OFFICE OF FAIR TRADING

Anticipated acquisition by ITV plc of SDN Limited

The OFT's decision on reference under section 22(1) given on 15 August 2005. Full text of decision published 24 August 2005.

PARTIES

1. **ITV plc (ITV)** is a vertically integrated broadcaster active in the acquisition and production of broadcasting content, the packaging of that content into channels (ITV1, ITV2, ITV3, ITV News, and Men and Motors) and the distribution of those channels on analogue and the Digital Terrestrial Television (DTT) platform. It has 48.5 per cent share ownership on Digital 3and4 limited, which holds the licence for Multiplex 2.[1]

2. **SDN Limited (SDN)** holds the licence for and operates Multiplex A, part of the DTT transmission system. It was jointly controlled by S4C, United Business Media and NTL. In the year ending 31 December 2003 it had a turnover of £7.76 million in the UK.

TRANSACTION

3. On 27 April ITV acquired the entire shareholding in SDN, following the shareholders' triggering of a buy out option.

4. The statutory deadline is 26 August. The administrative deadline has expired.

JURISDICTION

5. As a result of this transaction ITV and SDN have ceased to be distinct. The parties overlap in the ownership of DTT multiplex licences and in the supply of multiplex capacity for pay-TV and commercial TV. The share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met as they have 33 per cent of multiplex licences and at least 25 per cent of capacity available for both pay-TV and commercial TV in the UK. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

[1] Channel 4 also has 48.5 per cent share ownership and Teletext UK Limited holds the remaining 3 per cent.

RELEVANT MARKET

6. Channels for DTT are broadcast via six multiplexes. Each multiplex is licensed under the Broadcasting Act 1996 for 12 years (running from 1998 or 2002 in different cases) with a right of renewal, unless a licence condition is breached. Each multiplex has capacity, or streams, to carry a number of TV channels and may also carry a limited number of data and radio services. Licences limit what can be done with that capacity in some cases. The number of streams varies between multiplex depending on the transmission mode they are permitted (16 or 64QAM) and the sophistication of the encoding technology. Total multiplex capacity is largely fixed until the switchover from analogue to digital TV is completed, which is expected by 2012. In the interim, improvements in encoding technology may allow an extra stream or two to be created on an individual multiplex. By way of background, the licensee and the limits on capacity use on individual multiplexes are as follows:

- Multiplex 1 is gifted to the BBC and is solely for its channels.

- Multiplex 2 is licensed by and (will shortly be) entirely used by Channel 4, ITV and Teletext, although they can choose to lease most capacity to third parties. Each shareholder controls some capacity.

- Multiplex A is licensed by SDN. Five has reserved rights to 50 per cent of its capacity and currently leases all but one stream of this to pay-TV. S4C has reserved rights in Wales. The remaining streams that can be let by SDN are leased to several shopping channels, radio stations, Disney and a pay-TV channel. Only Multiplex A and 2 can lease capacity to pay-TV channels.

- Multiplex B is licensed by the BBC and although it can lease spare capacity to third parties it has not so far done so.

- Multiplexes C and D are licensed by Crown Castle, the only remaining licensee who does not operate its own channels downstream and therefore does not use capacity for its own channels.

7. As multiplex licensees the parties overlap in a) the ownership of DTT multiplex licences and b) the supply of multiplex capacity and related technical services.

Ownership of DTT multiplex licences

8. Although the current multiplex licences expire in 2010 and 2014, their renewal provisions mean that no auction is likely to occur until 2022. As the number and scope of the licences will be determined by regulation and available spectrum there will be no supply side substitutes. Each licence competition will represent a separate frame of reference. Although, it is very difficult to predict who will bid for the licences from 2022, the merger does not lead to a substantial reduction in potential bidders. SDN was a bid

vehicle for its three parents, who remain at liberty to bid for any licence. Considering this and the absence of third party concern, this issue is not considered further.

Supply of multiplex capacity and related technical services

9. The parties supply DTT multiplex capacity, combined with technical multiplex services. Such capacity is leased, usually on long-term fixed price contracts by television, radio and data broadcasters.

10. From a demand side perspective, capacity on digital satellite and cable multiplexes should not be considered in the same frame of reference as DTT.

- Broadcasting is a fixed cost intensive industry and therefore a channel wants to be on DTT, cable and satellite to drive subscription revenue or acquire advertising revenue. This suggests the three platforms are complementary.

- There is very limited capacity on DTT compared to satellite or cable and recent auctions of capacity suggests there is very strong demand.

- By 2012 it is expected all TV broadcasting will be digital and DTT is forecast to be the default platform by that point. Accordingly channels will want to be on DTT.

11. Demand side considerations and regulation also suggests that DTT multiplex capacity for radio and data and pay-TV should be considered separately: only two multiplexes can carry pay-TV; radio and data cannot exceed 10 per cent of capacity; and the capacity used for those services cannot be converted to carry an extra TV channel. Digital radio can also be carried on Digital Audio Broadcast multiplexes for reception by digital radio sets and there is currently a surplus on those multiplexes.

12. As the supply of DTT multiplex capacity is fixed by license it is not possible for satellite or cable multiplex operators to switch to supply DTT multiplexes, at least not until a new multiplex is licensed.

13. A cautious view is therefore taken and the merger is considered within the frame of references of the supply of DTT multiplex capacity to radio and data broadcasters, pay-TV broadcasters, and TV broadcasters as a whole.

Geographic market

14. Multiplexes are licensed, and capacity generally sold, on a nationwide basis. It is not possible for customers or suppliers to switch to or from DTT provision in other countries. Provisions for regional broadcasting on Multiplex A means that capacity is reserved for lease on in Wales and Scotland but with this exception the frame of reference is the UK.

HORIZONTAL ISSUES

Multiplex capacity for radio and data broadcasters

15. The merger does not change the situation with regard to radio or data broadcasters as prior to the merger ITV controlled no data or radio streams (Channel 4 controlling the data streams on Multiplex 2). SDN only accounted for about 10 per cent of capacity currently leased to data broadcasters and 25 per cent of capacity currently leased to radio broadcasters. Further, ITV is not active downstream so the merger does not alter ITV's incentives to continue supplying capacity downstream to those customers.

Multiplex capacity for pay-TV broadcasters

16. The parties' control at least 50 per cent of the supply of capacity to pay-TV broadcasters. With Channel 4 having chosen to use all its capacity on Multiplex 2 for its own channels, in effect only Five will provide an alternative. However, third parties were not concerned about this aspect of the merger and in the event that ITV did seek to raise price, other multiplex licences could be amended to allow them to carry pay-TV.

Multiplex capacity for TV broadcasters

17. Although ITV now controls the licences for both Multiplex A and Multiplex 2 it does not have the right to lease all the capacity on those multiplexes due to the control over capacity held by Five, Channel 4 and S4C as noted above. Taking this into account, ITV controls about 30 per cent of streams. However, the number of streams available for lease to third parties competing with ITV channels downstream for TV advertising revenue is realistically going to be smaller. The BBC cannot lease capacity on Multiplex 1 and has chosen not to on Multiplex B. Similarly ITV and Channel 4 have chosen to use all the capacity on Multiplex A for their own channels. In addition Five must use one stream on multiplex A to simulcast the analogue channel Five. Removing all those streams from consideration still leaves ITV with about 30 per cent of DTT multiplex capacity for TV broadcasters, although it would now only face competition from two (Five and Crown Castle) rather than four licensees (adding Channel 4 and the BBC). However share of supply is calculated, Crown Castle is the largest rival with 30-50 per cent of capacity and the other three suppliers are all of a similar size to ITV. As previously stated relative shares are unlikely to change significantly prior to the introduction of new capacity until 2012.

18. Despite this relatively low share of supply figure third parties raised concerns arising out of ITV's downstream position in the supply of airtime for television advertising. These are grouped into two main areas: a) foreclosure of multiplex capacity to competitors for the supply of airtime for television advertising; and, b) unilateral effect in the supply of multiplex capacity.

Foreclosure

19. ITV has publicly stated that it acquired SDN to gain a revenue stream from the leased capacity and to gain access to capacity for its channels from 2010. Third party concern is that when the current long term contracts for the streams which ITV controls on Multiplex A expire, ITV will then either use the streams for its own channels or allocate them solely for shopping or pay-TV channels that carry very little advertising. The result will be a reduction in the number of TV channels competing with ITV channels downstream. This third party concern would be magnified if Five follows suit when contracts expire on its half of Multiplex A and as the importance of DTT as a means for advertisers to reach viewers increases. This may allow ITV to bolster its position as the leading provider of airtime for television advertising as ITV1 continues to lose share. In other words third parties have suggested that, post merger, ITV would have the ability and incentive to foreclose rival TV broadcasters from access to DTT streams on its multiplexes. The incentive is said to arise because the income foregone from leasing (some or all) capacity to third parties would be outweighed by the higher prices ITV will be able to charge in the downstream market for the supply of TV advertising airtime having disadvantaged its rivals in that market.

20. Assessment of this theory of harm is complicated by assessment far in advance of any resulting changes in commercial conduct, in an industry that is as rapidly evolving as digital broadcasting and advertising, and with the uncertainties of the impact of digital switchover. However, taking the sum of the following factors into account the OFT does not consider there to be a realistic prospect of a substantial lessening of competition.

- Only 30 per cent of DTT multiplex capacity for TV broadcasters would be foreclosed. In such circumstances, downstream rivals would still be able to compete with ITV channels for TV advertising revenue with the channels already carried on the remaining 70 per cent of DTT multiplex capacity leased to third parties by Crown Castle and Five. Competition for advertising revenue would also remain from the other two vertically integrated broadcasters who control multiplex capacity which they supply to their own channels, namely the Channel 4 and Five channels.

- The loss of the channels currently carried on that 30 per cent of capacity would represent a very small reduction in actual competition for airtime for TV advertising. Most are shopping channels that do not carry advertising and only one is a pay-TV channel that has limited advertising revenue.

- The impact on potential competition, in the form of channels with greater advertising revenue that may replace the existing channels in 2010, may be greater. However, even the top 5 channels on DTT (excluding the simulcasts of ITV1, Channel 4 and Five from analogue TV) only account for a 7 per cent share of commercial impacts (an impact being one viewer watching one advert once) and two of those are ITV channels.

- Substantial amounts of new capacity, at least as much as ITV gains control of on Multiplex A, will become available with digital switchover and may be further supplemented by advances in encoding technology. This is expected to occur within a couple of years of ITV gaining access to the capacity on Multiplex A.

- Any channel unable to gain access to DTT in 2010 would be able to continue to trade on cable and satellite until new capacity was created.

- This is a regulated sector. The Communications Act 2003 already prohibits the licensee of Multiplex A from acting in a manner which prejudices fair and effective competition or engaging in undue discrimination. ITV has agreed with Ofcom to add a clause requiring allocation on a fair, reasonable and non-discriminatory basis to the license, which mirrors that in the licences for Multiplexes B, C and D. The license may be further modified when it is renewed in 2010.

- Advertisers did not express concern about foreclosure but of conditional selling of new ITV channels with existing channels. Such behaviour is prohibited and Ofcom investigates complaints about any such conduct.

Unilateral effect

21. If ITV does not lease the capacity on Multiplex A to third party channels, and if Five follows suit for its streams, only Crown Castle will be able to supply capacity to such channels. Crown Castle might then unilaterally raise price. This position may not be offset by the increase in capacity resulting from digital switchover as most of the increased capacity on existing multiplexes would be generated by Multiplex C and D switching to 64QAM transmission.

22. However, it appears that ITV and Crown Castle would constrain each other little in the sale of multiplex capacity. The use of long term contracts and the differing dates for licence renewal means that there is a gap of several years between when ITV and Crown Castle capacity becomes available. If, in the absence of temporal competition, a customer for DTT multiplex capacity attempts to use the threat of switching to ITV in negotiating with Crown Castle (or vice versa) it is unlikely to be an effective threat. Such a customer would likely face substantial costs in switching, as advertising or subscription revenue would be foregone by not having the channel on DTT for a period of years. The presence of such costs are likely to mute any prospects for demand side switching and the level of demand for DTT multiplex capacity means that the supplier is unlikely to face a similar loss of revenue. In these circumstances any expected reduction in competition caused by the withdrawal of ITV's capacity cannot realistically be characterised as substantial.

THIRD PARTY VIEWS

23. Most third party customers for multiplex capacity were concerned about ensuring fair access to capacity on Multiplex A and that failure to ensure such access may have competition implications downstream. However, downstream advertisers did not share the concern over foreclosure. Ofcom was not concerned by the merger and believed that even if issues arose, they could be dealt with by regulation.

ASSESSMENT

24. The parties overlap in the ownership of DTT multiplex licences and the supply of multiplex capacity and related technical services.

25. Post-merger ITV will account for some 30 per cent of capacity for TV broadcasters and at least 50 per cent of capacity available for pay-TV. Pay-TV operators were not concerned about ITV's position with regards to capacity for pay-TV. However, as ITV is a vertically integrated broadcaster and supplier of airtime for TV advertising in competition for advertising revenue with many potential customers for its multiplex capacity, most third parties did express concern. This took the form of a fear that ITV would unfairly allocate capacity to foreclose access to rivals to lessen competition substantially in TV advertising and that the remaining supplier would then be able to raise price unilaterally.

26. In relation to the foreclosure concern, the theory is that ITV would use capacity for its own channels or for channels that do not carry advertising. As this could not occur until around 2010, when existing fixed price contracts expire ahead of licence renewal, it is difficult to predict the impact. However, a number of factors taken collectively indicate that a substantial lessening of competition is not a realistic prospect.

27. Firstly ITV channels still face competition from the channels broadcast on the remaining 70 per cent of capacity and from Channel 4 and Five who use their own capacity. The channels that currently use capacity leased from ITV are weak competitors to ITV channels in the supply of TV advertising airtime as they carry very little, if any, advertising. In other words, the merger does not materially affect ITV's incentives to engage in the mooted foreclosure strategy because of the weak constraint represented by the current mix of customers in the downstream supply of TV advertising airtime.

28. Even if the current channels were replaced after 2010, these potential competitors may well not prove substantial competitive constraints given the limited number of channels that can be carried on ITV's capacity and even the strongest of the existing channels competing with ITV channels on DTT have a very small share of supply of commercial impacts. If these competing channels are unable to gain access to DTT they can broadcast on satellite and cable until the substantial new capacity on DTT arrives with digital switch over, which is expected in 2012. Potential customers for ITV's multiplex capacity may also have a degree of security in the existing regulations enforced by

Ofcom, which may be supplemented by 2010. Finally the advertisers who buy airtime on ITV channels did not share concerns about foreclosure.

29. If ITV and Five withdraw their DTT multiplex capacity on Multiplex A from the market, concern was expressed that Crown Castle could raise price unilaterally for Multiplexes C and D. However, it appears that capacity on Multiplex A and Multiplexes C and D does not become available for lease in the same year due to differences in licence renewal dates and existing long-term contract length. As such customers cannot effectively use the threat of switching from one to the other without incurring substantial costs in the form of revenue forgone while the channel is not broadcast on DTT. High level of demand for limited DTT multiplex capacity means that multiplex licensee will not be left without revenue from letting the capacity or using it for its own channels.

30. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

31. This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.