

MOVIES ON PAY TV MARKET INVESTIGATION

Provisional findings report

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Summary

The reference

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

2. 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.

3. 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 (ie results in an adverse effect on competition (AEC)).

Background and market developments

4. The three largest providers of linear (ie scheduled, broadcast) pay TV are Sky, Virgin Media and BT Vision. Sky is the largest provider of pay TV in the UK, with over 10 million subscribers. The number of subscribers to Sky's pay-TV services has more than doubled over the last ten years. Its total revenues for the year ended 30 June 2011 were over £6.5 billion. Virgin Media is by far the largest cable operator in the UK and, at the end of 2009, it had 3.7 million subscribers to its pay-TV services. BT

Vision, which launched in December 2006, offers linear pay-TV channels via digital terrestrial television (DTT), and on-demand content via Internet protocol TV (IPTV). At 31 March 2010, BT Vision had 0.5 million customers. All three of these pay-TV providers offer pay movie products. In addition to pay TV, they also all offer telephony and broadband services.

5. Many other providers offer pay-TV services, in most cases distributing content over the Internet. For example, with regard to movie services, LOVEFiLM (owned by Amazon), Apple, Google, Microsoft, Blinkbox (controlled by Tesco) and many others offer movies to download or stream on demand. In recent weeks, there has also been much press speculation about Netflix, a large provider of DVD and Internet-distributed movie services in the USA, entering the UK.
6. In the UK, as in most geographic markets around the world, movies are sold in different formats in distinct or overlapping release 'windows', which enable the studios to maximize the value they are able to generate from their movies. Typically, a movie is first released in cinemas, then on DVD and electronic sell-through (EST, ie where the consumer buys a permanent electronic copy of the movie), then for transactional video on demand (TVOD), then on subscription pay TV (both linear channels and SVOD) and finally on free-to-air (FTA) TV. After a movie has progressed through these windows it is categorized as a library movie. In most windows, 'hold-back' constraints restrict the extent to which the same movie can be distributed in other formats at the same time (eg a movie in the first subscription pay-TV window (FSPTW) cannot be viewed on TVOD). However, certain windows continue to run indefinitely once they have started (eg the DVD window).
7. For the last 20 years, Sky has acquired the exclusive rights to distribute movies from the six largest Hollywood studios, and many other studios, in the FSPTW in the UK,

using both its satellite platform and the Internet (eg to offer the Sky by Wire service available from TalkTalk or the Sky Go service (formerly known as Sky Player)). Sky incurs significant cost acquiring this content, which it packages into 12 linear movie channels and an SVOD service. Consumers subscribe to a pack of channels (ie Sky Movies 1, Sky Movies 2 or dual movies) at the same time as subscribing to a pack of basic channels. Customers may also subscribe to other premium channels (eg Sky Sports 1 or dual sports) to give a combined package (eg dual sports dual movies).

8. Currently, around three-quarters of all movie viewings in the UK are on linear TV, of which around 16 per cent are on pay TV and the remainder on FTA TV. VOD accounts for less than 1 per cent of the total movie audience.

9. We considered whether demand for Internet-distributed movie services (VOD and EST) might grow so as to alter materially the competitive conditions relating to the supply of products with FSPTW movie content. Over 70 per cent of households now have a broadband Internet connection and can potentially access movie content distributed over the Internet. Furthermore, the ownership of Internet-connected devices, which enable content to be viewed on the TV (including 'smart' set-top boxes (STBs), games consoles and Internet-connected TVs) is large and increasing. However, forecasts about the further adoption of these devices and the growth of VOD and EST services vary considerably. Evidence from the six largest Hollywood studios indicated that, although the demand for Internet-distributed movie content (in particular for EST) is growing rapidly, it continues to be dwarfed by the much larger revenues generated from DVD sales and pay TV.

Theories of harm

10. On the basis of the reference and the initial submissions we received, we articulated the concern to be investigated in terms of a hypothesis, as follows:

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).

11. We identified four circumstances which we expected to be present were this hypothesis to be correct, and we used these circumstances to provide the focus for our analysis:
 - (a) Sky has market power as a retailer of pay TV such that there is ineffective competition in the market for pay TV;
 - (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;
 - (c) most movie content in the FSPTW on pay TV is controlled by Sky, 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
 - (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.

Market definition

12. The evidence we have seen suggests that other products, such as DVD rental and retail and movies on FTA TV, are not close substitutes for Sky Movies. Furthermore, it appears to us that, if other ways of viewing movies were close substitutes for

watching Sky Movies, the value of FSPTW rights would be a matter of indifference to the studios (because they could replace FSPTW rights revenue with revenue from the rights for substitutes) but we found that, in general, the six largest Hollywood studios were very concerned about the value they could extract from the FSPTW. Therefore, our provisional view is that there are no close substitutes for Sky Movies.

13. However, market definition is not just concerned with the presence or absence of close substitutes. Market definition is intended to provide a framework for the analysis of competitive effects. We have found that the frame of reference for our analysis needs to be wider than just Sky Movies because consumers' subscription decisions are affected by other elements of pay-TV packages including at least basic pay-TV content and sports pay-TV content, and competition for subscribers is across all these elements.
14. It appears to us that pay-TV providers impose a sufficiently strong constraint on each other for pay-TV retailing to be a separate market and we focus our assessment of retail competition on this market. However, we note that there are links between competition to supply pay-TV products and competition to supply communications products (broadband and telephony) and also that FTA TV exercises some constraint on pay TV. We take into account the constraints from communications products and FTA TV as appropriate in our assessment of pay-TV retail competition.
15. Sky is an actual wholesaler of Sky Movies to Virgin Media and a few small cable pay-TV retailers, and a notional wholesaler of Sky Movies to itself as a pay-TV retailer. We considered defining a market including both the actual and notional wholesale supply of Sky Movies, but we did not see a sustainable source of market power arising simply from wholesaling Sky Movies (the source of Sky's market power derives from its position in the pay-TV retail market (see paragraphs 17 to 20)).

Therefore, we have provisionally found that defining a wholesale market for Sky Movies is not a useful step in establishing a framework for analysing competition.

16. We have also provisionally found that the supply by movie studios of subscription pay-TV movie rights in the FSPTW is a market (specifically, a price discrimination market). We believe that this market includes the FSPTW rights of all studios, not just the six largest Hollywood studios.

Retail competition

17. Pay-TV retailers compete for subscribers, but it appears to us that competition is limited by barriers to switching pay-TV retailer. These barriers are associated with the perceived inconvenience of changing retailer and with customer inertia. In addition, it appears to us that there are significant barriers to large-scale entry and expansion, including the need for significant investment in brand marketing (associated with the need to overcome the barriers to switching, in particular customer inertia), the need to acquire content, and the likely response from Sky to any large-scale entry or expansion. Together with Sky's large number of existing subscribers deriving from its historical position (Sky's incumbency advantage) and the restricted geographical coverage of Sky's main historical competitor (Virgin Media), these factors result in Sky having market power in the pay-TV retail market and in competition in that market not being effective.
18. We believe that there is some competition in the pay-TV retail market but the very high and stable level of concentration, the low level of switching between suppliers, the difficulty of large-scale entry/expansion and the absence of countervailing buyer power in pay TV indicate that, currently, competition is not effective. We noted that Sky's high profitability from its pay-TV activities was consistent with this finding.

19. Although UK pay-TV innovation seems to have been strong, it appears to us that it has been biased towards the developments most favourable to Sky's satellite platform. In our view, the evidence on innovation is insufficient to change our assessment about the level of current competition.
20. While we noted that there are new developments (both technological and commercial) which could affect significantly the extent of competition in the pay-TV retail market (see paragraph 9), we could not form an expectation that they would have this effect in the foreseeable future.

Significance of movies

21. About one-third of all subscribers to pay TV subscribe to Sky Movies,¹ which indicates that it is a popular pay-TV product and suggests that, for at least some subscribers, the desire to view Sky Movies is a contributing factor in their choice of pay-TV retailer.
22. We conducted a survey which found that 22 per cent of Sky Movies subscribers (25 per cent ignoring 'don't knows') would cancel their current pay-TV service if their provider stopped offering Sky Movies. This suggests that there are a significant number of subscribers (over 1 million, representing more than 7 per cent of all pay-TV subscribers) whose choice of pay-TV retailer depends on Sky Movies. Sky's research also appears consistent with these results. Since Sky Movies is only available from Sky and Virgin Media (and some small cable operators) and not all subscribers to pay TV are able to access both providers, due mainly to the limited geographic coverage of cable, there may be further subscribers for whom the presence of Sky Movies would be sufficiently important to induce a switch but who

¹ The only pay-TV movie products with FSPTW content from the six largest Hollywood studios, and many other studios, are the Sky Movies products.

are unable to switch and so did not indicate their interest in doing so. For this reason we believe that these results are likely to understate the significance of Sky Movies to consumers in their choice of pay-TV provider.

23. Other survey data (eg covering responses to questions about the importance of movies and the reasons for subscribing) is more difficult to interpret. Sky Movies emerges consistently from survey data as less important to pay-TV subscribers than Sky Sports, but this does not in itself mean that Sky Movies is not significant to pay-TV competition.
24. We also attach some weight to the significant expense which Sky incurs acquiring FSPTW movie content to show on Sky Movies and on its significant expenditure marketing Sky Movies. In addition, we attach some weight to Sky's comment to us that it would wish to retail an alternative movies channel with FSPTW content if another party bid successfully for FSPTW rights.
25. For these reasons, we have provisionally found that pay-TV products with FSPTW movie content are significant to consumers in their choice of pay-TV provider.

Barriers to the acquisition of FSPTW movie rights in order to create a movie product which can compete effectively with Sky's movie products

26. For many years, Sky has acquired the exclusive FSPTW rights in the UK of all the six largest Hollywood studios and many other studios. It appears to us that other bidders face material barriers to acquiring these rights, whether to offer linear movie channels and/or to create an SVOD movie service (though the barriers to create a stand-alone SVOD service appear to be lower).

27. We have provisionally found that the principal barriers to acquiring sufficient FSPTW rights from the six largest Hollywood studios in order to create a movie product which can compete effectively with Sky's movie products are:

(a) The position which Sky holds at the retail level, which gives it significant advantages in bidding for FSPTW rights. In particular: (i) the size of its Sky Movies subscriber base means that, when bidding for rights, Sky can be more confident, relative to its rivals, of the take-up it will achieve of its movie services, and that it will not face the same delays in building a subscriber base; and (ii) the size of its total pay-TV subscriber base, relative to those of other pay-TV retailers, means that, when bidding for rights, Sky can be more confident, relative to its rivals, that it can attract new subscribers to its movie products. As a result, Sky can submit a bid worth more and with less inherent risk than its rivals. These factors prevent Sky's rivals and potential rivals from being able to access and exploit FSPTW movie rights as effectively as Sky.

(b) Factors which mean a rival bidder could not rely on being able to circumvent these disadvantages by retailing directly to consumers via Sky's direct-to-home (DTH) satellite platform. These factors include the marketing costs a new entrant would need to incur to attract subscribers and the disadvantages a new entrant would face relative to Sky in being unable to bundle its channel or SVOD service with Sky's other channels and services.

(c) Factors which mean that a rival bidder could not rely on being able to circumvent these disadvantages by wholesaling to Sky. These factors include the risks associated with entering into a commercially attractive wholesale arrangement with Sky, including the risk that any agreement does not enable the rival bidder to get its product promoted as effectively as one of Sky's products, and that it does not enable the rival bidder to benefit fully from any associated sales (eg sales of non-pay-TV products such as telephony and broadband).

28. Although there are many changes occurring in the market, both technological developments and changes in consumers' viewing habits (see paragraph 9), we do not think that, in the foreseeable future, these changes can be expected to diminish significantly the barriers which inhibit greater competition with Sky in the acquisition and exploitation of movie content in the FSPTW.

Availability of FSPTW movie content and products to other pay-TV retailers

29. We have provisionally found that, although Sky has made its movie products with FSPTW content available to some other pay-TV retailers, this supply has not enabled its rivals to compete effectively with Sky (in relation to movie products). This is because: (a) the wholesale prices Sky charges for its Sky Movies standard definition (SD) channels are set at levels which place rivals at a material disadvantage compared with Sky (with respect to products which include, or for which the price is based on, a Sky Movies SD package); and (b) Sky's rivals have been limited to offering the portfolio of Sky Movies products offered by Sky and to offering them in largely the same way in which they are offered by Sky, thereby preventing these rivals from offering movie products in ways which may be more attractive to their respective subscriber bases and more suited to their respective platforms.

Effects of Sky's control of the acquisition and distribution of FSPTW movie content on competition between the suppliers of pay-TV movie rights

30. In the upstream market (the market in which FSPTW movie rights are supplied and acquired (see paragraph 16)), there are many studios which license the rights to distribute their content and no studio has a particularly large or stable market share. Overall, we found that there was no reason to investigate a distinct theory of harm relating to ineffective competition between the suppliers of movie rights at the upstream level.

31. Nevertheless, the demand side of the upstream market, in which aggregators of movie content (ie broadcasters or other service providers) bid for movie rights in the FSPTW, is concentrated, with Sky having obtained for many years a licence to these rights from all of the six largest Hollywood studios ('major' studios) and many other studios ('non-major' studios). Therefore, we considered whether Sky's control of the acquisition of FSPTW movie content on pay TV might have affected competition between the suppliers of FSPTW movie rights.
32. We investigated whether the major studios suffered lower prices or worse terms in the UK compared with other geographic markets in which there is more than one licensee for their FSPTW rights, but it was not clear that they did.
33. We also investigated whether the non-major studios suffered lower prices or worse terms for their FSPTW rights compared with the major studios but the evidence was inconclusive. However, we noted that, even if the non-major studios had suffered compared with the major studios, this was unlikely to have affected adversely competition between all studios.
34. Overall, we have not found that Sky's control of the acquisition of FSPTW movie rights gives rise to any adverse effect on competition in the upstream rights market.

Provisional findings

35. Ofcom referred us two markets (see paragraph 1). We are required to consider and decide the statutory question (see paragraph 3) in respect of each of these markets.
36. In summary, we have found that Sky has market power in the pay-TV retail market due to many factors (see paragraphs 17 to 20) and that this provides Sky with advantages when bidding for FSPTW movie rights, creating barriers to others

acquiring these rights (see paragraphs 26 to 28). We have also found that pay-TV products with FSPTW movie content are significant to many consumers when choosing their pay-TV retailer (see paragraphs 21 to 25). We considered whether, despite the barriers to the acquisition of FSPTW movie rights, Sky's pay-TV rivals might nevertheless be able to compete effectively with Sky in the pay-TV retail market (in relation to movie products) by virtue of Sky's supply of its movie products with FSPTW content to them, but we found that they could not (see paragraph 29). We noted that, as a result of Sky's control of the acquisition and distribution of FSPTW movie content on pay TV, Sky's market power in the pay-TV retail market is enhanced, which further strengthens its advantages when bidding for FSPTW movie content.

37. We considered how Sky's control of the acquisition and distribution of FSPTW movie content on pay TV affected competition in the pay-TV retail market. We found that, as a result, there had been limited innovation, in particular in the development of new SVOD products and in product differentiation, and, although FSPTW movie products were available to other pay-TV retailers, the prices were such that these rivals were at a material disadvantage in competing with Sky. This evidence indicated that Sky's control of the acquisition and distribution of FSPTW movie content on pay TV had adversely affected competition in the pay-TV retail market. We also noted that movie products with FSPTW content are significant to between 7 per cent (see paragraph 22) and 33 per cent (see paragraph 21) of pay-TV subscribers. On this basis, we judged that, although Sky's rivals in the pay-TV retail market may be able to attract consumers to their pay-TV offerings through other factors, their disadvantages with regard to movie products with FSPTW content, which were important to many pay-TV subscribers, limited their ability to compete in this market. We noted that other factors may be more important in contributing to Sky's market power in the pay-TV retail market but we found that Sky's control of the acquisition and distribution of

FSPTW movie content on pay TV was a significant contributing factor. We noted also that Sky's largest pay-TV rival, Virgin Media, which offers the full range of Sky Movies channels, had been less successful in selling packages which include a Sky Movies pack than it had been in selling those packages which do not.

38. For these reasons we have provisionally found that Sky's control of the acquisition and distribution of FSPTW movie content on pay TV affects adversely competition between pay-TV retailers.
39. While we recognized that the way in which some people watch movies on TV is changing and that there are many developments which might occur and which might affect the extent of competition in the market, we based our findings on the evidence before us and we could only take account of developments which were likely to occur in the foreseeable future. On this basis, we saw no evidence to suggest that we should alter our findings. We recognized that, were developments to occur following the publication of our provisional findings, it would be necessary to take them into account before reaching our final findings.
40. We considered the statutory question in respect of each of the markets referred (see paragraph 1). We noted that the markets referred were different to the economic markets which we had defined through the course of our analysis (see paragraphs 12 to 16).
41. We have found that Sky's market power in the pay-TV retail market gives rise to barriers to the acquisition of FSPTW movie rights, and Sky's control of the acquisition of FSPTW movie rights gives rise to it controlling almost all FSPTW movie content in the wholesale market. Sky's control of the acquisition and distribution of FSPTW

movie content on pay TV affects adversely competition between pay-TV retailers (see paragraph 38).

42. On this basis, we have provisionally found that the following feature of the rights market gives rise to an AEC in the pay-TV retail market:

- *There are barriers to the acquisition of sufficient FSPTW movie rights to be able to create a movie product which can compete effectively with Sky's movie products.*

We have provisionally found that this feature gives rise to the following feature of the wholesale market, which gives rise to the same AEC in the pay-TV retail market:

- *Sky controls the vast majority of FSPTW movie content.*

43. We have expressed our finding in terms of a decision on two statutory questions because we were referred two markets. However, the two markets referred are vertically related so the feature which we have identified in the rights market gives rise to the feature which we have identified in the wholesale market and they result in the same AEC in the pay-TV retail market.

44. We considered the extent of the detriment likely to have been suffered by consumers of pay TV as a result of the AEC we have identified. While noting that the detriment related to pay TV generally, we focused our estimate of the detriment on the supply of pay-TV movie products. We recognized that there are weaknesses with all of the available methods for estimating the potential detriment but we estimated that, as a result of the AEC, consumers were paying around £50–£60 million a year more than would otherwise be the case. If there were to be no change in the market over the next five years, we estimated that the undiscounted detriment to consumers would be around £250–£300 million. In addition, we noted that we would expect the limited innovation which had occurred as a result of the AEC (see paragraph 37) to have had effects in restricting both the range and quality of movie products available to

consumers, and we noted that this detriment may be at least as important as the static detriment on prices which we had quantified.