PART TEN DEFINITION OF ABUSE OF A DOMINANT POSITION RELEVANT TO BSkyB

I. BSkyB’S SUBMISSIONS

322. BSkyB made submissions regarding the concept of abuse and stated that it could not exercise a margin squeeze on its distributors infringing the Chapter II prohibition because it had no duty to license them to distribute its premium channels.

323. BSkyB stated that (in general) to prove an abuse, the Director must demonstrate that conduct has adversely affected or impaired competition or would be likely to do so, and that there is no objective justification for such conduct. BSkyB stated that it is not enough for the Director to demonstrate that there is a merely hypothetical adverse effect on competition. BSkyB also stated that there is not a wholly different set of principles applicable only to ‘superdominant’ undertakings.

324. In BSkyB’s view, conduct which amounts to ‘normal competition’ is objectively justified. BSkyB stated that a question arising is whether an undertaking’s conduct is a reasonable and proportionate competitive response to a market situation. Further, BSkyB stated that the conduct of a dominant undertaking should be deemed to be normal competition unless it can be shown that it is only rational by virtue of an anticipated anti-competitive outcome. To assess this, BSkyB maintained that the motives of the dominant undertaking in engaging in the conduct in question are crucial.

325. BSkyB stated that it invests considerable effort in creating its premium channels. Accordingly:

(i) BSkyB’s premium channels are protected by copyright.

(ii) BSkyB is free to exploit this intellectual property right as it sees fit since its premium channels are not ‘essential facilities’. BSkyB therefore can refuse to license others to distribute them as the exceptional circumstances in Magill are not present in this case.

(iii) BSkyB argued that, therefore, it is free to license its premium channels on whatever terms it sees fit, however unreasonable. This is because an unreasonable licence is more competitive than

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278 Response Part 6.
279 Response Part 9.
280 Case 322/81 Michelin v European Commission [1983] ECR 3461 at paragraph 70.
281 Response Part 6, paragraph 20.
granting no licence at all. In particular, BSkyB cited two judgments of Mr Justice Laddie:

‘…it is not an abuse of a dominant position to refuse to licence an intellectual property right on reasonable terms. Even if the royalties sought by the plaintiff are objectively unreasonable and have the effect of destroying the competitiveness of the defendant, it is not an abuse of a dominant position defined by reference to the existence of the intellectual property right. Indeed the proprietor may offer terms which no reasonable competitor could accept. It is difficult to see how that can be worse, or commercially different, to offering no terms at all - i.e. to refusing a licence - a course the rights owner is entitled to take.’

In other words, BSkyB stated that a third party distributor, having obtained a licence on BSkyB’s terms cannot, as a matter of law, then rely on the Act to reduce the royalty payable in circumstances where there was no obligation on BSkyB to grant a licence in the first place.

II. THE DIRECTOR’S VIEW

1. Definition of abuse

326. The Chapter II prohibition forbids the abuse of a dominant position, not holding such a position. Accordingly, BSkyB has infringed the Act only if its conduct amounts to an abuse that affects trade within the UK.

327. The list of abuses given in section 18 of the Act is illustrative, not comprehensive:

‘[The] concept of an abuse is an objective concept’ and ‘…covers practices which are likely to affect the structure of a market where, as a direct result of the presence of the undertaking in question, competition has already been weakened and which, through recourse to methods different from those governing normal competition in products or services based on traders’ performance, have the effect of hindering the maintenance or

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283 Phillips Electronics v Ingman Ltd [1998] 2 CMLR 839 at paragraph 55; see also Case CH 1996 0 NO 7642 HMSO and Ordinance Survey v Automobile Association judgment of 25 September 2000.

284 This is clear from the wording of section 18(2). See OFT 402 The Chapter II prohibition at paragraph 2.3 and Case 6/72 Europemballage Corp and Continental Can Co Inc v European Commission [1973] ECR 215, paragraph 26.

development of the level of competition still existing on the market.'\textsuperscript{286}

328. However, as a dominant undertaking, BSkyB has, according to the
Competition Commission Appeal Tribunal in \textit{Napp}:\textsuperscript{287}

‘a special responsibility not to allow its conduct to impair genuine
undistorted competition’, as held by the Court of Justice in \textit{Michelin} [1983] ECR 3451, at paragraph 57. It is well established
that such a special responsibility may deprive a dominant
undertaking of the right to adopt a course of conduct that would
be unobjectionable if adopted by a non-dominant undertaking
(Case T-111/96 \textit{ITT Promedia v Commission} [1998] ECR II-2937,
paragraph 139), but the actual scope of that special responsibility
must be considered in the light of the specific circumstances of
each case: \textit{Compagnie Maritime Belge} [2000] ECR I-1365 at
paragraph 114.’

329. The Director also notes that:

‘...whilst the fact that an undertaking is in a dominant position
cannot deprive it of its entitlement to protect its own commercial
interests when they are attacked, and whilst such an undertaking
must be allowed the right to take such reasonable steps as it
deems appropriate to protect those interests, such behaviour
cannot be allowed if its purpose is to strengthen that dominant
position and thereby abuse it (\textit{United Brands}, paragraph 189; \textit{BPB
Industries and British Gypsum}, paragraph 69; \textit{Tetra Pak}, paragraph
147; \textit{Compagnie Maritime Belge Transports}, paragraph 107).’\textsuperscript{288}

330. In the following Parts, the Director assesses the three practices that he
proposed in the Rule 14 Notice amounted to such an abuse.

- Whether BSkyB has exercised a margin squeeze on each of its
distributors, by offering a margin between the prices it charges those
distributors, and the retail price BSkyB charges its own subscribers,
insufficient for them to make a normal profit, even if they were as
efficient as BSkyB’s own distribution business (see Part Eleven).

- Whether BSkyB’s mixed bundling is anticompetitive in the degree to
which it has been exercised (see Part Twelve).

\textsuperscript{286} \textit{Michelin}, cited at footnote 240 above, at paragraph 70 of the judgment.

\textsuperscript{287} Case No 1001/1/1/01 \textit{Napp Pharmaceutical Holdings Ltd v Director General of Fair
Trading}, judgment of the Competition Commission Appeal Tribunal of 15 January
2002 at paragraph 219.

\textsuperscript{288} Case T-228/97 \textit{Irish Sugar v European Commission} [1999] ECR II-2969 at
paragraph 112, referring to Case 27/76 \textit{United Brands v European Commission}
[1978] ECR 207; Case T-65/89 \textit{BPB Industries and British Gypsum v European
II-755; Joined Cases T-24-26 and 28/93 \textit{Compagnie Maritime Belge v European
• Whether the fact that BSkyB offers three discounts to distributors in the pay to basic ("PBR") version of its ratecard forecloses, or has the potential to foreclose, rival premium channel providers and distort the competitive conduct of those distributors (see Part Thirteen).

2. Intellectual property and the Chapter II prohibition

331. BSkyB’s conduct at issue broadly amounts to allegations of abusive pricing in relation to its premium channels, which contain intellectual property (i.e., copyright). Licensing a third party to use an intellectual property right is different from supplying a third party with ordinary goods. When supplying intellectual property to a third party there is a risk of unlimited reproduction of that intellectual property by that third party. Therefore the specific subject-matter of the intellectual property right must be protected from exploitation outside the control of the original rights holder, as without such control the right would lose all value.

332. However, when applying the Chapter II prohibition, the terms of supply of intellectual property need to be assessed, like other forms of property, in their economic context. In Volvo v Veng, the European Court said:

‘It must...be noted that the exercise of an exclusive right by the proprietor or a registered design...may be prohibited by Article [82] if it involves, on the part of an undertaking holding a dominant position, certain abusive conduct such as...the fixing of prices for spare parts at an unfair level...’. 289

333. There are many cases from the European Court which indicate that the price set by a dominant undertaking for a product covered by intellectual property may be abusive.290

334. The Director has not determined whether any or part of BSkyB’s premium channels are ‘essential facilities’, since this is not necessary to establish whether or not BSkyB has abused its dominant position, for the following reasons.


335. First, an allegation of abusive pricing with respect to existing customers can be distinguished from the situation in *Magill*,\(^{291}\) for example, which related to a refusal to supply a new customer.

336. Second, even though there is case law establishing that it can be an abuse to refuse to supply an existing customer,\(^{292}\) this can also be distinguished from an allegation of abusive pricing. In any event, this line of case law also indicates that once an upstream undertaking has voluntarily chosen to license or supply undertakings (which may or may not be competitors) downstream, its conduct can then be constrained by the Chapter II prohibition.\(^{293}\)

337. Third, the terms of intellectual property licences can infringe the Chapter I prohibition. Vertical price fixing, for example, is prohibited.\(^{294}\) In this light, the Court of First Instance in *Tiercé Ladbroke* said:\(^{295}\)

> ‘...it is conceivable that some aspects of the manner in which an intellectual property right is exercised may prove to be incompatible with Article [81] of the Treaty where they serve to give effect to an agreement which may have as its object or effect the prevention, restriction or distortion of competition within the common market (see *Coditel II*, paragraph 14).’

It is therefore not possible to assert that all terms of all intellectual property licences voluntarily offered by a dominant undertaking fall outside the Chapter I prohibition,\(^{296}\) or, consequently, the Chapter II prohibition.\(^{297}\) The terms on which licences are granted can prevent, restrict or distort competition irrespective of whether the product licensed is an ‘essential facility’.

\(^{291}\) *RTE and ITP v European Commission*, cited at footnote 282 above.

\(^{292}\) See, for example, Joined Cases 6 & 7/73 *Commercial Solvents v European Commission* [1974] ECR 223; *United Brands*, cited at footnote 288 above, and Case 311/84 *CBEM v CLT and IPB* [1985] ECR 3261 (the ‘Telemarketing’ case).

\(^{293}\) See further, OFT 414 *Assessment of Individual Agreements and Conduct* at paragraphs 7.1 and 7.2.

\(^{294}\) See, for example, Article 3 of the Technology Transfer Block Exemption (Regulation EC 240/1996) which covers intellectual property. Article 4 of the EC Verticals Block Exemption (Regulation EC 2790/1999) similarly prohibits vertical price fixing for goods and services which are not covered by intellectual property. There is no reason to treat intellectual property rights different to goods and services as a resale price does not relate to the specific subject matter of an intellectual property right.

\(^{295}\) Case T-504/93 *Tiercé Ladbroke v European Commission*, cited at footnote 282 above, at paragraph 146.

\(^{296}\) See also, Case 193/83 *Windsurfing v European Commission* [1986] ECR 611 at paragraphs 45-46, 57, 63-67, 73 and 92 with respect to the terms of an agreement involving a patent.

\(^{297}\) See European Commission Evaluation Report on the Transfer of Technology Block Exemption Regulation No. 240/96 (December 2001) at paragraphs 40 and 45.
338. Fourth, the fact that competition law can control the exploitation of intellectual property is expressly recognised in the WTO agreement on Trade-Related Aspects of Intellectual Property Rights (the ‘TRIPS Agreement’). Article 8(2) (principles) of the TRIPS agreement states:

‘Appropriate measures, provided that they are consistent with the provisions of this Agreement, may be needed to prevent the abuse of intellectual property rights by holders or the resort to practices which unreasonably restrain trade or adversely affect the international transfer of technology’. 298

This interface between competition law and intellectual property law is further illustrated by the fact that the Act repealed sections 44 and 45 Patents Act 1977.299 These provisions provided for the control of certain restrictive conditions within contracts relating to patented products. The Act now regulates this. In addition, a number of recent EC Directives regulating intellectual property are expressed to be without prejudice to the application of EC competition law.300 Therefore ‘legislators’ at WTO, EC and UK level have recognised that competition law has an important role in the control of the anti-competitive exploitation of intellectual property rights.

339. Fifth, regarding the views expressed by Mr Justice Laddie, High Court judgments do not create precedent insofar as they deal with EC law points, as is the case with the two judgments cited. Accordingly, such judgments are not expressed to bind the Director under section 60 of the Act. Further, the views expressed in one case (HMSO cited at footnote 283 above) appear to be obiter dicta.

3. Conclusion

340. Notwithstanding the fact that the primary object of the supply of BSkyB’s premium channels is the provision of a copyright licence, the Director is satisfied that the normal principles of UK and (via section 60 of the Act) EC competition law apply to its conduct, in particular the constraints exerted by the Chapter II prohibition on dominant undertakings. BSkyB is therefore not immune from the prohibitions the Act contains purely on the basis that its market power and dominance stems in particular from the holding of certain intellectual property rights.

298 See also Article 40 of the TRIPS Agreement.
299 Section 70 of the Act.
PART ELEVEN  MARGIN SQUEEZE

I. MARGIN SQUEEZE UNDER THE CHAPTER II PROHIBITION

1. The Complaint

341. Each of the principal distributors of BSkyB’s premium channels alleged that BSkyB had exercised a margin squeeze on it. By this, they meant that the wholesale price at which BSkyB supplied them was so high that, in order to match BSkyB’s own retail prices (as they must to be competitive with BSkyB), they would necessarily incur losses in distributing those channels.

2. EC precedent

342. That margin squeeze may abuse a dominant position has been recognised by judgments of the European Court and decisions of the European Commission which bind the Director and to which he must have regard, respectively. In National Carbonizing, the EC Commission (citing its previous letter, and with the apparent approval of the Court of Justice) observed that:

‘an undertaking which is in a dominant position as regards the production of a raw material ... and therefore able to control its price to independent manufacturers of derivatives ... and which is itself producing the same derivatives in competition with these manufacturers, may abuse its dominant position if it acts in such a way as to eliminate the competition from these manufacturers in the market for these derivatives. From this general principle the ... Commission deduced that the [dominant undertaking] may have an obligation to arrange its prices so as to allow a reasonably efficient manufacturer of the derivatives a margin sufficient to enable it to survive in the long term.’

301 NTL, Telewest and ITV Digital each alleged that BSkyB had exercised a margin squeeze.

302 ‘The Application in the Telecommunications Sector’, OFT 417 also analyses margin squeeze. Paragraph 7.26 states:

‘The vertically integrated undertaking could subject its competitors in the downstream market to a price or a margin squeeze by raising the cost of the key input and/or by lowering its prices in the downstream market. The integrated undertaking’s total revenue may remain unchanged. The effect would be to reduce the gross margin available to its competitors, which might well make them unprofitable.’


303 OJ [1976] L-35/6
343. In the more recent case of *IPS*, the Court of First Instance held that:

‘Price squeezing may be said to take place when an undertaking which is in a dominant position on the market for an unprocessed product and itself uses part of its production for the manufacture of a more processed product, while at the same time selling off surplus unprocessed product on the market, sets the price at which it sells the unprocessed product at such a level that those who purchase it do not have sufficient profit margin on the processing to remain competitive on the market for the processed product.’

3. Testing for margin squeeze

344. The practical application of a test for margin squeeze may be complex. Precedents have not related to multi-product, high technology, expanding distribution businesses with different revenues and costs that are not in a steady state. These are characteristics of the case at hand.

345. In *Napier Brown/British Sugar*, the European Commission stated:

‘The maintaining by a dominant company, which is dominant in the markets for both a raw material and a corresponding derived product, of a margin between the price it charges for a raw material to the companies which compete with the dominant company in the production of the derived product and the price which it charges for the derived product, which is insufficient to reflect that dominant company’s own costs of transformation (in this case the margin maintained by Napier Brown between its industrial and retail sugar prices compared to its own repackaging costs) with the result that competition in the derived product is restricted, is an abuse of a dominant position.’

346. The European Commission’s Telecommunications Access Notice sets out two methods of demonstrating a margin squeeze (at paragraphs 117 and 118):

- ‘A price squeeze [i.e., margin squeeze] could be demonstrated by showing that the dominant company’s own downstream operations could not trade profitably on the basis of the upstream price charged

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306 The Director considers that there is no need for the company to be dominant in both the raw material and derived product markets to operate a margin squeeze. If the company is dominant in the raw material market it can exercise a margin squeeze, distorting competition in the derived product market, as long as it is active in that market.

307 ‘The Application in the Telecommunications Sector’ OFT 417, page 25, restricts itself to the first of these options.
to its competitors by the upstream operating arm of the dominant company.’ (i.e., the test applied in Napier Brown/British Sugar).

- ‘In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company’s own downstream operations, if any) for access and the price the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient).’

347. Although primarily concerned with the application of competition law in the telecommunications sector, the Access Notice points out (at paragraph 6) that:

‘the principles set out in this Notice will, to the extent that comparable problems arise, be equally applicable in other areas, such as access in digital communications sectors generally. Similarly, several of the principles will be of relevance to any company occupying a dominant position, including those in fields other than telecommunications.’

4. BSkyB’s submissions on precedents and the relevant test

4.1 BSkyB’s submissions on precedents

348. In the Response, BSkyB considered the precedents cited above, and stated that the principal concern was exclusion of rivals.308 The precedents concerned the processing of reasonably homogenous products in developed markets, by undertakings with similar business models, and so with comparable costs and revenues.309 BSkyB also considered that the Telecommunications Access Notice was not applicable to the terms on which BSkyB licensed its channels, particularly as it was not a former state monopoly subject to regulation, in particular liberalisation directives under Article 86 EC and harmonising directives under Article 95 EC.310

4.2 Submissions on relevant test

349. In the Rule 14 Notice, the Director applied the first option in paragraph 346 and assessed whether the margin between the wholesale prices BSkyB offered to third party distributors of its premium channels and BSkyB’s own retail prices for those channels was sufficient to enable its own UK distribution operations, collected together under the title ‘DisCo’, to earn a reasonable return.

308 Response, Part 12, paragraphs 30-35.
309 Response, Part 12, paragraphs 7-18.
310 Response, Part 12, paragraphs 36-45.
BSkyB, supported by a paper prepared by Professor Bolton, objected to this test for the following reasons in particular:

(i) a vertically integrated firm may fail the Rule 14 notice test even where it has no anticompetitive motive and is profit maximising. This may arise in particular where third party distributors (a) face less elastic demand, (b) have different cost structures or (c) benefit from other and complementary revenue streams than the vertically integrated firm.

(ii) BSkyB has no incentive to exert a margin squeeze. BSkyB can benefit from third party distribution to customers that BSkyB itself cannot reach at all, or only reach at greater cost than such distributors.

(iii) To assess exclusion of actual distribution rivals, the Director must assess those rivals’ costs. Since third party distributors continue to supply BSkyB’s channels, they must consider that they are better off carrying those channels than not doing so.

5. Third party submissions on the relevant test

ITV Digital and Telewest alleged that there was a margin squeeze, initially partly on the basis that the wholesale price they had to pay for a specific BSkyB premium package was at or very close to the price difference between BSkyB’s retail price for that premium package and BSkyB’s retail price for its ‘Family’ basic package. Accordingly, they equated that retail price difference to the retail price of the premium package.

6. The Director’s conclusion on the relevant test

6.1 The competitive harm caused by margin squeeze

Margin squeeze may have exclusionary effects, as it may force distribution rivals to quit or contract in the relevant distribution market by depriving them of the reasonable return necessary to engage in this activity. Even absent exclusion, it may compromise rivals’ ability to compete, as they may be forced to incur losses in order to match the dominant undertaking’s prices. Their ability to sustain such losses is no defence to an allegation of margin squeeze. Margin squeeze may also

311 Response, Part 10.
312 Response Part 10, paragraph 21.
313 Response, Part 10, section 2.1; Part 12, paragraphs 25-28, 48-61.
314 Response Part 12, paragraphs 62-80.
315 Response Part 10, section 3.2.1.
316 See, for example, ITV Digital submission dated 5 May 2000, tables pages 89, 90; Telewest submission dated 28 April 2000, pages 58-63.
(simultaneously) have exploitative effects, by charging an excessive wholesale price to third parties.317

353. Accordingly, the dominant undertaking can exert its dominance in the wholesale market to shield its own retail business from effective competition by ensuring retail rivals pay such high wholesale prices that they cannot compete with it, regardless of their efficiency relative to that of the undertaking’s own retail business.318 Competition in the downstream market is therefore distorted as the dominant undertaking acquires or defends a market share above that it would achieve in the absence of a margin squeeze on its rivals.

6.2 Applicability of precedents

354. Notwithstanding BSkyB’s submissions, the Director considers that the principle contained in the precedents cited, namely Carbonizing Coal, Napier Brown, and IPS, and the Commission’s statement contained in the Telecommunications Access Notice are of general application. They do no more than set out the special responsibility that falls on a vertically integrated dominant undertaking supplying at two levels of production under Article 82 EC, and so, via section 60 of the Act, under the Chapter II prohibition.319

355. There are certain differences between the precedents: Carbonizing Coal refers to the elimination of competition, and the need to allow a reasonably efficient manufacturer to survive in the long term. IPS refers to actual distributors having a sufficient profit margin to remain competitive. Napier Brown refers to the dominant undertaking’s failure to reflect its own costs of transformation with the result that competition in the derived product is restricted.

356. The Director considers that the correct test, consistent with these precedents, should determine whether an undertaking as efficient in distributing as BSkyB can earn a normal profit when paying the wholesale prices charged by BSkyB to its distributors, and that this should be tested by reference to BSkyB’s own costs of transformation. BSkyB has strong incentives to minimise such costs. If BSkyB is not covering such costs, then it will acquire or maintain a market share not justified by any competitive advantage but rather by restricting its rival distributors’ ability

317 The Director has not attempted to assess directly whether BSkyB’s wholesale prices are excessive due to the absence of appropriate comparators.

318 Where the undertaking as a whole is profitable, a margin squeeze implies that it is subsidising its loss making retail business with the profits from its wholesale business, to the detriment of retail competitors that pay the wholesale price it sets.

319 BSkyB appears to acknowledge this with regards to the Telecommunications Access Notice: Response Part 12, paragraph 41. It does not, however, consider that the issues raised by access to telecommunications networks granted by vertically integrated network operators are comparable to those raised by the prices at which the vertically integrated BSkyB offers its channels to downstream distributors.
to compete. This test will indicate whether BSkyB’s downstream business can operate profitably without subsidy from BSkyB overall.

6.3 The specific test: use of DisCo

357. In this regard, BSkyB stated that consideration of DisCo’s costs and revenues cannot give any meaningful indication of an anticompetitive margin squeeze, for the reasons summarised in paragraph 350 above, so that DisCo may give a ‘false’ result. The Director does not accept these reasons.

6.3.1 Different revenues and costs

358. With regard to BSkyB’s preferred test, the Director cannot directly assess the relative efficiencies of rival technologies or undertakings. BSkyB emphasised in particular the additional revenues that cable operators may earn through offering bundled telephony and internet services, and stated that ITV Digital had lower customer acquisition costs.\(^{320}\) It does appear to the Director that each distributor had competitive advantages and disadvantages, and he aims to ensure that these are realised through undistorted competition.

359. While the precedents considered do not directly address the situation where a distributor may be active in several markets and so have several (bundled) revenue streams, this does not affect the underlying analysis.

360. BSkyB argued in effect that if competing distributors have lower costs than DisCo (either because they are more efficient or because they benefit from economies of scope) then BSkyB should be able to set wholesale prices that would ensure that its own, higher-cost distributor could set competing retail prices. The Director does not agree. The outcome of such discriminatory pricing could be to prevent competition on the merits, since BSkyB would be allowed to provide DisCo with a subsidy to compensate for any competitive advantages enjoyed by other distributors.

361. To the extent that any distribution rival is more efficient than BSkyB, it should benefit from that relative advantage, and win market share. The converse is equally true, even to the point of insolvency: BSkyB has no obligation to ensure that inefficient competitors remain in the market.

362. The Director therefore considers that a vertically integrated dominant undertaking in BSkyB’s position may not price discriminate without limit according to the ability to pay of its distributors, but must instead offer a wholesale price that is no higher than the maximum at which its own distribution business could make a normal profit.\(^{321}\)

\(^{320}\) Response, Part 12, paragraphs 50-61.

\(^{321}\) The dominant undertaking may of course offer discounts from this level to third parties, consistent with the constraints imposed by the Chapter II prohibition.
6.3.2 Different customer set

363. The Director considers that the cable companies and ITV Digital were active in the same relevant distribution market as BSkyB. BSkyB did not contest this. Therefore they each are, in principle, competing for the same customers, even though certain actual or potential subscribers might in fact only have access to just one distributor.

6.3.3 Incentive to margin squeeze

364. BSkyB stated it had no incentive to margin squeeze, referring to Professor Bolton’s paper, given that cable and DTT might acquire customers that BSkyB could not, or more cheaply than BSkyB could. BSkyB referred to a survey showing that [over 50]% of ITV Digital customers, [over 50]% of NTL customers and [over 50]% of Telewest customers did not even consider BSkyB Digital as an option. Examination of the reasons given, however, indicates that BSkyB was considered in each case.322

365. BSkyB further stated that it had consistently sought to negotiate licence terms with third party distributors.323 The Director considers this does not show lack of an incentive to margin squeeze. Several of these proposals were either rejected by the potential distributor, or abandoned on competition grounds following action by the European Commission or the Director.324 The current investigation was to a large degree provoked by the complaints of ITV Digital, NTL and Telewest that they were suffering a margin squeeze, which indicates that they considered that they were the subjects of an anticompetitive margin squeeze.

366. The Director considers that BSkyB is a vigorous competitor eager to acquire market share at distribution level, and so may be expected to have strong incentives to increase share at the expense of rivals, including anticompetitive incentives. In so doing, BSkyB could potentially limit the ability of its retail rivals to bid successfully for and obtain programming content, thereby improving the terms upon which BSkyB may secure it.

6.3.4 Evidence of actual exclusion

367. BSkyB proposed that the Director should examine the costs and revenues of actual competitors to determine if they were profitable on the prices it charged them. The Director cannot determine whether such undertakings are reasonably efficient. Accordingly, any losses discovered would not reveal whether such distributor was suffering a margin squeeze, being


323 Response, Part 12, paragraphs 76 – 80.

324 For example: the Director’s rejection of BSkyB’s proposed revised ratecard, by letter dated 23 December 1999; […]; and BSkyB’s abandonment of its broadband cable distribution agreement dated 6 September 2000 with NTL in the face of competition concerns raised by the Director on 31 August 2001.
inefficient, or incurring losses for some other reason unrelated to BSkyB’s pricing strategy, and so could not reveal an infringement of the Chapter II prohibition.325

368. Applying the test to DisCo (in line with the precedent in Napier Brown/British Sugar) has the following advantage of principle. If DisCo failed the test, then rivals with similar efficiency to DisCo would be prevented by BSkyB’s pricing strategy from competing on the merits to expand their businesses, or perhaps even from staying in the market at all.

6.4 Conclusion

369. The Director is therefore satisfied that BSkyB, as a vertically integrated undertaking that supplies at retail and wholesale levels of the distribution chain, and is dominant at the wholesale level, should ensure that the margin between the prices it sets at those levels is sufficient at least to cover its own costs of transformation.

370. Applying this test determines whether any distributor as efficient as DisCo could make a profit, in which case competition between distributors of premium channels would not be distorted. Accordingly, the Director has determined DisCo’s profitability, applying the methodology set out below.

II. MODELLING DISCO’S PROFITABILITY

1. DisCo is not in a steady state

371. Since 1998, BSkyB has been moving from an analogue to a digital transmission system for distributing channels, and consequently has incurred significant costs in replacing analogue with digital equipment and moving from analogue to digital satellite transponders.326 However, the largest investment cost has been incurred in acquiring new subscribers and persuading existing analogue subscribers to switch to the digital system.327 Consequently, BSkyB (DisCo) has not been in what could reasonably be considered a steady state.328

325 As a practical matter, this method would, to protect BSkyB’s rights of defence, require the disclosure of large amounts of confidential third party data to BSkyB.

326 [...] Such customer acquisition and transition costs comprise two broad categories: marketing costs to attract new subscribers and subsidies of new digital set-top boxes and satellite receivers and their installation to encourage take-up of the digital services.

327 BSkyB considered that there is a greater variety of factors which contribute to a lack of steady state (Response, Part 11, paragraph 7). These issues are considered in more detail in section 5.14 below.
372. A margin squeeze test must take account of losses resulting from legitimate investments. A test that matches revenues with the associated costs is therefore required.

2. Adopting an historical approach

373. Margin squeeze assessment requires consideration of whether margins between wholesale and retail prices are sufficient to allow an undertaking as efficient as DisCo to make a normal profit during specific periods, and the Director has therefore considered how to treat capital costs in assessing margin squeeze. 329

374. One method that would take account of the investment nature of such costs would be to calculate the present value of the net cash flows of DisCo, adjusted for their timing and risk (the net present value (‘NPV’) approach). Alternatively, an historical approach, which matches costs and revenues by amortising investment expenditures, could be adopted. In the Rule 14 Notice, the Director chose an historical model.

2.1 The parties’ views

375. BSkyB considers that the Director should adopt an NPV approach. According to BSkyB, ‘it is not possible to make a robust assessment by examining a limited part of the investment cycle’. 330

376. NTL also considered that the NPV approach to be more appropriate. NTL suggested that the NPV approach is of greater economic significance and notes the model’s ability to accommodate the time value of money. 331

377. BSkyB, along with NTL, did not accept the Director’s rejection of the subjective forecasts necessary to construct an NPV model (see paragraph 383 below). 332 BSkyB considered that there exists a wide range of ‘reasonable’ estimates of future cash flows. BSkyB suggested that, in addition to its own detailed forward planning analysis, the Director could make use of several broker’s reports projecting the future profitability of BSkyB. 333

378. By adopting an historical approach, BSkyB argued that ‘the Director is requiring BSkyB (DisCo) to recover its investments according to an arbitrary schedule which the Director has selected’. 334 BSkyB therefore

\[\text{Capital costs generate revenues in periods beyond the period in which they were incurred.}\]

329 Response, Part 11, paragraph 57.
330 NTL’s submission of 8 March 2002, page 17.
332 Response, Part 11, paragraph 62.
333 Response, Part 11, paragraph 72. BSkyB’s comment concerning the recovery schedule was made in response to the Rule 14 Notice, in which the Director
contended that any failure of the margin squeeze test would only indicate that BSkyB had failed to recoup its investment costs in the pattern that the Director’s test necessitates.

379. BSkyB considered that the NPV approach is consistent with the underlying objective of a margin squeeze test. An NPV approach would indicate whether or not DisCo is a viable and sustainable business, given the wholesale prices available from BSkyB, and whether an equally efficient third party could therefore profitably enter the market on the basis of the margin available.335

380. BSkyB noted that in avoiding the NPV approach, the Director has not avoided uncertain issues including the treatment of investment expenditure.336 The Director’s approach requires him to identify an appropriate amortisation period for each investment cost, which should correspond to the duration of the associated benefit.

381. ITV Digital’s advisor, Frontier Economics, suggested that both models should be run and should, if modelled appropriately, give the same result.337

2.2 The appropriate model

382. The Director considers there to be several flaws to the NPV approach, when used to detect margin squeeze. First, it would only show if DisCo is expected to earn a positive net present value (i.e., the surplus of discounted cash inflows compared to discounted cash outflows and investment expenditures) over the period employed for the analysis, such as the average period a customer subscribes to BSkyB.338 It would not identify periods in which any margin squeeze has taken place.339 The application of the Chapter II prohibition in the course of investigations such as this is necessarily ex post, and so a methodology is required which allows the Director to determine for specific periods whether DisCo has incurred losses.

383. The NPV approach requires knowledge of the cash flows during the whole life of the project (or over a reasonably long period, knowledge of cash flows during that period, plus a terminal value). Such forecasts are, by their nature, uncertain and cannot be used to reach conclusions proposed to amortise customer acquisitions using a different approach (see paragraphs 491 to 493 below).

335 Response, Part 11, Annex 4, paragraph 3.
336 Response, Part 11, paragraph 62.
337 The suggestion was made at a meeting with OFT officials on 13 February 2002.
338 This would be the relevant period as it is the period over which BSkyB can earn revenues from its specific investment in transitioning to a digital system by attracting digital subscribers. This is distinct from valuing DisCo over an indefinite period.
339 Methods exist for allocating investment costs to specific periods but they are unhelpful in a setting of periodic negative cash flows.
sufficiently robust for the Director’s purposes. While there are numerous forecasts available (see paragraph 377 above), these remain subjective. The Director notes, for example, the greatly varying projections made at the beginning of BSkyB’s digital roll-out, compared with those immediately after the transition from analogue to digital was completed.  

384. The Director disagrees with BSkyB’s interpretation of the implications of a positive net present value (see paragraph 379 above). BSkyB’s approach applied as a test of anticompetitive pricing would ignore the possibility that a period of margin squeeze could successfully restrict competition and boost BSkyB’s (monopoly) profits subsequently. A positive net present value could therefore be interpreted not as evidence of anticompetitive price squeeze but partly as evidence that the exercise of a margin squeeze is a viable strategy, as distribution losses incurred during a temporary squeeze are subsequently recovered.  

341 Specifically, an interpretation of such an analysis could be that by squeezing rival distributors in early periods and thereby dampening competition, BSkyB could anticompetitively accelerate its acquisition of digital subscribers to enable early achievement of its minimum efficient scale.

385. The Competition Commission Appeal Tribunal (‘CCAT’), in Napp, made a similar observation to the Director’s regarding profits that result from anticompetitive behaviour. It rejected Napp’s contention that below cost sales to hospitals could be considered profitable (and therefore competitive) due to the resultant revenues generated through sales to GPs:

‘If these loss-making sales also have the effect of excluding competitors, the very conduct which is profitable to Napp on a net revenue basis has at the same time the effect of eliminating competition. To then argue that the below-cost pricing in the hospital segment is justified by the revenues from the community segment is the equivalent of saying that anti-competitive behaviour which protects Napp’s virtual monopoly can be justified on the basis of the profits made from the monopoly which the anticompetitive behaviour is designed to protect. The argument is circular’.  

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386. Subject to this point, the Director accepts the suggestion that the NPV and historical tests should theoretically give the same result over the

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340 For example, in June 1998 ABN Amro projected Digital DTH subscriber numbers of 3,442,000 by 2005, compared to a projection for 2005 of 7,373,000, in its February 2002 report.

341 Whether as a means of increasing an NPV that would be profitable absent anticompetitive behaviour, or as a means of turning a negative NPV into a positive NPV.

342 Case No. 1001/1/1/01 Napp Pharmaceutical Holdings v Director General of Fair Trading, judgment 15 January 2002.

343 Ibid., para. 260.
lifetime of a project (see paragraph 381 above). However, no such consistency applies to an assessment of specific periods. Whereas an historical approach can identify an anticompetitive squeeze in a given period (by identifying losses that can be classified as operating losses rather than losses caused by investment costs), an NPV analysis might still indicate that a project is profitable over its lifetime, erroneously suggesting that an anticompetitive margin squeeze has not been exercised. Accordingly, a positive NPV does not confirm the absence of margin squeeze.

387. Therefore an NPV approach is not suitable to assess whether BSkyB has exercised a margin squeeze. The Director has concluded that DisCo’s investment expenditures should be capitalised and amortised over an appropriate period to match the duration of the ongoing benefit to be derived from them. This approach uses past observed costs only (not future projections) and allows costs to be allocated to distinct periods, which allows assessment of margin squeeze.

388. The Director does not consider the implied ‘recovery schedule’ of an historical test need necessarily be ‘arbitrary’ (see paragraph 378 above). By adopting a depreciation method (see paragraph 493 below) that reasonably matches the pattern and duration of investment expenditures with the revenues produced by the subscriptions resulting from such investment, the Director is confident that the proposed recovery ‘schedule’ is reasonable.

389. The Director accepts that an historical test involves some uncertainty, but considers that it will incorporate a far greater proportion of objective and factual information than would an NPV analysis.

2.3 Conclusion

390. The Director considers that the historical approach is the appropriate way of assessing margin squeeze in this case. The Director does not consider that a positive NPV for DisCo would necessarily imply that BSkyB has not margin squeezed. An historical approach that recognises and treats investment expenditures appropriately is therefore the best option available.

III. THE TEST

1. Accounting methodology

391. The Director has used accounting treatments that, to the extent possible, produce economically meaningful results. These results are derived, where possible, from BSkyB’s accounts. The approach is ‘top-down’ and uses BSkyB accounting data as its starting point.

392. In determining the appropriate accounting methodology for the margin squeeze test, the Director has considered:
(i) the appropriate return that DisCo needs to earn for BSkyB to avoid margin squeeze;

(ii) the method of allocating revenues and costs; and

(iii) the treatment of investment expenditures.

2. Appropriate return

393. As the European Commission’s Telecommunications Access Notice makes clear, determining margin squeeze depends on whether a downstream operator as efficient as DisCo can earn a normal profit. Assessments of normal profit for a business typically rely on calculation of the cost of capital (i.e., costs of funds) of a business. This cost of capital is then applied to the capital employed to calculate the required return (by multiplying the cost of capital by the book value of the net assets).

394. In the Rule 14 Notice however, the Director adopted a required return based on turnover as the basis for determining profitability, for the reasons set out below.

2.1 The parties’ views

395. BSkyB’s advisor, Professor Bolton, favoured the use of return on capital rather than return on sales, a measure he regarded as arbitrary. Professor Bolton argued that return on turnover is a profitability measure without economic significance, as opposed to return on capital which he describes as ‘the minimum level of profit that is required to justify any particular economic activity’.

396. NTL supported this view and considered that ‘the correct economic approach is to look at the ROCE [return on capital employed]’. Further, BSkyB and NTL argued that unlike when applying the cost of capital to an NPV analysis, there is no objective method of establishing a required rate of return on turnover.

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344 At paragraph 118. Although this requirement is included only in the context of the construction of a model of an efficient retail rival, the Director considers that it applies equally to DisCo.


346 Response, Part 10, section 4.5.


2.2 Return on turnover required

397. The Director accepts that return on capital employed is a profitability measure generally of greater economic significance. However, for the reasons set out below, in the Rule 14 Notice he considered that a measure based on capital employed would be inappropriate in this case.

398. DisCo is a distribution business that buys most of the services it offers, including BSkyB and third party programming, conditional access and subscriber management services (see section 5 below. Bought-in services account for [over 50]% of DisCo’s total costs. Over [10]% of DisCo’s turnover is accounted for by costs of programming acquired from BroadCo, which is considered to be a bought-in price for purposes of the margin squeeze test. The charges for these activities are passed to consumers with a commercial mark-up. The principal activities that DisCo provides on its own behalf are transmission (see paragraphs 471 to 481), the organisation of these bought-in activities, and marketing. As with other service providers or distributors, it is expertise in providing these services, rather than investment, that permits DisCo to add value.

399. Reflecting this, DisCo’s accounting capital employed (as disclosed in the separated accounts) is small relative to its turnover. Much of DisCo’s capital employed is represented by working capital which is generally variable, making any ‘return on asset’ calculation unreliable.

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349 Those operations within BSkyB that are necessary to the supply of programming to the pay-TV distribution companies are gathered together under the title ‘BroadCo’.

350 See paragraphs 434 to 443 below for assessment of the wholesale prices that DisCo pays for BSkyB’s premium channels.

351 For example, its tangible fixed assets at 30 June 2000 were £[...](excluding any share of transmission assets of £[...]), compared with a turnover for the preceding 6 months of £[...]- a fixed asset to turnover ratio of [...]%. Similarly, at 30 June 1998, fixed assets of £[...] were allocated to DisCo, whereas turnover for the six month period was £[...], giving a fixed asset to turnover ratio of [...]%. For June 1999 a fixed asset to turnover ratio (£[...]: £[...]) of [...]% was observed. Source: BSkyB separated accounts dated June 1998, June 1999, June 2000.

<table>
<thead>
<tr>
<th>Date</th>
<th>Current assets (£m)</th>
<th>Current Liabilities (£m)</th>
<th>Working capital (£m)</th>
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<tbody>
<tr>
<td>June 1998</td>
<td>[...]</td>
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<td>June 1999</td>
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<td>June 2000</td>
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352 The usual theoretical framework for calculating ROCE would not allow the capitalisation of customer acquisition costs (see paragraphs 489 to 493 below). This is because they are not separable assets under the control of the entity and have no market price. This is not to deny that such outlays may result in continuing revenues and this is why such costs have been amortised (see paragraph 414 below). The valuation of any such benefits cannot be ascribed to these specific investments and any such benefits represent internal goodwill which is not incorporated in conventional ROCE calculations.
400. A similar view was taken by the then MMC in its report on BT,\textsuperscript{354} where instead of using return on capital employed, the MMC calculated return on turnover for BT’s call business. The MMC considered that the reason this approach could be applied to BT’s call business was the ‘very high proportion of turnover accounted for by bought-in services’.\textsuperscript{355}

2.3 Establishing a rate of return

401. The MMC concluded that a return on turnover of 1.5% would be appropriate for BT’s calls-to-mobiles activity. In contrast, in its report on Scottish Hydro-Electric plc a return of 0.5% was adopted.\textsuperscript{356} The MMC considered that ‘the potential for competition from new operators and the speed with which it could impact on BT are factors which we believe differentiate BT’s calls to mobile activity from the circumstances of Scottish Hydro-Electric’\textsuperscript{357}. Due to the existence of certain retail rivals during the relevant period, the Director considered the higher return on sales to be more appropriate in assessing DisCo and the Rule 14 Notice adopted a required return of 1.5%.

402. The complainants each considered that a required rate of return of 1.5% was too low. Telewest criticised the MMC’s methodology in establishing the figure of 1.5% and stated that ‘it is even less clear why the ROT of 1.5% should now be applicable to BSkyB’s distribution business – a fortiori when applied with no adjustments for its particular circumstances’.\textsuperscript{358} Telewest considered that due to the high risk evident in the pay-tv environment, the figure of 1.5% should be revised upwards.\textsuperscript{359}

403. Similarly, NTL and ITV Digital each considered that a required return of 1.5% is too low.\textsuperscript{360} NTL suggested basing the required return on turnover on a survey of European DTH companies.\textsuperscript{361}

\textsuperscript{354} British Telecommunications Plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the charges made by British Telecommunications Plc for calls from its subscribers to phones connected to the networks Cellnet and Vodafone. MMC, 21 January 1999. The MMC concluded (paragraph 2.113) that calculating a return on net assets employed was an unreliable basis for setting a reasonable return as the mean net assets employed in call activities are not only relatively small but they consisted for the most part of working capital items which could fluctuate considerably from year to year.

\textsuperscript{355} Paragraph 2.116. In the case of BT, ‘over 80% of the retail price to consumers represents the cost of bought in services’ (Paragraph 2.112).


\textsuperscript{357} Paragraph 2.117

\textsuperscript{358} Telewest submission dated 20 March 2002, Section 1.1

\textsuperscript{359} Telewest submission dated 20 March 2002, Section 1.1.

\textsuperscript{360} See page 21 the NTL submission dated 8 March 2002 and page 16 of the ITV Digital submission dated 27 March 2002.
BSkyB considered that the Director has not offered sufficient justification of the adoption of a return of 1.5% rather than one of 0.5% (see paragraph 401 above). BSkyB rejected the Director’s view that the increased risks faced by DisCo merit the adoption of the higher required return. BSkyB suggested that ‘it is issues such as the capital intensity of different industries which are key to understanding differences in required return on turnover’. Absent robust justification, BSkyB suggested that DisCo should be required to earn a return of no more than 0.5% of turnover.

2.4 Comparator companies

The Director has considered a variety of companies that might provide a reasonable proxy for the normal profit that DisCo may be expected to earn. The necessary criteria identified by the Director included having a similar capital structure, proportion of bought-in services and function to DisCo.

The Director considered UK television companies. Given the complaints regarding margin squeeze and the multiple revenue streams of cable companies, rival pay-TV distributors could not be considered to be good proxies. Further, other UK television companies such as Carlton and Granada are integrated production and distribution companies and so are not good proxies for DisCo.

Overseas television companies were also considered. The major pay-TV companies operating in Europe are, like BSkyB, integrated companies, and financial data relating to the distribution functions of such companies is not available. The Director did not find suitable proxies to DisCo in North America.

The Director also considered other areas of economic activity. The former public electricity supply companies were considered to be a reasonable proxy, since their capital structure has similarities to that of DisCo, and they also make extensive use of bought-in services.

The Director estimated the average return on turnover for the former public electricity supply companies in 1996/97, 1997/98, 1998/99 and 1999/2000 (see Annex 14). In these years, the average return on turnover was 2.1%, 2.2%, 3.3% and 2.6% respectively. The Office of

361 The Director completed a survey of the companies that NTL suggested could be used as comparators. However, the companies were integrated and not considered to be a reasonable proxy for DisCo.
362 Response, Part 11, paragraph 287.
363 Response, Part 11, paragraph 287.
364 Response, Part 11, paragraph 289.
365 Competition was introduced to domestic electricity supply in 1998/99.
366 These returns are before exceptional items and before any disclosed current cost adjustments.
Gas and Electricity Markets (‘OFGEM’) no longer receives regulated accounts for the former public electricity supply businesses, so figures are not available for either 2000/01 or 2001/02. OFGEM however understands that some within the broker community consider that average return on turnover levels in the electricity supply sector are currently higher than their historic levels. While the Director considers that the former public electricity supply companies capital structure has similarities to that of DisCo, and they also make extensive use of bought-in services, there have been at varying times during the period from 1996/97 up to the time of this decision several issues specific to these companies and their market sector which do not make their return on turnover a suitable comparison for DisCo.

410. Other distributors considered include major high street retailers and supermarkets (return on turnover percentages are shown in Annex 15), as well as professional service organisations. Retailers and supermarkets have very different capital structures to DisCo, but their return on turnover ranged from roughly 4% to 10%. While professional service companies did have similar capital structures to DisCo, they have very little in the way of bought-in services.

411. While the Director was unable to establish a strong portfolio of comparator companies, it appears that the return on turnover that is observed across a range of industries is typically higher than the 1.5% that he considered appropriate in the Rule 14 Notice.

412. The Director notes that the required return implied by BSkyB’s own estimate of DisCo’s cost of capital, when applied to a capital base including capitalised marketing expenditure (see paragraphs 489 to 493 below), is higher than that required given a 1.5% required rate of return on turnover.367

2.5 Conclusion

413. Notwithstanding the parties’ representations, the Director considers that return on turnover is the best measure of DisCo’s profitability in the current case and that, for the purposes of this investigation, it should be required to achieve a return of at least 1.5%. Given the level of commercial risk faced by DisCo, this rate is a conservative assumption of the minimum that DisCo might be expected to earn.

3. The treatment of revenue and expenditure

3.1 Investment expenditure

414. DisCo’s investment expenditures should be capitalised and amortised over an appropriate period to reflect the ongoing benefit to be derived from them. The appropriate amortisation periods are considered below at paragraphs 463 to 465 and 489 to 493.

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367 BSkyB submission dated 12 January 2001), pages 49 to 51, section 10.11 to 10.13.
3.2 Methods of allocating revenues and costs

415. The European Commission’s Recommendation on Interconnection Pricing states that ‘Accounting separation should be based on the principle of causation.’ The allocations of revenue and cost detailed below follow both the causality basis recommended by the European Commission, and BSkyB’s understanding of its cost drivers, as far as practicable. However, this approach is constrained by the accounting system that BSkyB employs and the data it produces.

416. Broadly, costs must be allocated between two primary notional entities, ‘BroadCo’ and ‘DisCo’. The terms ‘BroadCo’ and ‘DisCo’ were devised on the basis that BSkyB operates a broadcasting business (BroadCo) and a distribution business (DisCo). This, in itself, does not define the dividing line between the two businesses. Since BSkyB is an integrated business, the Director has assessed those functions necessary to channel provision and those necessary to channel distribution. He has then, to the extent possible, allocated revenues and costs accordingly.

4. Revenues

417. The table below summarises the treatments adopted for each material revenue category reported by BSkyB in the separated accounts provided in line with its 1996 Undertakings. The paragraphs following explain those treatments.

<table>
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<th>REVENUES</th>
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<td>(i)</td>
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<td>(iv)</td>
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369 The Director considered that it would not be proportionate to require BSkyB to implement a new accounting system solely for the purposes of this investigation.
4.1 Sales of premium sports and film channels

418. BSkyB dominates the markets for the provision of unique to premium sports channel content (currently identified as live FAPL football) and unique to premium film channels content (see Part 9). Given that such content is provided in bundles (i.e., channels, which themselves are provided bundled with other channels), it is the margin between BSkyB’s wholesale and retail premium channel prices that the Director intends to assess, and so the revenues deriving from the sale of BSkyB’s premium channel subscriptions are included as DisCo’s revenues. He cannot, and has not sought to, allocate revenue to specific content within such premium channels.

419. The Director has excluded revenues deriving from third party à la carte premium channels (i.e., those that may be purchased on an individual basis), but has not attempted to allocate any revenues to third party channels where they are provided as bonus channels (such as, in certain BSkyB packages, The Disney Channel), or to specific content within BSkyB’s premium channels (for the same reasons given for basic channels below) and to exclude such allocated revenue from his assessment of margin squeeze (see Annex 16).^370

4.2 Sales of basic channels

420. Determining DisCo’s revenues from BSkyB premium channel subscriptions is complex, as DisCo supplies such channels only in bundles with basic channels (including certain radio/audio channels). To separate the revenues derived by DisCo from the distribution of basic channels (BSkyB’s own and third party) and premium channels would involve arbitrary allocations. The Director considers that inclusion of revenues deriving from basic channel subscriptions does not adversely affect analysis of margin squeeze on BSkyB’s provision of its premium channels. Any failure by DisCo to be profitable may properly be attributed to a margin squeeze in its distribution of BSkyB’s premium channels for the following reasons.

4.2.1 BSkyB cannot inflate the wholesale price of basic channels

421. BSkyB’s basic channels do not confer dominance in the market relevant to their supply. Sky One has a leading position amongst basic pay-TV channels, but is subject to direct competition from such basic channels as E4. Sky News is one of at least four 24 hour news channels available on Pay TV platforms (BBC News 24, CNN, ITN news). BSkyB’s other basic channels, such as Sky Sports News, Sky Travel and [.tv] achieve minor market shares.

422. Absent dominance, BSkyB cannot successfully exert a margin squeeze on basic channels by inflating wholesale prices of its own basic channels, as

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^370 The Director considers that [...] the wholesale price of any package that includes the Disney channel as a bonus, could actually be subject to a price rise corresponding to the price paid by BSkyB (per subscriber) for Disney. [...]
this would provoke switching by rival distributors to competing channels. Accordingly, since the prices DisCo ‘pays’ BroadCo for BSkyB basic channels are the same wholesale prices paid in an undominated market by retailers such as ITV Digital, NTL and Telewest, they can be assumed not to be excessive.

4.2.2 There is no rationale for BSkyB to make losses on the retail supply of basic channels when bundled with premium channels

423. Any ‘loss leading’ on basic channels when bundled with premium channels would be rational only if compensated by enhanced revenues overall. If, notwithstanding such a strategy, DisCo were still making overall losses, this must be due to additional losses on premium channel sales.

424. Accordingly, the revenues (and costs, see paragraph 443 below) of basic channels (both BSkyB and third party) are included in the assessment of margin squeeze.

4.2.3 The Director rejects the suggestion that the price for premium is the increment between the premium and basic retail prices

425. ITV Digital suggested that a test based on the incremental price of premium channels is relevant, either as the basis of the margin squeeze test or as a supplement to a margin squeeze test focused on DisCo in its entirety.\(^{371}\)

426. ITV Digital suggested that, given the assumption that the market for basic channels is competitive, a test considering DisCo as a whole would be equivalent to one in which ‘the reselling firm should earn positive profits on the incremental sale of premium at the resale price’.\(^{372}\)

427. ITV Digital is not correct to infer that the incremental price of premium packages has such meaning in this instance. The difference between the retail price of the largest basic package and the price of a premium package does not correspond to the revenue that should be allocated to premium channel retail.\(^{373}\) ITV Digital’s inference relies on the condition that the costs incurred in the provision of a basic-only package relate solely to basic channel provision. If this were the case, given the assumption that the market for basic channels is competitive, the Director could reasonably treat the increment between premium and basic package prices as the total revenue attributable to premium channels.

428. In fact, significant proportions of the costs associated with basic channel packages are common to the provision of packages including premium channels.\(^{374}\) Implicit therefore in the cost of any BSkyB package is


\(^{373}\) His use of such increment in paragraph 145 was indicative rather than determinative.

\(^{374}\) For example, marketing, overheads and subscriber management expenditure.
effectively, a ‘platform access charge’. Whenever a subscriber of any package joins the platform, BSkyB (DisCo) seeks to recover platform costs that are fixed, irrespective of the package purchased. To infer that the incremental price is the revenue that should be allocated to premium channels would be to understate the share of revenues that should be allocated to premium channels, as none of the premium revenue would be allocated to the recovery of this ‘platform access charge’.

429. Telewest noted similar concerns with respect to the inclusion of basic channels when testing for margin squeeze. Telewest states that it ‘earns a margin of between [...] over programming costs for basic content’ and is concerned that including basic provision ‘has a major distortionary effect which... dilutes the extent of margin squeeze found by the OFT’. Specifically, Telewest considered that ‘for a set overall return, (from basic and premium combined), BSkyB can earn a lower return on the premium element if this is counterbalanced by a higher margin in basic. In other words, higher margins on BSkyB’s basic sales could be cross-subsidising lower premium margins. If premium were considered in isolation the squeeze would be deeper’. Telewest’s point rests on the assumption that the required rate of return set by the Director is either itself too low, or that the rate of return that can be earned from basic channel provision is above the competitive level. The Director is satisfied that the required rate of return is reasonable, and also that, as outlined in paragraph 422 above, that BSkyB cannot earn returns on basic channel provision above the competitive level.

4.3 Other revenues

430. Other revenues comprise marketing contributions received from third party channel suppliers related to the cost of promoting their basic packages retailed by DisCo (see Annex 17). These revenues have been allocated to DisCo in their entirety. While this allocation errs against a finding of margin squeeze, its impact is not material.

4.4 Excluded revenues

431. BSkyB is not only active in the provision and distribution of premium and basic channels via its DTH platform. Accordingly, the Director lists below

\[\text{375} \quad \text{Telewest submission dated 20 March 2002, page 4.}\]
\[\text{376} \quad \text{Telewest submission dated 20 March 2002, page 3.}\]
\[\text{377} \quad \text{Telewest submission dated 20 March 2002, page 4.}\]
\[\text{378} \quad \text{In that no portion of these marketing contributions have been allocated to the Eire or commercial services.}\]
\[\text{379} \quad \text{BSkyB argued that there is a case for crediting DisCo with increased ‘other revenue’. The test assumes that no marketing contributions are received by DisCo from BroadCo, when ‘BSkyB (BroadCo) does in fact make contributions to the expenses and efforts of other distributors’ (Response, Part 11, paragraph 363). The Director accepts that there is a theoretical argument in favour of increasing ‘other revenues’. However, absent evidence on the extent of such an increase, no adjustment has been made.}\]
those BSkyB activities excluded from the BroadCo and DisCo businesses and therefore from his assessment of margin squeeze, as they comprise no part of distributing BSkyB’s premium sports and film channels to DisCo’s subscribers, and do not fall within the relevant market. Further, their revenues (unlike those related to the distribution of basic channels), and a substantial proportion of their costs, may be separated from those relating to the distribution of BSkyB’s premium channels. As noted, the Director has not allocated revenues between content within BSkyB’s premium channels. The excluded activities are:

(i) Pay Per View (see Annex 18);
(ii) British interactive Broadcasting;
(iii) Sales to Eire (see Annex 16); and
(iv) Commercial sales (see Annex 19). \(^{380}\)

432. Excluding the revenues from these activities means that the respective costs should also be excluded. See paragraph 452 below.

5. Costs

433. The table below summarises the treatments the Director has adopted for each of the cost categories reported by BSkyB in its management accounts. The paragraphs following explain why those treatments have been adopted.

\(^{380}\) As noted, this decision does not relate to BSkyB activities in its direct and indirect supply of its premium channels to commercial users.
### COSTS

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Details</th>
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<tbody>
<tr>
<td>(i)</td>
<td><strong>BSkyB premium programming costs</strong></td>
<td>DisCo pays the prices BSkyB charged to each of its principal third party distributors.</td>
</tr>
<tr>
<td>(ii)</td>
<td><strong>BSkyB basic programming costs</strong></td>
<td>DisCo pays the price charged to other distributors for its basic channels.</td>
</tr>
<tr>
<td>(iii)</td>
<td><strong>Third party programming costs</strong></td>
<td>Third party programming costs are those incurred by BSkyB and are charged to DisCo.</td>
</tr>
<tr>
<td>(iv)</td>
<td><strong>Excluded costs</strong></td>
<td>All costs directly attributable to PPV, Eire, Commercial, and à la carte services are excluded, as are payments made with respect to bonus channels offered by BroadCo. Common costs allocated to these services are also excluded (see paragraphs 509 to 520).</td>
</tr>
<tr>
<td>(v)</td>
<td><strong>EPG costs</strong></td>
<td>Direct electronic programme guide (‘EPG’) costs have been allocated between UK DTH, Eire DTH, PPV, à la carte and dedicated Commercial channels where possible. Indirect EPG costs have been allocated in line with other common costs (see paragraphs 509 to 520).</td>
</tr>
<tr>
<td>(vi)</td>
<td><strong>Subscriber management</strong></td>
<td>DisCo’s subscriber management costs have been calculated using a schedule supplied by BSkyB. Subscriber Management costs have been allocated between UK DTH, Eire DTH, Commercial and PPV.</td>
</tr>
<tr>
<td>(vii)</td>
<td><strong>Conditional access</strong></td>
<td>DisCo’s CA costs are based on the indicative ratecard constructed by SSSL (the BSkyB company responsible for providing CA services). CA charges for non-sports subscribers are discounted [slightly] from the charges on the indicative ratecard. DisCo’s total CA charge has been allocated between UK DTH, Eire DTH, Commercial and PPV.</td>
</tr>
<tr>
<td>(viii) Transmission</td>
<td>DisCo bears all BSkyB’s transponder costs excluding those related to BiB, Eire, Commercial, PPV and third party channels. It also pays other transmission costs not attributable to BroadCo.</td>
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<tr>
<td>(ix) Marketing</td>
<td>Costs relating to customer acquisition and transition are capitalised and amortised over a 10 year period, using a reducing-balance approach. Ongoing marketing incurred on behalf of DisCo is treated as expensed as incurred.</td>
<td></td>
</tr>
<tr>
<td>(x) Overheads</td>
<td>This includes all depreciation charges and largely adopts the allocations given by BSkyB. These are changed only where they are inappropriate. This is so for ‘depreciation’.</td>
<td></td>
</tr>
<tr>
<td>(xi) Fixed and common costs</td>
<td>DisCo does not pay directly attributable costs of excluded activities. À la carte and PPV services bear a proportion of fixed and common costs. The remainder of common costs are allocated in proportion to the volume of subscribers to BSkyB’s UK DTH, Eire DTH and Commercial services.</td>
<td></td>
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### 5.1 DisCo’s premium programming costs

#### 5.1.1 The Director’s approach

434. The Director must determine what price DisCo should pay for premium channels. In the Rule 14 Notice, DisCo was charged the prices paid by the principal third party distributors.

#### 5.1.2 BSkyB’s submissions

435. BSkyB noted that DisCo incurred certain costs that would typically enable DisCo to achieve the maximum discounts available on the PBR ratecard (were it in fact a separate undertaking, as opposed to a set of accounts prepared for the purposes of this investigation).\(^{381}\) BSkyB alleged that the

\(^{381}\) Response, Part 11, paragraph 225, which states that, in achieving a high pay to basic ratio, DisCo incurs high costs with regard to conditional access payments, commission payments to retailers, certain promotions, consumer marketing campaigns and telemarketing expenditure.
test is therefore ‘internally inconsistent’. 382 Specifically, BSkyB considered that:

‘in assessing whether or not there has been a margin squeeze, [the Director] has used DisCo’s costs which reflect the fact that DisCo makes a considerable effort to sell premium channels. He has then combined the costs associated with this business model with the prices for premium channels paid by other businesses which have not incurred DisCo’s costs and which have chosen to operate quite different business models’. 383

436. BSkyB stated that any firm that were to incur the same costs as DisCo, as efficiently as DisCo, would also expect to achieve the same level of performance in selling BSkyB channels as DisCo and therefore be eligible for the same discounts. 384

5.1.3 Analysis

437. The Director rejects BSkyB’s assertion that a test based on observed wholesale prices is ‘internally inconsistent’. The decision by BSkyB to spend heavily on marketing, in order to achieve a high proportion of premium unit sales, is not driven by the incentive to earn a discount on the ratecard, which is irrelevant to the integrated BSkyB. The reward of the higher margin afforded from 4-Pay subscribers, 385 for example, is presumably the prime reason for this strategy. The extra costs of attracting ‘4-Pay’ subscribers are compensated for within the test, in the form of increased revenues at any given level of ratecard discount.

438. Given its transmission technology, the Director assumes that this strategy is the most efficient for DisCo. Therefore, if DisCo cannot earn above the required rate of return (see paragraph 413), when paying any of the prices that BSkyB charges rival distributors, BSkyB is exercising a margin squeeze on the respective distributor. 386

382 Response, Part 11, paragraph 223.
383 Response, Part 11, paragraph 220.
384 To this end, BSkyB rejected an argument put by ITV Digital (ITV Digital submission dated 27 March 2002, page 11, paragraph 2) that BSkyB’s high pay-to-basic ratio (see Part Thirteen) is largely a function of its ‘first-mover advantage’, and should not therefore be translated into corresponding discounts for the purpose of the margin squeeze test. BSkyB reported that the pay-to-basic ratio attained in respect of its new subscribers (since November 1998), ‘has regularly been above [100]% and has often been above [100]%’ (Response, Part 11, paragraph 248).
385 i.e., subscribers to all four of BSkyB’s premium channels.
386 The Director notes that it is theoretically possible for the test based on DisCo and (for example) NTL prices to show a loss, when a smaller, similar satellite distributor with smaller volumes and costs may actually make a normal profit given the same prices. The Director, however, considers this extremely unlikely given BSkyB’s submissions concerning the significance of fixed costs to DisCo, and its failure to yet achieve its minimum efficient scale (see paragraph 529 below).
439. The margin squeeze test is concerned only with the relation of wholesale to retail prices, rather than the design of discount structures. The margin squeeze test is concerned only with whether, given its most efficient or profit maximising strategy, DisCo is able to earn a normal profit when paying the prices charged to other distributors.

5.1.4 Conclusion

440. Margin squeeze arises if BSkyB sets a margin between its wholesale prices charged to third parties and its own retail prices insufficient to allow a normal profit to a distributor of the relevant products that is as efficient as DisCo (see Section 6 above).

441. The Director has used DisCo as a way of determining a unit cost of distributing BSkyB’s premium channels to consumers. If, after paying BSkyB’s price for its premium channels and covering this cost, a distributor cannot make a normal profit (even if it is as efficient as DisCo), then BSkyB is anticompetitively hindering rival distributors in competing against BSkyB in the distribution of BSkyB’s premium channels.

442. Accordingly, the Director has assessed DisCo’s profitability when it ‘pays’ the prices paid by each of its principal third party distributors, namely ITV Digital, NTL and Telewest for the relevant period. If DisCo was not profitable when paying any of these prices, BSkyB was exercising an anticompetitive margin squeeze in breach of the Chapter II prohibition on the respective company.

5.2 BSkyB basic programming costs

443. Since the revenues deriving from DisCo’s sales of BSkyB’s basic channels are necessarily included in DisCo’s revenues due to BSkyB’s bundled pricing practice (see paragraph 420 above), the costs of such channels to DisCo are also included (see Annex 20). DisCo is imputed the wholesale prices that BSkyB charges competing distributors for its basic channels. Where no price can be observed, the price as per the extant ratecard has been adopted, until such time that an alternative price was offered for the given channel.

387 The Director considers that Atlantic Group was unrepresentative within the premium channel retail market. In December 2000, Atlantic Group sold [less than 100,000] BSkyB premium units (see Atlantic Group submission dated 9 May 2001), compared to the [more than 100,000] units sold by NTL in the same period (NTL submission dated 14 May 2001). Atlantic Group is no longer active.

388 BSkyB’s submission dated 12 January 2001, Part 1, section 10.4.4 states that Sky Travel and [.tv] are charged to DisCo ‘at historic rates when those channels were on the ratecard’, Sky One is charged according to the ratecard then extant, SkySports.com TV is charged at the price offered to NTL and Sky News is not included at any charge, being free-to-air.
5.2.1 BSkyB basic channel charges

(ii) Sky One

444. During the relevant period BSkyB charged distributors at varying rates for Sky One. Whereas NTL and Telewest were charged at the price according to the extant ratecard, the price charged to ITV Digital was as set out in the ‘Divorce agreement’.

445. BSkyB considered the ITV Digital price to be more representative of the price likely to be agreed between DisCo and BroadCo, if negotiated on an arm’s length basis. ‘This is because the price agreed between BSkyB and ITV Digital reflects a five-year agreement under which ITV Digital committed to carry Sky One for the duration of the deal. The cable operators do not provide BSkyB with any security of carriage’.

446. The Director considers that the charges to Telewest and NTL are in fact more representative of what an independent distributor could expect to pay during the period being examined. The circumstance surrounding the Divorce Agreement were not typical and so the prices paid by Telewest and NTL are those that are imputed to DisCo in assessing margin squeeze with respect to those companies.

447. In a proposed agreement between BSkyB and NTL, BSkyB offered NTL a price of [less than £1] per subscriber for Sky One and Sky News combined. The Director does not consider this sufficient evidence to support such a charge to DisCo. The margin squeeze test applies observed prices whenever possible.

(iii) Sky Travel and [.tv]

448. BSkyB also argued that in the case of Sky Travel and [.tv], DisCo should not be charged the historical ratecard price. During the period investigated, no distributor purchased either channel, and as such no price could be observed with regard to these channels. Absent an observed price, DisCo is charged according to the ratecard until 1 January.

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389 Response, Part 11, paragraph 314. The ‘Divorce agreement’ was an agreement between BSkyB plc, Carlton Communications plc and Granada Group plc, dated 20 June 1997. During the period of analysis, the ratecard price for Sky One was between 75p and 78p per subscriber, compared to a price of [less than 75p] quoted in the ‘Divorce Agreement’.

390 Response, Part 11, paragraph 315.

391 A broadband cable distribution agreement dated 6 September 2000, between BSkyB Ltd, BSkyB plc and NTL Inc, was notified on 30 October for a decision under Chapters I and II of the Act.

392 In particular given the competition concerns he raised regarding that agreement, and that it was subsequently abandoned by the parties.

393 Response, Part 11, paragraph 323.
2001. After this date, [less than 10p is charged] with respect to these channels, consistent with the terms offered to Telewest.\(^{394}\)

(iii) Sky Sports News

449. BSkyB suggested that, from October 1999, Sky Sports News should be charged to DisCo at no more than [less than 20p] per digital subscriber.\(^{395}\) This is despite the fact that in the proposed BSkyB-NTL agreement (see paragraph 447 above) the charge proposed for Sky Sports News was [less than 50p] per subscriber, which was the price prevailing in the extant ratecard. In fact, BSkyB’s reason for claiming a price of [less than 20p] for Sky Sports News relates to an agreement that was due to take effect in July 2002,\(^{396}\) 6 months after the end of the period under investigation. DisCo therefore is charged [less than 50p] per subscriber for Sky Sports News, throughout the period investigated.

5.3 Third party programming costs

450. The charges DisCo pays for third party channels are taken as negotiated competitively, for purposes of this assessment, and so the Director has accepted them for the margin squeeze test.\(^{397}\) Basic channels are charged as an amount per subscriber per month (see Annex 21).

451. As well as the BSkyB/BroadCo premium channels, DisCo offers some à la carte premium channels from third parties, such as MUTV, Music Choice, Disney and Film Four. As noted above, at paragraph 419, the Director has excluded these activities from his assessment of margin squeeze, other than where such channels are offered as bonus channels (i.e., The Disney Channel in certain cases).

5.4 Excluded costs

452. PPV costs (Annex 18), and programming costs relating to subscribers in Eire (see Annex 16) and Commercial subscribers (see Annex 19) are excluded from DisCo’s costs, for the same reason that the associated revenues are excluded (paragraph 431 above).

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\(^{394}\) This price assumes the channel is retailed to [over 50]% of a distributor’s subscribers. See the proposed Telewest carriage terms dated 26 September 2000, at annex 8.3, part 2 of the BSkyB response to the section 26 notice dated 5 December 2000.

\(^{395}\) Response, Part 11, paragraph 333.

\(^{396}\) Response, Part 11, paragraph 331, which notes that a ‘non-binding term sheet was agreed between NTL and BSkyB on 25 September 2001’.

\(^{397}\) In almost every case examined, BSkyB paid [...] less to third party channel providers than the cable companies or ITV Digital, often obtaining prices [...] to [...] more cheaply than its retail rivals. Application of these charges for purposes of this margin squeeze assessment carries no implication regarding their compliance with the Act.
5.5 **EPG costs**

453. BSkyB provides an electronic programme guide (‘EPG’) which lists and facilitates access to services provided via the DTH platform.\(^{398}\) DisCo and third party channel providers bear the cost of this service. The EPG is provided by another BSkyB business and so this cost represents an intra-group charge. The Director has assessed the EPG charges paid by DisCo to see whether they are appropriate for the margin squeeze analysis.

454. BSkyB currently retails services that require 153 TV channel slots and 46 radio/audio slots on the EPG.\(^ {399}\) However, the Director has excluded the EPG costs of certain services from the margin squeeze assessment because they are not in the same market. Accordingly, the EPG costs of PPV, Commercial, Eire-dedicated services and à la carte channels are excluded (see Annex 22).

455. Since the revenues deriving from DisCo’s sales of basic channels and radio/audio channels are necessarily included in DisCo’s revenues due to BSkyB’s bundled pricing policy, the associated EPG costs are also included. This means that for the purposes of the margin squeeze test DisCo pays a share of the charges for 102 TV Channel slots and 46 radio/audio slots (see paragraphs 509 to 520 on common costs).

5.6 **Subscriber management**

456. Subscriber management costs are incurred in husbanding retail customers. BSkyB produces a ratecard that sets out the charges it offers to third parties for providing subscriber management for the analogue service. The analogue ratecard includes a composite charge, which combines analogue CA and subscriber management, and so it is not possible to calculate a separate analogue subscriber management charge.

457. There is no ratecard for digital subscriber management services. BSkyB provided a schedule of charges to be applied to DisCo in response to a request from the Director.\(^ {400}\)

458. The Director has examined both analogue and digital charges to determine whether DisCo bears the cost of the subscriber management reasonably attributable to it. The Director is satisfied that the charges BSkyB has proposed achieve that.

459. The subscriber management charge attributable to DisCo has been calculated using the schedule of prices supplied by BSkyB. These costs

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\(^{398}\) The treatment of EPG costs was outlined at tab 10.5 of BSkyB’s submission dated 12 January 2001. ‘Channels that DisCo does not retail are charged £28,000 per annum for a listing on the EPG. For DisCo’s own channels and for those 3rd party channels that DisCo retails, DisCo pays EPGCo £28,000 per annum per television channel and £8,000 per audio channel for a listing on the EPG’.

\(^{399}\) BSkyB’s submission dated 12 January 2001, Part 1, sections 10.11, 10.12, 10.13, page 34.

\(^{400}\) BSkyB’s submission dated 12 January 2001, Part 1, section 10.7.
are largely a function of subscriber numbers and have been allocated between UK DTH, Eire DTH, PPV and Commercial on this basis (see Annex 23).

5.7 Conditional access

CA enables channel providers to encrypt channels before they are transmitted to, and then from, satellite transponders. The signal is received by the customer’s satellite dish and delivered to the set top box. The set top box determines whether the customer has subscribed to that channel and, if so, decodes the signal so that it can be viewed on the television screen. Analogue and digital services have separate CA systems. Analogue CA charges were considered in the section on subscriber management since they are included in a composite ratecard (see paragraph 456). The rest of this section concerns only digital CA costs.

Broadcasters requiring encryption on the DSat platform need access to BSkyB’s CA system, as the set top boxes developed for BSkyB’s digital service cannot use any other system. BSkyB has a separate business (dubbed ‘CACo’) responsible for providing CA services. Its charges to DisCo and third party broadcasters for CA services are based on an ‘indicative ratecard,’ which sets out certain maximum charges for BSkyB’s CA services.

In the Rule 14 Notice, the Director imputed charges to DisCo at the rates quoted in the indicative ratecard.

5.7.1 Adopting the indicative ratecard framework

BSkyB argued that the benefit of its investment expenditures in CA would be realised over the average subscriber life, and this could be found by analysing churn rates. By analysing its churn figures, BSkyB argued that

401 In the 1996 Undertakings, BSkyB undertook to provide its analogue conditional access system, Videocrypt, to third parties on non-discriminatory terms: paragraph 3(1) of the 1996 Undertakings.

402 Any service provider wishing to charge subscriptions needs to be able to deny access, and so requires encryption. Even free-to-air broadcasters may need encryption (depending on the extent of the intellectual property rights they hold), as otherwise anyone within the DSat footprint, covering much of western Europe, may receive services, possibly infringing national intellectual property laws.

403 The conditional access system adopted by BSkyB was developed by News Digital Systems Limited (‘NDS’) and is called VideoGuard. BSkyB owns the rights to use it. News Corporation is the majority shareholder in NDS as well as holding 40% of the shares in BSkyB.

404 The Advanced Television Standards Directive 95/47/EC ([1995] OJ L-281/15) requires each Member State to have a body responsible for regulating CA systems. In the UK this is OFTEL, which has issued guidance on the structure of the charges that BSkyB could levy for digital CA to third parties. OFTEL requires BSkyB to publish indicative charges for digital CA, although these are subject to commercial negotiation. See http://www1.sky.com/corporate/sssl.htm.
an assessment of margin squeeze should assume an average subscriber life of 10 years, and that this is the period over which investment expenditures should be amortised.\textsuperscript{405} BSkyB accepted that it is still not possible to calculate accurately the average subscriber life of a digital subscriber,\textsuperscript{406} and acknowledges that its analogue churn rate increased from an initially low base to around 20\% partly because of the roll out of analogue cable TV.\textsuperscript{407}

464. The Director, in co-operation with OFTEL, has considered whether CACo is projected to make a reasonable return (by charging customers on the indicative ratecard) over an appropriate period reflecting the useful economic life of BSkyB’s investment expenditures on CACo. He is satisfied that the indicative charges (that were used in BSkyB’s preparation of its separated accounts under the 1996 Undertakings) are broadly consistent with efficient cost recovery over such anticipated economic life.

465. Accordingly, absent convincing evidence that the average subscriber lifespan will in fact be less than 10 years, and since over such a period CACo may be projected to make profits, for purposes of assessing margin squeeze, the indicative charges have, where appropriate, been applied to DisCo.\textsuperscript{408}

5.7.2 DisCo’s eligibility for discounted charges

466. An NPV analysis presented by BSkyB to OFTEL assumed that DisCo was eligible for a [small] discount from the prices observed on the indicative ratecard, which BSkyB states is simply a starting point for negotiation.

467. BSkyB justified its approach by stressing the likely bargaining power that DisCo would have when negotiating CA charges. Because DisCo’s payments constitute such a significant share of CACo’s revenue stream,

\textsuperscript{405} BSkyB’s submission dated 12 January 2001, Part 1, questions 10.11, 10.12, 10.13, page 42.

\textsuperscript{406} At page 42 of BSkyB’s submission dated 12 January 2001, Part 1, questions 10.11, 10.12, 10.13, it notes that, ’In the context of digital acquisitions, the problems with measuring subscriber lives directly is even more acute because the digital service was only launched slightly more than 2 years ago and, compared to around 4.7m digital subscribers today, only around [...] digital subscribers (more than 1\%) have ever churned. The remaining [less than .99\%] have stayed with BSkyB. It will be a long time before we can measure actual subscriber lives directly.’

\textsuperscript{407} See BSkyB’s submission dated 4 May 2001, tab 70, page 3, where BSkyB noted that ’...both churn figures relate to a period in which BSkyB’s churn rate was at peak levels for a number of reasons. The early lead that had been established by the analogue DTH platform was being eroded at an accelerating rate by the roll out of analogue cable and the combination of cable TV with attractive telephony offerings.’

\textsuperscript{408} CA charges are largely driven by subscriber numbers. Elements of the CA charge that are not linked implicitly to subscriber numbers on the ratecard have also been allocated in terms of average subscriber numbers (see Annex 23).
BSkyB considered that DisCo would be especially likely to negotiate discounts given an arm’s length negotiation. 409

468. The Director rejects the claim for a [small] discount on all CA charges. With respect to sports subscribers, the Director does not accept that DisCo should ‘earn’ a [small] discount on the CA charges outlined in the ratecard. As outlined in the treatment of basic programming costs, the Director’s test is based on observed prices. No sports channel broadcaster has paid less than the £2.50 charge observed on the indicative ratecard. Further, guidance from OFTEL supported the application of the £2.50 charge.410

469. With respect to non-sports subscribers, the Director accepts that, because several broadcasters have successfully negotiated CA charges down from the indicative charge of £1.50, DisCo should itself benefit from the [small] discount advocated by BSkyB.

5.7.3 Conclusion

470. The Director has imputed as charges to DisCo the prices observed. Conditional access payments for sports subscribers are as per the indicative ratecard, whereas for non-sports subscribers a [small] discount is adopted.

5.8 Allocation of transmission costs

471. The Director observes that both BroadCo and DisCo use satellite transmission to distribute channels to their respective customers. The Director must consider how transmission costs should be allocated between BroadCo and DisCo.

5.8.1 The parties’ views

472. BSkyB argued that other channel suppliers such as Flextech pay their own transmission costs and so BSkyB’s transmission costs should be allocated to BroadCo.411 BSkyB presented evidence to illustrate that the majority of channel suppliers bear their own transponder costs.412 Further, BSkyB suggested that all negotiations concerning channel carriage ‘start from the assumption that transmission costs are borne by the person who broadcasts the channel, i.e. the broadcaster’.413

409 Response, Part 11, paragraph 342.
410 In a letter from OFTEL, dated 6 June 2002, it is stated that: ‘Oftel does not consider that a price of lower than £2.50 should be used in the margin squeeze test. If CA had in practice been supplied to a third party premium channel provider at a lower price such a course may appear reasonable’.
411 See, for example, BSkyB’s submission dated 4 May 2001, Part 1, tab 54, page 3.
412 Response, Part 11, paragraph 185.
413 Response, Part 11, paragraph 188.
473. BSkyB considered that the question is not whether transmission is a broadcasting or distribution function, but whether the wholesale prices on the ratecard include the cost of transmission to the cable head end via satellite. BSkyB presented evidence that this was the case. For example, BSkyB stated that cable operators who receive channels via their own land-lines pay the same as those who receive channels via satellite.

474. BSkyB considered that the transmission costs that relate to DisCo are those that relate to receipt of the satellite signal at subscribers’ homes. As such, BSkyB stated that ‘there is no reason why a competing distributor could not establish its own platform of installed satellite dishes connected to set top boxes containing a conditional access system administered by him or a third party conditional access supplier’. The implication is that cable operators, for example, effectively re-transmit using a second technology rather than mirror DisCo’s strategy of implementing satellite reception equipment at subscribers’ homes. ‘Although the signal could be received directly at the customer’s home (by means of a satellite dish), the cable operator elects to receive the signal at a central point and then to re-transmit the signal to the customer’s home by means of a wire’.

475. NTL considered that the allocation of transmission costs must take account of which transmission technology an independent BroadCo would most efficiently adopt. ‘NTL believes that the most cost efficient way for BroadCo to transmit its programming to distributors would be over leased landlines’. If satellite transmission were not the most efficient means of transmitting to other distributors, it would be clear that it was retail distribution (i.e. DisCo) that was the driver behind BSkyB’s adoption of satellite transmission. BroadCo would also use the satellite transmission infrastructure, given the minimal incremental cost of such a strategy. BroadCo, as an independent entity, would not efficiently adopt satellite transmission.

476. BSkyB argued that satellite was in fact the most efficient means of supplying channels to its distribution customers since, at the beginning of 2000, it was transmitting to around 120 separate cable head-ends. BSkyB cited this as evidence that ‘satellite delivery is not, therefore, caused by DTH subscribers’.

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414 Response, Part 11, paragraph 174.
415 Response, Part 11, footnote 143.
416 Response, Part 11, paragraph 181.
417 Paragraph 1, page 23, of the NTL submission dated 8 March 2002.
418 No evidence was provided in support of this claim. See NTL submission dated 8 March 2002, paragraph 2, page 23.
419 Response, Part 11, paragraph 179.
420 Response, Part 11, footnote 141.
5.8.2 Analysis

477. The Director does not accept that evidence concerning which party typically makes the explicit transmission payment is sufficient to determine the allocation of costs between BroadCo and DisCo. Which party pays the costs of transmission is a matter of commercial negotiation and reflects the bargain struck between BSkyB and other channel providers. [...] 421

478. With regard to BSkyB channels, the principal cable operators took delivery of BSkyB channels by means of land-line links, 422 and BSkyB did not pay for carriage of its channels on such third party platforms. ITV Digital paid the costs of the cable link from BSkyB’s site at Osterley to the BT Tower (from where it transmits on digital terrestrial) for BSkyB channels and ‘for the most part the non-BSkyB channels do not recover the costs of the link from their offices to BT Tower directly from ONdigital [subsequently ITV Digital].’ 423 NTL and Telewest equally were responsible for, and paid for, distribution of BSkyB’s premium channels to their subscribers. 424

479. The Director observes that paramount to any discussion of which transmission technology is most efficiently adopted is consideration of whether it would be rational for a notionally independent BroadCo to adopt any form of transmission technology. BroadCo, as an independent channel supplier, appears to have no incentive to rent transponders. Only the minor third party distributors are now reliant upon satellite transmission for reception of BSkyB channels, and the revenue received from such companies would not justify BroadCo’s investment in satellite transmission. 425

480. As BroadCo would not, independently, choose to continue to rent transponder capacity to distribute channels to a small minority of customers, DisCo is the driver behind the transmission costs incurred by BSkyB.

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421 At tab 75, page 1 of BSkyB’s submission dated 4 May 2001, BSkyB noted that [...] .

422 Response, Part 11, paragraph 205. BSkyB stated, however, that ‘all the cable operators which have established land-line links between Sky’s facilities at Osterley and their respective head-ends continue to require the option of receiving Sky’s channels for digital re-transmission by means of satellite’ (Response, Part 11, paragraph 209). Submissions from the cable operators stated that while they have the option to use satellite transmission, they no longer rely on digital satellite transmission for receipt of BSkyB channels. ‘[...]’ (letter from Telewest dated 20 September 2002). See also NTL submission dated 19 September 2002.


425 Specifically, Atlantic Aberdeen, omne Communications, Isle of Wight CTC, Eurobell and Newtel received BSkyB channels by means of satellite throughout the period of investigation (Response, Part 11, paragraph 202).
5.8.3 Conclusion

481. The Director considers transmission to be a distribution function and accordingly elements of this cost are borne by DisCo.\textsuperscript{426} BSkyB’s satellite transmission costs are caused by DisCo. Any distributor of BSkyB’s premium channels must transmit them to its subscribers, as channel transmission is an essential function of distribution.

5.9 Calculating the transmission costs to be imputed to DisCo

482. Transmission costs include the cost of preparing BSkyB’s channels for transmission, the cost of the uplinking facilities and of the satellite transponders needed for their transmission. The Director accepts the prices BSkyB has negotiated with third party channel providers and has not sought to allocate to DisCo the cost of transmission of such channels, notwithstanding that in certain cases such providers have additionally paid for transmission on BSkyB’s platform. In those cases BSkyB has struck a highly advantageous deal, as it pays less than its competitors for those channels and also does not pay for their transmission.\textsuperscript{427}

5.9.1 Transponder leasing costs

483. Leasing transponders on satellites is one of the main transmission costs attributable to DisCo. DisCo has been allocated the share of the transponders and parts of transponders that it uses.\textsuperscript{428} Where DisCo shares a transponder with non-BSkyB, PPV, Commercial or Eire-dedicated services, the gross leasing cost has been allocated between DisCo and such other activities on the basis of the typical average capacity requirement of channels on the transponder.\textsuperscript{429} The typical average capacity requirements used are those provided by BSkyB.\textsuperscript{430}

484. Some of DisCo’s transponders are sub-leased to third parties and DisCo receives revenue from this. [...]. Capacity trading is not a function of distributing premium pay TV channels. DisCo may not and does not benefit from any third party transponder sub-lease revenues.

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\textsuperscript{426} BroadCo incurs channel production costs up to the point at which the channels are passed to the distributor (either cable, DTT, or DisCo’s own uplinking facilities) for onward transmission, including a small amount of costs that BSkyB classifies as transmission and which are reasonably incurred by the upstream BSkyB business in producing channels that are made available for transmission.

\textsuperscript{427} See footnote 397 above concerning the prices BSkyB pays for third party channels.

\textsuperscript{428} Some BSkyB-leased transponders do not relate to DisCo activities but support, for example the EPG, Eire-dedicated services, BIB or PPV services. The costs of such transponders are excluded.

\textsuperscript{429} The Director considered other bases, such as average or peak capacity, but BSkyB indicated that such bases of apportionment would not be feasible: BSkyB’s submission of 25 May 2001, Part 1, tab 49, page 7.

\textsuperscript{430} BSkyB’s submission of 25 May 2001, Part 1, tab 49, page 11.
During the period of analysis, BSkyB incurred transponder leasing costs on both the digital and analogue transmission platforms. The implications of this ‘duplication’ are considered below at paragraphs 531 and 533.

Finally, BSkyB had a disaster recovery agreement with the transponder leasing company (SAS), the costs of which are borne by DisCo, as a necessary cost of channel distribution.

5.9.2 Allocation of the remaining transmission costs between BroadCo and DisCo

Transmission costs other than transponder leases are not all attributable to DisCo. DisCo has been allocated the costs of uplinking and of BSkyB’s transmission department, as well as transponder rental costs, as these are necessary for premium channel distribution. BroadCo has been allocated the cost of licence fees, creative services (such as the provision of graphics for promotions), studios and ‘other technical operations’.\(^{431}\) BroadCo has also been allocated the costs of engineering and of the leased landlines (see Annex 24).\(^{432}\) In both cases, it would be appropriate for DisCo to bear some of the cost, but absent a clear method of allocation, no allocation has been made.

As for depreciation charges, the appropriate allocation of all of BSkyB’s depreciation has been examined under the heading of overheads and so no depreciation charge is included under the heading of transmission.

5.10 Marketing

5.10.1 Customer acquisition and transition marketing

Two categories of customer acquisition and transitional cost have been identified: (i) marketing costs; and (ii) set top box subsidies. The set top box element of these costs are borne by BSkyB’s notional CA business, CACo, whereas others are borne by DisCo directly. In the case of the costs borne by CACo and recovered through CA and Access Control charges, appropriate charges have been allocated on the basis of the CA charges contained in CACo’s indicative ratecard (see paragraphs 460 to 470).

This section concerns those customer acquisition and transition costs incurred directly by DisCo. These costs are recorded within DisCo’s marketing costs. However, not all marketing costs are concerned with

\(^{432}\) The leased line expenditure ‘relates to the use of landlines to transfer digital and analogue information to and from a number of locations as well as the landlines used to distribute Sky’s online content.’ (BSkyB submission dated 25 May 2001 question 47). While the Director considers that the expenditure relating to delivery of channels to the uplinking site should be allocated to DisCo, he has not attempted to allocate the costs associated with leased landlines between BroadCo and DisCo, and has allocated them all to BroadCo, an allocation that errs against a finding of margin squeeze.
customer acquisition. DisCo also incurs on-going marketing costs and the treatment of these is explained in paragraphs 494 to 496.

491. Consistent with the treatment of the set top box subsidy in the CA charge analysis (see paragraph 465 above), customer acquisition and transition costs are also amortised over a 10-year period. By adopting a 10-year amortisation period, DisCo’s investment expenditures will be matched to the anticipated benefit associated with these expenditures (see paragraphs 463 to 465 on churn rates and implied subscriber life times).433

492. While a 10-year amortisation period may appear excessive for marketing expenditure, the Director is satisfied that this approach is appropriate given the nature of these marketing costs. As BSkyB stated, the customer acquisition and transition marketing is distinct from consumer or brand marketing, which may reasonably be written-off over a relatively short time period.434 Major cost items included within BSkyB’s ‘customer acquisition’ category include the installation subsidy costs,435 retail commissions and door to door sales.436

493. Customer acquisition marketing is amortised using the ‘reducing balance’ method. This method acknowledges the exponential decay nature of churn.437

5.10.2 On-going marketing

494. In addition to customer acquisition costs (which include an element of marketing), BSkyB incurs ongoing marketing costs. Certain of these costs are attributable to DisCo. This has meant identifying and excluding marketing costs that are properly attributable to BroadCo and to the excluded activities of PPV, BiB, Commercial and marketing in Eire.438 The allocation of costs to these activities that was provided by BSkyB have been used (see Annex 25).

495. BSkyB argued that its own allocation of marketing costs leads to DisCo bearing excessive costs. In particular:

433 This treatment represents a modification of that adopted in the Rule 14 Notice, which assumed straight-line depreciation over a 5-year period for customer acquisition/ transition marketing reflecting a refined understanding of the type of costs involved.

434 Response, Part 11, page 49, paragraph 117.

435 The installation subsidy cost is the difference between the total installation costs and the installation fees paid (see question 40, page 3 of the BSkyB response to the section 26 notice dated 29 March 2001).

436 BSkyB’s submission of 12 January 2001, tab 10.9, appendix 10.9.2.

437 Response, Part 11, paragraph 84.

438 For example, the marketing costs of ‘SBO [Sky Box Office] - Movies’ have not been included in DisCo because PPV services are not in the same market.
‘To date BSkyB has generally adopted a very conservative rule under which the cost of certain advertisements have been allocated entirely to Disco. Many of these advertisements will, however, also promote particular BSkyB channels. Accordingly, it could reasonably be argued that some of the categories of marketing costs that have been entirely allocated to Disco should in part be allocated to CA Co and/or Broadco.’

496. The Director recognises this but notes conversely that some of the marketing costs borne by BroadCo and CA Co also benefit DisCo. For example, references made to services available exclusively to BSkyB Digital viewers within programming distributed to all platform operators could reasonably be construed as valuable advertising for DisCo. As there is no compelling evidence on the size or direction of the net effect of these adjustments, no adjustment has been made.

5.10.3 Other marketing costs

497. In its response to the Rule 14 Notice, BSkyB indicated that the allocation of marketing expenditure it previously suggested results in an over-allocation of ongoing marketing costs to DisCo. BSkyB considered that the treatment originally proposed did not treat the costs associated with the customer magazine appropriately. BSkyB stated that as the magazine promotes BSkyB channels primarily, BroadCo should be allocated a share of its costs, given the potential for increased advertising revenues emanating from greater BSkyB channel sales.

498. The Director does not agree with BSkyB’s assertion that BroadCo should bear a share of the costs of the customer magazines. DisCo is a proxy for an independent retailer, and as BSkyB made no contributions to the costs of any other distributors’ customer magazine, all of the costs of the magazine are allocated to DisCo.

499. Concerning the treatment of the customer magazine costs, in the Rule 14 Notice, the non-specific ongoing marketing expenditure, including the cost of the customer magazine, was allocated between the UK and Eire DTH services. BSkyB stated that the customer magazine also promotes the à la carte and PPV services offered by DisCo and such services should bear a share of the cost. The Director accepts this and has amended the treatment of the customer magazine cost accordingly.

5.11 Overheads

500. In the case of overhead costs, each of the main categories of cost has been considered and those BSkyB activities to which they are attributable

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440 For example, references concerning the interactive service available to viewers of Sky Sports, ‘for Sky Digital viewers’.
441 Response, Part 11, paragraph 368.
442 Response, Part 11, paragraph 368.
has been identified. The Director sought and obtained from BSkyB the cost drivers for these overheads. Using that information he has examined the overhead allocations used by BSkyB.

501. BSkyB adopted three bases of allocation:

(i) for transmission and programming overheads, DisCo was allocated none of the costs.

(ii) for general overheads DisCo was allocated 20% of the cost on the premise that BSkyB is predominantly a content business.

(iii) for Group general management and legal and corporate overheads DisCo was assigned 50% of the costs.

The Director accepts that there is no uniquely correct allocation, but BSkyB did not have the detailed cost drivers for its overheads that should be used to allocate common costs. The Director has considered several alternative assignment methods, but is satisfied that with the data available it is only possible to use BSkyB’s bases.

502. In the case of transmission and general overheads, the Director considers that DisCo should be allocated an increased share of costs in several of these categories relative to the shares proposed by BSkyB, since DisCo bears transmission costs. However, in the absence of a rigorous method for reallocating overheads, no adjustment has been made. This errs against a finding of margin squeeze.

503. The Director has adjusted the depreciation charge allocated to DisCo as a consequence of the decision to allocate certain transmission costs to DisCo (see paragraph 487 above and Annex 26). The adjustment relates to the asset category termed ‘Technical equipment’. This is the equipment BSkyB uses for transmission, some of which will fall within DisCo using the Director’s treatment, but which BSkyB treated as entirely BroadCo.

504. The Director has allocated a share of these assets, and also the depreciation charge, to DisCo. The share is equal to the ratio of DisCo’s transmission costs (excluding those which do not seem to be asset based, and therefore only ‘Transmission’ and ‘Chilworth’)

5.11.1 BSkyB considered that its suggested allocations were ‘very conservative’

505. Following issue of the Rule 14 Notice, BSkyB claimed that the overhead allocation method adopted in the separated accounts (and subsequently

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443 See, for example, BSkyB submission dated 12 January 2001, Appendix 10.10.1.
the Rule 14 Notice) was in fact ‘very conservative’ and ‘was developed in the context of BSkyB believing it passed the Director’s margin squeeze test’, and therefore this method made it more likely that BSkyB would fail a margin squeeze test. Accordingly, BSkyB stated that should the Director persist with his allegation of margin squeeze, a re-appraisal of the allocation of the overhead costs would be required.

506. BSkyB has not re-evaluated the overheads allocated to DisCo nor provided detailed evidence of why an adjustment should be made. Such an analysis should include information concerning cost drivers and how they have been used to establish the allocations used. BSkyB has not presented such analysis. The Director has therefore adopted the same approach as that taken in the Rule 14 Notice, outlined above.

5.11.2 BSkyB suggested revising the treatment of share symmetry

507. Additionally, BSkyB considered that the treatment of a cost item termed ‘share symmetry’ was inappropriate in the Rule 14 Notice. Share symmetry relates to the BSkyB Employee Share Ownership plan and is explained by BSkyB: ‘the costs associated with share symmetry relate to the difference in exercise price and market price of those share options exercised throughout the relevant accounting period by Sky staff’. In the separated accounts, as DisCo (as part of BSkyB Ltd.) was treated as a BSkyB plc subsidiary, a share of the ‘share symmetry’ costs were expensed through the DisCo profit and loss account, in line with accounting convention. BSkyB considered that, as the Director’s intention is to create the accounts of an independent stand-alone distributor, that entity, DisCo, ‘would be able to debit such costs to its profit and loss reserve not expense them through its profit and loss account’.

508. The Director acknowledges that accounting convention would allow (although not insist upon) such a treatment. However, as a cost that is incurred with respect to BSkyB (DisCo) employees, the Director considers that a share of the costs of the share ownership plan should be charged to DisCo, notwithstanding the fact that in the BSkyB plc accounts the charge is made to the profit and loss account reserves.

5.12 Allocation of fixed and common costs

509. With regard to excluded activities, for example PPV programming costs, some costs are directly attributable to those activities, and are excluded from the margin squeeze assessment.

5.12.1 The approach adopted in the Rule 14 Notice

510. BSkyB should benefit from services that contribute to the recovery of its fixed and common costs. However, there is no unique method of

\[445\] Response, Part 11, paragraph 357.
\[447\] Response, Part 11, paragraph 360.
allocating fixed and common costs. Each available method of allocating common costs to each activity has possible difficulties. The Director has examined several methods and has adopted the method carrying most economic significance.

511. The Director considers that the markets for the wholesale and retail provision of PPV and à la carte channels are broadly competitive. Consequently, the Director expects such channels to earn a normal profit in the long term. As such, in the Rule 14 Notice, common costs were allocated to DisCo’s à la carte and PPV services on the basis that such services make a return on turnover of 1.5% (see paragraph 401).

512. The remainder of common costs require allocation between UK DTH, Eire DTH and Commercial services, and the Director has adopted a method of proportional mark-up, in line with common regulatory practice. The options considered included allocation in proportion to: (i) revenues generated in each area; (ii) identified direct costs; and (iii) subscriber numbers.

513. Option (i) incorporating direct revenues was discounted due to the circularity involved in adopting such an approach. For example, any downstream operator upon which a margin squeeze was being exercised could potentially show depressed revenues compared to an identical operator functioning in a competitive market. The margin-squeezed business would wrongly be allocated a lesser share of common costs as a result, distorting a test for margin squeeze. Similarly, an allocation based on direct costs could result in a distorted result, with a margin squeezed operator (paying an excessive wholesale price) being allocated too large a share of the common costs.

514. Even absent these difficulties, the Director considers subscriber numbers to be, in the long run, the more likely cost-driver. For example, a significant rise in subscriber numbers would result in a rise in many of the common costs incurred by DisCo. Marketing costs are linked to subscriber numbers, as are, in the long-term, many elements of the overheads incurred by DisCo. The same cannot be said of direct costs or revenues. Were DisCo’s programming costs to rise, it is more difficult to establish how, if at all, this occurrence would impact upon DisCo’s common costs. In any event, the methodology chosen for common cost allocation does not materially affect the outcome of the Director’s assessment of margin squeeze (see Annex 27).

5.12.2 BSkyB’s views

515. BSkyB considered that the approach set out in the Rule 14 Notice results in too small a proportion of common costs being allocated to the PPV service. BSkyB argued: (i) that the proposed transfer price should be adjusted given the Director’s treatment of transmission costs; and (ii) its PPV service, a relatively new venture, should not yet be required to earn a positive required return on turnover (see paragraph 413 above).
(i)  The PPV transfer price

516.  In its submissions, BSkyB assumed that DisCo would retain [less than 50]% of ex-VAT PPV revenues.\(^{448}\) BSkyB, having observed the Director’s proposed treatment of transmission costs considers that ‘a satellite distributor would not find it economical to enter into a deal in which it retained only [less than 50]% of the PPV revenues, if it was also expected to pay for transmission costs’.\(^{449}\) Accordingly, BSkyB suggested that transmission costs should not be allocated to the PPV distribution service.

517.  The Director accepts that when BSkyB sets a transfer price between two notional businesses, the allocation of costs between those businesses will be a significant factor. However, in this case, the Director notes that the implied [over 50]% wholesale price is in fact an observed market rate. BSkyB itself acknowledged that its proposed ‘split of revenues reflected the terms agreed between BSkyB (BroadCo) and CWC for the provision of SBO (BSkyB Box Office) movies’.\(^{450}\) This is a market price, on which the allocation of transmission costs has no bearing. Transmission costs are allocated to PPV (DisCo) and the transfer price is not adjusted.

(ii)  PPV earning the required rate of return

518.  BSkyB did not consider that the PPV distribution service should be required to earn a rate of return of 1.5%, due the relative immaturity of the service. Specifically, BSkyB stated that ‘during this period the PPV business was hampered by, amongst other things, the burden of very significant fixed costs (in the Director’s formulation in which transmission costs are borne by PPV-DisCo), [...] and the fact that certain PPV rights that had been anticipated were not yet available’.\(^{451}\)

519.  The Director accepts the principle of this argument. Without a suitably robust method for calculating the required return of such a start-up, the Director has opted to allocate common costs to the PPV (DisCo) business, to the point at which PPV (DisCo) breaks-even.

5.12.3 Conclusion

520.  Common costs are allocated to PPV to the point at which the service breaks even. Common costs are allocated to the à la carte service up to the point at which the service earns a return of turnover of 1.5%. The remaining common costs are allocated between the UK DTH, Eire DTH and commercial subscribers in terms of subscriber numbers.

\(^{448}\) Response, Part 11, paragraph 294.

\(^{449}\) Response, Part 11, paragraph 295.

\(^{450}\) Response, Part 11, paragraph 294.

\(^{451}\) Response, Part 11, paragraph 299.
5.13 **BSkyB considered that the test does not recognise all of DisCo’s investment costs**

521. Further to the investment costs outlined above, BSkyB considered that certain costs set out below should also be treated as investments.

5.13.1 **Costs associated with calls to book installations**

522. The installation booking calls relate to calls from new subscribers relating to the installation of satellite reception equipment. These costs are classified as subscriber management costs. Despite not being classified as customer acquisition costs in submissions by BSkyB, BSkyB considered that ‘these costs are clearly associated with acquisition and... they should be treated in the same way as other acquisition costs’.

523. The Director considers these costs to be operating costs and does not consider that they could be considered an asset from which future value could be derived. He does not therefore consider that such costs should be capitalised and amortised but accepts that interpretation of the results of the DisCo margin squeeze test should consider the fluctuation in cost items such as this.

5.13.2 **Costs associated with other calls typically made by subscribers soon after subscribing**

524. BSkyB’s experience was that subscribers are generally more likely to call soon after joining the platform. For this reason BSkyB considered that the so called ‘excess calls’ should be classed as a customer acquisition cost.

525. The Director recognises that during the period under consideration such costs could reasonably be higher than they would typically. As such, whilst he does not consider that such an operating cost should be capitalised and amortised, he would again accept that consideration of the trend should be made when interpreting the margin squeeze test’s results.

5.13.3 **Certain other marketing costs associated with acquisition activity**

526. BSkyB considered that further marketing costs should have been classified as customer acquisition costs, compared to the allocation made previously. ‘DisCo incurs costs associated with various forms of media which is designed to trigger subscription activity. The advertisements typically set out packages and prices and earn subscription by a certain date’.

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452 Response, Part 11, paragraph 104.
453 Response, Part 11, paragraph 105.
454 See, for example, appendix 10.9.2 of the BSkyB submission dated 12 January 2001.
455 Response, Part 11, paragraph 108.
527. The Director considers that such marketing is likely to be relatively stable and is satisfied that this item should continue to be treated in the same manner as other on-going customer marketing costs, and written off as it is incurred.

5.14 **BSkyB considered that the test fails to accommodate ‘temporal items’**

528. In addition to the additional investment costs suggested above, BSkyB considered that the burden of fixed costs, the increasing retail prices, the duplication of transmission costs and the apparently inflated payments for third party channels are also factors that the margin squeeze test should recognise.\(^{466}\)

529. With regard to fixed costs, BSkyB argued that the test inappropriately required DisCo to be profitable when its subscriber numbers were growing and it is not in a steady state.\(^{457}\) In the period of analysis, BSkyB considered that fixed costs will be particularly burdensome, with DisCo yet to reach its fully efficient scale.\(^{458}\)

530. BSkyB also referred to the rising retail prices charged to DisCo subscribers. The rising prices, which it justified by the increased breadth and quality of the digital service, are resulting in an increased absolute profit margin, with wholesale prices set as a percentage of the corresponding retail price.\(^{459}\)

531. Transmission costs were duplicated during the period of analysis, as subscribers were transitioned from the analogue to the digital service. BSkyB considered that by recognising the costs of both technologies in his analysis, the Director fails to derive the results of DisCo in what could reasonably be considered ‘representative of the DisCo business going forward’.\(^{460}\)

532. With regard to third party programming, BSkyB expected that, on a per subscriber basis, costs will decrease. This is a reflection of the fact that while ‘a channel provider’s costs are typically fixed’,\(^{461}\) subscriber growth has been significant and significantly above the level expected when contracts were initially agreed with third party programmers.\(^{462}\) In addition, BSkyB states that uncertainty over the popularity of new channels (available due to the greater capacity of digital) meant that

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\(^{456}\) Response, Part 11, paragraph 13.

\(^{457}\) Response, Part 11, paragraph 21.

\(^{458}\) Response, Part 11, paragraph 24.

\(^{459}\) Response, Part 11, paragraphs 26-27.

\(^{460}\) Response, Part 11, paragraph 25.

\(^{461}\) Response, Part 11, paragraph 28.

\(^{462}\) Response, Part 11, paragraph 28.
BSkyB agreed to carriage fees that are likely to decrease when renegotiated.

533. The Director considers each of the additional ‘temporal items’ outlined above to be operating items that are unexceptional in nature. They are not cost items that directly cause revenues in current and future periods, and therefore cannot be considered investment costs. The Director accepts, however, that in interpreting the results of the test such factors should be considered.

IV. DISCO’S PERFORMANCE UNDER THE MARGIN SQUEEZE TEST

534. The previous section of the margin squeeze analysis explained the Director’s methodology for assessing margin squeeze under the Chapter II prohibition in this case. It described the accounting policies and identified the allocations of costs, revenues and assets that the Director has adopted for the margin squeeze test. This section shows the result of applying these allocations to BSkyB’s costs, revenues and assets and provides the results of the margin squeeze test.


536. The Act came into force on 1 March 2000 and so a margin squeeze may only infringe the Act on and following that date. However, the Director has in addition applied this test to the data for 1 January 1998 to 29 February 2000 (a period of 26 months) so that he has a longer period to provide a comparison with the period under investigation.

537. Annex 28 sets out the result of this analysis. The six month period 1 January 2000 to 30 June 2000 has been split into a two month and a four month period (since the Act only entered into force on 1 March 2000). In the case of some categories of cost this has meant allocating them between the two periods. This allocation is on the basis that costs are incurred evenly over the whole period. Other categories of costs and most of the revenues have been calculated month by month, so no allocation was required.

538. DisCo, when it paid the wholesale price ITV Digital pays, was profitable for the first six months ending 30 June 1998, it made very small losses in the six months ending December 1998 and made losses of 4.93% and 5.14% of turnover for the six months ending 30 June 1999 and the eight months ending 29 February 2000 respectively. (ITV Digital paid higher
wholesale prices than Telewest or NTL and so was more likely to suffer a margin squeeze.)

539. The results of the Director’s margin squeeze analysis for three periods after the Act entered into force are summarised in the table below, together with the results for the total period.

<table>
<thead>
<tr>
<th>Company</th>
<th>10 months ended 31 December 2000</th>
<th>6 months ended 30 June 2001</th>
<th>6 months ended 31 December 2001</th>
<th>22 months ended 31 December 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITV Digital</td>
<td>-6.10%</td>
<td>-1.61%</td>
<td>4.30%</td>
<td>-1.59%</td>
</tr>
<tr>
<td>NTL</td>
<td>-2.34%</td>
<td>-1.60%</td>
<td>4.27%</td>
<td>-0.09%</td>
</tr>
<tr>
<td>Telewest</td>
<td>-3.28%</td>
<td>0.27%</td>
<td>6.06%</td>
<td>0.63%</td>
</tr>
</tbody>
</table>

DisCo’s profits/losses are shown as share of turnover when paying the prices charged to each third party distributor. Its cost base, used to calculate DisCo’s margins in Annex 28, includes the required 1.5% return on turnover.

540. The table shows that the DisCo made a loss under the margin squeeze test until (and including) the first half of June 2001 when paying the wholesale prices charged to ITV Digital and NTL respectively and required to make a return on turnover of 1.5%. When paying the prices charged to Telewest, it ceased incurring losses in the 10 months ended 31 December 2000. It made profits, however, when paying the prices charged to any of these three companies from July 2001. Taking the whole period from 1 March 2000, when the Act came into force, to the end of 2001, DisCo approximately broke even when paying the wholesale prices charged to the cable operators, and it made a small loss on the basis of the prices charged to ITV Digital.

V. ANALYSIS

541. In interpreting the losses that DisCo has incurred, the Director notes the following.

1. **The results show limited and temporary losses after charging the required return on turnover**

542. As illustrated in the table above and in the graph below, DisCo’s losses over the period under consideration, after being charged the required return on turnover of 1.5%, are relatively limited. DisCo’s losses were highest at the start of the period in the 10 months to December 2000, at
which point they vary between 6.10%\textsuperscript{464} of turnover and 2.34%\textsuperscript{465} of turnover. However when the aggregate position, for the 22 month period investigated (i.e., March 2000 to 31 December 2001) is calculated the losses Disco incurs when it pays the wholesale prices charged to ITV Digital and NTL are, as a proportion of turnover small; and when DisCo pays Telewest’s wholesale prices over this period it makes a profit. The range of profit and loss over the 22 month period is between –1.59% and +0.63%.

2. **The profit/loss curve is u-shaped**

543. DisCo’s results from the model show that the profit curve it achieved is u-shaped. It has made losses over a period followed by a rapid recovery into profit (see graph below).

544. In constructing the model, the Director has, as stated elsewhere, made a number of assumptions and decisions. Arguably, some of these are favourable to BSkyB and others not. While alternative assumptions or decisions have been considered and analysed, the Director considers that those he has used are the best possible, on a fair and objective basis.

545. When considering whether the results derived from the model demonstrate a breach of the Chapter II prohibition by way of margin squeeze by BSkyB, the Director has, in particular, considered the following:

\textsuperscript{464} Assuming the wholesale charges incurred by ITV Digital.

\textsuperscript{465} Assuming the wholesale charges incurred by NTL.
the losses are not large (see paragraph 542);

DisCo’s rapid return to profitability in 2001 is a result of a combination of factors. Key to the recovery in profits is the increasing retail price and the increased subscriber volumes;

the possible effect of the temporal factors identified by BSkyB (see paragraph 528), which has been taken into account in interpreting the results of the model; and

that even the fairest and most objective modelling assumptions necessarily involve an irreducible element of uncertainty.

VI. CONCLUSION

546. The model shows that BSkyB incurred some losses in distribution during the period investigated, but also made some profits. The Director believes the model is robust, subject to an inevitable level of uncertainty, and that the results from it are derived fairly. The Director therefore has to consider whether, in the light both of these results and other factors, the output of the model demonstrates to a sufficient standard that BSkyB has abused a dominant position by operating a margin squeeze on its third party distributors.

547. Having regard to the limited and intermittent nature of the losses, and the possible influence of other factors, the Director does not consider that there are sufficient grounds to find that BSkyB has exercised a margin squeeze infringing the Chapter II prohibition.
PART TWELVE   MIXED BUNDLING

I.   THE COMPLAINT

548. Mixed bundling refers to the situation where two or more products are offered as unbundled (i.e., undiscounted) products and simultaneously offered together at a price less than the sum of the individual product prices (i.e., discounted). Telewest and ITV Digital alleged that BSkyB’s mixed bundling foreclosed entry to the wholesale premium channel markets.

549. In Part Nine above, the Director found that BSkyB dominated the markets for the wholesale and retail supply of unique to premium sports channel content (currently identified as live FAPL football) and for the wholesale and retail supply of premium film channels (characterised by the carriage of category A and B films in the premium channel window).

II.   BSkyB’S WHOLESALE BUNDLED PRICES

550. Table 2 shows BSkyB’s wholesale pricing structure during the period investigated before the application of ratecard discounts.

551. As the number of channels in any package increases, the price of subscribing to an additional premium channel (i.e., the implied price) progressively decreases (see Table 2 below). For example, in 2001, moving from buying one to buying two premium channels, the implied incremental wholesale price of sports channels decrease from £12.05 to £2.01, likewise the implied wholesale prices of film channels decrease from £12.55 to £2.51.

466 In contrast to pure bundling when, for example, sports channels are not available on a stand-alone basis at all.

467 For description and analysis of the ratecards and their discounts see Part Thirteen below.
### TABLE 2: WHOLESALE PRICES 2000 & 2001

<table>
<thead>
<tr>
<th>Pay channel package</th>
<th>Wholesale price (before ratecard discounts)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000(^1)</td>
</tr>
<tr>
<td>Sky MovieMax</td>
<td>£10.54</td>
</tr>
<tr>
<td>Sky Premier</td>
<td>£12.55</td>
</tr>
<tr>
<td>Single Sports</td>
<td>£11.55</td>
</tr>
<tr>
<td>Dual Movies</td>
<td>£13.56</td>
</tr>
<tr>
<td>Dual Sports</td>
<td>£13.56</td>
</tr>
<tr>
<td>Sky MovieMax &amp; Single sports</td>
<td>£12.55</td>
</tr>
<tr>
<td>Sky Premier &amp; Single sports</td>
<td>£14.56</td>
</tr>
<tr>
<td>Dual Sports &amp; Sky MovieMax</td>
<td>£14.56</td>
</tr>
<tr>
<td>Dual Sports &amp; Sky Premier</td>
<td>£15.57</td>
</tr>
<tr>
<td>Dual Movies &amp; Single Sports</td>
<td>£15.06</td>
</tr>
<tr>
<td>Dual Movies &amp; Dual Sports</td>
<td>£16.07</td>
</tr>
</tbody>
</table>

**Notes:**

Prices are excluding VAT and assuming a 59% applicable percentage. The ‘applicable percentage’ is the share of BSkyB’s retail price for a given premium package when bought in addition to its ‘Family’ pack. This 59% assumed applicable percentage errs against a finding of abuse: the lower the applicable percentage, the lower the implied incremental price BSkyB recovers. Prices applicable to all broadband cable and DTH distributors.


3. Prices derived from retail price and rounded only after final calculation.

BSkyB offered implied discounts for sports and film premium channels that are conditional on taking the other type of premium channel. This is illustrated below by Tables 3 and 4.
### TABLE 3: FILMS – SKY MOVIE MAX/SKY PREMIER

<table>
<thead>
<tr>
<th>Package</th>
<th>Incremental wholesale price of 1 film channel</th>
<th>Percentage of price of 1 film channel only</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Film Only:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sky MovieMax</td>
<td>£10.54</td>
<td>£12.55</td>
</tr>
<tr>
<td>Sky Premier</td>
<td>£12.55</td>
<td>£12.55</td>
</tr>
<tr>
<td><strong>Packaged with 1 Sports Channel:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sky MovieMax</td>
<td>£1.00</td>
<td>£2.51</td>
</tr>
<tr>
<td>Sky Premier</td>
<td>£3.01</td>
<td>£2.51</td>
</tr>
<tr>
<td><strong>Packaged with 2 Sports Channels:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sky MovieMax</td>
<td>£1.00</td>
<td>£1.51</td>
</tr>
<tr>
<td>Sky Premier</td>
<td>£2.01</td>
<td>£1.51</td>
</tr>
<tr>
<td><strong>Packaged with 2 Sports channels &amp; 1 other film channel:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sky MovieMax</td>
<td>£0.50</td>
<td>£1.50</td>
</tr>
<tr>
<td>Sky Premier</td>
<td>£1.51</td>
<td>£1.50</td>
</tr>
</tbody>
</table>

Note:
These prices, and those in the following Tables, are calculated by reference to BSkyB’s wholesale prices in Table 2 above. So, for example, the incremental wholesale price in 2000 of Sky MovieMax when packaged with one sports channel of £1.00 given above is calculated by the 2000 price of Sky MovieMax and single sports (£12.55) minus the 2000 price of a single sports channel (£11.55).

Prices are excluding VAT and assuming a 59% applicable percentage.

### TABLE 4: SPORTS CHANNELS

<table>
<thead>
<tr>
<th>Package</th>
<th>Incremental wholesale price of 1 sports channel</th>
<th>Percentage of price of 1 sports channel only</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1 Sports Channel Only</strong></td>
<td>£11.55</td>
<td>£12.05</td>
</tr>
<tr>
<td>Package with 1 Movie Channel</td>
<td>£2.01</td>
<td>£2.01</td>
</tr>
<tr>
<td>Packaged with 2 Movie Channels</td>
<td>£1.50</td>
<td>£1.01</td>
</tr>
<tr>
<td>Packaged with 2 Movies &amp; 1 other Sports channel</td>
<td>£1.01</td>
<td>£1.00</td>
</tr>
</tbody>
</table>

Note:
Prices are excluding VAT and assume a 59% applicable percentage.
553. Tables 3 and 4 above illustrate the ‘mixed bundling’ of BSkyB’s premium channels. Table 3 shows that the wholesale price of the first film channel depends on the number of sports channels taken. Table 4 similarly shows that the wholesale price of the first sports channel depends on the number of film channels taken. This mixed bundling means that the implied wholesale price of the additional channel of the other genre becomes progressively lower. For example, Table 3 shows that in 2001 the wholesale price of one film channel (Sky Premier or MovieMax) when bought alone costs distributors £12.55. Taking the first film channel together with a sports channel reduces the effective price of the film channel to just £2.51 (an 80% discount), and this reduces to £1.51 when a second sports channel has been added to the package.

III. BSkyB’S INCREMENTAL PROGRAMMING COSTS

554. BSkyB provided the Director with estimates of the incremental programming costs per additional subscriber of Sky Sports 1, Sky Sports 2, Sky Premier, and Sky MovieMax. These are set out below in Table 5.

<table>
<thead>
<tr>
<th>Channel</th>
<th>Incremental Programming Cost</th>
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<tr>
<td></td>
<td>July 1999 – June 2000¹</td>
</tr>
<tr>
<td></td>
<td>July 2000 – December 2000¹</td>
</tr>
<tr>
<td></td>
<td>January 2001 – June 2001²</td>
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<td>[... ]</td>
<td>[... ]</td>
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<td>[... ]</td>
<td>[... ]</td>
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<tr>
<td>Sky Sports 1</td>
<td>£0.00</td>
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<tr>
<td>Sky Sports 2</td>
<td>£0.00</td>
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</tbody>
</table>

1. Source: BSkyB Section 26 response, 13 July 2001, Table 1.3, Question 1, page 3.

555. Table 5 indicates that of the four premium channels, [...]. Sky Sports 1 and 2 incur no incremental per subscriber programming costs because purely fixed licence fees are paid for all sporting events broadcast on BSkyB’s premium sports channels. However, incremental programming costs per additional subscriber are incurred for BSkyB’s premium film channels. [...].

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468 Adding either film channel to the other film channel when no sports channel is included in the package also yields an incremental price of £2.51 (i.e. £15.06 - £12.55), based on 2001 prices.


471 This incremental programming cost has been calculated so as to reflect per subscriber costs incurred by BSkyB under its ten largest (by value) agreements for
IV. **SUBMISSIONS**

1. **Third party submissions during the investigation**

556. Telewest and ITV Digital alleged that BSkyB’s mixed bundling wholesale pricing strategy foreclosed the wholesale market to rival premium channel suppliers. \(^{472}\) Given the limited upstream competition for film and sports rights, any entry into the premium wholesale supply market is likely to be on a single-channel basis only. If distributors are attracted by a third party channel, they will offer it in addition to BSkyB’s existing premium channels, given the subscriber attraction of, and reliance on, BSkyB’s premium channels. Given BSkyB’s dominant position, it is unlikely that entry will be on a scale sufficient to allow distributors to take whole packages of premium channels from new entrants and replace BSkyB’s premium channels altogether.

557. Accordingly, due to BSkyB’s dominance in the wholesale supply of premium sports and film channels, distributors will require at least one BSkyB premium channel. Therefore BSkyB’s wholesale pricing structure, which offers a high price for the first channel purchased and significantly lower prices for subsequent premium channels, disincentivises distributors offering a third party channel within the package, and forecloses the market to entrants. The distributor is not able to choose between BSkyB’s and the new entrant’s average channel prices. Instead, the distributor’s choice is between the new entrant’s ‘stand-alone’ price and BSkyB’s incremental prices, where a substantial proportion of BSkyB’s fixed costs have already been recovered through the price of the first premium channel.

558. ITV Digital stated that its decision not to create a dedicated premium film channel was partly motivated by BSkyB’s mixed bundling strategy. \(^{473}\)

559. Telewest, ITV Digital and ITV Carlton Granada alleged that, although the general implications of mixed bundling as a form of price discrimination have ambiguous implications for welfare, BSkyB’s specific wholesale price structure represents a significant deviation from short run profit maximising behaviour. \(^{474}\) BSkyB’s wholesale prices can only be profit

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\(^{472}\) See, for example, ITV Digital submission, dated 5 May 2000, page 93; Telewest’s submission, dated 28 April 2000, section 5.2.2, page 67.

\(^{473}\) ITV Digital submission, dated 5 May 2000, page 93.

maximising by virtue of the longer term benefits that accrue from anticompetitively foreclosing entry to the wholesale premium channels market.

560. They also contended that a vertically separated and profit-maximising wholesaler of BSkyB’s premium channels would aim to incentivise all distributors to maximise sales of premium channels. Yet, such is the structure of BSkyB’s wholesale prices, rival distributors make an incremental loss on final customers if they upgrade from basic-only to packages with premium content. BSkyB’s wholesale pricing structure front-loads one channel and two channel prices, and simultaneously concentrates on selling four channel packages as a distributor. According to Telewest, this means that other distributors must either concentrate on selling basic-only packages or entirely mimic BSkyB’s customer distribution. This results in less competition, and less consumer choice, between these two extremes.

561. In this context, Telewest argued that an appropriate remedy would be to compel BSkyB to offer the option of an unbundled set of prices, and allow distributors to bundle in a way that reflects their own subscriber base and their own strategy. ITV Digital stated that it cannot be the case that a dominant firm may introduce any form of discounts it wishes simply because the relevant costs of supply are fixed, and so cannot be attributed to any individual customer.

2. BSkyB’s submission

562. BSkyB pointed out that its wholesale price structure (i.e., mixed bundling) is a form of price discrimination and that such price discrimination is a common feature of market economies. If buyers differ in how much they are willing to pay for a product, sellers can make greater profits by selling their product at prices that reflect its value to individual buyers than by selling at a single price.

563. BSkyB also argued that, since the provision of pay TV is characterised by high fixed costs and low marginal costs, price discrimination can also be more efficient. Mixed bundling is efficient since it results in increased consumption of BSkyB’s channels and minimises the number of viewers


475 See, for example, ITV Granada submission in response to the Rule 14 Notice, dated 27 March 2002, page 9.


479 BSkyB submission dated 19 May 2000, Section 5.3.5.
that are excluded, compared to where BSkyB’s channels are priced on an individual basis.\footnote{BSkyB provided the following example (Submission dated 19 May 2000, page 143). A sports fan may be willing to pay £10 for a sports channel and then £5 more for a movie channel, while a movie fan would do the reverse. If all channels cost £10, then each would buy one channel only, and this would amount to under-consumption because the rights have been purchased and the channels distributed on satellite, making each channel available to an additional household at zero incremental cost. However, if subscribers are offered one channel for £10, and two channels for £15, each viewer would subscribe to two channels.}

564. These benefits would not be achieved in respect of the provision of BSkyB’s channels to non-BSkyB subscribers if the prices which BSkyB offers to cable operators were set on an individual and additive basis. Moreover, distributors would not find it economic to price BSkyB’s premium channels in such a way as to give subscribers that purchased more than one channel a discount unless such discounts were also incorporated into the wholesale prices which cable operators pay to BSkyB.

565. BSkyB contended that mixed bundling cannot act as a barrier to entry in the wholesale market because it does not have the exclusive right to practice it. Furthermore, a new entrant would not need to own all of the channels which were offered as part of the mixed bundle but could price its channels in combination with other entrants that offered other types of channels. BSkyB’s second point regarding foreclosure was that consumers could choose to subscribe to the new entrant’s channel in addition to the BSkyB channels that they currently consume. Third, a new entrant could also target consumers who do not currently subscribe to any of BSkyB’s premium channels.

V. THE RULE 14 NOTICE

566. In the Rule 14 Notice, the Director stated that, in finding an abuse of the Chapter II prohibition, it would not be sufficient to show that the wholesale pricing structure affected entry to the wholesale market to some degree. The characterisation of the abuse would also need to take into account BSkyB’s need to recover costs efficiently in a high fixed, low marginal cost industry in which customers have varied but unidentifiable preferences across premium channels.

567. In \textit{Hoffman-La Roche},\footnote{Case 85/76 \textit{Hoffman-La Roche v Commission} [1979] ECR 461, paragraph 91.} the European Court stated that a dominant firm abuses its position if it uses methods different from those that would prevail in normal competitive conditions to hinder the competition remaining.\footnote{An essential question is whether an act is profit maximising by virtue of the economic rents generated by the conduct – conduct that would not be profit maximising if such rents were excluded.} In assessing whether this is the case, the Director considered relevant not only whether the pricing is based on any
economic saving by BSkyB (i.e., cost efficiencies), but also if it relates to wider economic efficiencies and consumer benefits.\textsuperscript{483}

568. The Director recognised in the Rule 14 Notice that a form of price discrimination, such as mixed bundling, permits BSkyB efficiently to recover its high fixed costs from a variety of consumers, some of whom value its channels very highly, and others less so. For example, by offering its premium channels in mixed bundles, it allows subscribers to self-select to some extent, according to their willingness to subscribe to the various channels.\textsuperscript{484} Therefore the sports (in particular the FAPL) fan (in effect having paid most for the channel s/he values most) can subscribe in addition to film channels at a low incremental price, while the film fan can additionally take sports channels at a low incremental price. Each subscriber effectively pays more for the channel s/he prefers, and overall output may be increased by permitting sales at a lower price to the less enthusiastic viewer.\textsuperscript{485} Discounts that reduce incremental price towards incremental cost may increase output and efficiency. Conversely, if mixed bundling were disallowed, BSkyB would be precluded from reducing the incremental price of additional channels towards their incremental cost, and as a result many customers whose willingness to pay exceeded that incremental cost would be deterred (inefficiently) from taking additional channels.

569. Unless the number of subscribers with uniform preferences far exceeds customers with these varying preferences, it is likely that a degree of bundling at the wholesale level is rational for BSkyB, before any entry deterrence effect is taken into account. The Director concluded that to demonstrate that BSkyB was abusing its dominant position required more than establishing that there is some degree of bundling. For bundled pricing to be abusive, the Director considered that its extent should exceed that which would occur in conditions of normal competition.

\textsuperscript{483} Mixed bundling, as a form of second degree price discrimination, may result in increased efficiency by allowing higher levels of output (i.e., more sales of premium channels), and improved allocative efficiency resulting from customers facing prices closer to marginal costs.


\textsuperscript{485} Whilst the analytical focus is wholesale pricing, for the purpose of clarity, this analysis is constructed as though consumers are buying channels directly from BSkyB. This is in effect what happens because distributors’ demand is derived demand (i.e., based on their final customers’ demand) and distributors buy from BSkyB on a per customer basis (for example, if one final customer buys two BSkyB premium channels from NTL, NTL must, in turn, purchase a two-channel package from BSkyB).
570. Given that this is difficult to determine in this industry, the Director proposed a test that if passed would be sufficient, but not necessary, evidence of abuse: whether the implied price for incremental channels was less than the incremental avoidable cost per additional subscriber of supplying such channels.

571. The rationale is that if, in each case, such incremental price does not exceed such incremental cost, BSkyB is forgoing profit (i.e., before any foreclosure benefits are taken into account), and the Director considered that this would infringe the Chapter II prohibition.

572. If just one channel is sold at below its incremental cost, this may foreclose channels particularly of its own genre. This is because in choosing additional premium channels, customers may face the choice of an additional BSkyB channel sold at below its own incremental cost, and the third party channel at full price.\footnote{For example, a sports fan subscribing to Sky Sports 1 and Sky Sports 2 may face a marginal decision of whether to add Sky Premier or a rival’s sports channel. The distributor could currently offer Sky Premier to the subscriber for a small incremental wholesale price (but, as is shown below, less than the cost to BSkyB of supplying it) or the standalone wholesale charge of the rival.} Accordingly, the below-incremental-cost channel distorts competition. Further, discounting to below incremental cost would deter potential entrants to the relevant market, and in particular the relevant genre.

573. In the Rule 14 Notice, the Director also stated that failure to pass the test implies a clear abusive act as defined above, but passing the test does not exclude abuses within the pricing structure, as mixed bundling may be anticompetitive, in that it exceeds what would be chosen in the absence of anticompetitive incentives, even when discounts are not at such an extreme level.

574. The Director assessed the incremental programming cost per additional subscriber [...] relative to the incremental wholesale price BSkyB would gain from such an additional subscriber [...].

575. Table 6 shows that apart from when an additional subscriber is subscribing to [...], the incremental programming cost exceeds the incremental wholesale price achieved. [...].\footnote{A BSkyB internal memorandum illustrates by means of a similar incremental price and cost comparison how at the retail level its pricing structure in respect of [...] could be viewed as discounted ‘too deep’ (i.e. as incrementally loss making). Source: BSkyB internal memorandum of 22 April 1999, provided in BSkyB submission dated 30 August 2001, File 1, page 0009.} If an applicable percentage less than 59% were used to derive BSkyB’s wholesale prices, the incremental losses would be even greater than shown.
### TABLE 6: [...] INCREMENTAL COST AND PRICE

<table>
<thead>
<tr>
<th>BSkyB Premium Channel Package and year</th>
<th>Wholesale Price of Package¹</th>
<th>Implied Wholesale Price of [...] (Incremental Price)</th>
<th>Incremental Programming Cost per Additional Subscriber²</th>
<th>Incremental Price minus Incremental Cost</th>
<th>Incremental Price as a percentage of Incremental Cost</th>
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Note:

1. 2000 Prices refer to the period 10 September 1999 to 31 December 2000 and 2001 prices apply to the period post-2001. Prices exclude VAT and assume a 59% applicable percentage.


576. The Director stated that such a pricing structure could be anticompetitive. Furthermore the evidence for this abuse was strengthened once the effect of incorporating the Disney Channel in a premium film package is considered. BSkyB gives the Disney Channel free to cable operators with packages comprising at least its two premium film channels. The wholesale price of this package is no greater than when the Disney Channel is excluded, although the incremental programming cost incurred by BSkyB is not zero. In 2000 the incremental programming cost of the Disney Channel was [...] As can be seen from Table 7, the inclusion of the Disney Channel with [...] implies an even greater net incremental loss for a given package.

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488 At the retail level, BSkyB recognised concerns regarding packages incorporating the film channels and the Disney Channel. (BSkyB internal memo dated 22 April 1999 enclosed with BSkyB submission dated 30 August 2001.)

489 BSkyB letter to OFT of 1 October 2001.
### TABLE 7: [...] PLUS DISNEY INCREMENTAL COST AND PRICE

<table>
<thead>
<tr>
<th>BSkyB Premium Channel Package and year</th>
<th>Wholesale Price of Package¹</th>
<th>Implied Wholesale Price of [...] (Incremental Price)</th>
<th>Incremental Programming Cost per Additional Subscriber²</th>
<th>Incremental Price minus Incremental Cost</th>
<th>Incremental Price as a percentage of Incremental Cost</th>
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Note:

1. 2000 prices refer to the period 10 September 1999 to 31 December 2000 and 2001 prices apply to the period post-2001. Prices exclude VAT and assume a 59% applicable percentage.


1. **BSkyB’s submission on the Rule 14 Notice**

   1.1 **Appropriateness of Director’s test**

577. In the Response, BSkyB argued that the Director’s set out test above was fundamentally flawed because it can be rational, even without any exclusionary intent, to offer bundled prices which result in the notional incremental price for one component of the bundle being less than its incremental cost. BSkyB offered some hypothetical examples of an abstract pay TV market with three types of consumers and two channels to support this point (see Annex 29).

578. BSkyB argued that the Director’s test was incorrectly predicated on the assumption that the effect of offering a bundled price is to cause some customers that would have purchased one channel to purchase another channel. Instead, bundling is often used to cause customers to buy both products when otherwise they would purchase neither. The calculation for the net revenue test for the purposes of measuring incremental profitability is not necessarily the difference in price between four and three channel packages (or three and two channel packages).

579. In addition, BSkyB argued that underpinning the Director’s test is an incorrect assumption that consumers decide how many channels to purchase on a sequential basis. That is, consumers go through the thought process of purchasing a first-choice channel at its standalone price and then subsequently deciding to purchase each additional channel based on its notional incremental price. In other words, the Director had mistakenly assumed that consumers would always trade down to a package that includes one less premium channel at prevailing price levels.
if the discounts reflected in the wholesale bundled price for their current premium package were no longer offered.

580. Instead, BSkyB argued, consumers choose packages on the basis of maximising consumer surplus (i.e., the difference between the amount a consumer is willing to pay to consume a particular package and how much s/he actually has to pay to consume the package). If none of the available packages is priced to reflect his or her willingness to pay, the consumer will not subscribe at all. It is therefore incorrect to designate any particular channel being a subscribers’ first choice or to consider that a consumer chooses to subscribe to premium channels only on the basis that s/he already subscribes to other premium channels.

581. BSkyB also contended that even if premium channels were chosen sequentially, it would be incorrect to assert that [...] Movie channels are broadly as popular as sports channels, whilst [...] The implication of this is that the notional incremental price of [...] may exceed the avoidable cost for most subscribers.

1.2 Evidence

582. BSkyB provided some empirical evidence which in its view supported its arguments. First, BSkyB presented marketing literature which it claimed is consistent with its contention that [...].

583. Second, BSkyB provided historical information which it claimed supported its proposition that [...] who take top tier would be willing to subscribe to BSkyB’s sports channels at their prevailing price if the discounts reflected in the current bundled price for the top tier were no longer offered. From January 2001, BSkyB introduced a new pricing structure in which the price of dual movies was increased by more than the price of dual sports and by more than the price of the top tier. This change had the effect of causing the notional price of adding dual movies to a sports package to increase by 20% and by more than the increase in the price of any of the bundled packages. BSkyB argued that, had there been a category of subscribers who took top tier (rather than dual sports) by virtue of the discount on dual movies reflected in the bundled price, the 20% increase in the notional incremental price might be expected to have resulted in a degree of spin-down to dual sports. BSkyB’s figures show that did not in fact occur.

584. Third, BSkyB also provided evidence of subscriber viewing behaviour which it contended contradicts the notion that its mixed bundling is aimed simply at inducing sports fans to subscribe to BSkyB premium film channels and film fans to subscribe to BSkyB sports channels. BSkyB

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\[490\] In the year to December 2001 in multichannel homes, BSkyB’s movie channels (including Sky Cinema and all multiplexes) had a combined viewing share of 4.5%, whereas its sports channels had a combined viewing share of 2.88%. [...]. Source: BARB/SPC

\[491\] Response, Part Seven, Annex 3.

\[492\] Response, Part Seven, Table 6. [...]
stated the viewing data supplied did not provide any evidence of negative correlation as between Sky sports channels and Sky film channels.\textsuperscript{493} BSkyB contended that, since the offering of a bundled price for top tier (to the extent that it is taken by subscribers who should not be described by sports or film fans) was clearly profitable, this viewing data was consistent with BSkyB’s bundled price for the top tier being profitable overall.

585. Fourth, BSkyB provided an analysis of spin down and upgrade activity which indicated that there was very little switching between premium channel packages.\textsuperscript{494} During 2000/01, \textit{[less than 200,000]} of BSkyB’s subscribers \textit{([less than 5%]} of BSkyB’s DTH subscriber base) sought to supplement their existing premium channel package by subscribing to one or more additional premium channels.

586. Fifth, BSkyB argued that consideration of NTL’s retail prices in June 2001 demonstrated that the incremental programming cost faced by NTL of supplementing a subscriber’s package with additional channels was often more than the incremental revenue that NTL would receive.\textsuperscript{495} BSkyB argued that NTL’s pricing strategy of setting notional incremental prices below incremental cost was consistent with normal conditions of competition; and consistent with BSkyB’s wholesale pricing strategy. NTL cannot be departing from profit maximisation in order to benefit from a foreclosure benefit and so its conduct validated the rationality of such pricing.

1.3 The role of pre-entry prices

587. Finally, BSkyB argued that pre-entry prices have no bearing on the competitive strategies after entry has occurred (and hence no impact on the profitability of the entrant). BSkyB, supported by a paper by Lexecon, noted that there are essentially three ways by which pre-entry strategies can affect post-entry strategies, none of which apply to the circumstances in this case.\textsuperscript{496}

\begin{itemize}
  \item[(i)] Pre-entry strategies may entail a perfect commitment to follow a particular strategy once entry has occurred. BSkyB argued that this way to link pre-entry strategies to post-entry strategies should not play an important role in the current case.
  \item[(ii)] Pre-entry strategies may be used by the incumbent to signal private information. Choosing a relatively low price even before entry has occurred may credibly signal to any potential entrant that the incumbent enjoys relatively low (marginal) costs and can
\end{itemize}


\textsuperscript{494} Response, Part Seven, Table 7. Number of subscribers changing Sky Digital package, 2000/01.

\textsuperscript{495} Response, Part Seven, Table 8. NTL prices as at June 2001.

\textsuperscript{496} ‘Commitment and the Ratecard Prices Offered by BSkyB’, Lexecon April 2002.
thus be expected to compete aggressively once entry has occurred. BSkyB argued that no case for signalling can be made in the current case.

(iii) Pre-entry prices may affect post-entry competition by virtue of the role of the incumbent’s ‘reputation’. A firm’s actions can credibly communicate to other market participants its future strategies (for example, that it will react aggressively following any future entrant). BSkyB asserted that this argument cannot be used in this case.

2. Third party submissions responsive to the Rule 14 Notice

588. Telewest argued that the below incremental cost pricing test in the Rule 14 was too lenient because it is based on incremental per subscriber costs. It contended that an appropriate test would be one based on whether the pricing increments are greater than the long run average incremental costs of producing that channel (and subject to a combinatorial test to ensure all joint costs are covered).497

VI. THE DIRECTOR’S CONCLUSIONS ON MIXED BUNDLING

589. Dominant undertakings may not discount or bundle if this has an anticompetitive object or effect.498 Such anticompetitive effects include raising artificial barriers to entry to rivals and foreclosing markets. Pricing structures that offer discounts across different products may have this effect. In Coca-Cola/Amalgamated Beverages GB,499 the European Commission referred to an undertaking whereby Coca-Cola undertook not to offer discounts that were conditional on the customer’s purchase of one or more additional beverages along with the purchase of one or more Coca-Cola Megabrand products. In Digital,500 the European Commission alleged that Digital Equipment Corporation had abused a dominant position by offering package discounts, i.e., the prices of software services were considerably more attractive when included in a software-and-hardware service package than when sold on a stand-alone basis.

590. The Director considers that, given the nature of the industry and its consumers, BSkyB is not required by the Act to offer a wholesale pricing structure that implies a zero level of mixed bundling, nor is it permitted to offer all forms of mixed bundled discounts as it sees fit. To find mixed bundling to infringe the Chapter II prohibition, the Director considers that

497 Telewest further submission in response to Rule 14 Notice, dated 7 May 2002, page 7. The long run average cost of producing a channel includes the direct fixed cost of producing it.

498 ‘Assessment of Individual Agreements and Conduct’, OFT 414, section 5.


500 Commission press release IP/97/868 of 10 October 1997. The case was settled by means of an undertaking.
its extent must exceed that which would occur in conditions of normal competition.

591. As outlined in paragraphs 567 to 569, the Director considers that the key principle to adopt in assessing a state of normal competition in this industry is whether, absent any entry deterrence, the mixed bundling represents a clear deviation from a profit maximising strategy. In the absence of evidence of intent or consumer preferences showing such a deviation, the Director would not normally expect a pricing structure characterised as mixed bundling to be grounds for a finding of infringement of the Chapter II prohibition.

592. However, the Director would not expect, under conditions of normal competition, bundling to the extent that the incremental avoidable cost per additional subscriber of supplying particular channels exceeds the implied incremental price of such channels. Therefore if such bundling exists together with evidence of foreclosure, the Director would expect to find an infringement of the Chapter II prohibition, unless there was objective justification.  

593. The Director accepts that there are hypothetical examples (such as those constructed by BSkyB) such that a company could ‘fail’ this test (i.e., incremental cost exceeds incremental price) yet still be profit maximising without any entry-deterrence benefits. However, the Director expects such circumstances to be rare in reality, and their existence would need to be demonstrated, not just hypothesised, to rebut a presumption of abuse.

1. **BSkyB’s below cost incremental pricing**

1.1 **BSkyB’s premium sports channels**

594. In BSkyB’s case, the implied incremental price of its premium sports channels always exceeded their incremental cost. Consequently, the Director has not considered further whether BSkyB’s mixed bundling has foreclosed entry to potential suppliers of premium sports channels, given the absence of additional evidence showing anticompetitive intent or effects.

1.2 **BSkyB’s premium film channels**

595. BSkyB’s incremental implied price for [...], however, seldom exceeds the incremental avoidable cost per additional subscriber of supplying such channels.

596. BSkyB has not demonstrated that below incremental cost pricing for [...] is profit maximising and (understandably) it does not know the exact

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501 The Director does not consider that Telewest’s test relating to long run average incremental cost adequately captures the fullest degree of bundling that would occur under conditions of normal competition. Telewest’s average incremental cost test would facilitate entry, but taken to its logical limit, it would forbid providers from offering channels at all and force all offerings to be PPV.
preferences of its consumers. Accordingly, to find an infringement of the Chapter II prohibition, the Director has considered whether there is evidence of foreclosure of competitors who would otherwise supply premium film channels as a result of such below-cost incremental pricing.

2. Evidence of foreclosure of premium film channels

502 Response, Part Seven, paragraph 106. ‘...Sky cannot know for certain the preferences of subscribers...’


597. BSkyB argued that its wholesale prices (before the entry of any new channel) have no bearing on what its competitive strategies would be should entry occur, and hence no impact on the ability of a potential competitor to launch a premium channel.

598. The Director accepts that BSkyB’s mixed bundling does not entail an absolute commitment to follow a particular strategy once entry has occurred. The Director does not accept, however, that mixed bundling cannot be used by BSkyB to signal information or intentions, nor that it cannot be used to alter BSkyB’s reputation with actual or potential rivals. In particular, the Director considers that BSkyB’s wholesale prices convey signals on the likelihood that BSkyB would continue with such mixed bundling post entry.

599. The Director has not, however, been presented with sufficient evidence to suggest that BSkyB’s mixed bundling has, in fact, foreclosed entry to any rival premium film channel providers. The Director noted in paragraph 249 that BSkyB holds the great majority of rights to the relevant premium film content rights. Therefore, even if BSkyB’s mixed bundling had the hypothetical ability to foreclose, the particular circumstances of the upstream market means that the bundling could not produce this effect during the period investigated. BSkyB also argued that Film Four had successfully entered the premium film market on the basis that most subscribers take it in addition to BSkyB’s premium channel portfolio. It had been relatively successful in attracting over 430,000 subscribers in just over three years.

3. Conclusion

600. BSkyB has supplied bundles of its premium channels priced so that for certain of its packages, the incremental implied price of [...] does not exceed the incremental cost of such supply. However, for the reasons set out above, in particular the absence of evidence that such pricing has foreclosed premium film channel rivals, the Director does not consider that there are sufficient grounds to conclude that BSkyB’s mixed bundled wholesale pricing strategy has infringed the Chapter II prohibition.
PART THIRTEEN DISCOUNTS IN BSKYB'S RATECARDS

I. THE COMPLAINT

601. Telewest, ITV Digital and NTL, the principal distributors of BSkyB’s premium channels, alleged that the discounts BSkyB offered in its ratecard distort downstream competition in pay TV.\textsuperscript{504} ITV Digital also alleged that the ratecard foreclosed entry to the wholesale premium channel market.\textsuperscript{505}

II. BSKYB’S RATECARDS

602. BSkyB charged distributors for its premium channels on a per subscriber basis, so that a distributor must pay BSkyB for each subscriber taking BSkyB’s channels. BSkyB offered distributors a choice between two ratecards setting out its wholesale charges for packages of its channels: the Pay to Basic Ratio (‘PBR’) ratecard and the Premium Pay Unit (‘PPU’) ratecard.

603. Both the PBR and the PPU ratecards set the wholesale price for premium channels as a percentage of BSkyB’s own retail price for the package containing the chosen premium channels, when bought through BSkyB’s ‘Family’ package.\textsuperscript{506} The percentage is called the ‘Applicable Percentage’ and was 59\% for the PBR ratecard and 57\% for the PPU ratecard. Distributors therefore faced wholesale prices that are automatically linked to the retail price that BSkyB itself sets.

604. Both ratecards contained discounts that could reduce the wholesale price of the channel packages to distributors.

1. PBR Ratecard

605. The PBR ratecard offered three discounts (available cumulatively), which operated by reducing the Applicable Percentage.
## DISCOUNTS UNDER THE PBR RATECARD

<table>
<thead>
<tr>
<th>Name of Discount</th>
<th>Method of Calculation</th>
</tr>
</thead>
</table>
| Pay to Basic     | Pay to Basic Ratio = \( \frac{\text{No. of BSkyB Premium Pay Units}}{\text{No. of Basic Cable Subscribers}} \)  <br> PBR Target = 60% of average DTH Pay to Basic Ratio  <br> 1 percentage point discount awarded for every 4 PBR percentage points above target.  
Note: A premium pay unit is the sale of a premium subscription to a subscriber – a subscriber may take several premium pay units. A Basic Cable Subscriber is the subscriber to a package containing basic pay TV channels. |
| Volume           | Discount for achieving levels of BSkyB basic subscribers:  <br> 100,000 – 199,999  1 percentage point  <br> 200,000 – 399,999  2 percentage points  <br> 400,000 – 599,999  3 percentage points  <br> 600,000 and above  4 percentage points |
| Basic Penetration| Basic Penetration = \( \frac{\text{No. of BSkyB Basic Subscribers}}{\text{No. of Homes Passed}} \)  <br> A ‘passed home’ is one that lies on a cable network and could be connected should a consumer decided to subscribe.  <br> Target = average for industry  <br> 1 percentage point of discount/penalty for every 1 percentage point above/below target |

Note: the Pay to Basic discount has the distributor’s number of basic cable subscribers as its denominator, whereas the Volume and Basic Penetration discounts are concerned with the distributor’s number of BSkyB basic cable subscribers. The latter are the subset of the former who subscribe to a basic channel package containing at least Sky One or Sky News.
2. **PPU Ratecard**

606. Following the Director’s 1996 Review, BSkyB introduced the Premium Pay Units (‘PPU’) discount as an option for cable companies. The PPU ratecard has a single discount, summarised in the table below.

<table>
<thead>
<tr>
<th>Premium Pay Units (providing a discount of 0 to 8 percentage points)</th>
<th>Premium Pay Unit Ratio = ( \frac{\text{No. of Premium Units}}{\text{No. of Homes Passed}} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target = Cable industry average for last quarter in previous calendar year</td>
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</tr>
<tr>
<td>1 percentage point of discount for each 2.5 percentage points above target</td>
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</tr>
</tbody>
</table>

### III. DISCOUNTS

607. During the period under investigation, NTL received discounts on the PBR ratecard. Throughout 2000, NTL’s Applicable Percentage was [...] comprising a [...] volume discount, a [...] basic penetration discount, and a [...] discount on the pay to basic discount. In 2001, the Applicable Percentage under the PBR decreased to [...], comprising a [...] volume discount and a [...] penalty on the basic penetration discount.\(^{507}\)

608. Telewest also earned discounts under the PBR ratecard, resulting in an Applicable Percentage of [...] during 2000 and 2001. The discounts earned were [...] on the volume discount, a [...] discount on basic penetration and [...] on the pay to basic discount.

609. ITV Digital was on the PPU ratecard. As homes connected cannot be determined meaningfully for DTT, its Applicable Percentage was fixed at [...] for both 2000 and 2001.\(^{508}\)

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\(^{507}\) As stated in paragraph 622, the volume discount is normally fixed over time for a specific distributor. The reason that NTL’s volume discount increased from 3% in 2000 to 4% in 2001 reflected the amalgamation of NTL and CWC subscribers. Source: NTL facsimile to OFT dated 30 August 2002.

\(^{508}\) Data from BSkyB submission dated 2 November 2001 Question 8.
IV. SUBMISSIONS FROM THIRD PARTIES AND THE RULE 14 NOTICE

1. PBR discount: wholesale foreclosure

610. ITV Digital argued that the PBR discount restricted competition by foreclosing entry to the wholesale market for premium channels.\(^{509}\) Although ITV Digital’s concern appeared to be primarily related to mixed bundling, the Director undertook his own analysis in the Rule 14 Notice and considered that the PBR discount had a potential foreclosure effect because it discourages distributors from taking non-BSkyB channels from a single channel entrant.

611. Distributors might be impeded in establishing or developing rival premium channels (either their own, or produced by third parties), as these would likely cannibalise the subscription rates of BSkyB’s premium channels, hindering achievement of the Pay to Basic Ratio Target. The foreclosure effect was particularly pronounced because the discount applied to all units purchased when a discount level is achieved and not just the additional units purchased. In this case, this led to a range in which the cost of taking additional BSkyB premium pay units to the distributor is close to zero. This is demonstrated in Chart 3 below:\(^{510}\)

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\(^{509}\) ITV Digital submission dated 5 May 2000, section 5.3, page 85.

\(^{510}\) Chart 3 is based on an analysis that considers the PBR Discount in isolation. It holds constant 1 million basic subscribers and varies the number of premium units to give the full range of Pay to Basic Ratios (i.e. 1 percentage point increment in the Pay to Basic Ratio equals 10,000 premium pay units: 1,000,000/100 = 10,000). Changing the number of basic units changes the size of the wholesale bill and not the shape of the line depicted by the chart. Changing the applicable percentage changes the slope of the line. The applicable percentage prior to any PBR discount is set at 56 per cent. This is one percentage point below the PPU ratecard applicable percentage before discount of 57 per cent. Otherwise, the hypothetical distributor would choose the PPU ratecard. The price per unit is calculated by first applying the applicable percentage to the retail price of the Family Package and then calculating the average price per premium channel within a package. For example, if the discount schedule were being constructed on a two-channel average basis, there would be a PBR percentage on the X-axis corresponding to an applicable percentage of 48%. At 48%, the wholesale prices for the two channel packages during the relevant period would be £11.03 (Dual Movies), £11.03 (Dual Sports), £10.21 (Movie Max + single sport); and £11.85 (Sky Premier + single sport). The overall two-channel average price per premium unit is £5.51 and this would need to be multiplied by the appropriate number of premium units to achieve the corresponding Y-Axis value.
Chart 3: Relationship between the Pay to Basic Ratio and the Wholesale Charge, PBR Discount

<table>
<thead>
<tr>
<th>Pay to Basic Ratio (%)</th>
<th>Total premium wholesale bill to BSkyB (£ million)</th>
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<tbody>
<tr>
<td>170</td>
<td>£6.00</td>
</tr>
<tr>
<td>175</td>
<td>£6.25</td>
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<td>180</td>
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<td>205</td>
<td>£7.75</td>
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<tr>
<td>210</td>
<td>£8.00</td>
</tr>
</tbody>
</table>

PBR target = 176.5%

A

B

612. In Chart 3 above, the PBR discount is earned over the range $AB$, (which covers PBR ratios between 180.5 per cent to 208.5 per cent). The target of 176.5% is 60% of the ratio that BSkyB achieved on its platform, and a discount is earned once that target is exceeded by 4%.

613. Where a distributor lies close to or within the range $AB$, the cost to the distributor of taking additional BSkyB premium channels will be approximately zero. In the hypothetical scenario set out in Figure 1, the discount range $AB$ covers 280,000 premium pay units. Over this range, the wholesale bill increases by only approximately £57,200. The average price per additional premium unit over the discount range is therefore as little as £0.20. This is 94% lower than the price of an additional unit immediately before the discount takes effect. However, as is clear from paragraph 554 above, [...] has an incremental cost of £[...] (June 2001), and the Disney channel (supplied as a bonus channel together with BSkyB’s two premium film channels) has an incremental cost of £[...] (June 2001). Accordingly, over this range, the Director

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511 This occurs because of the interaction of the one percentage point of discount on the whole wholesale bill with the achievement of four percentage points above the PBR Target. In other words, the cash amount of discount earned through an additional percentage point of discount almost offsets the increase in the premium unit wholesale bill (generated by the additional sales of premium units needed to have exceeded the target Pay to Basic Ratio by 4 per cent, or a further 4 per cent).

512 Again, the number of basic cable subscribers is fixed at 1 million in Chart 3 and the number of BSkyB premium pay units increased to illustrate the range of Pay to Basic Ratios.
considered in the Rule 14 Notice that BSkyB is offering channels at below their incremental cost.

614. The Director considered that the wholesale bill plateau of $AB$ generated by the PBR discount accordingly acts as a disincentive for distributors to take non-BSkyB premium channels. Single premium channel entry will be foreclosed by the PBR discount where a distributor lies at or close to the range between $A$ and $B$ because the wholesale price of additional BSkyB premium units up to point $B$ is close to zero. The disincentive effect is equally true of small or large distributors because of the scaling effect of the Pay to Basic Ratio in calculating the PBR discount earned.

615. Accordingly, the PBR discount has a potential foreclosure effect, as a result of the level of the PBR target, which, as noted out above, is set at 60% of BSkyB’s own DTH Pay to Basic Ratio.

2. PBR discount: distortion of downstream competition

616. NTL argued that the operation of the discount has resulted in a rigid structure that has not provided BSkyB’s downstream competitors with the flexibility to develop different retail offerings (e.g., with more emphasis on basic channel packages). Consequently, cable operators have been compelled to follow BSkyB’s retail pricing approach. ITV Digital argued that it is the absolute number of premium units that is relevant to the generation of cost savings, and as such, there is no basis for basing the PBR discount on premium units relative to the number of basic units.

617. In the Rule 14 Notice, the Director stated that the PBR discount had the potential to distort the marketing decisions of distributors downstream in the retail market. Assuming that the discount effectively incentivised a distributor to enhance the discount achieved, the distributor will aim to maximise its PBR by increasing the Premium Pay Units it sells while minimising basic-only subscriptions. This is because the numerator of the Pay to Basic Ratio used to calculate the PBR discount is the total number of BSkyB Premium Pay Units a distributor sells.

618. The denominator for the discount is the distributor’s total number of basic-only subscribers. The advantage of this denominator is that it generates a scaling effect, so that, unlike a pure volume discount, all distributors, regardless of size, can in principle earn the PBR discount and so are all similarly incentivised to sell additional BSkyB Premium Pay Units (or would be if the level of the PBR target was set appropriately).

619. Premium channels supply costs are largely fixed (though see paragraph 554 on the variable costs of BSkyB’s premium film channels) and BSkyB has stated that as the number of subscribers increases, the average

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513 NTL submission dated 8 May 2000, page 32.
514 ITV Digital submission dated 5 May 2000, Section 5.3.3, page 99.
515 For example, if a distributor sells a package containing three BSkyB premium channels to a subscriber, this counts as three ‘Premium Pay Units’.
BSkyB cost per subscriber decreases as it can divide its fixed costs across the increasing number of subscribers.\textsuperscript{516} In this respect, the PBR discount brings incremental price closer to incremental cost.

620. Since the denominator is based on all basic subscribers, discounts on its premium channels are not linked directly to sales of BSkyB’s basic channels by the PBR discount. However, in the Rule 14 Notice the Director considered that using basic subscribers as the denominator was anticompetitive insofar as it disincen tivises distributors from taking basic-only customers. Basic-only strategies for distributors now include offering bundled telephony, e-mail, and Internet access.

3. Volume discount

621. Telewest argued that the volume discount also introduced distortions to competition at the distribution level.\textsuperscript{517} The volume discount is a discount on the price of premium channels but based on the volume of basic subscribers at the beginning of the period. It is therefore predetermined and offers no incentive for selling additional premium channels in any given period. Telewest also argued that, when the discount was predetermined, it was based only on BSkyB basic cable subscribers and not other basic subscribers. Cable companies were penalised for selling basic packages that did not include either Sky One or Sky News.

622. In the Rule 14 Notice, the Director assumed that the volume discount was recalculated annually, as the pay to basic and basic penetration discounts in the PBR ratecard are recalculated by reference to performance. The Director considered that by linking the sale of basic packages containing BSkyB basic channels to the discount earned on BSkyB premium units, the volume discount leverages, and/or has the potential to leverage, BSkyB’s dominance in premium channels into the more competitive market in which basic channels compete. The volume discount also had the potential to distort the packaging or marketing decisions of distributors downstream in the retail market as distributors have an incentive to maintain a threshold level of 600,000 basic subscribers to attain the maximum 4\% discount. Since the Rule 14 Notice was issued, the Director has learnt that the volume discount was calculated by reference to a distributor’s volume of BSkyB basic cable subscribers before 1 October 1997. It was effectively fixed and predetermined, and therefore Sky Basic cable subscribers acquired (or lost) by a distributor after that date were disregarded for the purpose of calculating the volume discount.\textsuperscript{518}

\textsuperscript{516} BSkyB, \textit{Response to OFT Issues Paper Annex I}, 10 May 2000, 5.3.1 \& 5.3.2. Telewest (28 April 2000 submission, page 49-51) and ITV Digital (May 2000 submission, pages 100-101) have also argued this.

\textsuperscript{517} Telewest submission dated 28 April 2000, page 52.

\textsuperscript{518} Response paragraph 106, page 41.
4. Basic penetration discount

623. Telewest argued that the basic penetration discount offers perverse incentives to third party distributors. The discount decreases the price of premium channels, yet is based on the volume of basic subscribers at the beginning of the period. NTL also noted that the discount is based on a distributor’s performance relative to the cable industry average, so that in practice an individual distributor has limited ability to influence the level of discount it actually receives.

624. In the Rule 14 Notice, the Director considered that the discount had no apparent cost-based justification and also had the potential to leverage BSkyB’s dominance in premium channels into the more competitive market in which basic channels compete. This leverage is achieved by effectively linking the sale of basic packages containing BSkyB basic channels to the discount earned on BSkyB premium units. The Director also noted that, by being based on BSkyB basic subscribers, the discount provides no incentive for selling BSkyB premium channels during the period.

5. PPU discount

625. Telewest considered that the PPU discount discriminated against targeted marketing. If a distributor chooses to segment the market by selling premium channels to only those consumers that it considers will most likely buy them, this would be penalised by the PPU ratecard because it is based on premium channels per home. At its most extreme it would reward a smaller operator selling more premium channels per home, but at low absolute volumes, while penalising a much larger distributor with higher absolute volumes but fewer overall sales per home.

626. In the Rule 14 Notice, the Director applied the same analysis to this discount as to the PBR discount. The Director considered that the PPU ratio did not produce a significant ‘plateau’ and that a cable distributor’s wholesale bill is almost always positively related to the number of BSkyB premium units sold. Therefore, there was less scope for distortion of competition by competing premium channels than with the PBR discount. While the scaling effect of homes passed may have some disincentive effect on cable companies’ network build decisions, this is not likely to be appreciable in the context of the high costs associated with such build. Rather it appears to be a legitimate scaling factor so that large and small distributors are comparably eligible for discounts.

519 Telewest submission dated 28 April 2000, Section 5.1.1, page 54. See also Telewest submission dated 20 March 2002, section 3, page 21


V. BSkyB’s Submission

627. BSkyB argued that it is standard practice for a manufacturer/wholesaler to grant quantity discounts to its retailers in an attempt to persuade those retailers to maximise sales of the manufacturer’s product. BSkyB argued that this practice is widespread throughout industry and is not confined to firms that have market power. It is found in all industries where the amount of effort expended by the retailer has an impact on the sales of the product, regardless of the number of upstream companies.

628. BSkyB also stated that the discount structure incorporated into its ratecard, in part, reflects BSkyB’s cost structure. In supplying its premium channels to distributors, a significant portion of its costs are fixed. Therefore, as the number of third party distributor subscribers increases, BSkyB’s average cost of supplying these subscribers declines. Each of the discounts included on the ratecard has the effect of lowering the average price paid by distributors as the number of third party distributor subscribers increases. In BSkyB’s view, the fact that a sizeable proportion of BSkyB’s costs of supplying channels are fixed also explains why it is particularly concerned that third party distributors have an incentive to sell BSkyB’s premium channels to their subscribers.

1. PBR discount: wholesale foreclosure

629. BSkyB argued that within the PBR discount range specified by the Director (the ‘plateau’, see paragraph 611), the cost of adding BSkyB premium channels is, in fact, not close to zero. BSkyB modelled the premium wholesale bill between the same pay to basic ratio range as that adopted in the Rule 14 Notice (180.5% and 280.5%) and concluded that it would increase by £670,809. The average price per additional premium sports unit over the discount range is approximately £2.40. Consequently, in the absence of a plateau, there could be no disincentive to distributors in taking new entrant channels as replacement for existing BSkyB premium channels.

630. BSkyB also argued that, even if a wholesale bill plateau did exist, distributors would still have incentives to carry the channels of new entrants. The conditions of competition between television distributors are such that, even if a distributor were achieving the pay to basic ratio required to qualify for the pay to basic discount, it would not cause the distributor to decline to carry other attractive channels. A failure to carry attractive channels would result in the distributor’s channel offering being inferior to that of other distributors. Subscribers who are interested in obtaining the new channel might be encouraged to switch platforms if their existing distributor did not offer the new service.

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522 BSkyB submission dated May 2000, section 5.3, page 134.
523 BSkyB submission dated May 2000, section 5.3.3, pages 138-139.
524 Response, Part 8, paragraphs 36-46.
525 BSkyB also modelled another scenario where the wholesale bill for the same range is £1,070,260 which equates to £1.80 per additional premium unit.
631. Even without the threat of churn, BSkyB argued that it was highly likely that the additional profit earned by a distributor as a result of carrying a new premium channel would exceed any revenue foregone as a result of subscribers electing to drop subscription to a Sky Premium channel in favour of subscription to the new premium channel.\(^{526}\) It is not just the case that existing subscribers would substitute the new channel for a BSkyB channel: existing subscribers will take the new channel in addition to the existing BSkyB portfolio, whilst new customers, who had not previously subscribed to any BSkyB premium channels, will also take the new channel.

632. Finally, BSkyB argued that the potential foreclosure effect of the PBR discount considered by the Director in the Rule 14 Notice is irrelevant on the facts.\(^{527}\) At no stage during the period relevant to the Rule 14 Notice were any of the third party distributors close to achieving the pay to basic target (i.e., they were not close to the plateau considered in the Rule 14 Notice). Consequently, the pay to basic discount could not have had any foreclosure effect during the relevant period.

2. **PBR discount: distortion of downstream competition**

633. BSkyB argued in its Response that the PBR discount does not distort competition downstream. First, in considering the disincentive to increase basic subscribers, the Director had not taken into account the availability of other discounts under the same ratecard which operate contrary to the alleged disincentive effects. Although a distributor would have faced higher wholesale costs as a result of the PBR discount, it would also likely face lower wholesale costs as a result of the basic penetration discount. If a distributor had considered that the PBR discount unduly hampered its marketing decisions, it would be open to it to opt for the PPU ratecard.

634. Second, BSkyB argued that the Director failed to recognise that the contribution which distributors would expect to earn from basic-only subscribers was too significant for the PBR discount to have the effect of disincentivising them from taking basic-only customers.\(^{528}\) BSkyB gave an example in which the contribution a distributor expects to earn on basic-only subscribers outweighs any potential increase in the distributor’s wholesale bill by virtue of no longer qualifying for the pay to basic discount.

635. Finally, BSkyB argued that there was no evidence that any of the disincentive effects considered by the Director in the Rule 14 Notice had occurred in practice. BSkyB noted that the PBR ratios earned by distributors fell consistently during the relevant period, and that the

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\(^{526}\) BSkyB used numerical examples to support this point: Response Part 8, paragraphs 47-59.

\(^{527}\) Response, Part 8, paragraphs 63-71.

\(^{528}\) Response, Part 8, section D(l)(c)(ii), pages 32-33.
proportion of broadband cable homes that subscribed only to a basic
television service more than doubled.\textsuperscript{529,530}

3. Volume discount

636. In its Response, BSkyB points out that the potential effect on competition
alleged by the Director in the Rule 14 Notice rests on an incorrect
construction of the volume discount. The effect is based on the
assumption that distributors were deterred from allowing BSkyB basic
subscriber volumes to fall below certain levels for fear of losing some or
all of the volume discount on premium channels. BSkyB points out that
this assumption is incorrect for the reasons outlined and accepted by the
Director in paragraph 622.

4. Basic penetration discount

637. In its Response, BSkyB argued that the Director had not proved that the
basic penetration discount in the PBR ratecard affected competition
during the relevant period.\textsuperscript{531} BSkyB argued that the following evidence
does not support an hypothesis that there has been any distortion to the
basic channels market:

(i) there has been substantial basic channel entry on each UK
distribution platform;\textsuperscript{532}

(ii) the ability of distributors to compile and sell a variety of basic
packages has not been constrained;

(iii) during the relevant period, ITV Digital, NTL and Telewest offered
entry level packages that did not include either of Sky One or Sky
News;

(iv) the penetration of Sky One and Sky News decreased during the
relevant period.\textsuperscript{533}

\textsuperscript{529} Source: Response, Part 8, paragraph 65.

\begin{tabular}{|l|c|c|c|}
\hline
               & 1999  & 2000  & 2001  \\
\hline
PTB target ratio & 176.5\% & 170.3\% & 160\% \\
\hline
ITV Digital PTB ratio & [...] & [...] & [...] \\
\hline
NTL PTB ratio & [...] & [...] & [...] \\
\hline
Telewest PTB ratio & [...] & [...] & [...] \\
\hline
\end{tabular}

\textsuperscript{530} Based on data reported by cable operators to BSkyB, the share of basic-only
broadband cable subscribers increased from 30\% in January 1997 to 73\% in July
2001: Response, Part 8, paragraph 82.

\textsuperscript{531} Response, Part 8, paragraphs 90-102.

\textsuperscript{532} BSkyB list a high number of basic tier channels launch on cable and DTT between
VI. THE DIRECTOR’S CONCLUSIONS

1. Wholesale foreclosure effects

1.1 PBR discount

638. The Director notes from BSkyB’s Response that it is possible, using different assumptions, to model the PBR discount schedule such that it is continually upward sloping for all values of the pay to basic ratio. BSkyB has argued that there cannot therefore be a disincentive for distributors in taking new premium channels from entrants to the market. After examining BSkyB’s models, however, the Director still concludes that the plateau does indeed exist within the range specified in paragraph 611 to 615. 534

639. However, the Director considers that any disincentive resulting from the shape of PBR discount schedule (plateau or otherwise) was only hypothetical under the circumstances in the period investigated. In order

533 Source: Response, Part 8, paragraph 95.

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<tbody>
<tr>
<td>ITV Digital</td>
<td>Not carried*</td>
<td>Not carried*</td>
<td>[...]</td>
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*ITV Digital launched on 15 November 1998. Sky One was carried by ITV Digital from ITV Digital’s launch.

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* [...]. This indicates that the price charged for carriage of Sky News itself, rather than any possible basic penetration discount to Sky premium channel wholesale prices, was the key determinant of Telewest’s marketing decisions in relation to Sky News.

534 The Director notes that the modelling is complicated and sensitive to assumptions, because the horizontal axis in Chart 3 is a ratio, and movement along this axis (i.e., increasing the ratio) may be achieved in a number of different ways. BSkyB examined and changed key assumptions in the Rule 14 Notice: (i) that increases in the PBR are achieved by upgrading the packages taken by existing subscribers, with no increase in the number of overall subscribers; and (ii) that the mix of subscribers across BSkyB’s premium channel packages is constant and does not vary with increases in the PBR. It is the Director’s view that the alternative assumptions used by BSkyB to derive the upward-sloping line are more ‘special case’ than those adopted in the Rule 14 Notice.
for an actual or realistic potential wholesale foreclosure effect to exist, the distributors would at least need to lie on, or near, the critical part of the PBR discount range (i.e., range AB in Chart 3). The Director notes that although NTL and Telewest purchased premium channels under the PBR ratecard, neither receive PBR discounts. Moreover, the Director has also noted that each of these distributors have, in fact, moved away from the critical range during the relevant period. The Director concludes that the PBR discount contained within BSkyB’s PBR ratecard has not infringed the Chapter II prohibition on the grounds that it did not and was not likely to foreclose entry to the wholesale market for premium channels in the period investigated.

1.2 PPU discount

640. The Director also concludes that the PPU ratecard does not infringe the Chapter II prohibition on the basis that a distributor’s wholesale bill would almost always be positively related to the number of BSkyB premium units sold and it appears to be a legitimate scaling factor so that large and small distributors are comparably eligible for discounts.

2. Distortions of downstream competition

2.1 Volume discount

641. Although this discount could not affect behavioural incentives, the nature of the calculation means that BSkyB was discriminating between its distributors on a purely arbitrary basis. That is, the discount for each distributor was not recalculated annually but fixed arbitrarily according to each distributor’s volume of BSkyB basic cable subscribers at 1 October 1997 (see paragraph 622). The Director notes, however, that since all the distributors were receiving similar volume discounts on the PBR ratecard there was no material distortion of competition.

2.2 PBR discount and basic penetration discount

642. The Director notes that, despite BSkyB’s arguments (paragraph 627), the ratecard has not been successful in incentivising distributors to sell premium channels. The distributors’ pay to basic ratios have all reduced over the relevant period. This may well be for reasons other than the structure of the ratecard alone. In any case, given that the discounts have been offered on a non-discriminatory basis, the Director would not, by itself, find an infringement of the Act based on the weakness of incentives offered to downstream operators.

536 Response, Part 8, Section D(II)(b), page 29.
537 A company in a position of dominance, for example, exerting no other anticompetitive conduct, and offering non-discriminatory prices, is free to determine, as a matter of commercial negotiation, discounts and risk sharing with its downstream distributors. There is sometimes a trade-off for the upstream company between the profit per unit and offering incentives to sell a higher
643. Of more concern to the Director is whether the discounts have distorted downstream competition through their effect on basic channel distribution, as alleged by the principal third party distributors. In particular, the key considerations are whether: (i) the PBR discount has had the effect of anticompetitively preventing distributors increasing basic channel packages and following a different retail strategy to BSkyB; and (ii) the Basic Penetration discount has promoted the growth of BSkyB basic channels anticompetitively at the expense of non BSkyB channels.

644. The Director considers that there is no evidence to suggest that either effect has resulted from the PBR ratecard. As noted in paragraphs 635 and 637, and footnote 529, distributors’ pay to basic ratios have decreased markedly; the proportion of broadband cable homes that only subscribe to basic television has more than doubled; there has been substantial basic channel entry on all platforms; and the penetration of BSkyB’s two principal basic channels, Sky News and Sky One, has decreased over the relevant period. Further, Telewest and ITV Digital themselves have offered evidence that they have been successful in launching small entry-level basic packs.538

2.3 **PPU Ratecard**

645. The evidence above applies equally to the effect of the PPU ratecard. There is no evidence available to the Director which suggests that the PPU ratecard had in practice prevented distributors increasing basic channel packages or had the effect of promoting the growth of BSkyB basic channels at the expense of non BSkyB channels.

3. **Conclusion**

646. The Director concludes that BSkyB has not infringed the Chapter II prohibition by offering the discounts in either the PBR ratecard or the PPU ratecard.

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538 In its submission to the OFT of 5 May 2000, page 50, ITV Digital stated that: “Cable was also the first platform to introduce small basic packages, which were designed to lower the entry-point price. Their success in winning these low valuation subscribers is demonstrated by the fact that the number of cable subscribers rose by 15% in 1999, but the number of Sky premium pay units for cable only rose by around 1%”. In its submission to the OFT of 19 December 2000, Telewest stated that “Telewest has had considerable success with its small entry-level basic packs, especially since the digital relaunch.”
PART FOURTEEN CONCLUSION

647. The Director therefore considers that

(i) there are insufficient grounds to find that BSkyB has exercised an anticompetitive margin squeeze in the supply of its premium channels infringing the Chapter II prohibition;

(ii) there are insufficient grounds to find that BSkyB has applied mixed bundled wholesale prices in supplying its premium channels in such a way as to infringe the Chapter II prohibition; and

(iii) the discounts offered in BSkyB’s ratecards did not infringe the Chapter II prohibition.

648. While, for the reasons given in Annex 1, no further statement regarding the 1996 Undertakings is necessary, for the avoidance of doubt, the Director considers that BSkyB need not observe those undertakings, although it must of course observe the prohibitions contained in the Act.

17 December 2002

JOHN VICKERS
DIRECTOR GENERAL OF FAIR TRADING