OFFICE OF FAIR TRADING

Anticipated acquisition by BSkyB Broadband Services Limited of Easynet group plc

The OFT's decision on reference under section 33(1) given on 30 December 2005. Full text of decision published on 13 January 2006.

Please note that square brackets indicate information excised for reasons of commercial confidentiality.

PARTIES

1. **BSkyB Broadband Services Limited** is a wholly-owned subsidiary of **British Sky Broadcasting Group plc (BSkyB)**. BSkyB is a holding company for a number of subsidiaries whose main activities relate to television broadcasting and retailing in the UK and Ireland, including: the creation of channels; the wholesale supply of channels to closed-access cable operators; and the retail distribution of channels via Direct-to-Home (DTH) and digital-subscriber-line (DSL) services.

2. **Easynet Group plc (Easynet)** is a pan-European broadband company offering wholesale and retail broadband internet access services via DSL, as well as business data communications services. In the UK Easynet operate DSL through local loop unbundling (LLU[1]), covering 18 per cent of UK homes. It offers retail and wholesale broadband Internet access services; retail narrowband Internet services; IT services; and business data communications services. Easynet's UK turnover in the year ending 31 December 2004 was £77.73 million.

TRANSACTION

3. On 21 October 2005, BSkyB Broadband Services Limited announced a recommended cash offer to acquire the entire issued and to be issued share of capital of Easynet.

[1] LLU allows a competitor to lease the copper wire infrastructure that runs from BT's local exchange building to a customer's premise, and to attach its own telecommunications equipment to that wire.

4. The parties notified on 28 October 2005. The 40 day administrative deadline is 23 December 2005.

JURISDICTION

5. As a result of this transaction BSkyB and Easynet will cease to be distinct. The UK turnover of Easynet exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

RELEVANT MARKET

Product market

6. The parties overlap horizontally only in (i) the provision of website design, hosting management and maintenance services; and (ii) the sale of on-line advertising. In both of these areas, the parties' combined shares of supply are less than 5 per cent and no third parties raised concerns. Accordingly these are not looked at any further.

7. Third parties have raised vertical concerns in relation to pay-TV content and 'triple play' services. It is therefore necessary to consider these further.

8. The supply chain in pay-TV has a number of levels. At the 'upstream' level are programme inputs such as content rights. Programme producers use content rights to create programmes that are sold to channel providers, who in turn combine programmes with other inputs to produce channels to sell to distributors. Distributors often bundle channels together into packages and retail these packages to the final consumer via distribution systems capable of supporting pay TV - Direct to Home satellite (Sky offers DTH), cable (as offered by NTL and Telewest), Digital Terrestrial TV (which carries Top-Up TV) and DSL (currently only offered by HomeChoice and Kingston Communications).

9. Previous OFT decisions[2] have considered the provision of premium channels (such as Premier League football and first run movies) and non-premium channels separately. We have received no evidence to suggest a different conclusion in this case.

[2] Decision of the Director General of Fair Trading, No CA98/20/2002 - BSkyB investigation: alleged infringement of the Chapter II prohibition, 12 December 2002.

10. Channel distribution has traditionally been divided in to pay and free to air based upon the means of access (e.g. Competition Commission report on the proposed acquisition by NTL Incorporated of Cable and Wireless Communications Limited, March 2000). The parties argue that there is no separate market for pay TV services, which form part of a wider market for the provision of multi-channel television services, following the launch of Freeview and freesat from Sky. Third parties (including Ofcom) were generally unable to offer evidence on the extent of competition between services such as Freeview and basic cable and DTH packages. However, given that the competitive assessment does not depend on the frame of reference, this question is left open.

11. Triple play services involve the supply of voice, data and TV as a one-stop service to consumers with integrated billing, customer care, etc. From the supplier's perspective, they appear to reduce customer churn. Triple play services may be provided over cable or DSL networks[3] but cannot be provided via satellite. As cable networks are not obliged to provide access, the most realistic entry strategy for Sky is to provide triple play over a DSL network using LLU.[4] Around a 1000 exchanges would be needed to reach 60 per cent of UK homes. Easynet currently has about 230 exchanges, with Bulldog nearly twice that size and Homechoice half that size.

12. Sky maintains the provision of triple play services is not a relevant frame of reference as competition exists for each of the separate components of a triple play offering and customers continue to make purchasing decisions by comparing the relative value of the bundle and the individual components. Some providers only offer two of the services (e.g., BT and Sky). Although convergence of the three services is increasing, it is the view of Ofcom that it is not yet a relevant frame of reference. Although the following analyses the impact of the transaction with respect to voice, data and TV individually and combined, the ultimate decision does not turn on this issue.

Geographic market

13. Despite the geographic limitation of some of the providers e.g., cable networks, all the services under consideration are provided and priced on a national basis. Accordingly the merger is considered within a national frame of reference.

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[3] DSL technology is currently the most common type of broadband technology in the UK, used to provide digital services to the homes of subscribers via the analogue telephone line provided by BT. Under the Communications Act, BT is required to provide access to telephone lines through a process known as local loop unbundling (LLU). It is sometimes called interactive broadband.

[4] The alternative of using BT wholesale products severely limits the capacity available for TV services.

HORIZONTAL ISSUES

14. As noted there is a minimal horizontal overlap and so actual competition is not considered further.

15. It was suggested by third parties that the merger led to a lessening of potential competition as Easynet and Sky could separately become DSL providers of triple play. However, there are larger DSL internet and telephony providers such as Cable and Wireless, a dominant telecommunications operator in the form of BT, an existing triple play provider in Home Choice and a number of others who have announced the provision of service; at the same time, there was insufficient evidence to suggest that potential entry into triple play by both parties would materially increase competition. Given the evidence before the OFT it is unduly speculative to characterise the loss of this potential competition - if indeed lost - as amounting to a realistic prospect of a substantial lessening of competition.

NON-HORIZONTAL ISSUES

16. The parties claim that the rationale for the merger is to be able to offer a triple play service to rival the cable operators more quickly than would be possible through developing its own network. A merger of complementary, rather than competing, services rarely leads to a substantial lessening of competition solely as a result of its conglomerate effects. On one hand, it does not eliminate any direct competition between the parties while on the other hand offers the consumer potential benefits such as improved service.[5] There is, therefore, a readily identifiable pro-competitive motive to this transaction. However, where market power exists at one level of the supply chain, consideration must be given as to whether the merger results in an enhancement of the ability and incentive of the merged entity to exploit that market power.

17. A number of competitors have raised concerns which derive from Sky's market power in the supply of, and possibly the purchasing of, content for pay-TV. A rival to Sky using DSL as its delivery or distribution mechanism clearly requires competitive content to be a credible TV rival. Two theories of harm arise, both of which posit Sky seeking to constrain the emergence of DSL as a significant competitor to its pay-TV service by foreclosing access to content to rivals employing DSL to compete with Sky. The first theory assumes that Sky will deny access to, or raise the cost of, its premium channels for competitors. The second theory is that Sky will use its buyer power to require third party channel providers with popular channels to give Sky exclusive rights for its own DSL network and that it will enforce exclusivity where such terms have already been negotiated. In respect of both theories, Sky's posited aim is to foreclose 'must-have' content to

emerging competitors and this will be reinforced by the use of a bundled triple play offering priced to consumers at a discount to rival triple play offers.

18. The relevant counterfactual rests on the fact that Sky has already been found to be dominant in the provision of premium channels[6] (and no evidence has been put to us that this position has changed) and that it is already the largest purchaser, as well as a significant producer, of non-premium channels. The proper ambit of merger control under the Act focuses on the material effects of - or material changes brought about by the merger. The OFT has a duty to refer only in respect of a substantial lessening of competition that arises from the merger (as demonstrated by the language of causation in s 33 of the Act and its reference to merger situations that 'result in' a SLC.) The issue, therefore, is not the state of competition based on issues that predate the merger, such as any refusal by Sky to supply its channels on a wholesale basis. Rather, the issue is whether the merger itself causes a substantial lessening of the degree of competition already present in the market. Here, the question is whether the merger itself creates or substantially strengthens Sky's ability and incentive to exploit its market power to foreclose rivals and thereby ultimately harm consumers of pay-TV.

Premium channels

19. The significance of foreclosing premium content to rival suppliers of triple play services is based on the assumption that the sale of triple play is driven by offering pay-TV and premium channels, rather than by offering broadband access, as has been suggested by some third parties. However, assuming that premium channels are a key driver of triple play, it has already been noted that Sky has the ability to foreclose its premium channels and that it already differentiates between cable operators and other competitors by providing only the former with a wholesale deal. Although the OFT decision found that Sky had not abused its dominant position through pricing (margin squeeze) or bundling, it does set out limits as to what Sky can do in supplying third parties. As Easynet has no premium content and given the lack of evidence that it would have developed a position in this area absent the merger, Sky's position in the provision of premium content is not altered by the merger.

20. Third parties initially assumed that Sky would be motivated to foreclose premium content by the extra revenue that could result. However, Sky's incentives are not changed by the merger as there is only one monopoly profit to be made from its position in premium channels and the incentive for it to maximise revenue is not

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[5] See OFT Substantive Assessment Guidance, Ch. 6.

[6] Decision of the Director General of Fair Trading, No CA98/20/2002 - BSkyB investigation: alleged infringement of the Chapter II prohibition, 12 December 2002.

enhanced through acquiring Easynet. Pre-merger, Sky extracted a monopoly profit from its premium channels through a strategy of widespread distribution. DSL will increase those to whom it can sell premium channels. The monopoly profit would not increase if Sky chose to limit distribution.

21. There are circumstances where the one monopoly profit argument will not hold. Accordingly, this critique of the foreclosure theories raised was put back to third parties. Their advisors then suggested Sky's incentive to foreclose premium content (or non-premium content as discussed below) was to sacrifice the ability to profit maximise in the short term so as to prevent a potential increase in its cost in the long term. It was alleged that Sky feared the emergence of pay-TV operators to compete against Sky's pay-TV operation in bidding for premium content and that it saw DSL operators as providing a sufficient challenge to do so.

22. In examining the robustness of this cost of content motivation we asked the concerned third parties to provide internal documentation supporting their concerns and their own assessment of the likelihood of them becoming vertically integrated content providers. In the context of this question and of responses to the NTL/Telewest merger investigation, third parties who were not already present upstream either ruled themselves out of being able to provide their own premium channels by bidding against Sky for rights or had no documented plans to do so. This suggests that Sky was unlikely to consider them a threat. No evidence was forthcoming to support the contrary position.

23. Sky's internal documents seen by the OFT did not identify the concerned parties as potentially significant competitors in bidding for content but it does regard all the existing channel providers, channel distributors and potential entrants (such as telecommunications firms) as competing bidders. It did, however, state in a competitor assessment (that had been undertaken separately from the merger) and in relation to one third party (who did not raise this issue) that if in the longer term DSL emerged as a serious competitor it may bid for content and that this would be best addressed by [ ]. It did not propose exclusivity or increased pricing for premium content as a mechanism for doing so, however.

24. Neither the ability nor incentive of Sky to operate the first theory of harm is substantially increased by the merger. On the revised version of the theory of harm, relating to an incentive to defend content costs, the absence of evidence that the complainants saw themselves as likely to successfully bid for premium content undermines the theory that such a concern provides an added incentive to foreclose premium content.

Third party non-premium content

25. The concern expressed by third parties was that Sky's buyer power (as the pay-TV broadcaster with access to the largest number of homes and the largest capacity for carrying channels) could be used to foreclose access to this content for competing DSL operators. This would be implemented by insisting on or paying a premium for exclusivity or right of first refusal on a number of channels, in particular the most popular ones.

26. Third parties believed that Sky already had some ability to foreclose as they understood there are clauses in several contracts with third party providers that provided for exclusivity or preference to Sky for DSL rights. If so, Sky could already have the ability to foreclose those channels irrespective of the merger. However, it was alleged that the ability to use those clauses would be increased by the acquisition of a DSL network, because Sky would have to have a DSL network on which to carry the channels to trigger the clauses. A third party also suggested that attempts to enforce exclusivity in the absence of such a network would constitute a breach of Chapter I of the Competition Act 1998 (CA98) or Article 81 of the EC Treaty.

27. Such agreements exist in relation to about a third of Sky's channel providers. Although this includes several of the most popular channels, several of those expire by the end of this year and some only apply to the Kingston upon Hull area. Sky has stated it no longer seeks such clauses, nor has it done so for more than 12 months, and its internal documents do not suggest a business strategy based on such exclusivity. It states that these clauses were originally included in long-term agreements as Sky was aiming to sell a retail package of channels on DSL when Kingston Communications launched the first DSL service. Subsequently, if others have refused to enter into such an arrangement, Sky has waived the clauses in relation to third party channels. Whilst Sky may re-instate the clauses in future contracts, such agreements can be scrutinised under CA98 and Ofcom has informed us that this is an area it will subject to scrutiny. If Sky chose to exercise the existing contracts, competitors still have the choice of many non-premium channels which are unaffected, including some of the most popular. In addition, some DSL providers have chosen to offer a premium only service combined with the existing Freeview channels.

28. We also asked content providers for their view, in particular in relation to how the merger would alter their bargaining position with Sky, and none raised concerns.

29. Even assuming Sky has the ability to foreclose third party non-premium channels and that its ability is increased by the acquisition of its own DSL platform strengthening the enforceability of its exclusivity clauses, its incentive to foreclose

remains unchanged by the merger. Sky could extract the monopoly profit from its exclusive DSL rights by selling these rights on to DSL platform providers. As discussed in relation to premium content there was no evidence to support the theory that Sky would have the incentive of preventing the emergence of extra competition for non-premium content.

Bundling

30. Third parties also suggested that the addition of internet services with Easynet increased the ability and incentive of Sky to foreclose all three triple play services by using bundling and mixed bundling to leverage its position in pay-TV in to the internet and telephony.

31. The merger does change Sky's ability to bundle, as previously it only offered pay-TV and telephony (via Skytalk). Third parties were concerned that Sky could tip the market to triple play to allow it to exploit its dominant position in pay-TV. In this theory it would only offer its TV services on DSL as part of bundle to capture those motivated by premium channels. It could capture those motivated by non-premium channels through foreclosing from competitors the third party non-premium channels they needed to attract those customers only wanting more basic channels. By discounting triple play to the same level of its competitors it would also attract some of those only motivated by telephony or broadband as they would be getting pay-TV for no extra cost.

32. In terms of incentive, Sky would have to pay a premium in order to secure exclusivity on DSL and the merger would allow Sky to spread that premium across all three services. This would only provide an increased incentive if Sky can make reasonable margins in broadband and telephony, as otherwise the incentive would remain the same as pre-merger, namely to maximise return from pay-TV. Sky's internal documents cast doubt on the availability of sufficient margins. First, [ ] Second, [ ].

33. In addition such a bundling strategy would fail to profit-maximise in any service, as it would simply be moving part of the [ ] from pay-TV to the [ ] internet and telephony. In order to raise price in the long term Sky would have to ensure DSL rivals were unable to re-enter from their existing internet and telephony platforms once Sky raised its price. This would need to be done by migrating customers from Sky DTH to Sky DSL so as to prevent them switching back to an unbundled Sky DTH service with third party telephony and internet, where Sky faces competition from strong competitors such as the incumbent telcos. To do so would require substantial investment in DSL infrastructure given the size of Sky's DTH coverage. One third party suggested this may be achieved by refusing to sell DTH or price-discriminating in areas where its DSL service was available. Even if

this were a profitable strategy, given the loss of those customers not seeking triple play at all and Sky's belief that [ ] of its pay-TV customers will be triple play consumers, its business plans [ ] are not predicated on such a migration strategy.

Collusion

34. It should also be noted that some third parties believed that the merger increased the ability and incentive of Sky and the cable companies to collude in the theories of harm set out above so as to prevent entry or expansion by DSL. However, to the extent that incentive exists pre-merger, it is not materially increased as a result of Sky's acquisition of one DSL provider.

Conclusion

35. Given the potential efficiencies of vertical and conglomerate mergers and the speculative nature of any consideration of the development of a new technology such as DSL, the OFT requires sufficiently strong evidence to support the non-horizontal theories of harm set out by third parties. The test for reference is not met on the basis of mere suspicion, but based only on a positive belief objectively justified by relevant facts. Here, the evidentiary base supporting the theories is thin, rendering the theories speculative. In particular, no competitor produced documents setting out the impact of the merger upon their DSL plans to support their arguments. Similarly, on an issue which they have had longer to consider, all but one competitor has refused to provide documents on how they planned to deal with Sky's dominance in premium content. [ ] On the other hand, Sky's internal documents do not support the theory.

36. Sky's ability and incentive with regard to premium content is not changed as it has already been found dominant and - absent evidence to suggest that this situation does not apply here as it can, in the circumstances of this supply chain, extract its monopoly profit only once. Sky does not appear to regard DSL as a significant threat to its bidding position for content. Similarly, its incentive to foreclose third party non-premium content is not changed by the merger, and any ability thorough exclusivity clauses are not caused by the merger. The bundling hypothesis does not establish that the merger strengthen Sky's relevant incentives. This is not supported by its business plans, nor did any internal document suggest an anti-competitive rationale for the merger.

THIRD PARTY VIEWS

37. A number of third parties expressed concerns about the merger as set out above. These are actual or potential competitors to Sky. Ofcom has also given its view on the merger, stating that [its stakeholders have raised a number] of potential competition problems relating to Sky's potential ability to wield vertical or horizontal leverage, particularly as a result of holding the rights to certain types of premium content, [both in connection to the merger and more widely. However, it thinks] that these issues exist independently of the proposed acquisition, and that the acquisition in itself does not increase potential competition problems.

ASSESSMENT

38. Sky will through the merger acquire a position in DSL more speedily than via organic growth and facilitate its provision of triple play services in competition with other providers, from which consumers may benefit. At the same time, the merger raises no horizontal issues as the competition between the parties is insignificant.

39. The focus of the OFT's merger assessment is to consider the impact of the merger, rather than to analyse more broadly whether the relevant markets are working well for a competition standpoint; the latter is the domain of CA98 and other enforcement mechanisms. Third parties have understandably raised foreclosure concerns given Sky's market power in premium content provision and its significant buyer power in non-premium content. However, Sky already has the ability to foreclose DSL rivals and the merger does not materially heighten its incentives to do so. In short, the OFT does not believe that consumers would be significantly worse off as a result of any foreclosure effects that might be attributable to the merger.

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

DECISION

41. This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.