

MOVIES ON PAY TV MARKET INVESTIGATION

Theories of harm

Introduction

1. Theories of harm provide a framework for our analysis and this paper presents the theory of harm we are investigating. The theory set out in this paper represents an update to the high-level analytical framework which we published in our issues statement and is based on our thinking so far.
2. We begin by setting out the context for our investigation before describing the theory of harm and setting out the circumstances in which we believe it would be established. We then outline the factors which are relevant to our analysis.

Summary

3. We have identified the following theory of harm:

The control by Sky of the acquisition and distribution of movie content on pay TV during the first subscription pay TV window (FSPTW),¹ as a result of its market power in the pay TV retail market, adversely affects competition between pay TV retailers. This adverse effect on competition in the pay TV retail market results in effects both on consumers and/or on the suppliers of pay TV movie rights for the FSPTW (with possible consequential effects on competition between the suppliers of pay TV movie rights for the FSPTW).

¹The FSPTW is the period of movie release which currently comes after the pay transactional window (PPV or TVOD) and before movies are released for general showing on TV. It is usually 9–12 months after cinema release and is of about 15 months' duration.

Context

The complaint

4. Virgin Media, BT and other retailers of pay TV made submissions to Ofcom, which they have repeated to us, that they face a 'vicious circle' whereby Sky can continuously reinforce its market power due to its vertical integration and its ability to aggregate key content rights, whilst also creating high barriers to entry and expansion. These parties told us that these factors conferred on Sky considerable advantages in winning key premium movie rights. They said that Sky's control of movie content in the FSPTW restricted competition between pay-TV retailers and led to higher prices and less choice for consumers.

5. BT told us that Sky's refusal to supply key premium channels to its competitors prevented them from competing effectively to gain customers at the retail level, while Sky was able to use its ownership of these channels to drive the growth of its own subscriber base. BT said that its lack of scale relative to Sky at the retail level prevented it from competing effectively with Sky in the bidding process for rights to premium movie content, thereby allowing Sky to maintain its exclusive ownership of these rights. BT added that Sky had both the incentive and the ability to ensure that effective wholesale and retail competitors of packages containing channels showing recent movies from the six largest Hollywood studios in the FSPTW in the UK did not emerge, allowing Sky to sustain its position of market power in these markets.

The reference

6. On 4 August 2010 Ofcom referred to us the supply and acquisition of subscription pay-TV movie rights and the wholesale supply and acquisition of packages which include core premium movies channels for investigation (the reference).²

7. Ofcom defined 'subscription pay TV movie rights' as the intellectual property rights licensed by the six largest Hollywood studios, which:
 - (a) permit the exhibition of movies on broadcast channels and/or subscription video on demand (SVOD) services in the UK; and
 - (b) relate to the first period during which movies are licensed for exhibition on subscription broadcast channels or SVOD services.Ofcom defined 'core premium movies channels' as Sky's movie channels.

Our approach

8. We are required to determine whether any feature or combination of features of each relevant market in which the reference products are supplied or acquired prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.³

9. On 3 September 2010, we published an issues statement, setting out the issues which we believed we needed to investigate, and we invited parties to submit evidence and views in response to this statement. Since September, we have received evidence in submissions, responses to questionnaires, through site visits and orally in hearings.⁴

²The reference was made under sections 131 and 133 of the Enterprise Act 2002 (the Act).

³See [section 134\(1\)](#) of the Act.

⁴Further information on the status of our inquiry is set out in working paper 1.

The relevant markets

10. We discuss the definition of the relevant markets in working paper 8.
11. It appears to us that there is a distinct market in which pay-TV movie rights for the FSPTW are supplied and acquired. We refer to this market as the upstream market.
12. We considered whether Sky's aggregation of content and supply of movie packages occurred in a distinct wholesale market.⁵ However, our initial analysis indicates that Sky's position as an aggregator and a supplier of movie packages to other pay-TV retailers (ie its 'wholesale' activity) derives largely from its position as the largest pay-TV retailer. For example, Sky's large subscriber base appears to confer advantages upon Sky when it bids for premium movie content compared with other, smaller pay-TV retailers (see working paper 18), so enabling Sky to acquire and aggregate this content.⁶ As such, any distortions or restrictions of competition at the 'wholesale' level of the kind that have been alleged appear to us to derive from the strong market position of Sky in the retail market. Moreover, Sky's 'wholesale' supply of movie packages is mostly to itself, which would limit the effectiveness of any analysis confined to wholesale supply (see working paper 8).⁷ It therefore seems appropriate to us to take into account Sky's market position in the pay-TV retail market as a central aspect of our analysis of its 'wholesale' activities. We refer to the market in which pay-TV retailers sell to consumers (and cross-supply to one another) as the downstream market or the pay-TV retail market.
13. At this stage, it appears to us that the issues arising from the reference can be considered comprehensively within an analytical framework consisting of the

⁵Sky has a near total monopoly on the wholesale supply of movie content to pay-TV retailers in the FSPTW. Under Ofcom's definition of the market, which included only the content from the six largest Hollywood studios, Sky has a complete monopoly; however, if the definition is widened to include the movie content of all studios, Sky has a near total monopoly. See footnote 11.

⁶Working paper 18 discusses the barriers to creating new linear movie channels (or SVOD services) on pay TV with content in the FSPTW.

⁷Working paper 8 discusses market definition.

upstream market in which studios license rights to movie content for use in the FSPTW to pay-TV retailers, and the downstream market in which pay-TV retailers sell to consumers (and cross-supply to one another). The remainder of this paper sets out the theory of harm we have developed within this framework, and discusses why we are not intending to pursue some other theories of harm.

Possible theories of harm in the upstream market

14. In the upstream market, there are many movie studios which license the rights to broadcast and distribute their content. No studio has a particularly large market share and market shares are volatile, depending in each period on the commercial success of each studio's creative output (see working paper 3).⁸ Therefore, on the supply side, this market is not heavily concentrated. Due to this lack of concentration, and because we have not received any complaints or seen any evidence which would indicate that an individual movie studio holds sufficient market power to suggest concerns about its licensing arrangements, we are not pursuing a theory of harm relating to the supply of rights to movie content for use on pay TV in the FSPTW by an individual studio. In addition, because we have not received any complaints or seen any evidence which would indicate concerns about collective action by movie studios, we are not pursuing a theory of harm relating to the supply of rights to movie content for use on pay TV in the FSPTW from movie studios collectively.

15. Nevertheless, the demand side of the upstream market, in which aggregators of movie content bid for movie rights in the FSPTW, does appear concentrated, with Sky having obtained a licence to these rights from all of the six largest movie studios, and many of the smaller studios, for more than 20 years. We discuss whether Sky's position as the licensee of rights gives rise to adverse effects in the upstream market in paragraphs 25 to 27.

⁸Working paper 3 discusses concentration in the upstream market.

Theory of harm

16. The control by Sky of the acquisition and distribution of movie content on pay TV during the FSPTW, as a result of its market power in the pay-TV retail market, adversely affects competition between pay-TV retailers. This adverse effect on competition in the pay-TV retail market results in effects both on consumers and/or on the suppliers of pay-TV movie rights for the FSPTW (with possible consequential effects on competition between the suppliers of pay-TV movie rights for the FSPTW).

Assessment of the theory of harm

17. It appears to us that the theory of harm will be established in the following circumstances:
- (a) Sky has market power as a retailer of pay TV such that there is ineffective competition in the market for pay TV;⁹
 - (b) pay-TV movie content in the FSPTW is significant to consumers in choosing their pay-TV retailer, which requires, inter alia, that movie content on pay TV in the FSPTW has no close substitutes;¹⁰
 - (c) most movie content in the FSPTW on pay TV is controlled by Sky,¹¹ and there is limited availability to other pay-TV retailers both of movie content in the FSPTW and of Sky's movie products which include this content; and

⁹The possible sources of Sky's market power at the retail level include its installed customer base, its technology and its sport and other content. If the other three circumstances set out in paragraph 17 are present, Sky's movie content will be a source of its market power.

¹⁰There are two relevant substitutes: (i) if consumers consider other content available on pay TV to be a substitute for movie content in the FSPTW, it will be less important for pay-TV retailers to gain access to this movie content in order to be able to compete at the retail level; (ii) if consumers consider other mechanisms by which to watch movies (eg DVDs) to be substitutes for movie content on pay TV in the FSPTW, this movie content is less likely to be a significant driver of consumers' choice of pay-TV retailer.

¹¹Sky supplies almost all movie content in the FSPTW on pay TV as it has obtained exclusive rights to the content of the six largest Hollywood studios and many of the smaller studios. There are some small movie studios with which Sky does not have an exclusive contract for all content and some of the content of these studios in the FSPTW may appear on pay TV on channels not supplied by Sky. See footnote 5.

(d) other pay-TV retailers (and/or third parties) cannot obtain the rights to sufficient movie content in the FSPTW directly from the studios in order to create movie services which compete effectively with Sky.¹²

18. Part (b) of paragraph 17 has two elements: (i) there are no close substitutes to movie content in the FSPTW on pay TV; and (ii) this content is significant to consumers in their choice of pay-TV provider. At this stage of our inquiry, we are continuing to consider the relationship between these two elements.¹³

Analysis of the theory of harm

19. In order to consider whether the four circumstances listed in paragraph 17 are present, the following analysis might be required.

(a) Ineffective retail competition

20. Relevant factors include Sky's market share, churn, consumer switching costs, barriers to entry, and appropriate measures of the outcome of competition between pay-TV retailers (or potential retailers), eg profitability and innovation. These factors are discussed in working papers 11 to 13.

¹²It might be that there are complementarities or economies of scope which make it economically efficient for one party to aggregate all available movie content. For example, offering movie content in the FSPTW under a single brand could encourage increased marketing and generate higher demand than would otherwise be the case, eg a single Sky Premiere channel might facilitate the promotion of new releases, whereas having two providers could introduce inefficiency and increase the total price consumers have to pay to access all movie content. However, these considerations are not relevant to our evaluation of the theory of harm as they do not affect the circumstances described in paragraph 17. If we were to find that the theory of harm is established, and identify features which prevent, restrict or distort competition, we would consider whether there are any relevant customer benefits from the current market structure and conduct of parties as part of our evaluation of possible remedies.

¹³If element (i) is not satisfied (ie there are substitutes), then it is unlikely that circumstance (c) would be present (for example, because consumers of Sky's movie products on Virgin Media could switch to substitute content if Sky restricted the supply or raised the prices of these products to Virgin Media). However, if element (ii) is not satisfied (ie consumers choose their pay-TV retailer for reasons unrelated to movies) but parts (a), (b)(i) and (d) are present, Sky's incentive to limit the supply of its movie products to other pay-TV retailers is unclear and circumstance (c) may or may not be present. Nevertheless, in this scenario, Sky could still charge high prices for its movie products (both to its subscribers and other pay-TV retailers) and this could represent an adverse effect on consumers of movie products on pay TV. At this stage of our inquiry, it is unclear to us whether it is possible for movie content in the FSPTW on pay TV to have no substitutes (ie for element (i) to be satisfied) but for Sky's movie products with this content to be insignificant to consumers in their choice of pay-TV retailer (ie for element (ii) not to be satisfied). We invite parties' thoughts on this question.

(b) Significance of movies and no close substitutes

21. Relevant factors include the significance of movies to subscribers to pay TV, including the extent to which other forms of content are a substitute for movies and the extent to which other mechanisms for viewing movies are a substitute for pay TV. These factors are discussed in working paper 14.

(c) The supply, acquisition and aggregation of movie content in the FSPTW on pay TV and the supply of products with this content

22. Relevant factors include the terms on which the rights to distribute movie content in the FSPTW on pay TV are supplied and acquired (eg what restrictions exist), how Sky aggregates movie content (eg into linear channels and SVOD services), and how Sky supplies movie packages and services to its customers and other pay-TV retailers (ie the terms on which these packages and services have been sought and offered (eg price, range of services and timing)). These factors are discussed in working papers 15 to 17.

(d) Inability to access rights to movie content in the FSPTW from studios

23. Relevant factors include the effects of Sky having the largest pay-TV subscriber base when it bids for content from the studios, difficulties for other pay-TV retailers or independent wholesalers of movie content to access Sky's subscribers or challenge Sky's retail position, the conjoining of linear and SVOD rights, the timing of contracts with the studios, and the granting of linear and SVOD rights in the FSPTW on an exclusive basis. These factors are discussed in working paper 18.

Effects on competition, other parties and customers

In the downstream market

24. The effects of the theory of harm in the downstream market would be (i) Sky restricting the access of other pay-TV retailers to its FSPTW movie content and/or charging other pay-TV retailers higher prices for this content; and/or (ii) all pay-TV

retailers undertaking reduced levels of innovation and/or supplying products of lower quality than would otherwise be the case. These effects on competition in the downstream market would result in higher prices and/or restricted access and/or less innovation and/or lower quality for consumers of movie content on pay TV. There may also be effects in relation to the supply and acquisition of other products which are often sold with pay TV, eg broadband and fixed line telephony.

In the upstream market

25. If Sky has monopsony power in the upstream market, the studios which license their content to Sky might achieve lower prices or worse terms (for example, relating to how rights to exhibit films in different formats are linked and the timing of windows) than would otherwise be the case. As a result, the studios might produce fewer movies or movies of lower quality, or they might innovate less, thus affecting competition between them. Relevant factors for us to consider in investigating these effects include whether greater competition between pay-TV retailers (or other aggregators) for movie content in the FSPTW from the studios would affect the prices and terms achieved by the studios (for example, by comparing the prices and terms achieved in the UK with the prices and terms achieved in other territories where there is more than one pay-TV retailer bidding for the rights). These factors are discussed in working papers 19 and 20.

26. In addition, some small movie studios have submitted to us that Sky's control of movie content on pay TV in the FSPTW means that they are restricted from accessing the market on fair terms. They told us that Sky's agreements with the six largest Hollywood studios mean that Sky has limited space on its schedules for content from smaller movie studios. As a result, competition between the studios in the upstream market might be affected. Relevant factors for us to consider in investigating this effect include the number of films distributed and the prices obtained by smaller

studios for their content relative to those obtained by larger studios (controlling for other factors, eg movie quality). These factors are discussed in working paper 19.

27. If we find that either of these effects in the upstream market exists, we will consider how greater competition in the demand for movie content in the FSPTW from the studios might affect the ultimate consumers of that content (eg in greater choice, quality or innovation).