimal distribution of the advertising and, given where ITV are at the moment, that would seem an extremely perverse thing to do.

We’ll move on to Pay TV.

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**PAY TV MARKET INVESTIGATION**

*Steve Unger*

*Competition Director and CTO*

As I am sure most of you are aware, the third consultation in our Pay TV market investigation has just closed. What I want to do today is to talk about the proposals that we set out in that consultation. It was published in June and I should emphasise that we have only just started reviewing the responses to that consultation. The responses are quite extensive. All I shall do is talk about where we were in June; I’m not going to try to respond to those consultation responses.

We understand that there was a fair amount of interest in the detail of the proposals we set out. We are happy to take questions towards the end but if they are too detailed, we shall have to pick those up off-line. Finally, I should emphasise that, although we are happy to talk about the details of the proposed remedy, that should not be taken as implying we have made any decision at this point as to the more basic question of whether we should intervene at all. We’ll have to return to that question once we have reviewed all the responses.

**Context**

With those caveats out of the way, let me talk about where we actually are. The market investigation was initiated in 2007, following a submission from BT, Setanta, Top Up TV and Virgin Media.
The first consultation was in December 2007 and there we set out some initial concerns particularly around premium content. The second consultation talked about those in more detail and in the June consultation we set out some more specific proposals for a ‘wholesale must-offer’ obligation in relation to Sky’s premium channels. We also talked about how we would take forward some residual concerns around upstream rights markets. I note here that the consultation has just closed and we are starting our analysis of the responses.

**Content markets and market power**

The first substantive point really relates to the importance of premium content. What we believe, and it is probably no surprise to anyone here, is that we premium content matters as it is the key driver of Pay TV subscriptions. Consumers’ choice of Pay TV services is mainly driven by the choice of content that is available. We believe that for specific content to be an effective driver of subscriptions it has to have two characteristics. Obviously, it has to be attractive to consumers but also, importantly, it cannot have a wide range of substitutes available on free-to-air TV, otherwise consumers would not pay for that content.

The most important examples of content that fall into those two categories are live top-flight sports and first-run Hollywood movies. Our view, which I think is a widely held view, is that Sky’s success has historically been largely based on acquiring most such content rights in those two areas, aggregating that content onto its channels and broadcasting those channels onto its platform.

I should emphasise that we are not trying to imply that we believe that type of aggregation is a bad thing. Indeed, aggregation is often a very effective mechanism of delivering a high quality service to consumers. The concern potentially arises when aggregation also results in market power and, as I have also set out on this slide, we do have a concern that Sky has market power in the wholesale supply of what we have described as core premium sports and movie channels. It is worth noting that is not all of the channels that Sky markets as premium channels, it is essentially Sky Sports 1, Sky Sports 2 and most of the movie channels. I should say that, in terms of reaching that conclusion, there is a lot of debate about precise market definitions. The conclusion on market power is actually not particularly sensitive to the precise market definition that you adopt.

**Three effects on competition and consumers**

We have then talked in more detail about the ways in which we believe that Sky exploits its market power. Firstly, we consider that Sky distributes its premium channels in a way that favours its own platform, its own retail business, and that distorts competition. The
main effects of that from the consumer perspective are that, most immediately, it reduces consumer choice: so most obviously, consumers on terrestrial television are unable to access premium content. Secondly, and probably in the longer term, it potentially holds back innovation in that is likely to be difficult for new platforms to develop if they are unable to access this premium content. So we have talked about that set of concerns in some detail throughout our consultation process. Alongside that concern about the restricted distribution of channels, we are also concerned that Sky may have an incentive to exploit its content rights in a way that favours its own platform.

One specific example of that, which we have highlighted in our most recent consultation, relates to subscription ‘Video-on-Demand’ rights. This is a particular set of rights that is likely to be important for the future development of IPTV services. At the moment, particularly in relation to premium movies, Sky acquires the rights from all six studios for subscription video-on-demand alongside the linear channel rights, they are bundled by the studios. However, Sky only has a limited capability to exploit these rights itself, so it does not exploit them very extensively. It does exploit them via, for example, its Sky Player service but not very extensively, and the effect is that other platforms which might be better placed to exploit these rights are unable to do so. That could prevent innovative IPTV type services which might make use of this content being delivered to consumers.

The third set of concerns we have relate to levels of pricing. There is a potential risk that Sky could set high wholesale prices, and that would feed through into high retail prices for consumers. This is a very complex question and the evidence is quite difficult to interpret. Where we came to on our last document is that on a range of different scenarios, we believe that Sky is currently making returns above 20%, and that is well above our estimate of its current cost of capital.

We have recognised that care is needed in interpreting these types of figures on a historic basis, given the risks that Sky has historically incurred in building its business. I'd emphasise that in our last document we have not attempted to make any comment about historic returns. However, we do believe that the risky investments that Sky made in the early 1990s in building its business are less relevant on a forward-looking basis now in 2009.

**A wholesale must-offer remedy**

What we have proposed is a wholesale must-offer remedy. What we have suggested is that this is preferable to the most obvious alternative which would have far-reaching changes in the way that content rights are sold, and that is because it is would deliver significant benefits to consumers with a relatively low risk of unintended consequences. Specifically, we believe it would allow other operators to develop Pay TV
offers which include premium content that both increases access to that content, provides more consumer choice and allows new types of platforms to develop and innovate.

Very importantly, we did not believe that this proposal would be particularly disruptive for Sky’s existing business or for consumers who are currently purchasing services from Sky. There are several reasons for that belief. First, Sky already wholesales to Virgin Media, as I think we all know. Secondly, Sky has offered on a voluntary basis to extend this supply arrangement to other platforms. I believe Sky disclosed on Friday the fact that it entered into detailed discussions with us about such an extension, and I shall return to that point in a minute. At a high level, I would emphasise that we disagreed on the price associated with such an arrangement but there were no show-stoppers around the overall principle of such a supply arrangement.

Finally, I note that we did not believe this would be disruptive for rights owners and the continued generation of content. We recognise that is important. The first reason why we did not believe that it would be disruptive is that our proposal would not materially reduce the level of wholesale revenues that are available to Sky and others to purchase content. Nor did we believe there would be a major change in the incentives faced by bidders, which are the main thing that determines the price that people pay. The reasons for that are a little more complex, so let me elaborate slightly. We can divide the potential bidders for content into different groups. Two sets of bidders are the free-to-air broadcasters and those broadcasters who are not vertically integrated, such as ESPN. We believe that for those two groups, the bidding incentives would not be affected by this wholesale supply arrangement. We recognise that there would be some effects for those companies such as BT and Virgin who are vertically integrated.

Therefore, in the short term the effect would be that those companies would have an alternative means of accessing premium content. That might mean that they were less interested in bidding for the rights themselves but we have taken the view that, if we look at the recent bidding processes, we do not believe that would have a very material effect on the outcome in terms of prices paid. In the longer term, and this is, I think, a particularly important point, as those companies build their own subscriber bases, they will become better able to bid for content rights themselves. Despite the presence of the wholesale must-offer, they will have a continuing incentive to bid for these rights, because ownership of rights gives you editorial and branding control over the channels you are able to develop with those rights. On balance, we felt this could even be beneficial for rights owners.

I said I’d return to the question of our discussions with Sky. We did refer to these discussions in our recent consultation. We redacted the relevant text at Sky’s request
because the discussions with Sky were confidential. Sky asked us to maintain that confidentiality, and of course we have respected that.

I’ll make a few high level comments, though, given the fact that those negotiations are now in the public domain. First, the discussions were serious and it took a significant amount of resource both from ourselves and from Sky over a period of several months and we were committed to trying to reach a voluntary settlement. I think we all recognise that, if we could have avoided the protracted formal process, it would have been a benefit to everyone. If we had reached agreement with Sky, the process we would subsequently have followed would have been to consult publicly on accepting these commitments in the form of undertakings in lieu of a reference to the Competition Commission, and that is the process by which they would become legally binding.

The expectation was that, in addition to that, these commitments would address the Competition Commission’s concerns associated with Picnic and that then would also allow the Picnic proposal to proceed, which would be very much in Sky’s interest, as well as in the consumer interest.

We made, I think, very significant progress on a number of quite difficult issues. It became clear that some quite complex non-price questions such as how you would address minimum security requirements on non-Sky platforms, how to include high-definition as well as standard-definition channels within these type of supply arrangements - those were difficult issues but they were not going to be show-stoppers.

Where we ended up disagreeing was on price, and the position there is that Sky came to us with a pricing proposal but they made it clear to us that the pricing proposal was not for negotiation. They maintained then, as they do now, that pricing is a matter for them, not for regulators, and it was excluded from the scope of our discussions.

As to why we weren’t able to proceed on the basis of the proposal from Sky, there are two sets of issues: one about the structure of the pricing proposal and the other about the level of the pricing proposal. On the structure, what they proposed, and I think they talk about this at a fairly high level in what they put out last Friday, is that they would start with the cable rate card as it is at the moment and, what they proposed is that although they did not want to move away from that cable rate card for the baseline prices, they were willing to consider a set of discounts to that cable rate card relating to platform penetration. That does have the effect for some companies of bringing the price down. There is, however, a potential concern that it would incentivise platform operators to focus on reselling Sky’s content rather than innovating around it. If that incentive becomes too extreme, that starts to run counter to our main objective which is, of course, to encourage new entrants to
differentiate themselves from Sky rather than simply reselling Sky’s services. So that was one type of concern.

The other concern we have is that, even at quite high levels of platform penetration, the prices that Sky were proposing would not have allowed an efficient entrant to enter the market, compete with Sky and deliver an attractive retail proposition to consumers. That is in the end why we weren’t able to proceed on that basis.

**Proposed terms of supply**

Back to the present, we consulted in June on the scope and structure of a wholesale must-offer obligation, we consulted on some pricing principles and we consulted on a specific range of prices. Firstly, we proposed that the obligation should apply to those channels which make a material contribution to Sky’s market power, and we have taken the view that Sky Sports 1 and 2, most of the movies channels and that should include HD, as well as SD variants of those channels.

In terms of the mechanics, we proposed that this would be implemented by a new licence condition on the relevant channels, that would be imposed under Section 316 of the Communications Act, which permits Ofcom to impose those licence conditions which we consider appropriate to ensuring fair and effective competition.

There are a couple of exclusions that we propose, both quite significant. Firstly, we propose to exclude Sky’s own platform from the scope of the obligation. We have taken the view that a world in which other operators were able to enter the market, resell Sky’s content and also resell Sky’s platform services, both on regulated terms, that would not deliver the type of competition we are seeking, the type of innovation we are seeking and would also be highly disruptive to Sky’s existing business.

We also propose to exclude commercial premises from the scope of the obligation. Concerns have been put to us in relation to the supply particularly of live sports to commercial premises, but those concerns relate mainly to the level of pricing and not the availability of this content, and a wholesale must-offer obligation set on a retail-minus basis can’t really address those sorts of pricing concerns. We also propose that Sky will be able to set minimum security requirements to guard against content piracy.

In terms of pricing principles, what we propose is that prices will be set on a retail-minus basis. We recognise that the alternative would be to set prices on a cost-plus basis. That does have some quite significant advantages. Cost-plus pricing has one advantage in that it does not require a regulator to take a view as to what downstream models of competition it wants to encourage. You look at the costs rather than trying to look at the
retail cost stack of different businesses. In that sense, it is a cleaner way of thinking about the problem.

Secondly, setting price on a cost-plus basis has the advantage that potentially it allows you to address any concerns around the levels of wholesale margins. However, there is also a significant risk in this case of unintended consequences that would flow from setting prices on a cost-plus basis, and that's because potential bidders for rights would have a strong incentive not to bid in order to try to keep down the price of those rights, which in turn would become the input to our cost model and, therefore, determine the prices they pay for the wholesale channels. We need to make sure, therefore, that we do not intervene in a way that creates that rather perverse set of incentives. Therefore, we focused on retail-minus pricing but what we have done is use a cost-plus model as a cross-check but also as a floor for the retail-minus prices to make sure we are not damaging the upstream production of rights.

The retail cost stack that we have looked at is based on Sky's own costs as the best available proxy for an efficient retailer. We have made two adjustments to that, the first adjustment is that we have looked at DTT as well as DTH transmission costs for the fairly obvious reason that we are keen to see entry on DTT as well as DTH. That includes from Sky, in terms of its own Picnic proposal, as well as from other platforms.

Secondly, we have made an adjustment to allow for the fixed costs associated with market entry. We have modelled a company which is as efficient as Sky but starts at a smaller scale, and our central case assumes a large entrant with £12 million fixed costs reaching three million subscribers after about 10 years. The proposed prices are based on a 10-year NPV, including a terminal value at the end of that period being zero. I would emphasise, therefore, that the way in which we have approached the pricing is designed to ensure that we are supporting entry by companies that are making a long-term commitment to sustainable market entry. We are not trying to set prices in a way that would allow companies to make a fast buck from reselling Sky's content.

I have given an example here, so the wholesale price of Sky Sports 1 and 2 at the moment is £18.39 - actually not at the moment, it's just changed - at the time we published our consultation in June, the wholesale price was £18.39 per month per sub. We consulted on a range of prices from £14.10 to £16.48 but we have said in the document that we have a preference for a central case which is a large entrant on DTT. That central case gets you to a price of £15.69, that is a 15% reduction on the current wholesale price. I think there's a number of of 30% which I've seen cited in some analysts' reports for our proposed reduction and that is not correct. The 30% figure is for the bottom of the range on which we have
consulted but I think we have made clear that our preference is for a central case which would correspond to this 15% figure.

One other point worth noting is that the current price of £18.39 includes Sky Sports 3. The way the wholesale rate card works is that, at the moment, Sky Sports 3 is a bonus channel provided to anyone who buys Sky Sports 1 and 2. We’re not proposing to extend the regulation to Sky Sports 3 as we do not see it as falling into our market for core premium content, so the prices we propose here do not include the supply of Sky Sports 3. Finally, I would note that you can compare these numbers to a cost-plus cross-check of £11.34, so we are well above what might be applied by cost base analysis.

I would emphasise of course there is a fair amount of uncertainty about these precise numbers. The models are quite complex and for that reason we set out a range of sensitivity checks in our consultation, and I am sure we shall return to this analysis once we have reviewed all the detailed consultation responses.

**Estimated impact of our proposals**

So in terms of the impact of our proposals, in our June document, we set out a fairly detailed analysis of the impact of these proposals. Even on a static analysis, we believe the effect will be broadly positive for most stakeholders. It is worth pulling out the basic reason for that belief from the detail. We believe that the remedy will primarily have the effect of expanding the market for premium content by allowing new consumers to access this content on DTT and IPTV. If the remedy is designed in a manner that ensures that is the main effect, then that can be beneficial for both consumers and producers. There will be some churn between platforms but we don’t believe that will be a level that will be disruptive to existing retailers.

The particular numbers we came up with in our last document are, first, in terms of our estimated consumer surplus which we believe works out at around £370 million over five years, mainly down to new consumers on DTT and IPTV. There is some benefit to consumers from being able to access packages for example on DTT which are a better match to their requirements than the packages they are currently providing, but that is not the main effect. Secondly, as far as the effects on Sky, we believe there will be a reduced growth rate of Sky’s retail subscriber base but that growth rate will still be positive, and the effect there will be more than offset by substantial growth in its wholesale subscriber base. That leads us to a net producer surplus for Sky of £240 million.

We have recognised there will be some additional administrative costs for Sky from these new arrangements but, given that they already have a wholesale supply arrangement in place with Virgin, we do not believe that is very significant.
In terms of the static effects on other Pay TV retailers, when we run our impact assessment model, the outcome is that over a 10-year period this is neutral for other retailers. That is not a surprise, that is an input assumption to the pricing model, we designed the prices precisely to ensure that over a 10-year period this is neutral for other retailers. The benefit that other retailers get from this is not in terms of being able to make a high margin on Sky’s content; it is the ability to innovate around that content. That really comes to the last point on this slide that we see significant dynamic benefits for consumers: the combination of this premium content with new distribution technologies enabling new services. Those benefits are very difficult to quantify but we believe they are likely to be at least as important as the static market expansion effects.

Next steps

The consultation closed last Friday. We now need to revisit our analysis. We are obviously getting some quite extensive responses to that analysis. Once we have done so, we expect to issue a statement, and that’s probably early in the New Year. In parallel with that process, we need to conclude our assessment of the Picnic proposal and I am sure you are all aware that the majority of the respondents to our last consultation agreed that our consent to Picnic should be subject to an effective wholesale must-offer obligation being in place.

We did say in June we did not believe there was a case for intervening to require far-reaching changes in the way that content rights are bought and sold, but we did identify a couple of specific areas where more targeted interventions may be appropriate. The first of those I have already touched on - that’s the question of the subscription Video-on-Demand rights. We said in our last document we thought there were benefits to consumers from those rights potentially being made available more widely. We were looking at whether there was a case for making a market investigation reference to the Competition Commission to explore that further, it is not something we would have jurisdiction over, but we first wanted to explore with the studios whether their existing commercial plans would essentially make those rights more widely available anyway and thereby remove the need for consideration of any form of regulatory intervention. At the moment, we are going through the process of talking to the studios.

In terms of live Premier League rights, we noted that the commitments previously agreed with the European Commission have now fallen away and we, therefore, expect to explore with the Premier League how it expects to ensure that the 2012 auction complies with competition law. That may involve the Premier League providing further commitments. That does not mean to say they would be simple carry-forward commitments that were
previously in place. For example, one particular area of focus might be the supply of live football to commercial premises, given that is not an area that is addressed by our wholesale must-offer proposals.

That is it.

Question & Answer Session

Ed Richards: Thanks, Steve. Any questions on what Steve has covered?

Question: It is a detailed question about your modelling of viability. If you have taken a DTT entrant, I assume they are not going to be able to use, say, existing spectrum blocks particularly given there is a high-definition component to those. Are you able to say what your assumption is of how much they have to pay for their spectrum?

Steve Unger: We did not disclose that in our consultation. We have disclosed it to a few parties but probably now is not the time to disclose it publicly.

Question: Is it fair to say that their viability is very sensitive to that assumption?

Steve Unger: We did publish a sensitivity check. We looked at the recent transactions around DTT capacity, we took a central case and we ran a quite wide-range sensitivity analysis around that. It is not massively sensitive, truthfully, particularly as you grow to scale in the latter years. It is an important determinant of per sub costs in the early years but over the 10-year period we have modelled, it is not such a significant effect.

Ed Richards: We have omitted to ask where you are from and almost none of you have said but, if you could do so from now on, that would be very helpful.

Julien Roch (Barclays Capital): The first question is that Sky in their Friday press release have claimed you made a significant error in your calculation, I believe they mentioned schoolboy. Could you tell us where you probably disagree with the Sky statement and what they are talking about? Secondly, in your remedy you only talk about Sky Sports 1 and 2, because Sky Sports 3 is a bonus channel, but could Sky remove the bonus element and start to do what they did a couple of years ago with Sky Sports Xtra, i.e. shift good content on Sky Sports Xtra and therefore completely undermine the remedy?

Ed Richards: Let me answer the first question and Steve will pick up the second. The answer to the first is that we received Sky’s submission late on Friday night and we have not had a chance to look at it yet, so we shall look carefully at what they have
to say, as we always do. I have not had a chance to read it yet, the team has just begun to read it and we'll see what they have to say. If we have made errors in their view, we'll have a look at it and I am sure we shall get submissions, and we have had submissions from other people for whom we have no doubt made errors the other way. I feel pretty confident that we'll get submissions of that kind. We'll see when we go through them all and we shall obviously look at our work, including the modelling, very carefully and take it from there. Steve, do you want to pick up the bundling point?

**Steve Unger:** There is a particular question about scheduling and to what extent can Sky move content around between different channels. We have said in the document that is one way in which they can potentially try and game any remedy, and there are two reasons why we are less concerned about that. First, I do not believe they have the incentive to undermine the quality of what are, after all, their flagship channels for their own business, so I do not believe they would do things to Sky Sports 1 and 2 which would undermine the attractiveness of those channels to their own retail subscribers. Secondly, I think we have made clear that if they, in a major way, moved content between channels in a way that creates a new source of market power, we would then have to look at that source of market power on the evidence and decide whether it was then appropriate to extend the obligation to cover those channels.

**Ed Richards:** The key point is that we have defined the source of the market power in relation to the nature of the content, so if the content gets moved somewhere else, the remedy in those circumstances has to follow the content. We are not over concerned about that as an issue in relation to the proposed remedy.

**Julien Roch:** But as a retail subscriber, you subscribe to 1/2/3/Xtra, so you don’t care whether it is on 1 or Xtra. The second thing is that, if Sky abuses it, you have to do another consultation when this one is not finished, there will be law suits…..

**Steve Unger:** For that reason, some parties have argued that we should extend regulation to all of Sky’s channels regardless of whether content is on them, which is quite a disproportionate response. We believe that there is a world in which Sky might move content around and tell people to keep switching channels to follow it. I do not think that is a very attractive consumer experience, and Sky is nothing if not focused on the retail experience. I do not believe they will do things that undermine that retail experience and, if they do, as Ed says we shall need to look again at which channels are captured, acknowledging the fact that our basic concern is around particular categories of content. You are right - that does take some time, it is a process we shall have to go through but, on
the other hand, I assume that the current process will establish the basic framework and the precedents would subsequently follow.

**Ed Richards:** You are racing rather a long way ahead. We are still in the process of looking at the arguments that different parties will make to us. Sky have made the arguments they have already put in the public domain and which we shall read during the course of this week and next. Other parties will make the kind of arguments that Steve has been talking about as well, so I would not race ahead too far today. We need to decide whether we think the proposed intervention is the right one, we have not made that decision yet, and we have to consider the cases put to us, both in relation to that core issue but also in relation to the effectiveness remedy if we decide to go ahead with the intervention. Those are the next steps and I think some of these other issues are things we can consider once we are over those steps.

**John Karidis (MF Global):** I have a couple of questions. First, oblique or otherwise, is there a link between the Government wanting to change the law to make Ofcom pro-actively encourage investment in infrastructure and the fact that in the Pay TV consultations you observe that the way that Sky controls content is having an impact on their development of a number of platforms, including IPTV? Secondly, talking to people who are close to Sky, Sky are of the opinion that they can kick this issue into the long grass by appealing it, and then you speak to people who are close to BT and Virgin Media who say the appeal will run concurrently with this issue being implemented. I am not a lawyer - is it possible to clarify the issues that are relevant to try to get an answer to this question please?

**Ed Richards:** On your second question, I am not a lawyer either so we may struggle with it but we shall try and give you the best understanding that we have. Let me deal with the first question first and say there is no direct or indirect link that I am particularly aware of. We started this process, as Steve said, some time ago, a long time before the kind of proposals that the Government came forward with. We made the argument for discussion and consultation about the dynamic benefits of innovation, particularly around other platforms and particularly around IPTV in the future. I think since that time, people have seen the case for, and development of, investment propositions around IPTV, so those two things have come together but I don’t think that comes as a surprise to anyone in the room. We have all known for some years that the potential for IPTV exists and that, sooner or later, network companies will begin to consider investing in that kind of capability.

I think separately, the Government have said what kind of network does the country need, and what set of duties does the regulator need to make sure those investment
concerns are placed at the forefront of their thinking alongside competition. Remember that we have a duty to promote competition, not a passive duty but a duty to promote competition. Therefore, I think the two things can co-exist perfectly happily without there being any particular link.

On the appeals side, and Steve may want to add something to this, our intention is to put out a final statement either just this side of Christmas or just the other.

Steve Unger: Just the other I think!

Ed Richards: I like this side, Steve likes the other - healthy internal debate on those sorts of things! Then we fully expect Sky to appeal in every way it can, we always have done and are perfectly relaxed about that, it is their right and we have no problem with it. The course of that appeal, as you rightly say you will have to ask lawyers, we have our own view of it but we would expect, if we were to take the decision that we set out in the proposal and if we were to use the powers that we have set out, we would expect to move swiftly to the implementation of a remedy under those circumstances. There are different forms of appeal that you can propose, so we would have to look at those and address them as and when they come, if indeed they do come.

John Karidis: I am sorry, can you tell us what your own opinion is? You said that you have your own opinion.

Ed Richards: No, because it depends upon the nature of the appeal. There are certain kinds of appeal which are a judicial review and there are other appeals on the merits.

Steve Unger: It also depends on the nature of the decision we reach. We haven't yet reached a decision, we therefore do not know what the grounds for appeal would be against that decision, and we don't know who would appeal. I think it is entirely likely that it is not just Sky but we could end up in a position where a number of parties are dissatisfied with the outcome and appeal it, so we do not know what the grounds for the appeal would be. It is not actually us who then apply the test. The test is around serious irreparable harm but it is not us who apply that test to the particular decision that we have taken. I think, there are several different reasons why for us to take a view now on the likely outcome would be highly speculative.

Ed Richards: Just to underline that, we have not made a decision, we are still consulting on it. When we make a decision, everyone is presuming it will be Sky that appeals. As Steve says, there are many other parties who might appeal as well, depending on what decision we come to and depending on where we go. It is important for everyone
here to remember that this is not something we initiated. This was a complaint brought to us by four other parties and sometimes we get complaints which we do not take seriously, because they don’t cross a threshold of administrative priority or, indeed, seriousness of the nature of the issue. In this case, it was a serious complaint and we have looked into it in the way we have. The notion that there is only one side to this discussion is really misplaced. There are two sides to this discussion and two very different points of view. If you go back to the original complaint and the proposed remedy or the proposed action suggested by the complainants is very substantially more draconian than the proposal that we are currently consulting on.

Patrick Wellington (Morgan Stanley): I have three questions. Have you done an impact assessment of your Pay TV review? If I look at Sky, they have 9.5 million subscribers, they have just had the best subscriber growth for the last five years, 2 million people use their PVR so that they can watch both Strictly Come Dancing and the X Factor, so there seem to be some benefits associated with Sky. What is the benefit to the consumer from all this process?

Ed Richards: I assume that question one, let’s keep going.

Patrick Wellington: Question two is that Virgin appears to get perhaps some unintended benefits out of this process in that they will get lower wholesale prices but they are not a new platform. Is it fair that they should be an unintended beneficiary of this review? My third question is a generic one about the nature of regulation. As you went through your process of describing your notional DTT platform, I wondered whether you would be prepared to fly to the moon using your models, because I don’t think I would be, in terms of their reliability and the assumptions that go into them. Don’t you think that you are making a rod for your own back in creating these sophisticated notional models, which may or may not divide by 12, in order to regulate going forward, and shouldn’t simpler method be used, whatever that may be?

Ed Richards: Patrick, since you ask the question, what would your simpler method be? Do you want to take that away and think about it and I’ll answer the three that you have posed?

Patrick Wellington: I will answer it. As analysts, we spend our entire lives trying to predict the future and I am not sure that many people here would use their DCF to fly to the moon with, to use the analogy. If you go back to the days of Oftel and Bryan Carsberg, it was a simpler process with, arguably, simpler remedies, which did not require the same level of modelling. If you go through this review, you will constantly have to update
your notional DTT retailer, your various versions. I note that Sky would suggest, to give a
direct answer, that you take a real life example of Picnic and use their assumptions of how it
might work for them, because they at least have some basis in reality.

**Ed Richards:** I am sure they would but that is an interesting supposition,
because it presupposes that the answer to the question is that we are going to do it,
whereas we have not reached that conclusion yet. Let us try to take your questions in order.
As far as the impact assessment, those of you who have actually read the document will
know that there is a very thorough impact assessment indeed, which is the source of the
numbers which Steve quoted about the overall consumer surplus and the additional benefit
we think a remedy of that kind would attribute to Sky. Steve, you might want to talk a little
more about what we did in that area but we always do impact assessments of policies and
this is no exception. I’m going to answer the nature of regulation one and you might come
back to the Virgin question.

There have been times in the world when things have been simpler, and I do not
think we approach this with any great relish. It may suit some people to characterise us as
sitting in here making up models because we like it, and because it is good fun, because we
want to interfere, having nothing better to do. However, I am afraid that is a characterisation,
it is not what we do. Just to repeat what I said a moment ago, this is a complaint that was
brought to us by four parties, it was a serious complaint about the nature of competition and,
in their view, the absence of effective competition in the market. When you are a
competition authority as we are and a sectoral regulator with a duty to promote competition,
you cannot go around ignoring those sorts of issues, it is as simple as that. If that brings
complex economic challenges, then it brings complex economic challenges and we have to
try to meet them as best we are able to.

Needless to say, when you do models of this kind, people can dispute them and
argue about them and, if we get to that point in the process, I am sure that will happen.
However, as I also said earlier, people will dispute it in both ways. People will dispute it from
the side that says any pricing intervention of that kind should be higher, and people will
argue that it should be lower. We need to try to take the best view and, of course, we need
to aim off uncertainty and to try to deal with that uncertainty in the best way we can. But
“because it is difficult” is not a good enough reason to ignore it, not when we believe there
are serious competition issues that need to be addressed in the consumer interest in the
way that we set out for consultation in the current document. Steve, do you want to pick up
the Virgin point and is there anything else you want to add on the impact assessment?
Steve Unger: Let me cover the impact assessment point first. The impacts divide into the static effects, which you might at least be able to quantify in some sense, and the more difficult-to-predict dynamic effects. What we did, in our impact assessment, we talked about the dynamic effects qualitatively. As far as the static effects, we do build a model to try to quantify them and that model is imperfect, of course. I am not sure we would use it to fly to the moon on. The alternative would have been not to make any attempt to quantify those effects. We felt it was better to attempt to quantify those effects to run a fairly extensive set of sensitivity checks around those effects, so the numbers I quoted alongside those numbers we have set out in our consultation document are upper and lower bounds of what we believe the model will produce. We have done some quite detailed analysis of the static effects, the dynamic effects we talked about qualitatively and that is all set out in the impact assessment in the June document. I am sure that Sky and others will respond on the detail of that.

In terms of the Virgin question, I mentioned that one of the advantages of a cost-plus approach is that it does allow you simply to work out what the wholesale price would be based on input costs without making any assumption about downstream models of competition. That, frankly, might have been our preferred approach as in many ways it is simpler and cleaner. The reason why we did not take that approach is precisely because we were concerned about the unintended consequences of rights owners and, if we had taken that approach, we would have been rightly criticised by those rights owners.

When you do a retail-minus model, you inevitably are taking a range of judgments about the types of retail model that you are trying to support. The way we addressed that was by modelling a number of different scenarios: competitors of different scale, competitors on different platforms. That led to a wide range of prices on which we have consulted and a central price, which is our preferred option, on which we have consulted. That has inevitably been a compromise between a number of different factors. We do not believe that it will give Virgin a sudden massive advantage given where they are at the moment in terms of the incremental profitability that they currently have from Sky’s content but that is, of course, for consultation.

There is a question as to whether there is something simpler and one suggestion was that we might look at Picnic. We did look in some detail at Sky’s Picnic proposal and one of the comments we have made in our document is that we do not believe that Picnic could have been profitable for Sky using Sky’s own wholesale prices as an input. Even taking that simplest approach, that does not get you to the current rate card. The rate card would have to drop in order for Picnic to have been profitable.
Patrick Wellington: So you think your proposal, which you think will benefit Sky by £240 million and to which they are vigorously opposed, is correct and that their proposal of Picnic would have lost them money, so you are doing them a big favour?

Steve Unger: What I said was that Sky’s Picnic proposal, based on the wholesale rate card which is somewhat notional in their case, would lose their retail business money. They would presumably still make money on an end-to-end basis.

Patrick Wellington: On a touchy-feely basis – don’t you think you have drifted away from reality?

Ed Richards: We have not drifted away from reality and I don’t want to turn this into a description of modelling. I am struggling with why you are particularly surprised that Sky would take a different view of the model to us, this is not remotely surprising. We have to take an approach to this which Steve has described and, as he said, it would have been much easier – much easier – on the kind of issues that you are raising to take a cost-plus approach. We have not done that for the reasons he has described and, in terms of our proposal, we are comfortable with that. We shall see what people say and what they respond to on that basis and take it from there.

Question: I have two questions around the FAPL and commercial properties. On the commercial property side, you mentioned that the issue is price not structure. Are you happy with where the prices are, or is it that you do not feel as a core part of this review you need to review those commercial prices now, and you will think about that more preceding the 2012 auction? My second question is on the rights structure for the Premier League: do you think the current rights structure is flawed?

Steve Unger: On the first point, we are not in a position at the moment to take a view on the pricing for commercial premises. Those stakeholders, those consumers have certainly argued very forcibly that the prices they are paying are too high and that they have increased in recent years. It is a very difficult question to look at and part of the reason it is difficult is because the rights prices which dominate the input cost for Sky’s business in this area are sold on the basis that combines the residential and commercial business. It is very difficult to separate out the input cost that you would ascribe to the residential and commercial sectors. Within the commercial sector, price discrimination is widely used, there is not a standard price. There is a range of different pricing structures used for different commercial premises and there is not necessarily anything wrong with that type of price discrimination. Therefore, where we are is not that we are saying there is a problem; we are saying that concerns have been put to us.
We would be interested to explore whether there are ways of providing greater transparency of input prices for that sector, and making that sector potentially more contestable. We have talked in the document about perhaps achieving that by seeing whether there is an option for those rights to be sold separately in order to achieve that. That is not trying to set out what the outcome ought to be in terms of levels of pricing.

**Ed Richards:** We do not have a formal view on the rights structure, that is obviously subject to the European Commission intervention, but we have signalled that we want to have a conversation with the FAPL in due course about the next auction structure to make sure that we are comfortable that it complies with competition law concerns and issues. We have had a discussion with the Commission about that and that is what we would expect to do next. We certainly do not have a formal view of it of any kind.

**Steve Liechti (Investec):** I have two questions. Have you put to one side the bundling issue now, because in one of your previous consultations you talked about bundling premium packages –

**Ed Richards:** You mean buy-through.

**Steve Liechti:** You call it buy-through, I call it bundling.

**Ed Richards:** With bundling we tend to think about bundles of channels, bundles of broadband –

**Steve Liechti:** Sorry, buy-through.

**Steve Unger:** One of the positive developments is that Sky has now introduced a new set of retail prices as of the beginning of this month, which means that for the first time it is possible to buy premium content on a standalone basis. I do not think that is widely advertised, it is quite difficult to find on their website but it is now available, which is a positive development.

**Ed Richards:** You can find something called zero mix if you look carefully on the website.

**Steve Liechti:** Great, thanks. To my second question, going back to your current cost of capital, you talked about how you did not want to look at previous investment. One of the things that Sky has done previously in these conversations is put forward its investment infrastructure and goodness knows what else, but you conveniently seem to be implying that we'll forget about that and look at the current cost of capital going forward. Can
you tell me exactly what you have in the cost of capital, and is that not an area that Sky is going to contest quite hard again?

**Ed Richards:** I shall make an overarching remark and Steve will pick up the detail. We haven’t conveniently done anything - I love the leading nature of some of these questions! On the contrary, we would be the first to recognise that Sky took considerable risks, huge risks, particularly in 1989 and before that, and in some years after that, and we think they have been an enormously successful, innovative and substantially risk-taking company and we are very supportive of that, so let’s not get that confused. That is not what this is about. We want to see and would expect to see companies of that kind earn good returns, and we think Sky has earned good returns. What we observe now, some 20 years on, is that, in our view, in one of the annexes we are consulting on, Sky are earning very, very healthy returns and we indicate a number of about 20%. If we just observe what their cost of capital is using the capital asset pricing model, we are not particularly surprised to find that it is about 10.4. Why are we not surprised by that? Because this is a profitable, pretty mature business, in a very established position in the market. I don’t think that should particularly surprise anybody, and the two things can coexist perfectly easily. Any more detail on that, Steve?

**Steve Unger:** I would comment that this is not so much about whether Sky will continue to invest, it is about the risk profile. It is clear that in the early 1990s, Sky made investments which were also very risky, and that certainly affects your view of what a reasonable return would be if you look retrospectively at those investments. What we are saying now is that, even though it may continue to invest, on a forward-looking basis we don’t believe that those investments have the same degree of risk associated with them, given the current position of their business.

**Marc Sugarman (Citigroup):** I have two questions. The first is if Sky is correct that there are inaccuracies in the model, or that some of the assumptions you have made have changed so radically, I think you were assuming inflationary advertising, whereas advertising is down 15-20%, and that’s very material, what then happens? Do you have a new pricing mechanism that we consult on, if it is sufficiently material that people should be able to see that?

**Ed Richards:** We have published a range with a different set of scenarios and different set of variables in it. One of the things to which people are responding now is that set of assumptions, so that is what we shall work through now. If we decide that an intervention is the right thing to do, then we’ll obviously pick up all the issues of that kind that
people raise with us. As I said, they will not just be those ones but there will be others as well.

**Mark:** Wouldn’t the assumptions I was just talking about affect the returns, We tried to figure out what Sky’s returns are, we came up with a figure of around 13-14% and we thought we were being quite generous on the return side, and that is using current advertising and so on. Doesn’t that colour the whole issue of whether there should be a regulated price?

**Ed Richards:** It is not the only argument. We are not making an argument here that there should be regulation because Sky is making high returns. In some ways, high returns are a reward for the risks that have been taken in the past. The argument we are making is based upon the consumer interests around the static benefits of the restriction of choice, and the dynamic benefits of innovation in the future. We are not resting this case on Sky’s returns. You need to see it as part of a much broader set of arguments in which those returns are part of the story but it is certainly not the central basis for the proposed remedy that we are consulting on.

**Mark:** If you are right that the returns they are making are not huge, wouldn’t that just say we should have a wholesale price but it should not be regulated in the way -?

**Ed Richards:** We don’t think that is the case. If you think it is 13%, you can send us a submission, we much look forward to it and we’ll read it, see how you derive that and compare it with our own analysis. That is not our analysis, we have put our analysis into the public domain, you are very welcome to study it, Sky certainly have, others certainly have, and we want to see what people say about it. Beyond that, at this point there is nothing else that I can say.

**Steve Unger:** We did consult on a range of prices as we recognise that this is something that is not certain. We were pretty sure that some of the numbers would change following consultation. Once we have reviewed all the responses, we shall work out where those changes take us but that is why we consult on a range of prices. We weren’t pinning everything at that very first stage on a single right answer, we were giving people the chance to comment on that before we reached some sort of conclusion and hopefully without the need to consult yet again!

**Ed Richards:** We are running out of time and you have had three gos at this, Marc, so if you don’t mind we shall pass to the lady in front of you.
**Andrea O'Keefe (JP Morgan):** Just two questions please. First, has the demise of Setanta in its old format changed in any way your view as to whether they had a valid point about the competition issues? A subset of that is, has the ESPN view changed anything from your perspective? Then on a separate subject, if you went down the wholesale must-offer route, say early in the New Year, could you impose it immediately on the basis that Sky will be complaining, the Government will be going into an election and there might be a lot of vested interests, and the last thing they want is another complication? How much ability do you have to put that through without getting caught up in legal tangles?

**Ed Richards:** The answer to your first question is, not really. If you go back to the root set of issues that we have argued need to be addressed, Setanta coming and going, being replaced by ESPN with a slightly different model does not really affect the core issues that we think are of concern. Therefore, broadly speaking the answer to that is no.

In terms of the timing and pressures of that kind, we are not really worried about those to be honest, because we are doing this as an independent sectoral regulator, having examined our sectoral powers and our competition powers and it is completely independent of Government. So we are not particularly concerned about that and I don’t think that a looming election makes any difference.

In terms of what would happen, we have to make a final decision and it depends what that final decision is. Only then, as we said earlier, will we know whether anyone will appeal and, if so, who and, if so, on what grounds. At that point, we shall deal with the appeals. In the meantime, our expectation is that whatever decision we have made we will move to implement swiftly and in whatever way is appropriate.

**Steve Unger:** We published our consultation in June which was only a week or so after Setanta had exited and ESPN had taken on the rights. We took a preliminary view that ESPN might have the same position in the market broadly as Setanta but that is something we’ll have to return to, based on the evidence when we publish our next document.

**Matthew Walker (Nomura):** I have two questions. Going back to your point about the timing of the implementation and, while I know you have not made a decision, let us say that you had made the decision that you still want to go ahead with the wholesale must-offer, Sky and others are unhappy, there was an appeal, what I am unclear about is what difference to timing of implementation does appealing on different grounds make? Perhaps you could make it clearer whether you are appealing on judicial grounds, whether you are appealing as part of a process or whether you are appealing because you are
unhappy with the outcome? The second question is that you mentioned Section 316 of the Communications Act. Does that give you the right to change the licences even where you are not proving an abuse of market power, just the very fact that market power exists and you are unhappy with the competitor situation? Are you happy that the Communications Act gives you the power to actually do what you want to do?

**Ed Richards:** In the event that we decide to proceed with an intervention, that is clearly one of the things that could be appealed, but our current view, which is why we have taken the approach we have and adopted the proposed remedy that we have, is that should we be satisfied that the concerns are such that we want to proceed, we would be able to use that power. It gives us power to ensure fair and effective competition and bear in mind that is in the context of us having a general duty to promote competition, so it is not a Competition Act power, it is a Communications Act power. We believe that absolutely what we have set out is consistent with that, which is one of the things that is appealing.

The difference in the nature of appeals, as I understand it, but I am not a lawyer and Steve is not a lawyer either but he might correct me if I get this wrong, is that there are certain kinds of appeal, particularly judicial review ones, where you could try to stop the implementation of a remedy of this kind but the threshold and hurdle for that is obviously relatively high: I believe it is irretrievable damage to the business.

**Steve Unger:** Serious irreparable harm.

**Ed Richards:** If we get to that point, if we have made that decision and if Sky wanted to appeal on that kind of basis, they would have to demonstrate irretrievable harm to the business which is a pretty high threshold. Subsequent to that there is a merits appeal and obviously that would proceed in the normal way, which I think would go to the CAT, but that would take place with the remedy being implemented. So that’s essentially the difference. There is a way of appealing to try to stop it from ever being implemented at all but that is quite a high threshold. There is another merits-based appeal which could overturn the remedy.

**Matthew Walker:** Your view is basically that, if it is a merits-based appeal, Sky would not be able to get a stay while the appeal took place?

**Ed Richards:** I believe they are different kinds of appeal, but that would be our understanding under Section 316.

**Steve Unger:** There are probably three different questions. One is whether Sky can get into measures which will suspend the decision, and that is not a decision for us but the threshold is high, as Ed says. The second route they have is that they can judicially
review the fact that we have used Section 316 and, thirdly, they can take on a merits appeal on the specifics of what we propose to do.

**Nick Bertolotti (Credit Suisse):** Just to confirm, if these proposals are implemented, your view is that they would not cause Sky serious irreparable harm. I think you say it would not be disruptive to Sky’s existing business.

**Ed Richards:** This is an important point. One of the reasons why we have approached the remedy in the way we have is because we are not in the business of doing irreparable harm to anybody’s business. That is one of the considerations that has animated and informed our thinking about the rights holders, and it is one of the things that has informed our thinking about the proposed remedy in relation to Sky. We are interested in opening out competition to other platforms in relation to the premium must-have content, and ensuring that offers greater choice for consumers and scope for new innovation by new platforms. That’s what we are interested in and that’s what we are consulting on.

The impact assessment which was mentioned earlier, you asked whether we did an impact assessment, and I explained that we had done. One of the features of that was to suggest that Sky would benefit from increased wholesale revenues. On that basis, it would be difficult for us to take a view that there was irretrievable harm to their business. We believe that the outcome of this is to expand the market, it will bring some people into the market for premium content who are currently not in it. The short answer to your question is no, we do not think a proposal of this kind will do irretrievable harm to Sky. Indeed, I believe that Sky have themselves discussed this point and have said on one occasion that they do not think a remedy of this kind would particularly affect the business but that is a matter between you and them. Any other final questions?

**Julien Roch, Barclays Capital:** I have a question on timing. Roughly how long will it take, if the appeal is a judicial one based on irretrievable harm, to determine that is the case?

**Ed Richards:** We do not have our lawyers, next time we shall bring them, but those things tend to happen very quickly, because essentially you are seeking an injunction to stop the work of an independent public agency, so it is both a high threshold and tends to be dealt with pretty fast.

**Question:** Within a month?
Steve Unger: Even with lawyers here I don’t think we would be able to answer that question at this stage, because we don’t know what the grounds would be. It comes back to the fact that we don’t even yet know what the decision is, we don’t know what the grounds of the appeal might be, this just gets too speculative, I think.

Ed Richards: We don’t know, we are not lawyers, it depends on the court system and it is speculative because we are not there yet, I think is the answer to that set of questions. Thank you all very much for coming.

- Ends -