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## Competition Act 1998

### Decision of the Office of Fair Trading under section 47 relating to decision CA98/20/2002: alleged infringement of the Chapter II prohibition by BSkyB

29 July 2003

Non-confidential version\*

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On 17 December 2002, the Director General of Fair Trading, following investigation under the Competition Act 1998, decided that there were insufficient grounds to find that British Sky Broadcasting Limited had abused a dominant position by exercising a margin squeeze on distributors of its premium channels, or by offering those channels in mixed bundles, and that it had not infringed the Chapter II prohibition by offering certain discounts with regards to those premium channels.

The Office of Fair Trading, which succeeded the Director General of Fair Trading on 1 April 2003, now rejects two applications to vary that decision.

\* Confidential information and data have been redacted. Redactions are indicated by '[...]', or by italic text in square brackets e.g., '*more than 10%*'.

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## **PART ONE    INTRODUCTION**

### **I.        PROCEDURE**

1.        On 17 December 2002, the Director General of Fair Trading (the 'Director') issued decision CA98/20/2002 (the 'Decision'). He found that British Sky Broadcasting Limited ('BSkyB') was dominant within the meaning of the Chapter II prohibition of the Competition Act 1998 (the 'Act') on two markets, namely the wholesale provision of TV channels carrying sports content that will only appear on premium pay TV sports channels (then identified as live Football Association Premier League football) and premium pay TV film channels.
2.        He considered that there were insufficient grounds to find that BSkyB had abused its dominant position by exercising a margin squeeze on its premium channel distributors, or by practising anticompetitive mixed bundling in the wholesale provision of such channels. He further considered that BSkyB had not infringed the Chapter II prohibition by offering the discounts set out in its Pay to Basic or Premium Pay Unit ratecards.
3.        This decision relates to two separate applications under section 47(1) of the Act, for the Director to vary the Decision, made by ONdigital 1998 plc (in Liquidation), formerly ITVDigital plc, ('ONdigital') on 28 February 2003 (the 'ONdigital Application') and by ntl Group Limited ('NTL') also on 28 February 2003 (the 'NTL Application', each an 'Applicant', together the 'Applicants'). The Applicants requested the Director to vary the Decision to find that BSkyB had infringed the Chapter II prohibition.
4.        BSkyB made submissions on the applications on 9 and 16 April 2003, to which the Applicants subsequently responded.
5.        The Office of Fair Trading (the 'OFT') has assessed both applications together in this decision, given their similarity.
6.        This decision should be read in conjunction with the Decision, which is hereby incorporated by reference, and terms used in this decision have the meaning ascribed in the Decision.<sup>1</sup>

### **II.       THE APPLICANTS**

7.        The OFT has considered whether each Applicant has sufficient interest in the Decision to make an application under section 47 of the Act.

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<sup>1</sup> For simplicity, references hereafter are to the 'OFT', which came into existence on 1 April 2003, replacing the Director (and the term OFT includes the Director, where appropriate); to 'ONdigital' (notwithstanding its trading at times under the name ITV Digital); and to 'ITV Sport' (notwithstanding that this premium sports channel was marketed for a while as ONsport).

**1. NTL**

8. NTL stated that it is directly and immediately affected by the OFT's conclusion that there were insufficient grounds to find an anticompetitive margin squeeze or anticompetitive mixed bundling, in that it is: (i) a distributor of, among others, BSkyB's pay TV channels containing unique to premium pay TV content (in which BSkyB was found by the OFT to be dominant); and (ii) a direct competitor of BSkyB's own retail distribution arm, referred to in the Decision as 'DisCo'.<sup>2</sup>
9. NTL stated that that the wholesale prices NTL pays to BSkyB under BSkyB's rate card represented a significant share of NTL's TV-related direct costs during 2001, in particular of its premium customer-related costs. They are key to determining the ability of NTL to compete with BSkyB at the retail level. NTL provided information and evidence to the OFT throughout the course of its investigation under the Act.<sup>3</sup>
10. The OFT accepts that NTL has sufficient interest in the Decision for the purposes of section 47 of the Act.

**2. ONdigital**

11. ONdigital was established as a joint venture between the commercial television companies Granada plc and Carlton Communications plc (CCM) and existed as a wholly-owned subsidiary of ITV Holdings Plc, itself jointly owned by Carlton and Granada.<sup>4</sup> The holding company was incorporated on 9 October 1996 and ITV Digital Plc on 15 January 1997. On 19 September 1997, ONdigital was awarded a digital terrestrial television ('DTT') broadcasting licence by the Independent Television Commission ('ITC'). The company commenced its DTT service in November 1998 under the brand name 'ONdigital'. The service was re-branded as ITV Digital in July 2001.
12. ONdigital was a distributor of BSkyB branded channels, including the premium channels that were the main subject of the OFT's investigation. It ceased broadcasting on 1 May 2002 and was formally placed into creditors' voluntary liquidation on 18 October 2002 by way of a resolution authorising the appointment of the liquidators.<sup>5</sup>
13. ONdigital participated throughout the OFT's investigation and made various submissions during the course of that investigation.
14. Although ONdigital is no longer a going concern, ONdigital stated that the impact of BSkyB's conduct was such that the company in liquidation may have claims for damages against BSkyB, for the benefit of its shareholders and creditors, and that the liquidators of the insolvent

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<sup>2</sup> NTL Application, paragraph 5.

<sup>3</sup> NTL Application, paragraphs 6,7.

<sup>4</sup> ONdigital Application, paragraph 2.1.

<sup>5</sup> ONdigital Application, paragraph 2.2.

company have an obligation to pursue such action as may lead to the recovery of funds. Such damages may stem from an anticompetitive margin squeeze, mixed bundling, and more broadly from the destruction of shareholder value (in effect ONdigital), and the loss of future profits had ONdigital been able to remain a going concern.<sup>6</sup> Further, ONdigital has an interest in determining the extent to which its liability to BSKyB, its largest creditor, is based on a lawful claim. The real net value of that claim can only be assessed once the lawfulness of BSKyB's pricing practices under the Act has been established.<sup>7</sup>

15. The OFT accepts that ONdigital has sufficient interest in the Decision for the purposes of section 47 of the Act.

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<sup>6</sup> ONdigital Application, paragraph 2.3; letter from Denton Wilde Sapte dated 25 March 2003.

<sup>7</sup> Letter from Denton Wilde Sapte dated 25 March 2003 (sent 28 March 2003).

## **PART TWO    MARGIN SQUEEZE**

16. The Applicants considered that the Decision, with regards to margin squeeze, should be varied for the following reasons:<sup>8</sup>
- (i) The model used by the OFT to determine DisCo's profitability is not robust. The Applicants therefore consider DisCo's profitability set out in the Decision to be significantly overstated.
  - (ii) The return that the OFT specified that DisCo needed to earn for BSKyB to avoid margin squeeze is too low.
  - (iii) In forming its conclusions on margin squeeze, the OFT explicitly took into account a period of apparent profitability outside the period of the investigation.<sup>9</sup>
  - (iv) ONdigital stated that the OFT failed to consider the effect of the margin squeeze identified in the Decision on the downstream market.<sup>10</sup>
17. The arguments made by the Applicants are considered in detail below. The OFT notes at the outset, however, that determining the issue of margin squeeze in respect of BSKyB's wholesale provision of its premium channels required detailed assessment of the costs and revenues that BSKyB incurred in distributing such channels. This was complicated by BSKyB's provision of several services via the same distribution platform, including premium and basic channels, PPV services, as well as interactive services. Several costs were common across services while certain revenues were bundled.
18. Further, during the period analysed, BSKyB was launching its digital platform and therefore incurring costs acquiring and transitioning customers from its analogue platform, and the OFT sought to take account of such high, but temporary, expenditure.
19. The OFT had to make many decisions and assumptions (set out in Part Eleven of the Decision) in constructing its model. Even the fairest and most objective modelling assumptions necessarily involve an irreducible element of uncertainty. While alternative decisions and assumptions might be considered, the OFT is satisfied, in the round, that its model is robust.
20. According to its analysis, the OFT found losses during the period investigated, however, these were small and temporary, with BSKyB returning to profit by the end of the period for which data was available (June 2001). The OFT therefore decided, in all the circumstances, that there were insufficient grounds to find that BSKyB had infringed the

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<sup>8</sup> NTL Application, paragraph 11; ONdigital Application paragraph 3.1.1.

<sup>9</sup> NTL Application, paragraph 11, third bullet.

<sup>10</sup> ONdigital Application, paragraph 3.1.1, fourth bullet; section 3.4.

Chapter II prohibition by exercising a margin squeeze on NTL and ONdigital.

21. BSKyB made detailed submissions on the Applications (with respect to margin squeeze) on 9 April 2003. They are referred to where necessary.

#### I. THE ROBUSTNESS OF THE MODEL

22. The Decision determined whether BSKyB had exercised an anticompetitive margin squeeze by reference to the costs and revenues of BSKyB's own distribution business, grouped together and dubbed 'DisCo'.<sup>11</sup> The approach taken by the OFT to assess DisCo's profitability is set out in Part Eleven of the Decision.<sup>12</sup>
23. Since the Applicants did not have access to the commercially confidential data that the OFT required BSKyB to provide to determine the question of margin squeeze,<sup>13</sup> they have used BSKyB's audited financial reports and other public information concerning BSKyB to calculate DisCo's profitability.<sup>14</sup> Despite apparently '*following the [OFT]'s recommended treatment of revenue and expenditure*', the Applicants' calculations suggest that DisCo made significantly heavier losses than those calculated by the OFT.<sup>15</sup>
24. In the following sections, the OFT considers the Applicants' treatment of DisCo's costs.<sup>16</sup> For the reasons set out below, the OFT is satisfied that the Decision accurately reflects DisCo's profits and losses.

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<sup>11</sup> Decision, paragraphs 341-370, which set out the reasons for this approach.

<sup>12</sup> Neither Applicant challenged this approach, although they did urge consideration of effects on the relevant downstream market. See paragraphs 149-159.

<sup>13</sup> After careful consideration under sections 55 and 56 of the Act (since replaced by equivalent provisions of the Enterprise Act 2002), and since BSKyB declined to consent to disclosure under section 55(2), the OFT did not disclose the relevant data redacted from the published version of the Decision to NTL or ONdigital. Accordingly, the OFT has not provided a reconciliation of the results of its margin squeeze test to the public data available in BSKyB's Forms 20-F.

<sup>14</sup> Primarily BSKyB's Forms 20-F submitted to the US Securities and Exchange Commission for the periods ended 30 June 1998- 2002. BSKyB's Forms-20-F can be obtained at [www.sky.com/corporate](http://www.sky.com/corporate).

<sup>15</sup> NTL Application, paragraph 11; see also ONdigital Application, paragraph 3.2.5.

<sup>16</sup> They made no submissions regarding DisCo's revenues: see paragraph 138-139 regarding BSKyB's submissions on this.



## 1. Marketing costs

### 1.1 Modelling assumptions

#### 1.1.1 The Applicants' modelling assumptions

25. In their model of DisCo's profitability, the Applicants allocate all BSKyB's reported marketing expenditure entirely to DisCo.<sup>17</sup> They state that this treatment is '*following the [OFT]'s recommended allocation of BSKyB's expenditure'*.<sup>18</sup>

#### 1.1.2 The OFT's finding

26. In the Decision, the marketing expenditure disclosed in the Form 20-F was necessarily allocated between BroadCo,<sup>19</sup> DisCo and CACo.<sup>20</sup> As stated at Decision paragraph 494, only certain elements of BSKyB's marketing expenditure are attributable to DisCo. This 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'*. Annex 25 to the Decision provides greater detail of the marketing cost items allocated to DisCo and their treatment.

27. The Applicants have used marketing costs in their model, taken from BSKyB's Form-20 F, that include several items that either should not be allocated to DisCo, or that have been double-counted since such cost items were also included elsewhere in the Applicants' estimate of DisCo's cost base. For example, the marketing expenditure disclosed in BSKyB's Form 20-F includes set top box subsidy costs, which the Applicants have double-counted by also including DisCo's conditional access payments (designed themselves to contribute to the recovery of the set top box subsidy).<sup>21</sup>

28. This overstatement of DisCo's costs is offset to a degree by a further error in the Applicants' analysis, which relates to their necessary (absent a detailed breakdown of BSKyB's marketing expenditure) amortisation of all marketing expenditure. In fact, only customer acquisition and transition marketing expenditure (see Decision paragraphs 489-493) should be amortised, reflecting the ongoing benefits derived from such expenditure (see Decision paragraph 414).

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<sup>17</sup> ONdigital Application, footnote 33; NTL Application, appendix 1, footnote 9.

<sup>18</sup> ONdigital Application, paragraph 3.2.3; NTL Application, paragraph 14.

<sup>19</sup> i.e., BSKyB's channel provision business. In part, such BroadCo marketing costs were recovered from DisCo via BroadCo's wholesale channel charges.

<sup>20</sup> i.e., BSKyB's conditional access provision business. In part, such CACo marketing costs were recovered from DisCo via conditional access charges.

<sup>21</sup> The marketing costs referred to in BSKyB's Forms 20-F include set top box subsidy costs, costs associated with generic marketing of the digital platform, and an element of retail commissions paid irrespective of subscription to a BSKyB channel package. See BSKyB submission dated 9 April 2003, section 3.2.

## **1.2 Allocation of marketing expenditure**

### *1.2.1 The Applicants' submissions*

29. The Applicants were unclear how the marketing costs reported by BSkyB in its Forms 20-F reconcile to the marketing costs used in the Decision.<sup>22</sup> They requested clarification concerning the allocation of marketing expenditure between DisCo, BroadCo and CACo.<sup>23</sup> ONdigital '*would expect that only a small proportion of BSkyB's marketing costs as reported in Form 20-Fs relate to marketing of BSkyB channels*',<sup>24</sup> implying that only a small proportion of total marketing expenditure should be allocated to BroadCo in the Decision.

### *1.2.2 The OFT's finding*

30. Year by year, the marketing expenditure figure reported in BSkyB's Forms 20-F during the period analysed will not reconcile to the annual marketing costs adopted by the OFT (before their allocation between DisCo, BroadCo and CACo). Digital acquisition and transition marketing costs were expensed as incurred in the 'separated accounts'<sup>25</sup> (i.e., charged to the profit and loss account as incurred, as opposed to on an accrual basis). There are therefore no provisions or deferral accounting entries in the separated accounts for either of these two costs.
31. The Form 20-F figures do, however, include provisions for transitioning subscribers from the analogue to digital platforms.<sup>26</sup> The OFT amortised both the digital acquisition and transition marketing costs in its model (see Decision paragraphs 489 to 493).
32. A reconciliation is set out below outlining the difference between the reported BSkyB marketing expenditure and the marketing costs allocated between DisCo, BroadCo and CACo (the example is for July 1999 to June 2000):

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<sup>22</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.7; NTL submission dated 23 May 2003, page 7.

<sup>23</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.7; NTL submission dated 23 May 2003, page 7.

<sup>24</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.4.

<sup>25</sup> BSkyB undertook to provide separate accounts for its distribution business following the Director General's Review of BSkyB's position in the Wholesale Pay TV Market in December 1996. These are known as the 'separated accounts'. The OFT accepted that BSkyB need no longer observe such undertaking from 14 April 2001. See OFT PN 14a/01 dated 14 April 2001.

<sup>26</sup> As the Applicants note, BSkyB's Forms 20-F marketing figures now include set top box subsidies formerly incurred by BiB (BSkyB now owns 100% of BiB shares whereas its stake was only 32.5% before 9 May 2001). Such expenditure was not allocated to DisCo as all costs and revenues associated with BiB were excluded in the OFT's test (see Decision paragraph 431).

	£m
Marketing costs per BSkyB Group plc Report and Accounts	381.3
Telemarketing costs reclassified from Subscriber Related Costs <sup>27</sup>	[...]
Transition expenditure expensed	[...]
Marketing Costs as per Decision Annex 25, line 1 (i.e. before allocation and amortisation)	Total

*Source: Tab 10.9 of BSkyB submission dated 12 January 2001*

33. In the Decision (paragraphs 489-496), the marketing costs before allocation and amortisation (in the year ending 30 June 2000) were allocated between DisCo, BroadCo, CACo and other BSkyB entities in the following proportions:

BroadCo	4.7%
DisCo (prior to any amortisation)	37.1%
CACo	58.2%
Other	0%
Total	100%

*Source: Tab 10.9 of BSkyB submission dated 12 January 2001*

34. ONdigital's expectation that only a relatively small proportion of BSkyB's marketing expenditure is allocated to BroadCo is therefore correct, and was incorporated into the OFT's conclusions.

### **1.3 Acquisition marketing**

#### **1.3.1 The Applicants' submissions**

35. The Applicants have requested clarification of the treatment of BSkyB's subscriber acquisition costs ('SACs') which include set top box subsidy costs, retailer commissions and other subscriber acquisition marketing costs.<sup>28</sup>

'The OFT should clarify... whether all or only some of the SACs reported in BSkyB's Form 20-F are recovered through CACo and the CA charge, and if not all, should confirm that any costs not recovered in this way are attributed to DisCo, and capitalised and amortised over an appropriate period with an appropriate rate of return'.<sup>29</sup>

<sup>27</sup> See Annex 1, for an illustration of such cost items.

<sup>28</sup> ONdigital submission dated 16 May 2003, paragraph 2.2.11; NTL submission dated 23 May 2003, page 5.

<sup>29</sup> ONdigital submission dated 16 May 2003, paragraph 2.2.11.

### 1.3.2 *The OFT's finding*

36. The treatment of BSKyB's SACs differs depending on the cost item involved. Decision paragraph 489 states that whereas customer acquisition and transition marketing costs are allocated directly to DisCo,<sup>30</sup> the remaining subscriber acquisition costs are incurred by CACo before being recovered via CA charges:

'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'.<sup>31</sup>

37. As stated in Decision paragraphs 491-493, BSKyB's customer acquisition and transition costs are amortised over a 10-year period, using the reducing balance method.
38. The OFT does not consider that costs incurred by DisCo itself,<sup>32</sup> which must satisfy its own rate of return (see section II below), should additionally be assigned a rate of return as appears to be suggested by ONdigital.<sup>33</sup> Such a treatment would constitute double-counting of the required rate of return.

## 2. **Conditional access costs**

### 2.1 *The Applicants' submissions on the charges applied*

39. ONdigital has requested the OFT to clarify '*whether an appropriate adjustment was made to the costs attributed to DisCo for the difference between the indicative CA charges attributed and the CA charges used in the Decision*'.<sup>34</sup> The Applicants were concerned that, in assessing CACo's profitability, CACo was imputed charges incorporating the discounts achieved by certain CACo customers (including DisCo in the Decision, see below) from the charges set out in the indicative ratecard.<sup>35</sup>

### 2.2 *The OFT's finding*

40. As stated at Decision paragraph 470:

'The [OFT] has imputed as charges to DisCo the prices observed. Conditional Access payments for sports subscribers are as per the

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<sup>30</sup> which include DisCo's retailer commissions.

<sup>31</sup> Decision paragraph 489.

<sup>32</sup> As distinct from those incurred by CACo, for example.

<sup>33</sup> ONdigital submission dated 16 May 2003, paragraph 2.2.11.

<sup>34</sup> ONdigital submission dated 16 May 2003, paragraph 2.2.6.

<sup>35</sup> ONdigital submission dated 16 May 2003, paragraphs 2.2.4 to 2.2.6; NTL submission dated 23 May 2003, pages 3, 4.

indicative ratecard, whereas for non-sports subscribers a [small] discount is adopted'.

41. The OFT notes that in BSkyB's model of digital CA costs provided to OFTEL, entitled '*The profitability of SSSL's Digital Conditional Access Services*',

'large broadcasters, including BSkyB, pay less than [the] indicative charges as, typically, large broadcasters take SSSL's indicative charges as starting points in negotiations, and obtain discounts from these indicative charges'.<sup>36</sup>

42. The OFT has been consistent with this approach of applying the indicative charges, although imputing observed third party prices, rather than speculating on the likely outcome of a negotiation between DisCo and CACo. Accordingly, DisCo received the small discount that non-sports broadcasters had achieved (Decision paragraph 469), but since no such discount had been achieved by any sports channel broadcasters, no discount in broadcasting sports channels (Decision paragraph 468).

### **3. Construction of CA charges**

#### **3.1 *The Applicants' submissions***

43. The Applicants submitted various questions concerning the construction of the indicative ratecard for conditional access charges.<sup>37</sup>

#### **3.2 *The OFT's finding***

44. The conditional access charges imputed in the Decision are regulated by OFTEL to ensure that they are 'fair, reasonable and non-discriminatory',<sup>38</sup> and such charges have been applied in the OFT's model. See Decision paragraphs 463-470.

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<sup>36</sup> BSkyB's submission dated 26 October 2001, page 3. The discount applied to large broadcasters is equal to the discount applied with respect to non-sports subscribers in the OFT's model (see paragraph 40 above).

<sup>37</sup> ONdigital submission dated 16 May 2003, section 2.2; NTL's submission dated 23 May 2003, pages 2 to 5.

<sup>38</sup> 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>.

#### 4. Transmission costs

##### 4.1 Applicants' submissions

45. In their model of DisCo's profitability, the Applicants allocate transmission costs entirely to DisCo. They consider that such treatment is '*following the Director's recommended allocation of BSKyB's expenditure*'.<sup>39</sup>

46. Further, the Applicants have sought clarification of the treatment of certain elements of BSKyB's transmission expenditure.<sup>40</sup> ONdigital '*expects that the [OFT] has attributed BSKyB's transponder rental, transmission, and uplink costs, as reported in BSKyB's Form 20-F, to DisCo*'.<sup>41</sup>

##### 4.2 The OFT's finding

47. Transmission costs were allocated between BroadCo and DisCo:

'DisCo has been allocated the costs of uplinking and of BSKyB's transmission department, as well as [the relevant] transponder rental costs, as these are necessary to premium channel distribution. BroadCo has been allocated the cost of licence fees, creative services [...], studios and 'other technical operations'.<sup>42</sup>

48. Further, Annex 24 to the Decision identifies which transmission activities have been assigned to DisCo and which have been assigned to BroadCo, and reconciles these to the total transmission figure for BSKyB. Accordingly, it is inappropriate to allocate the transmission expenditure (or related overheads) entirely to DisCo.

49. Decision paragraph 483 states that:

'DisCo has been allocated the share of the transponders and parts of transponders that it uses. 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 typical average capacity requirement of channels on the transponder'.

50. The cost of transponder leasing with respect to third party channels was not allocated to DisCo where such channel providers pay to sub-lease the transponder capacity from BSKyB. Decision paragraph 484 states:

'Some of DisCo's transponders are sub-leased to third parties and DisCo receives revenue from this... Capacity trading is not a

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<sup>39</sup> NTL Application, paragraph 19; ONdigital Application, paragraph 3.2.17.

<sup>40</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.13; NTL submission dated 23 May 2003, pages 8, 9.

<sup>41</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.13.

<sup>42</sup> Decision paragraph 487.

function of distributing premium pay TV channels. DisCo may not and does not benefit from any third party transponder sub-lease revenues.'

51. With regard to the other cost items mentioned by ONdigital, 'uplink costs' are allocated to DisCo. With regard to 'transmission costs' as reported in BSKyB's Forms 20-F, the OFT reiterates that transmission costs have been allocated between DisCo and BroadCo (see paragraph 47 above).

## **5. Subscriber management costs**

### **5.1 The appropriate charges**

#### *5.1.1 The Applicants' submissions*

52. The Applicants considered that a possible reason for the significant discrepancy between their and the OFT's results is the treatment of subscriber management costs.<sup>43</sup> Both Applicants consider that a failure to reconcile the charges adopted in the indicative ratecard to the underlying costs may have resulted in an understatement of DisCo's cost base. *'Using the information reported directly in BSKyB's Form 20-F, NTL calculates that BSKyB's subscriber management costs would equate to approximately £4.10 per subscriber per month in the year ending 30 June 2001'*.<sup>44</sup>

#### *5.1.2 The OFT's finding*

53. The subscriber management cost figure quoted in BSKyB's Form 20-F does not correspond to that adopted in the margin squeeze test, since the cost categories referred to in the Form 20-F do not coincide with those used by the OFT in modelling DisCo's profitability. The OFT obtained a breakdown of the subscriber management figure for the year to 30 June 2000, which is quoted, for example, at page F-16 of the Form 20-F for the period ending 30 June 2001. Within this figure is the unsubsidised element of the 'free' set top boxes and smart card costs, both of which are charged to DisCo as part of conditional access payments (see paragraph 36 above).<sup>45</sup> Thus, the Applicants have double-counted by also including a separate estimation of DisCo's conditional access payments (designed themselves to recover the set top box cost).
54. Conditional access and subscriber management charges are designed to ensure that the associated costs are covered in the long term. With regard to subscriber management costs, Decision paragraph 458 states that

'the [OFT] has examined both analogue and digital charges to determine whether DisCo bears the cost of the subscriber

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<sup>43</sup> NTL Application, paragraph 23; ONdigital Application, paragraph 3.2.9.

<sup>44</sup> NTL Application, paragraph 24.

<sup>45</sup> BSKyB response dated 4 May 2001, Table 32.

management reasonably attributable to it. The [OFT] is satisfied that the charges B SkyB has proposed achieve that'.<sup>46</sup>

55. The cost items included under the heading 'subscriber management' in B SkyB's Forms 20-F, and their treatment in the Decision, are outlined at Annex 1.

## **5.2 The treatment of subscriber management cost items**

### *5.2.1 The Applicants' submissions*

56. The Applicants have sought confirmation that any subscriber management costs (as defined in B SkyB's Forms 20-Fs) that are not recovered by CACo or CMSCo have been allocated directly to DisCo.<sup>47</sup>

### *5.2.2 The OFT's finding*

57. Such subscriber management costs, not recovered by CACo and CMSCo, have been allocated directly to DisCo. Such costs include bad debts, which are deducted when calculating DisCo's revenue, and installation subsidy costs (net of revenue received), which are included under the customer acquisition and transition marketing costs in the Decision.

## **5.3 CMSCo**

### *5.3.1 The Applicants' submissions*

58. The Applicants have requested confirmation that, since DisCo 'buys-in' its subscriber management services from the notional entity 'CMSCo', the assets B SkyB uses in its subscriber management provision are similarly allocated to CMSCo and that the charges incurred by DisCo enable CMSCo to generate a suitable rate of return.<sup>48</sup>

### *5.3.2 The OFT's finding*

59. By definition, the assets related to the provision of subscriber management are allocated to the notional entity responsible for the provision of subscriber management services, CMSCo.<sup>49</sup>
60. No required rate of return was calculated with respect to subscriber management charges and the profitability of CMSCo. The OFT's analysis of the profitability of CMSCo, however, indicated that CMSCo incurred

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<sup>46</sup> Decision paragraph 458.

<sup>47</sup> ONdigital submission dated 16 May 2003, paragraph 2.4.9; NTL submission dated 23 May 2003, page 8.

<sup>48</sup> ONdigital submission dated 16 May 2003 paragraph 2.3.2; NTL submission dated 23 May 2003, page 6.

<sup>49</sup> Decision paragraphs 456-459 state that DisCo incurs subscriber management charges. These charges are paid to the notional entity CMSCo, which provides such services.



minor losses in the period assessed.<sup>50</sup> During this period, however, subscriber management costs were incurred relating to the launch of the digital platform. For example, DisCo incurred charges relating to calls

'recorded from new digital satellite customers in their first few months on the platform [which] tend to relate to problems with their installation or smart card or confusion about the workings of the EPG or the platform more generally'.<sup>51</sup>

61. In addition, DisCo incurs call booking charges associated with new subscribers.<sup>52</sup> As such, during the period investigated, DisCo incurred disproportionately high subscriber management costs as these are biased towards the beginning of the digital project. For this reason no rate of return was levied upon subscriber management charges incurred in the period assessed.<sup>53</sup>
62. Significantly, in recent periods the profitability of CMSCo has improved and '*[i]t is anticipated that the improvement in CMSCo's profits... [will] continue through 2003 and beyond*'.<sup>54</sup>

## 6. Overhead costs

### 6.1 *The Applicants' submissions*

63. The Applicants considered that the disparity between the results of their own calculations and those outlined in the Decision can in part be explained by the OFT's failure to treat overheads, depreciation, and fixed and common costs correctly. The Applicants stated that:

'in BSkyB's Form 20-F, overhead, depreciation, and fixed and common costs are already attributed and included in reported programming, transmission and related functions, marketing,

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<sup>50</sup> The profitability of CMSCo was, however, understated following the complete allocation of SSSL's depreciation charge to the entity. See the BSkyB submission dated 18 June 2003.

<sup>51</sup> BSkyB submission dated 29 June 2001, section 3.

<sup>52</sup> BSkyB submission dated 29 June 2001, section 3.

<sup>53</sup> BSkyB submission dated 18 June 2003: '*Sky does not have forecasts for the profitability of notional CMSCo....*' Accordingly, the OFT cannot determine the subscriber management charges that will result in such costs being distributed proportionately and in CMSCo earning a specific rate of return. Further, the subscriber management costs incurred by CMSCo are a temporal item that the OFT considers should not be amortised, as they are equivalent to the temporal items discussed in Decision paragraph 528. As Decision paragraph 533 states: '*[t]he [OFT] 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.*'

<sup>54</sup> BSkyB submission dated 18 June 2003.

subscriber management, administration, and gaming operating expenses'.<sup>55</sup>

64. The Applicants considered that overhead costs relating to transmission and related functions, marketing, and subscriber management operating expenses should be allocated to DisCo, '*following the [OFT]'s recommended allocation of BSkyB's expenditure*'.<sup>56</sup> Given the public availability of this information, NTL and ONdigital considered that the OFT need not rely on the allocations suggested by BSkyB.

## **6.2 The OFT's finding**

65. The Applicants appear to have misunderstood what is included within the 'overheads' category adopted in the Decision.<sup>57</sup> The overheads referred to in the Decision relate only to administration costs and it is only in relation to these costs that BSkyB's suggested allocations were adopted.<sup>58</sup>
66. In any event, the Applicants' assertion that all overhead costs relating to transmission and related functions, marketing and subscriber management should be allocated to DisCo is incorrect, and their modelling of DisCo assuming the complete allocation of such overhead costs to DisCo is similarly flawed. Such cost items do not relate exclusively to DisCo, as the Applicants have assumed. Paragraphs 26, 47, and 53-55 above outline how the Applicants have incorrectly allocated such costs entirely to DisCo.

## **7. Administrative Overheads**

### **7.1 The Applicants' submissions**

67. The Applicants stated that

'administration operating expenses should be allocated to DisCo in proportion to the average number of full time equivalent (FTE) employees in transmission and related functions, marketing, and subscriber management activities shown in BSkyB's Form 20-F'.<sup>59</sup>

### **7.2 The OFT's finding**

68. This allocation is inappropriate as the items highlighted by the Applicants are either not allocated entirely to DisCo (i.e., marketing and transmission costs, see paragraphs 26, 47 above) or not incurred directly by DisCo (i.e., subscriber management costs). The employee allocations made by the Applicants are therefore similarly incorrect.

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<sup>55</sup> NTL Application, paragraph 19; see also ONdigital Application, paragraph 3.2.16.

<sup>56</sup> NTL Application, paragraph 19; ONdigital Application, paragraph 3.2.17.

<sup>57</sup> Decision paragraphs 500-508.

<sup>58</sup> Decision paragraph 501.

<sup>59</sup> NTL Application, paragraph 21; see also ONdigital Application, paragraph 3.2.19.

69. Within their analysis, the Applicants have mistakenly included employees involved in subscriber management as employees of DisCo, thus overstating the allocation of administration costs to DisCo. The costs of subscriber management are incurred by CMSCo<sup>60</sup> (the BSkyB business responsible for providing subscriber management services, see section 5), and the relevant overhead costs are already recovered via the subscriber management charges incurred by DisCo (also see section 5 above). To allocate overhead costs to DisCo on the basis of a headcount that includes subscriber management employees would be to 'double count' subscriber management overheads.
70. The OFT obtained a detailed 'head count' which grouped BSkyB employees by department and function.<sup>61</sup> The OFT's analysis of this information indicated that BSkyB's suggested allocations did not underestimate the proportion of overheads that should be allocated to DisCo.<sup>62</sup>

## **8. Fixed and common costs**

### **8.1 *The Applicants' submissions***

71. The Applicants list the treatment of fixed and common costs as a possible source of the discrepancy between their results and those of the OFT. ONdigital noted that the OFT allocates common costs on the basis of subscriber numbers.<sup>63</sup> ONdigital considered that this allocation is unnecessary as many of BSkyB's cost items, and their associated overheads, have been disclosed in BSkyB's Form 20-F.

### **8.2 *The OFT's finding***

72. The OFT notes that such disclosure does not preclude the allocation of common costs set out at Decision paragraph 520. As is made clear, this allocation is necessary to determine which costs necessary to BSkyB's channel distribution are relevant to the distribution of premium channels in the UK (as opposed to the excluded activities listed at Decision paragraph 431). Annex 27 of the Decision details the allocation of the common and fixed costs, using the various methods considered.
73. The Applicants' lack of access to the information necessary to assign costs and revenues to the various DisCo services (such as commercial, PPV and *à la carte*) further explains the disparity between returns they calculated and those determined by the OFT.

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<sup>60</sup> Analogue subscriber management costs were allocated to a combined analogue CA/CMSCo. See Decision paragraph 456, which notes that '*the analogue ratecard includes a composite charge.*'

<sup>61</sup> Section 26 notice of 29 March 2001

<sup>62</sup> BSkyB submission dated 4 May 2001 at Tab 3.

<sup>63</sup> In fact only a proportion of common costs (those common costs remaining following allocation to the *à la carte* and PPV distribution services) are allocated according to subscriber numbers (Decision paragraph 520).

## **9. Further inconsistencies identified**

74. The OFT has noted further inconsistencies between the models constructed by the OFT and those constructed by the Applicants.

### **9.1 *The Disney Channel***

75. The 'third party programming' heading adopted in the BSkyB Form 20-F included the costs BSkyB incurs in purchasing the Disney Channel. As suggested at Decision paragraph 419, the costs BSkyB incurs in purchasing Disney (when given 'free' to dual movie subscribers as opposed to sold '*à la carte*') are borne by BroadCo. The cost of the Disney Channel, which is typically supplied to distributors whenever a dual movie package is purchased from BSkyB,<sup>64</sup> is only allocated to DisCo in the sense that the cost of the Disney Channel is implicit in the price charged by BroadCo for a dual movie package. By adopting the third party programming figure as per the BSkyB Form 20-F in their analysis of DisCo, the Applicants have therefore further overstated DisCo's cost base, by double counting the cost of the Disney channel.

### **9.2 *BSkyB basic channels***

76. The charges that the Applicants have adopted for BSkyB's basic channels differ from those adopted in the Decision. The per channel costs used by the OFT were not disclosed in the published, redacted Decision. In fact, whereas in the Applicants' models DisCo was charged 10p or 20p per subscriber for Sky News,<sup>65</sup> in the Decision, DisCo was not charged for Sky News as it is a free-to-air channel.<sup>66</sup> Further, whereas the Applicants assumed a price of 5p per subscriber for Sky Travel,<sup>67</sup> a lower charge was assumed in the Decision, consistent with [...].<sup>68</sup>

## **10. The accounting figures used by the OFT**

77. The Applicants state that the difference between their results (based on published and audited information) and the OFT's results must be reconciled, and that the Decision does not provide sufficient information to assess the OFT's treatment of DisCo's profitability.
78. The figures used by the OFT were principally obtained from the separated accounts for BroadCo and DisCo, supplied by BSkyB, which reconciled with BSkyB's audited accounts. Thus, the figures used in modelling DisCo's profitability are derived from published financial information. The

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<sup>64</sup> The OFT understands that ONdigital did not receive Disney when purchasing a dual movie package but was still paying the same price as those who did receive Disney for packages including dual movies (letter from ONdigital to the OFT dated 2 April 2001, paragraph 12).

<sup>65</sup> ONdigital Application, footnote 27 and NTL Application, appendix 1, footnote 3.

<sup>66</sup> Decision footnote 388.

<sup>67</sup> ONdigital Application, footnote 27 and NTL Application, appendix 1, footnote 3.

<sup>68</sup> [...]

discrepancies between the OFT's results and those suggested by the Applicants arise in part as their estimates of DisCo's costs have included all services distributed by BSkyB, whereas the OFT has the information to derive more detailed cost figures for the specific services provided by DisCo. They also arise because the Applicants have failed in part to follow or incorporate the methods used by the OFT.<sup>69</sup>

## 11. Conclusion

79. The OFT rejects the Applicants' suggestion that its model is not 'robust'. They appear to have misunderstood or overlooked the details of the model set out in the Decision. This has contributed to their estimation of DisCo's return on turnover ('ROT') differing significantly from that applied by the OFT (see section II below). Further disparities occurred as the Applicants did not have access to the BSkyB confidential data used by the OFT to model DisCo's profitability.

## II. THE REQUIRED RATE OF RETURN

80. The Decision assessed whether DisCo was profitable after requiring it to make a return on turnover of 1.5% (see Decision paragraphs 393-413).

### 1. The Applicants' submissions

81. The Applicants expressed concerns with the required rate of return adopted in the Decision, summarised below:
- The Applicants argued that the OFT was incorrect to reject Return on Capital Employed ('ROCE') as a measure for determining the level of normal profit required to be earned by DisCo.<sup>70</sup> ONdigital also stated that ROCE was not used to cross-check the profit criterion used.<sup>71</sup>
  - The Applicants argued that the ROT figure of 1.5% used by OFT was too low and argued for a comparison with the average ROT of an index of UK FTSE listed companies.<sup>72</sup>
82. ONdigital also stated that:

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<sup>69</sup> BSkyB stated: '*During the course of the OFT's investigation, all cost and revenue data provided to the OFT by Sky were in a form in which they could readily be reconciled to Sky's audited accounts. Sky provided data to the OFT so that it could satisfy itself that all cost and revenue categories that the OFT determined should be attributable to Disco were in fact borne by Disco and that costs and revenues attributed to Disco have been based on accurate, audited accounts.*' BSkyB submission dated 9 April 2003, page 4, paragraph 1.

<sup>70</sup> ONdigital Application, paragraph 3.3.15; NTL Application paragraph 34.

<sup>71</sup> ONdigital Application paragraph 3.3.1.

<sup>72</sup> ONdigital Application paragraphs 3.3.1, 3.3.4 and 3.3.6; NTL Application paragraph 29.

'the Decision should be varied to set out details of the comparators the Director has considered in full, so that [ONdigital] can make its own assessment of the validity of the comparisons.'<sup>73</sup>

83. In the following sections, the OFT repeats and clarifies its reasons for:

- (i) using ROT;
- (ii) not using ROCE, indicating why the Applicants' proposed capitalisation of certain costs to form a DisCo asset base is inappropriate; and
- (iii) applying a ROT of 1.5%.

## **2. The OFT's reasons for using ROT**

84. The OFT's reasons for using ROT rather than ROCE as its measure of a normal profit are set out in Decision paragraphs 398-400, and are repeated and elaborated here.

### ***2.1 ROT is a standard measure of profitability***

85. ROT is a standard ratio for setting performance measures for service providers and distributors. ROT is also used as a performance measure in firms seeking to grow, which is one of BSKyB's objectives.<sup>74</sup> Competition authorities use ROT as a measure of required rate of return in industries with either a low level of fixed assets, or a high level of intangible assets, or both (see paragraphs 94-96).

### ***2.2 DisCo buys in most of its services***

86. DisCo is a distribution business that 'buys-in' most of the services necessary to it, including BSKyB (BroadCo) and third party programming, conditional access and subscriber management services. 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 the purposes of the margin squeeze test. Moreover, bought-in services, in total, account for [over 50]% of DisCo's total costs.

87. Accordingly DisCo, as such, provides added value only in terms of its remaining activities, which include the process of transmission, marketing and the organisation of its bought-in-services.<sup>75</sup> This high level of bought-in services means that DisCo has only a small amount of capital employed, which undermines the value of ROCE as the appropriate measure of DisCo's profitability.

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<sup>73</sup> ONdigital Application paragraph 3.3.3.

<sup>74</sup> See, for instance, BSKyB Annual Reports 2001 and 2002, Chief Executive Statements, Subscriber Growth section.

<sup>75</sup> Decision paragraph 398.

### 2.3 *DisCo has a small capital base*

88. DisCo's tangible fixed capital base compared to its turnover is very small. Its fixed assets, excluding any share of transmission assets were, on average, just slightly under £18 million (1.6% of turnover) in the period January 1998 to December 2001. The transmission assets allocated to DisCo would add an estimated £11 million (1.0% of turnover) to this figure.<sup>76</sup>
89. Other items which might conceivably be treated as assets are not capitalised as they are 'bought-in' by DisCo. Accordingly, DisCo need not hold assets for these purposes. These items include: transponders, which are leased; set top box expenditure, which is recovered via conditional access charges; and subscriber management services. Implicit in these charges is a rate of return for the relevant service provider.<sup>77</sup>
90. The only other major asset that might be included in DisCo's capital base, under some circumstances, would be DisCo's customer acquisition marketing costs. This would add, for example for the six-month period ending December 2000, a further £423 million to the capital base. The OFT's reasons for rejecting customer acquisition marketing costs in a ROCE calculation are set out in paragraphs 101-111. However, even if capitalised customer acquisition marketing expenditure were included, the capital base would still only correspond to on average 36% of DisCo's turnover in the period January 1998 to December 2001.
91. Finance and risk-bearing are not the primary value-drivers in this type of business. Profitability measures meaningful for DisCo are those that might indicate performance in providing its services superior to that of its competitors. *'As with other service providers or distributors, it is expertise in providing these services, rather than investment, that permits DisCo to add value.'*<sup>78</sup> Profit maximising behaviour for an entity which relies on little capital is to maximise the difference between net revenues and costs, rather than the return on the (limited) capital employed.
92. Not only has DisCo a small capital base, but much of it is represented by working capital,<sup>79</sup> which is generally variable, making any return on capital calculation unreliable.<sup>80</sup> This unreliability further undermines ROCE as an appropriate measure of profitability.

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<sup>76</sup> This figure has been calculated using the transmission cost data and asset value information supplied by B Sky B. The value of B Sky B's technical equipment (quoted at annex 59.1 of B Sky B's response to the section 26 notice dated 29 March 2001) has been allocated according to the split in asset related transmission costs allocated to BroadCo and DisCo (outlined at Decision paragraph 487 and annex 24).

<sup>77</sup> See paragraphs 56-62 above concerning subscriber management costs.

<sup>78</sup> Decision paragraph 398.

<sup>79</sup> Decision footnote 352 (data redacted from published Decision).

<sup>80</sup> Decision paragraph 399.

93. For the reasons which have been set out in paragraphs 85-92 above, the OFT therefore considers that ROCE is not a suitable indicator for measuring DisCo's performance.

#### **2.4 Use of ROT by Competition authorities**

94. ROT has been extensively used by UK competition authorities. The Competition Commission (the 'CC'), (and its predecessor the Monopolies and Mergers Commission (the 'MMC')) has often used ROT (or its equivalent, return on sales ('ROS')) for assessing profitability in its enquiries into a broad range of industries.<sup>81</sup> In its reports, the MMC followed similar lines of reasoning to those used by the OFT in its investigation. Its reasoning in its 'Fine Fragrances' report is set out below:

'The MMC's current practice in monopoly inquiries is to regard both return on capital employed (ROCE) and return on sales (ROS, being the operating profit, i.e., profit before interest, non-operating items and tax, expressed as a percentage of sales) as useful indicators. While we comment briefly on the consolidated ROCE of seven of the eight listed distributors, and individually on the ROCE of two of them [...], we do not regard this measure as an entirely useful or reliable guide for the purposes of this inquiry. This is because with the exception of Chanel, the eight listed distributors are not engaged in manufacturing. As a result many of them have relatively low, or in one case, negative capital employed...'<sup>82</sup>

95. A similar view was taken by the MMC in its more recent report on BT's charges for handling calls to mobile networks,<sup>83</sup> where instead of using

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<sup>81</sup> 'Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom', CC, October 2000. '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 of Cellnet and Vodafone', MMC January 1999. 'Ice Cream: A report on the supply in the UK of ice cream for immediate consumption', CCMarch 1994. 'Scottish- Hydro Electric plc: A Report on a reference under section 12 of the Electricity Act 1989, Monopolies and Mergers Commission', MMC May 1995. 'Classified Directory Advertising Services', MMC March 1996. 'The supply of recorded music: A report of the supply in the UK of pre-recorded compact discs, vinyl discs and tapes containing music', MMC, June 1994. 'Historical on-line database services: A report on the supply in the UK of services which provide access to databases containing archival business and financial information, MMC, May 1994. 'Contraceptive sheaths: A report on the supply in the UK of contraceptive sheaths', MMC, March 1994. 'Fine fragrances: A report on the supply in the UK for retail sale of fine fragrances, MMC, November 1993. 'Soluble coffee: A report on the supply of soluble coffee for retail sale within the United Kingdom' MMC, March 1991.

<sup>82</sup> Fine Fragrances: A report on the supply in the UK for retail sale of fine fragrances, paragraphs 5.17-5.118. MMC November 1993.

<sup>83</sup> British Telecommunications Plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the charges made by British Telecommunications



ROCE, 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*'.<sup>84</sup> Reflecting this, the MMC stated that

'[in] practice, the mean net assets employed in all the call activities are not only relatively small, but they consist for the most part of working capital items [...]. It appears to us that in such circumstances capital employed is not a reliable basis for setting a reasonable return.'<sup>85</sup>

96. The OFT notes that the range of BT activities under consideration by the MMC included marketing, customer service, billing and other retail activities that are similar to those of DisCo, although DisCo also provides some transmission activity.<sup>86</sup>

### **3. Rejection of ROCE**

97. The Applicants considered that the OFT:

- (i) should have sought to make an assessment of the true capital employed in the DisCo business.<sup>87</sup>
- (ii) has been inconsistent in amortising customer acquisition costs for ROT calculations but rejecting their capitalisation for ROCE purposes.<sup>88</sup>
- (iii) has been inconsistent with the CC's treatment of intangibles in the SME Banking enquiry.<sup>89</sup>

These points are considered below.

#### **3.1 True capital employed by DisCo**

##### **3.1.1 The Applicants' submissions**

98. The Applicants have attempted to estimate DisCo's capital employed. They have sought to capitalise:<sup>90</sup>

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Plc for calls from its subscribers to phones connected to the networks Cellnet and Vodafone. MMC, December 1998. Paragraphs 2.112-2.118.

<sup>84</sup> Ibid. Paragraph 2.116.

<sup>85</sup> Ibid, Paragraph 2.113.

<sup>86</sup> Ibid, Paragraph 2.112.

<sup>87</sup> ONdigital Application paragraph 3.3.13; NTL Application paragraph 34.

<sup>88</sup> ONdigital Application paragraph 3.3.16; NTL Application paragraph 35.

<sup>89</sup> ONdigital Application paragraph 3.3.17; NTL Application paragraph 35.

<sup>90</sup> ONdigital Application paragraph 3.3.13; NTL Application paragraph 35.

- (i) marketing costs (amortised over DisCo's reported estimated subscriber life);
- (ii) set top box subsidy costs (represented by BSkyB's share of BiB's losses);
- (iii) analogue-to-digital transition costs;
- (iv) DisCo's investment in BiB (whose chief asset is access to the DTH set-top boxes); and
- (v) an appropriate allocation of BSkyB's tangible fixed assets.

### *3.1.2 The OFT's finding*

99. The Applicants' calculations suffer from the problems that they have encountered in modelling DisCo's profitability and which were analysed in paragraphs 22-79 above. Each point raised in paragraph 98 above is however also considered as follows:

- (i) paragraphs 25-38 set out the OFT's treatment of marketing costs;
- (ii) relevant set top box costs are included in conditional access charges (see paragraphs 27, 36 and 39-44);
- (iii) the OFT regarded operating two systems of transmission for a transitional period as an operational cost (Decision paragraph 533);
- (iv) BiB is excluded from the margin squeeze analysis, as it is not an activity that a distributor as efficient as DisCo of BSkyB's premium channels must undertake (Decision paragraph 417);
- (v) see paragraph 88 for the OFT's inclusion of BSkyB's tangible fixed assets in the capital employed base.

100. As a result, the OFT considers that both Applicants have significantly overestimated DisCo's capital base.

## **3.2 Consistency of treatment of customer acquisition costs**

### *3.2.1 The Applicants' submissions*

101. NTL stated that:

'it was inconsistent for [the OFT] to reject capitalising customer acquisition costs in circumstances where [its] own methodology led [it] to capitalising and amortise investment expenditures for the purposes of calculating profit.'<sup>91</sup>

102. ONdigital stated:

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<sup>91</sup> NTL Application paragraph 35.

'In the context of the ROT model, despite [its] reservations concerning the capitalisation of customer acquisition costs, the [OFT] nevertheless recommended that DisCo's investment expenditures should be capitalised and amortised over an appropriate period to reflect the ongoing benefit derived from them. [Its] concerns regarding a ROCE based measure of profitability did not prevent [it] from adopting a similar approach in the context of an ROT based model.'<sup>92</sup>

### *3.2.2 The OFT's finding*

103. The amortisation of acquisition marketing costs over time in the ROT model reflected aspects of the dynamics of DisCo's business. With regard to asset capitalisation, Decision footnote 353 states:

'the usual theoretical framework for calculating ROCE would not allow the capitalisation of customer acquisition costs. 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. 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.'

104. The first two sentences of the footnote explain current accounting practice. The remaining two sentences explain why and when customer acquisition cannot be capitalised as assets for an economically meaningful ROCE calculation.
105. The OFT is not in principle against capitalisation of expenditures which cannot be treated as capital expenditures under the usual accounting principles, where such capitalisation gives a better economic picture of the entity under consideration. For this reason, the margin squeeze analysis allowed for the non-steady state of BSkyB, by matching revenues with associated costs. This included the amortisation of customer acquisition costs to obtain a reasonable picture of DisCo's profitability over time. Allowing matching of costs and revenues for this purpose does not mean that such expenditures should be incorporated in DisCo's capital base to determine its normal profit under an ROCE analysis. This is considered further in paragraphs 106-110 below.

## **3.3 The CC's capitalisation of intangibles in the SME banking report**

### *3.3.1 The Applicants' submissions*

106. The Applicants note<sup>93</sup> that in its recent report on SME banking,<sup>94</sup> the CC accepted the principle of capitalising some intangible assets even if this is

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<sup>92</sup> ONdigital Application paragraph 3.3.16.

<sup>93</sup> ONdigital Application paragraph 3.3.17; NTL Application paragraph 35.

not permissible under UK generally-accepted accounting practice, and that a decision to capitalise rests on the extent to which the costs are incurred for future, as opposed to current, benefit. ONdigital stated that:

'[t]he Commission accepted in principle that marketing and other customer acquisition costs, training costs, and systems-development costs, which are not normally treated as assets for accounting purposes, should be treated as assets that had to be financed by shareholders' equity and should be added to capital for the purpose of determining return on capital employed. Hence, [ONdigital] considers that the [OFT] is incorrect to assert that the framework for calculating ROCE would not allow the capitalisation of customer acquisition costs, or that ROCE is an inappropriate measure of DisCo's profitability.'<sup>95</sup>

### 3.3.2 *The CC's principles*

107. In its study of banking services for SMEs, the CC did allow a substantial amount of intangible assets, valued at their replacement cost, to be considered for inclusion in the capital base. However, the CC laid down strict principles for such recognition. It said:

- '(a) whether the expenditure on any given intangible should be capitalized will depend on the nature of the specific intangible identified and the context; and
- (b) if the revenue cost of a specific identified intangible are to be capitalized for the purposes of our inquiry, it must meet three conditions:
  - (i) it must comprise a cost incurred now, primarily to obtain earnings in the future;
  - (ii) this cost must be additional to those necessarily incurred at the time in running the business; and
  - (iii) it must be identifiable as creating such an asset separate from any that arises from the general running of the business.'<sup>96</sup>

108. The CC declined to include any unascrbed goodwill (whether purchased or generated internally) because the value would be derived from the

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<sup>94</sup> ONdigital Application paragraph 3.3.17; NTL Application paragraph 35 citing 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK' paragraphs 2.248-2.346, CC, March 2002.

<sup>95</sup> ONdigital Application dated 28 February 2003, paragraph 3.3.17.

<sup>96</sup> Paragraph 2.271 of '*The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*', Competition Commission, March 2002.

value of the business as a whole, rather than any specific asset excluded from the equity base.<sup>97</sup>

109. The CC also expressed reservations concerning the capitalisation of marketing expenditure, including uncertainty as to whether such expenditure would create an asset.<sup>98</sup>

### 3.3.3 *The OFT's findings*

110. The OFT considers that the recognition of assets for capitalisation involves difficult judgments. While the OFT did not expressly apply the CC's principles when it wrote its Decision, it considers that Decision footnote 353 is consistent with these principles in considering DisCo's intangible assets and in particular its customer acquisition costs.

### 3.4 **Conclusion on use of ROCE**

111. For the reasons given above (paragraphs 85,92 and 101-110), the OFT rejects the use of ROCE as the appropriate measure of determining DisCo's profitability.

## 4. **The level of ROT applied by the OFT**

112. The Applicants state that the ROT rate applied by the OFT is too low, on the basis that:
- (i) they dispute the criteria the OFT used to choose comparator firms.<sup>99</sup> Consideration of other companies' returns and the risky nature of DisCo should lead to a higher applicable ROT;<sup>100</sup>
  - (ii) a broad survey of UK FTSE listed companies would indicate a higher ROT;<sup>101</sup> and
  - (iii) the ROT implied by their calculations of DisCo's capital base and the CC's estimated normal ROCE of 13-18% (see paragraph 131) is higher than that applied by the OFT in the Decision.<sup>102</sup>

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<sup>97</sup> 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK', Competition Commission, March 2002, paragraph 2.258.

<sup>98</sup> 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK', CC, March 2002, paragraph 2.306.

<sup>99</sup> ONdigital Application paragraph 3.3.7; NTL Application paragraph 32.

<sup>100</sup> ONdigital Application paragraph 3.3.1; NTL Application paragraph 29.

<sup>101</sup> ONdigital Application paragraph 3.3.4; NTL Application paragraph 31.

<sup>102</sup> ONdigital Application paragraph 3.3.18; NTL Application paragraph 37.

#### **4.1 The OFT's criteria for seeking comparator companies**

##### **4.1.1 The Applicants' views**

113. The Applicants did not accept the OFT's criteria for seeking comparator companies. Neither considered:

'that having a similar capital structure, proportion of bought-in services, or function to DisCo represent "necessary criteria" for providing a reasonable proxy for the normal profit that DisCo may be expected to earn.'<sup>103</sup>

114. Both also stated that '*the relevant criteria should include the amount of cash invested in the business and the riskiness of the business.*'<sup>104</sup> ONdigital stated that '*DisCo has a very high level of cash invested in the business (in upfront platform development and customer-acquisition costs) and is also very risky (due to relatively high fixed costs and uncertain demand).*'<sup>105</sup>

115. ONdigital also stated that the '*[OFT] does not identify the particular companies considered, or, in some cases, give even the average rate of return of those companies.*'<sup>106</sup>

##### **4.1.2 The OFT's findings**

116. The OFT considers that Decision paragraphs 405-410 adequately identifies the comparators considered. The ROT percentages for supermarkets, high street retailers and electricity supply companies were set out in Decision Annexes 14 and 15.

117. The OFT considers that the cash invested in DisCo is not high compared to turnover. Most of BSkyB's cash investment can be attributed to other areas of BSkyB. The OFT considers that, because of its low fixed cost base, DisCo is relatively well protected from operational risk.

118. The causes of risk listed in BSkyB's Form 20-F include: risks to its intellectual property and proprietary rights, risks associated with cable operators, uncertainty about the continuance of long term agreements, risk associated with competition for programming content and competition more generally, uncertainty about the failure of technology, including transponder failures and set top box failure and regulatory uncertainty.<sup>107</sup>

119. Few of these uncertainties, however, apply directly to DisCo. DisCo experiences risk in transmission, but BSkyB has disaster insurance to

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<sup>103</sup> ONdigital Application paragraph 3.3.7; NTL Application paragraph 32.

<sup>104</sup> ONdigital Application paragraph 3.3.7; NTL Application paragraph 32.

<sup>105</sup> ONdigital Application paragraph 3.3.7.

<sup>106</sup> ONdigital Application paragraph 3.3.3.

<sup>107</sup> BSkyB Form 20-F, 2002 pages 10 and 11.

cover transponder breakdown.<sup>108</sup> The only other major uncertainty, of those listed above, that is faced by DisCo directly is that of general competition. Thus, the risks faced by BSKyB and DisCo need to be considered separately. The OFT considers that more of the risks faced by BSKyB are borne by BroadCo and other businesses within BSKyB than by DisCo. BSKyB made this point, stating that '*CACo will require "an appropriately high level of return" to encourage further investment, not Disco.*'<sup>109</sup>

120. In considering comparator firms as a means of establishing an estimate of DisCo's normal profit, like should be compared with like. DisCo is an unusual business, providing a narrow range of services, and therefore finding precise or appropriate equivalents is difficult. In this area judgment must be exercised.<sup>110</sup>
121. In seeking a ROT comparator, OFT considered a variety of companies with similar characteristics to DisCo in terms of capital structure, proportion of bought-in services and function.<sup>111</sup> Scottish Hydro-Electric and BT's calls to mobile business were broadly similar in these terms. BT's relevant functions comprise mainly marketing, customer service, billing and other activities included in retail costs, with over 80 percent represented by bought-in services.<sup>112</sup> A normal return of 1.5% was assumed by the CC.<sup>113</sup>
122. Similarly, Scottish Hydro-Electric passes through generation, transmission and distribution costs to customers and performs marketing, customer service and billing.<sup>114</sup> The MMC also said that it did not accept Scottish Hydro-Electric's argument that '*supply is a high-risk business...*'<sup>115</sup> A normal return of 0.5% was assumed by the CC.<sup>116</sup>
123. The OFT notes that '*in another previous MMC report, the returns on turnover in pharmaceutical wholesaling and retailing were found to be*

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<sup>108</sup> BSKyB response to section 26 notice dated 5 October 2001, dated 2 November 2001, Tab 13.

<sup>109</sup> BSKyB submission dated 9 April 2003 page 14.

<sup>110</sup> With regard to DisCo, the same problems would seriously hinder attempts to determine an appropriate cost of capital. BSKyB's own cost of capital could not be used as this reflects the risks and the financing mix of the business as a whole rather than the distribution business under consideration.

<sup>111</sup> Decision paragraph 405.

<sup>112</sup> 'British Telecommunications Plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the changes made by British Telecommunications plc for calls from its subscribers to phones connected to the networks Cellnet and Vodafone.' MMC, December 1998, paragraph 2.112.

<sup>113</sup> *Ibid*, paragraph 2.117.

<sup>114</sup> *Ibid*, paragraph 2.114.

<sup>115</sup> 'Scottish Hydro-Electric plc: A Report on a reference under section 12 of the Electricity Act 1989', MMC, May 1995, paragraph 2.85.

<sup>116</sup> *Ibid*, paragraph 2.85.

*between 1 and 2 per cent*'.<sup>117</sup> Pharmaceutical retailing, like DisCo, is a distribution business.

124. The OFT considered using European television companies as a comparator.<sup>118</sup> However, cable companies with multiple revenue streams represented a substantially different business, and other Pay-TV companies are typically integrated in terms of production and distribution.
125. The OFT also considered the former public electricity supply companies as reasonable proxies for DisCo's business, with similar capital structures and a heavy reliance on bought-in services.<sup>119</sup> However, industry specific problems make any meaningful comparison difficult. The OFT's survey of other distribution businesses found that they had very different capital structures to DisCo.<sup>120</sup>

## **4.2 Comparison of ROT to a broad index of UK quoted companies**

### **4.2.1 The Applicants' views**

126. The Applicants state that '*the [OFT] did not make a simple comparison to the ROT of a broad index of UK quoted companies...*'<sup>121</sup> ONdigital stated that this '*gives an indication of the range of return that might be expected, irrespective of the capital structure or other characteristics of the businesses concerned.*'<sup>122</sup> ONdigital also stated that '*the level of return suggested by the [OFT] is well outside the range of return for the broad spectrum of companies across a range of industries.*'<sup>123</sup> '*[ONdigital] therefore considers that the [OFT] has ignored this obvious comparative evidence and that 1.5% ROT significantly understates the normal return that DisCo should be required to earn [...]*'<sup>124</sup> Further, '*NTL considers that DisCo should earn a return on turnover at least equal to the average of companies in the FTSE 100 index*'.<sup>125</sup>

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<sup>117</sup> 'British Telecommunications Plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the changes made by British Telecommunications plc for calls from its subscribers to phones connected to the networks of Cellnet and Vodafone', MMC, December 1998, which refers to Unichem PLC, Macarthy PLC and Lloyds Chemists PLC /Macarthy PLC: a report on the proposed mergers, Cm 1845, HMSO, February 1992, Footnote 1, page 32.

<sup>118</sup> Decision paragraph 407.

<sup>119</sup> Decision paragraphs 408-409.

<sup>120</sup> Decision paragraph 410.

<sup>121</sup> ONdigital Application paragraph 3.3.4; see also NTL Application paragraph 31.

<sup>122</sup> ONdigital Application paragraph 3.3.4.

<sup>123</sup> ONdigital Application paragraph 3.3.5.

<sup>124</sup> ONdigital Application paragraph 3.3.6.

<sup>125</sup> NTL Application paragraph 33.



#### 4.2.2 *The OFT's finding*

127. An OFT research paper by Graham and Steele makes it clear that any ROT comparisons must ensure comparable capital intensity between firms or industries. It states that '*ROS is employed when low capital intensity renders ROCE implausibly high. ROS is, however, itself sensitive to capital intensity.*'<sup>126</sup>
128. The OFT considers that different industries differ substantially in their relevant characteristics and that firms in the same industry may themselves differ substantially. Accordingly, it considers that a gross comparison across the whole economy has no value, and that the particular characteristics of any comparators must be closely examined.

#### 4.3 ***ROCE calculations based on the ROT applied in the Decision***

##### 4.3.1 *The Applicants' calculations*

129. The Applicants calculated several ROT and ROCE figures for DisCo. ONdigital stated that it
- 'estimates that the [OFT]'s required ROT of 1.5% is equivalent to an average ROCE for DisCo of 1.2% for the years ending 30 June 2001 and 30 June 2002'.<sup>127</sup>
130. ONdigital noted that in the recent reports on calls to mobile telephones, SME banking, and on supermarkets, the CC accepted the validity of ROCE as a measure of profitability and concluded that a normal ROCE (equal to the weighted-average cost of capital) should be in the range 13%-18%.<sup>128</sup>
131. ONdigital also estimated that the '*Competition Commission's estimated normal ROCE of 13% to 18%*' is equivalent to an average ROT for DisCo of 16% to 22% for the period 1 July 2000 to 30 June 2002.<sup>129</sup>

##### 4.3.2 *The OFT's calculations and sensitivity analysis*

132. For the reasons given (paragraphs 85-92 and 101-110), the OFT considers that ROCE is not an appropriate measure, and that the capitalisations proposed by the Applicants are inappropriate. Accordingly, the OFT did not consider in detail the matter of DisCo's cost of capital, since it did not need to for its margin squeeze analysis of DisCo. Nevertheless, the Decision:

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<sup>126</sup> M. Graham and A. Steele, *The Assessment of Profitability by Competition Authorities*, Research paper no.10, OFT, February, 1997, paragraph 511, page 25

<sup>127</sup> ONdigital Application paragraph 3.3.18.

<sup>128</sup> ONdigital Application paragraph 3.3.14.

<sup>129</sup> ONdigital Application paragraph 3.3.18.

'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 [...], is higher than that required given a 1.5% required rate of return on turnover.'<sup>130</sup>

133. Contrary to the Applicants' assertions, the OFT considers that the CC does not have an '*estimated normal ROCE*'. Rather, the CC estimates cost of capital rates for each of its inquiries individually. The OFT notes that the CC's estimates for the clearing bank groups' nominal pre-tax cost of equity were in the range of 14%-16%.<sup>131</sup> The CC gave an illustrative range of the pre-tax weighted average cost of capital for mobile network operators of between 10.4% and 17.3%<sup>132</sup> and calculated for supermarkets the average pre-tax nominal cost of capital to be 12.6% for the period 1996 to 1999.<sup>133</sup>
134. Although the OFT considers that ROCE is not an appropriate measure, it has undertaken its own calculations for DisCo of the ROCE implied by a 1.5% ROT and the equivalent ROTs implied by costs of capital of 10% and 13%. These OFT calculations are not based on the Applicants' modelling assumptions, criticised in paragraphs 22-79. The OFT calculates that for DisCo's average capital employed for the year ended 31 June 2001,<sup>134</sup> a ROT of 1.5% would be equivalent to a ROCE of 4.0% rather than ONdigital's estimate of 1.2%. For the year ended 31 June 2001, ROTs implied by costs of capital of 10% and 13% would be 3.8% and 4.9% respectively.<sup>135</sup> The OFT considers it unlikely that a

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<sup>130</sup> Decision paragraph 412. Accordingly, ONdigital was incorrect to allege that ROCE was not used to cross check the profit criterion used. (ONdigital Application paragraph 3.3.1).

<sup>131</sup> Table 2.17, Volume 1, 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK' paragraph 2.405, CC, March 2002.

<sup>132</sup> Paragraph 8.82, Volume 2, 'Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom', CC, October 2000.

<sup>133</sup> Table 2.5, Volume 1, 'Vodafone, O2, Orange and T-Mobile: reports on references under section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed and mobile networks.' Paragraph 2.242. The OFT notes that the CC added 0.25 per cent to the real weighted average cost of capital ('WACC') that the CC used in this report. The real WACC had been taken from the illustrative range of the MNOs real cost of capital found in table 2.5.

<sup>134</sup> The OFT does not have separated accounts with which to calculate percentages for the year ended 30 June 2002.

<sup>135</sup> 10% was the cost of capital discount rate used by BSKyB's business SSSL in the model it provided to OFTEL '*to demonstrate to OFTEL that CACo is able to earn a reasonable rate of return under a wide variety of scenarios*' (BSkyB letter to OFT dated 26 October 2001). 13.1% was the internal rate of return achieved in the base case model excluding a terminal value in this CA model. 10% is also approximately the bottom of the CC range for the cost of capital, see paragraph 133.

detailed study would find that DisCo's cost of capital should be as much as 18%.<sup>136</sup>

135. Even if such derived returns on turnover were applied, the OFT still considers (as it did in the Decision when a ROT of 1.5% was applied),<sup>137</sup> that:

- The losses are not large (although clearly, the larger any ROT that DisCo is required to make, the larger the losses that DisCo would be found to make during the period investigated).
- Disco's rapid return to profitability in 2001 (although delayed if an 18% cost of capital were applied), is a result of a combination of factors. The increasing retail price and the increased subscriber volumes are key to its recovery in profits.
- The possible effect of the temporal factors identified by BSKyB (see Decision paragraphs 528-533), should be taken into account when interpreting the results of the model.
- That even the fairest and most objective modelling assumptions necessarily involve an irreducible element of uncertainty.

136. The sensitivity analysis (see paragraph 134) does not convince the OFT that it should change its findings concerning the profitability of DisCo.

137. First, the OFT does not consider an increase in ROT is warranted on the evidence (see paragraphs 113-128). Second, even increased losses would not demonstrate that BSKyB had departed from competition on the merits. The U-shaped profit/loss curve identified by the OFT in the Decision remains,<sup>138</sup> and these losses would still be temporary and associated with the launch of BSKyB's digital platform.

138. Third, the OFT recognises that alternative assumptions and decisions could be made on certain issues in constructing the DisCo model. The Applicants appear to have only challenged those assumptions and decisions that they believe are unfavourable to them. The OFT notes (without comment) that BSKyB considered several assumptions and decisions unfavourable to it. Of those, the most significant include:

- Imputing to DisCo the prices paid by the principal third party distributors for premium programmes, rather than the prices it might achieve from the then extant BSKyB ratecards.<sup>139</sup> For example, if the model assumed the ratecard discounts implied by DisCo's own subscriber base, its premium programming costs would be

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<sup>136</sup> Maximum percentage of the 'Competition Commission's estimated normal ROCE of 13% to 18%' see paragraph 131.

<sup>137</sup> Decision paragraph 545.

<sup>138</sup> Decision paragraph 543.

<sup>139</sup> Decision paragraphs 434 to 442

£229 million less in the 22 months to December 2001 than those incurred assuming the prices paid by ONdigital, and £178 million less given the prices paid by NTL. Over the 22 months to December 2001 DisCo's ROT would increase to 7.71% (assuming the price paid by ONdigital for Sky One), and 7.16% (assuming the Sky One price paid by NTL and Telewest).<sup>140</sup>

- The failure to accommodate 'temporal items' in the DisCo model itself.<sup>141</sup> For example, if the duplication in DisCo's transmission technologies was addressed by deducting its analogue transponder rental costs, DisCo would save £38.8 million in the 22 months to December 2001. Assuming the prices paid by ONdigital and NTL, DisCo's ROT would be 0.04% and 1.55% respectively, over the 22 months to December 2001.
- BSkyB stated that DisCo should not be imputed any transmission costs, as transmission is a broadcasting function.<sup>142</sup> If the transmission costs allocated to DisCo in the Decision were instead removed in their entirety, DisCo would save a further £40.8 million<sup>143</sup> in the 22 months to December 2001.<sup>144</sup> Assuming the price paid by ITV Digital, DisCo's ROT would shift to 1.68% in the 22 months to December 2001, and to 3.19% assuming the prices paid by NTL.

139. Further assumptions which BSkyB challenged included:

- The adoption of an accounting rather than a Net Present Value ('NPV') model.<sup>145</sup> The OFT also notes that NTL also considered the NPV approach to be more appropriate and to have greater economic significance.<sup>146</sup> Frontier Economics also saw merits in the NPV model suggesting that both the NPV and accounting models should be run.<sup>147</sup>
- The failure to recognise all of DisCo's investment costs.<sup>148</sup>
- Imputing to DisCo CA charges higher than would be achieved in arm's length negotiations with CACo.<sup>149</sup>

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<sup>140</sup> Decision paragraph 444 to 447.

<sup>141</sup> Decision paragraphs 528 to 533.

<sup>142</sup> Decision paragraphs 471-788.

<sup>143</sup> Having already deducted the costs of analogue transponder rental, above.

<sup>144</sup> Decision Annex 24.

<sup>145</sup> Decision paragraph 371 to 390.

<sup>146</sup> Decision paragraph 376, referring to NTL's submission of 8 March 2002, page 17

<sup>147</sup> Decision paragraph 381, referring to Frontier's suggestion made at a meeting with OFT officials on 13 February 2002.

<sup>148</sup> Decision paragraphs 521 to 527.

- Imputing Basic channel charges to DisCo which BSKyB considered were too high for a number of channels.<sup>150</sup>
- Allocation of overheads to DisCo.<sup>151</sup>
- The requirement that BSKyB's Pay Per View business should break-even during the period investigated.<sup>152</sup>

140. Accordingly, the OFT's required ROT of 1.5% should be seen in the context of paragraphs 138-139. The effect of a change to just one of the more significant modelling assumptions which BSKyB considers unfavourable to it, or to a number of the less important ones BSKyB considers unfavourable, would cancel out the effect of requiring a higher ROT as proposed by the Applicants.

## 5. Conclusion

141. The OFT stated in Decision paragraph 544:

'in constructing the model, the [OFT] 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 [OFT] considers that those [it] has used are the best possible, on a fair and objective basis.'<sup>153</sup>

142. The OFT considers that in the circumstance of this case, it was correct to prefer ROT over ROCE as a measure for determining the level of normal profit required to be earned by DisCo. It is satisfied with its choice of a ROT of 1.5% in the Decision. However even when sensitivity analysis is carried out (see paragraph 134) using a sample of costs of capital up to 18%, the U-shaped curve the OFT found in the Decision<sup>154</sup> remains.

143. The OFT therefore declines to withdraw or vary its Decision in response to the concerns raised by the Applicants in paragraphs 81-82.

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<sup>149</sup> Decision paragraphs 460-470. The effect of [*a small*] reduction in the sports subscriber conditional access charges would be a reduction in DisCo's cost base of £7.7 million in the 18 months to December 2000.

<sup>150</sup> Decision paragraphs 443-449. If the prices advocated by BSKyB were adopted, DisCo's cost base would fall by £6.2 million in the 12 months to December 2001.

<sup>151</sup> Decision paragraphs 500-508.

<sup>152</sup> Decision paragraphs 518.

<sup>153</sup> Decision paragraph 544.

<sup>154</sup> Decision paragraph 543.

### III. THE RELEVANT PERIOD

#### 1. NTL's submission

144. NTL stated that the OFT had wrongly taken into account periods outside the period investigated in deciding that there were insufficient grounds to find that BSkyB had infringed the Chapter II prohibition by exercising an anticompetitive margin squeeze.<sup>155</sup>

#### 2. The OFT's finding

145. On 17 December 2001, the OFT issued a Rule 14 notice to BSkyB,<sup>156</sup> stating that it proposed to make a decision that BSkyB had infringed the Chapter II prohibition by exercising a margin squeeze on its distributors, for the period from 1 March 2000 (i.e., the entry into force of the Act) to 30 June 2001 (the latest date for which data was available. In its response, BSkyB supplied data for the additional six month period ending 31 December 2001.

146. The OFT considers that it must examine the effects and available evidence relevant to alleged anticompetitive conduct in all the circumstances of the case, which involves taking into account all available data. Just as it has considered periods before the entry into force of the Act to understand such circumstances (see data considered in its *Aberdeen Journals* decision,<sup>157</sup> such consideration approved by the CAT on appeal<sup>158</sup>), the OFT considers that relevant new data provided in response to a Rule 14 notice may be taken into account (even if relating to a period outside that assessed in the Rule 14 notice) when deciding whether the Act has been infringed.

147. It is for this reason that companies enjoy the rights of defence provided for (*inter alia*) in OFT Rule 14(5): to enable them to provide additional data and analysis to show why the OFT should not proceed to an adverse decision. In this case, the additional data showed in particular that DisCo's losses were short-lived, and so (in BSkyB's submission) could not adversely affect competition.

148. Accordingly, the OFT rejects NTL's submissions.

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<sup>155</sup> NTL Application, paragraphs 11, 40.

<sup>156</sup> I.e., a notice as provided for in rule 14 of the Schedule to the Competition Act 1998 (Director's rules) Order 2000.

<sup>157</sup> <http://www.offt.gov.uk/Business/Competition+Act/Decisions/Aberdeen+journals.htm> (remitted decision), paragraphs 191-194 of the decision.

<sup>158</sup> *Aberdeen Journals v OFT* [2003] CAT 11, paragraph 249 of the judgment.

#### **IV. EFFECTS ON THE DOWNSTREAM MARKET**

##### **1. ONdigital's submission**

149. ONdigital stated that the OFT margin squeeze test would be sufficient to show that BSKyB had exercised an anticompetitive margin squeeze, but that, where the application of that test was not conclusive, the OFT should consider the effect of the identified margin squeeze in the downstream market.<sup>159</sup> It should consider the effect of the margin squeeze on each individual competitor, and should take account of the entire market context, including BSKyB's general stance.<sup>160</sup> According to ONdigital, the OFT's failure was particularly striking since ONdigital went into liquidation during the period of its investigation.

##### **2. BSKyB's submission**

150. BSKyB stated that an appropriately structured accounting test may be used to assess whether a vertically integrated firm's downstream arm would be unable to operate profitably at the wholesale prices charged to rivals in the downstream market. Two further conditions should be fulfilled (in addition to finding dominance and the failure of the accountancy test) to show abuse of dominance: (i) the conduct has, or is likely to have, an adverse effect on competition in a relevant market; and (ii) the absence of objective justification for that conduct.<sup>161</sup>

151. According to BSKyB, the OFT need not consider these conditions, since the OFT did not find sufficient evidence that DisCo failed its accounting test.

152. BSKyB stated that the losses identified were too small and too short lived to expel a competing retailer from the market.<sup>162</sup> It attempted to quantify the losses that third parties may have suffered as a result of the margin squeeze found by the Decision. For ONdigital, these comprised £5.3 million over 16 months, or £4.0 million per 12 month period. £4.0 million was approximately 0.5% of the total investment in ONdigital, or 1% of the losses recorded by ONdigital in the 6 months to June 2001. In context, ONdigital agreed to pay £105 million per annum for three years for the Football League rights.

153. BSKyB produced equivalent figures for NTL and Telewest. For NTL, BSKyB estimated that the figures amounted to £6.0 million over 16 months, or an average of £4.5 million per 12 month period. This, according to BSKyB, represented 0.26% of group turnover for the calendar year 2000, and 0.15% of group turnover in the six month period to June 2001. It stated that the alleged overcharge for the calendar year 2000 and the six months to 30 June 2001 represented less than 0.05%

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<sup>159</sup> ONdigital Application, paragraph 3.4.4.

<sup>160</sup> ONdigital Application, paragraph 3.4.9.

<sup>161</sup> BSKyB submission dated 9 April 2003, page 18.

<sup>162</sup> BSKyB submission dated 9 April 2003, page 22.

of group debt in those periods. This represented less than a day's worth of interest payments on group debt for the 6 months to 30 June 2001.<sup>163</sup>

154. BSKyB concluded that in each case the magnitude and duration of the alleged overcharge was too small to have any material impact on their businesses.<sup>164</sup> BSKyB stated that the notional losses identified by the OFT had not diminished competition between pay television distributors.<sup>165</sup>

### **3. The OFT's finding**

155. The margin squeeze test applied by the OFT, which accords with EC jurisprudence, ensures undistorted competition between distribution rivals, so that more efficient distributors should prosper relative to less efficient rivals.
156. In Decision paragraphs 367-368, the OFT rejected the need to consider the performance of third parties to determine if BSKyB had abused its dominant position by exercising an anticompetitive margin squeeze. If DisCo is profitable, then distribution rivals as (or more) efficient than DisCo would also be profitable, while less efficient rivals might not be. If DisCo were not profitable then, to remain in business, it must be subsidised by other parts of BSKyB (and any other equally efficient business would also require subsidies.)<sup>166</sup>
157. Whether or not there is an anticompetitive margin squeeze therefore depends on whether or not DisCo is profitable. Since the focus is on DisCo, it is not necessary to examine the performance of third parties, which is likely to be affected by various factors. It is also unnecessary to compare the performance of DisCo or third parties to some benchmark of maximum efficiency, which would be very difficult.
158. The OFT considers that, if DisCo made significant and sustained losses that were not objectively justified, then BSKyB would not be competing on the merits in the relevant distribution market and so would infringe the Chapter II prohibition. Such DisCo losses would necessarily adversely affect competition, as the relative efficiency of the distribution rivals would not determine their relative success, but rather their ability to match BSKyB's subsidy of DisCo. Accordingly, the performance of any actual third party does not provide compelling evidence of whether BSKyB has exercised an unlawful anticompetitive margin squeeze infringing the Chapter II prohibition.

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<sup>163</sup> BSKyB submission dated 9 April 2003, page 23.

<sup>164</sup> BSKyB submission dated 9 April 2003, page 24.

<sup>165</sup> BSKyB submission dated 9 April 2003, page 24, with examples of that BSKyB stated evidenced competition given on pages 25-27.

<sup>166</sup> A more efficient business than DisCo could survive without subsidy. However, if a dominant company were permitted to sustain its relatively inefficient distribution business by subsidy in this circumstance, it would distort competition by impeding the growth of the more efficient company.



159. The OFT notes ONdigital's insolvency, and the significant debts incurred by the cable companies NTL and Telewest but considers that there is insufficient evidence to attribute this to anticompetitive conduct by BSKyB.

## V. CONCLUSION ON MARGIN SQUEEZE

160. For the reasons given above, the OFT has decided not to withdraw or vary its conclusions on margin squeeze contained in the Decision in response to the Applications. The OFT found that BSKyB incurred distribution losses.<sup>167</sup> However, for the reasons stated at Decision paragraphs 541-545, it did not consider that these amounted to an anticompetitive margin squeeze. In particular, they were not large, they were temporary, they were associated with the launch of BSKyB's digital platform, and they contained the irreducible element of uncertainty inherent in any model. Accordingly, these losses could not have had the effect of distorting competition between rival pay TV distributors, if they were as efficient as DisCo.
161. Since the Decision was published, the OFT has discovered an immaterial miscalculation of the basic programming costs payable by DisCo.
162. This affects the 12 month period to December 2001 only. The effect of the adjustment, assuming the wholesale prices paid by ONdigital, is:
- For the 22 month period post entry into force of the Act, the loss moves from -1.59% to -1.52%;
  - For the 6 months to June 2001, DisCo's profitability improves slightly, moving from -1.61% to -1.18%;
  - For the 6 months to December 2001, DisCo's profitability worsens, moving from 4.30% to 4.13%;
  - The peak losses of -6.10% (to December 2000) are unchanged.

The effect of the adjustment, assuming the wholesale prices paid NTL, is:

- For the 22 month period post entry into force of the Act, the loss moves from - 0.09% to - 0.01%;
- For the 6 months to June 2001, DisCo's profitability improves slightly, moving from -1.60% to -1.18%;
- For the 6 months to December 2001, DisCo's profitability is marginally lower, moving from 4.27% to 4.11%;
- The peak losses of -2.34% (to December 2000) are unchanged.

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<sup>167</sup> Decision paragraph 539.

Accordingly, the table provided at paragraph 539 of the Decision should read as follows:

	<b>10 months to Dec 2000 (unchanged)</b>	<b>6 months to June 2001</b>	<b>6 months to December 2001</b>	<b>22 months to December 2001</b>
<b>[ONDIGITAL]</b>	-6.10%	-1.18%	4.13%	-1.52%
<b>NTL</b>	-2.34%	-1.18%	4.11%	-0.01%
<b>TELEWEST</b>	-3.28%	0.69%	5.89%	0.70%

163. The changes noted above are minor and do not affect the OFT's conclusions with regard to margin squeeze.

## **PART THREE    MIXED BUNDLING**

164. 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).<sup>168</sup> The Decision found that there were insufficient grounds to find that BSKyB's mixed bundling strategy had infringed the Chapter II prohibition.<sup>169</sup>

### **I.        THE APPLICABLE LEGAL TEST**

#### **1.        NTL's submission**

165. NTL made no submission on the law applicable to mixed bundling. It did not challenge the Decision's test for normal competition as a basis for finding an abuse by BSKyB.<sup>170</sup>

#### **2.        ONdigital's submission**

166. ONdigital stated that the Decision did not analyse BSKyB's mixed bundling consistently with the requirements of European competition law, as embodied in the case law of the European Courts, and having due regard to the relevant decisions of the European Commission.<sup>171</sup> It stated that the OFT assumed that, as this form of conduct efficiently allows BSKyB to recover high fixed costs, it would in principle constitute normal competitive behaviour and not be abusive.<sup>172</sup> ONdigital stated that the OFT had created an evidential burden on rival companies to provide it with evidence to overcome its presumption that this form of price discrimination is essentially pro-competitive.<sup>173</sup>

167. ONdigital stated that the correct approach is that:<sup>174</sup>

- (i)        BSKyB's mixed bundling should be characterised as the tying of separate but related products;
- (ii)       such price discrimination whose actual or potential effect would be to induce loyalty or to assist the tying of products has been condemned by the European Courts;
- (iii)      the conduct is not in the same class as predation so issues of BSKyB's intention are irrelevant;

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<sup>168</sup> Decision paragraph 548.

<sup>169</sup> Decision paragraph 600

<sup>170</sup> NTL Application, paragraphs 50-53.

<sup>171</sup> ONdigital Application, paragraph 4.1.1.

<sup>172</sup> ONdigital application, paragraph 4.2.1.

<sup>173</sup> ONdigital Application, paragraph 4.2.3.

<sup>174</sup> ONdigital Application, paragraph 4.2.10.

- (iv) there is evidence of actual and potential foreclosure in the relevant markets;
- (v) BSKyB was 'superdominant' in both the relevant markets, so its pricing practice would have had a significant anticompetitive effect;
- (vi) such a conclusion would have been consistent with European case law on such discounts;
- (vii) the OFT's decision should be consistent with the case law of the European Courts and it should have due regard to any relevant decision or statement of the European Commission;
- (viii) to establish whether significant benefits exist in respect of its conduct, it would be necessary to require BSKyB to demonstrate empirically the existence of such benefits amounting to an objective justification. BSKyB should also have been required to demonstrate that the scale and scope of its conduct was the least anticompetitive way to achieve such alleged benefits; and
- (ix) BSKyB, because of its virtual monopoly in both the relevant markets, carried the '*heaviest responsibility to the competitive process*'.<sup>175</sup> ONdigital considered first, that the welfare benefits of BSKyB's price discrimination had not been sufficiently established and, second, it had not been established that BSKyB's actual form of conduct was the least anticompetitive way to achieve any alleged benefits.

168. In respect of the concept of 'superdominance', ONdigital referred to the Director's decision in *Napp*,<sup>176</sup> the CCAT's judgment on appeal of that decision,<sup>177</sup> and the judgment of the European Court in *Compagnie Maritime Belge*.<sup>178</sup>

169. In arguing that discounts may infringe the Chapter II prohibition, ONdigital referred to *Hoffman-La Roche*,<sup>179</sup> *Michelin*,<sup>180</sup> and *Virgin/British Airways*.<sup>181</sup>

170. Responding to BSKyB's submissions (see paragraphs 172-175 below),<sup>182</sup> ONdigital developed its arguments and referred in particular to *Hoffman-*

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<sup>175</sup> ONdigital Application, paragraph 4.2.10(i).

<sup>176</sup> OFT Decision in *Napp Pharmaceuticals* dated 30 March 2001, paragraph 141.

<sup>177</sup> Judgment of CCAT in *Napp Pharmaceuticals*, paragraph 219.

<sup>178</sup> See Judgment of the European Court in *Compagnie Maritime Belge v Commission* [2000] 4CLMR 1076, paragraph 119.

<sup>179</sup> Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 91.

<sup>180</sup> Case 322/81 *Michelin v Commission* [1983] ECR 3461.

<sup>181</sup> OJ [2000] L30/1.

<sup>182</sup> ONdigital submission dated 16 May 2003.

*La Roche, Michelin and Irish Sugar*,<sup>183</sup> and stated that if, after appraising the circumstances in respect of a dominant undertaking's pricing structure, any rebate or discount is found to have a tendency to restrict a buyer's choice as to his sources of supply then *prima facie* there is an abuse, unless otherwise justified.<sup>184</sup> ONdigital considered that BSkyB's pricing restricted such choice of supply, since (contrary to BSkyB's view) Sky Sports 2 (the channel against which ONdigital's sports channel, ITV Sport most directly competed) was purchased as the second, third or fourth premium channel. Accordingly, it was the discounted incremental price of this channel that was the benchmark against which ITV Sport must compete.<sup>185</sup>

171. Given such tendency to distort consumer choice, BSkyB must demonstrate an objective justification, which must be one of commercial necessity (rather than desirability), and such necessity must overcome the disadvantage deriving from the loss of competition.<sup>186</sup> The more market power a dominant firm has, the more difficult it is to objectively justify conduct that restricts competition.<sup>187</sup>

### 3. BSkyB's submission

172. As a general point, BSkyB stated that while the OFT's judgment in the Decision of whether the degree of BSkyB's mixed bundling exceeds normal competition may be questioned, neither Applicant can object to the OFT's articulation of the legally relevant questions and its overall approach to addressing them.<sup>188</sup>
173. BSkyB noted that, as confirmed by the CCAT,<sup>189</sup> it is for the OFT to prove any infringement of the Act, including whether BSkyB had engaged in mixed bundling to an excessive degree. BSkyB also stated that ONdigital's assertion that the OFT has mistakenly created an evidential burden on rival companies is misconceived. BSkyB argued that it is clear that the OFT considered the question as to what kind of conduct is normal in the TV sector; that it examined the facts; and that it correctly concluded that: (i) some degree of mixed bundling would be expected; and (ii) there could be no presumption that mixed bundling is *per se* abusive.<sup>190</sup>

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<sup>183</sup> Case 228/97 *Irish Sugar v Commission* [1999] ECR II-2969.

<sup>184</sup> ONdigital submission dated 16 May 2003, paragraph 5.8.

<sup>185</sup> ONdigital submission dated 16 May 2003, section 6.

<sup>186</sup> ONdigital submission dated 16 May 2003, section 7.

<sup>187</sup> ONdigital submission dated 16 May 2003, section 8.

<sup>188</sup> BSkyB response dated 16 April, section 2.

<sup>189</sup> CCAT Judgment in *Napp Pharmaceuticals* (Case No 1001/1/1/01) of 15 January 2002, paragraph 100.

<sup>190</sup> BSkyB response of 16 April 2003, section 3.

174. BSKyB also disagreed that the Decision is inconsistent with the case law of the European courts. First, it stated that ONdigital is mistaken in considering that the OFT approached the case as one of predation. The OFT approached the matter from first principles, and the test it used was not taken from the case law on predation.<sup>191</sup> Second, BSKyB stated that ONdigital's suggestion that the OFT should have treated the case as one of, or akin to, loyalty rebates is misconceived. It would be incorrect for all new cases of potential abuse to be 'shoehorned' into some previously identified category of abuse.<sup>192</sup>
175. BSKyB denied that it is 'superdominant', but stated that even if it were, ONdigital has misunderstood the sense in which superdominant undertakings are subject to a more onerous special responsibility.<sup>193</sup> BSKyB stated that the more onerous special responsibility does not mean that superdominant firms must apply and pass a different test of objective justification/proportionality in order for their conduct to be justified. It means only that, if a firm faces very little or no competition, then conduct which may be necessary for lesser firms to protect their legitimate interests may not be necessary for the superdominant firm to protect its legitimate interest.

#### 4. The OFT's assessment of the applicable test

176. Given the paucity of EC precedents concerning mixed bundling (particularly in sectors such as channel provision),<sup>194</sup> the OFT assessed BSKyB's mixed bundling from first principles. The classic definition of abuse of a dominant position was provided by the European Court in paragraph 91 of its judgment in *Hoffman-La Roche*:

'The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition *normal competition in products or services on the basis of the transactions of commercial operators*, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.' (Emphasis added).

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<sup>191</sup> BSKyB response of 16 April, section 4.

<sup>192</sup> BSKyB response of 16 April, section 5.

<sup>193</sup> BSKyB response of 16 April, section 8.

<sup>194</sup> The Decision identified just two at paragraph 589: *Coca-Cola/Amalgamated Beverages GB* [1997] OJ L-218/15 referred to an undertaking limiting bundling, and *Digital* (see Commission press release IP/97/868 of 10 October 1997). Neither is a final Commission decision. ONdigital referred to neither case.

177. The OFT considers that the phrase in italics should be taken to mean 'competition on the merits' or 'normal competition'.<sup>195</sup> The European Court has subsequently used the formulation '*recourse to means other than those within the scope of competition on the merits*'.<sup>196</sup>
178. Accordingly, in line with these judgments, to find BSKyB's mixed bundling abusive, the OFT determined whether BSKyB had: (i) ceased to compete on the merits,<sup>197</sup> and (ii) whether such deviation had adversely affected competition.<sup>198</sup> This is in line with the approach of the CAT in *Aberdeen Journals v OFT*.<sup>199</sup>
179. In the Decision, the OFT was alert to the fact that the provision of those channels subject to its investigation was characterised by very high fixed and common costs, but very low marginal costs, and BSKyB was selling into a market with varied but unknown consumer preferences.
180. Given these key characteristics, to assist its assessment of whether BSKyB's mixed bundling exceeded that which would occur in conditions of normal competition (Decision paragraph 590), the OFT determined whether BSKyB bundled to the extent that the incremental avoidable cost per additional subscriber of supplying particular channels exceeded the implied incremental price of such channels (Decision paragraph 592.) This is not to equate mixed bundling with predation, contrary to ONdigital's Application.<sup>200</sup> The reason for considering this test was set out at Decision paragraph 571:
- '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)'.
181. Since the OFT considered that pricing above this level was consistent with normal competition, and that BSKyB did price above this level with regard to its premium sports channel packages, given the absence of additional evidence showing anticompetitive intent or effects (Decision paragraph 594), the OFT did not consider foreclosure of entry to potential suppliers of premium sports channels further.

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<sup>195</sup> The OFT considers this a better translation of the German version of the judgment: '*...welche von den Mitteln eines normalen Produkt oder Dienstleistungs-wettbewerbs auf der Grundlage der Leistungen der Marktbuerger abweichen*'. German was the original language of the judgment.

<sup>196</sup> Case T-228/97 *Irish Sugar plc v Commission* [1999] ECR II-2969, paragraph 111 of the judgment; see also Case 322/81 *Nederlandsche Banden-Industrie Michelin v Commission* [1983] ECR 3461, paragraph 70 of the judgment.

<sup>197</sup> Decision, Part Twelve, concluding with paragraphs 589-596.

<sup>198</sup> Decision, Part Twelve, concluding with paragraphs 597-599.

<sup>199</sup> [2003] CAT 11, paragraph 350 of the judgment

<sup>200</sup> ONdigital Application, paragraph 4.2.27.

182. The OFT concluded that in the case of premium film channels incremental prices seldom exceeded incremental avoidable cost (Decision paragraph 595).
183. Given the Applications, for completeness, the OFT has reviewed:  
(i) whether rival premium film and sports channels have been foreclosed by BSkyB's mixed bundling, notwithstanding the finding in the Decision that BSkyB had competed normally in its provision of its premium sports channels at bundled prices (Decision paragraph 594); and (ii) whether BSkyB's mixed bundling adversely affected the markets for premium content provision.
184. Contrary to ONdigital's Application, the OFT made no presumption that mixed bundling is justified automatically nor that it created an evidential burden on rival companies to present it with evidence of actual foreclosure.<sup>201</sup>

## **II. ECONOMIC ANALYSIS REGARDING FORECLOSURE OF PREMIUM CHANNEL SUPPLIERS**

### **1. ONdigital's submission**

185. ONdigital stated that certain facts amounted to evidence of foreclosure.<sup>202</sup>
- (i) Any new entrant premium channel would most directly compete with Sky Sports 2 or Sky MovieMax, given the popularity of Sky Sports 1 and Sky Premier, and so must compete with the low incremental prices of additional premium channels.
  - (ii) ONdigital's decision not to create a film channel on the basis of its rights from Sony-Tristar Columbia and Universal Pictures was, in part, motivated by BSkyB's deep discounting (i.e., mixed bundling) policy.
  - (iii) Film Four is not operated as a commercial venture and would probably be loss-making if operated as a stand-alone business. Its market share is insignificant and it is not therefore an example of successful market entry.
  - (iv) ITV Sport was constrained by the incremental price of Sky Sports channels, thus demonstrating actual foreclosure.
  - (v) ITV Sport effectively exited the premium sports channel market in May 2002.

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<sup>201</sup> ONdigital Application, paragraphs 4.2.1 to 4.2.4.

<sup>202</sup> ONdigital Application, paragraph 4.2.49.



- (vi) The absence of any rivals to BSkyB in the wholesale market for the provision of premium sports and any serious rivals in the market for premium film channels.

## **2. NTL's submission**

186. NTL drew attention to the two relatively recent entrants into the wholesale premium channel market: Film Four and ITV Sports.<sup>203</sup> ITV Sports channel closed in May 2002 following the closure of ITV Digital, while Film Four has made consistent losses since it was launched in 1998 and has recently shown very little subscriber growth. NTL argued that this was sufficient evidence of foreclosure in its own right but also speculated that the experiences of these two entrants will deter other potential channel providers.
187. NTL argued that, in the absence of mixed bundling, it would be realistic to expect other multiple movie and sports channel providers in the UK as is the case in the US, Netherlands and France.<sup>204</sup>

## **3. BSkyB's submission**

188. BSkyB stated that ONdigital appeared to have adduced no new evidence to support its case and that it merely referred to evidence that it had already provided to the OFT.<sup>205</sup>
189. BSkyB argued that ONdigital's claim that its decision not to create a film channel provides further evidence that BSkyB's mixed bundling policy acted to foreclose entry is contradicted by ONdigital's own previous submissions. In its May 2000 submission, ONdigital indicated that each studio's output tends to vary greatly in quality, attractiveness and volume from year to year and that, accordingly, any channel that had output deals with just one or two studios would have a very variable quality of offering over time. BSkyB argued that it is within this context that the May 2000 submission makes reference to ONdigital's decision not to pursue an opportunity presented by Sony and Universal to establish a DTT premium film channel.<sup>206</sup>
190. BSkyB also stated that the claim that BSkyB's mixed bundling strategy contributed to the exit of ITV Sport is incorrect. First, BSkyB has operated a mixed bundling strategy since 1991 and this was well known to ONdigital and did not deter ONdigital from bidding for rights and launching its own sports channel. Second, it was well documented that the principal factors undermining ITV Sport's ability to achieve profitability were: (i) ONdigital's overpayment for rights to the Nationwide Football league and (ii) ONdigital's decision to withhold

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<sup>203</sup> NTL Application, paragraphs 54-55.

<sup>204</sup> NTL Application, paragraph 56.

<sup>205</sup> BSkyB response of 16 April, section 6.

<sup>206</sup> BSkyB response of 16 April, section 6.

distribution of the channel from DSat subscribers in an attempt to drive subscribers to ONdigital's service.<sup>207</sup>

191. Further, BSKyB also argued that its mixed bundling at the wholesale level did not adversely affect ONdigital's ability to earn revenue by means of cable subscribers. ITV Sport successfully obtained carriage on NTL and, according to press reports, NTL would need to sell as many as 642,467 subscriptions to cover a significant minimum guarantee.

#### **4. The OFT's analysis**

##### **4.1 Premium sports channels**

192. The OFT accepts that BSKyB's mixed bundling is likely to have some effect on the ability of new entrants to enter the relevant wholesale market. However, in the Decision, the OFT stated that, to find an abuse of the Chapter II prohibition, it would not be sufficient to show that the wholesale pricing structure affected entry to some degree. For bundled pricing to be abusive, it should exceed that which would occur in conditions of normal competition. In the case of premium sports channels, the OFT, having examined the characteristics of the industry (high fixed and common costs, low incremental costs, consumers with varied but unknown preferences), did not find evidence showing that BSKyB had deviated from a pricing strategy consistent with normal competition. In particular, the OFT noted that the implied incremental price of its premium sports channels always exceeded their incremental cost.
193. While the evidence offered by the Applicants in respect of premium sports channel foreclosure highlights the effect on entrants, it does not show an unlawful anticompetitive effect. In particular, it does not address the OFT's framework for characterising an abuse of the Chapter II prohibition, given the industry conditions within which BSKyB competes. ONdigital emphasised the 'special responsibility' that dominant companies have not to distort competition.<sup>208</sup> The OFT considers that this responsibility entails not deviating from conduct that would prevail in conditions of normal competition. This is not necessarily the same as departing from normal commercial practice within a particular market. Equally, normal commercial practice might represent a departure from competition on the merits.<sup>209</sup>
194. In the Decision, the OFT characterised departure from conduct that would prevail in conditions of normal competition as (in particular and in

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<sup>207</sup> BSKyB response dated 16 April, section 6.

<sup>208</sup> E.g., ONdigital submission dated 16 May 2003, section 8.

<sup>209</sup> See ONdigital submission dated 16 May 2003, paragraphs 7.3-7.6, stating that a normal commercial practice or usage could abuse a dominant position.

principle) deviation from a strategy that would maximise profits absent benefits deriving from entry deterrence.<sup>210</sup>

195. Moreover, it appears that the exit of ITV Sports was driven by factors other than BSkyB's mixed bundling strategy. BSkyB highlighted the price paid for Nationwide Football league rights,<sup>211</sup> and ONdigital's failure to procure carriage on the DSat platform. The OFT considers these to be the more relevant factors in ITV Sports' failure.

#### **4.2 Premium film channels**

196. In the Decision, the OFT noted that the incremental implied price for one premium film channel type seldom exceeded the incremental avoidable cost per additional subscriber of supplying such channels. Although BSkyB had not demonstrated that such below-cost pricing was profit maximising,<sup>212</sup> the OFT did not have sufficient evidence in this respect to find an infringement, not least because of the entry barrier already existing as a result of BSkyB's premium film content rights.
197. The evidence that ONdigital and NTL present above is not new. However, in respect of ONdigital's decision not to use the available content rights of Sony-Tristar Columbia and Universal Pictures, it is clear to the OFT, even from ONdigital's own submissions, that BSkyB's mixed bundling was just one of several factors affecting ONdigital's decision not to enter the premium film channel market.
198. In its original submission, ONdigital stated:<sup>213</sup>

'...a channel with rights from just one or two studios would find it impossible to compete effectively with BSkyB's premium film channels..... Soon after ONdigital's launch it was approached by Sony-Tristar Columbia and Universal Pictures – the two studios for which BSkyB does not yet have DTT rights – with a view to setting up a DTT-exclusive premium film channel based on the films of these two studios. ONdigital declined this opportunity for a number of reasons. One of the reasons was its belief that such a channel would not have sufficient content to provide an effective competitor to BSkyB's premium films channel at this time. It took into consideration the fact that further rights would not become available for negotiation until 2003 at the earliest... BSkyB Broadco may have a further incumbency advantage in bidding for film rights relating to its strong existing subscriber base for movie channels... the fact that BSkyB does not have to invest

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<sup>210</sup> Decision paragraph 591; also Decision footnote 482.

<sup>211</sup> ONdigital stated that it had purchased these in a competitive auction and so had only paid the competitive rate: ONdigital submission dated 16 May 2003, paragraph 6.9. In retrospect, it appears to have been afflicted by the 'winner's curse'.

<sup>212</sup> Decision paragraph 596.

<sup>213</sup> ONdigital submission dated 5 May 2000, section 3.1.5.

significant amounts in customer acquisition tends to increase the profits it can generate from a given set of rights.'

199. ONdigital also stated:

'The barrier to entry in this market is an absolute one as BSkyB has exclusive deals with each of the major Hollywood studios for UK premium pay TV movie rights on all pay TV platforms which do not expire until 2003 – 2006... In summary, were all Hollywood rights available to ONdigital, then ONdigital would wish to adopt a strategy of creating competing movie channels to Sky Premier and Moviemax.'<sup>214</sup>

200. Accordingly, the OFT regards this evidence as consistent with its finding in the Decision that even if BSkyB's mixed bundling had the hypothetical ability to foreclose, the particular circumstances of the upstream market means that the bundling did not produce this effect during the period investigated.<sup>215</sup> It also notes that BSkyB has offered its film channels in mixed bundles at retail level since 1991, and at wholesale level since 1993.<sup>216</sup> This is consistent with BSkyB's claim that mixed bundling is an efficient way of distributing its channels, as opposed to a method of entry deterrence.

201. Moreover, it would be incorrect for the OFT to accept NTL's claim that the presence of multiple film and sports channel providers in certain other countries is evidence of foreclosure in the UK, because the extent to which content rights are dispersed in upstream markets is likely to vary from country to country.

### **III. ECONOMIC EFFECTS ON THE MARKET FOR PREMIUM CONTENT**

#### **1. NTL's submission**

202. NTL argued that the OFT failed to address the potential impact of BSkyB's policy of mixed bundled supply on the market for premium content generally.<sup>217</sup> In particular, that the bundling will deter upstream bidding for rights by limiting the maximum wholesale price that a prospective entrant would be able to charge distributors. Since this will provide an effective barrier and preserve BSkyB's dominant position in the supply of premium channels, NTL will be forced to remain dependent on BSkyB for premium channels and thus only able to offer muted competition to BSkyB generally.

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<sup>214</sup> ONdigital submission dated 26 January 2001, Question 3.

<sup>215</sup> See Decision paragraph 599.

<sup>216</sup> BSkyB submission dated 18 June 2003.

<sup>217</sup> NTL Application, paragraphs 57-58.

## **2. ONdigital's submission**

203. ONdigital did not make submissions on the effect of BSkyB's mixed bundling policy on the market for premium content generally.

## **3. BSkyB's submission**

204. BSkyB argued that there is a fatal flaw in NTL's argument that mixed bundling reduces the amount that a prospective wholesaler might charge for a premium channel and therefore has a knock-on effect in the market for premium content.<sup>218</sup> BSkyB argued that the Decision concludes that entry into the relevant markets in which BSkyB's channels are deemed to compete is contingent on obtaining licences to a very limited set of rights, the supply of which is fixed.
205. Accordingly, if a new entrant were able to acquire content sufficient to create a rival channel, this would necessarily reduce the content available to BSkyB. This would first mean that a new entrant may not need to persuade subscribers to drop a BSkyB film channel (on the basis that less output for BSkyB would mean less channels). Second, if BSkyB were no longer in a position to offer as many premium channels, its price structure would change. In particular, the notional incremental price currently charged for the second channel of a given genre (e.g., films) would become irrelevant.

## **4. The OFT's analysis of effects in content market**

206. In paragraphs 268 to 321 relating to BSkyB's dominance, the Decision outlines the significant advantages that BSkyB enjoys in acquiring content rights in the upstream pay TV market(s). The OFT does not have sufficient evidence to conclude that BSkyB's mixed bundling strategy has added significantly to such existing barriers to prospective bidders of film content rights.<sup>219</sup>
207. In the case of premium sports, the OFT concluded that, in the absence of evidence that BSkyB's bundling has exceeded the limits of normal competition, it did not need to consider further whether BSkyB's bundling foreclosed entry to rival suppliers. NTL has not challenged the OFT's analysis of normal competition.<sup>220</sup>

## **IV. THE OFT'S CONCLUSION ON MIXED BUNDLING**

208. While the characteristics that make a dominant undertaking's products more attractive to consumers (such as their quality and price) will make

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<sup>218</sup> BSkyB response of 16 April, section 9.

<sup>219</sup> For example, in its response to the OFT of 30 January 2001 (question 9), Film Four did not cite mixed bundling in its analysis of the main barriers to entry in the premium films market (although it did cite it as a possible barrier to expansion in question 21).

<sup>220</sup> Stated in Decision paragraphs 567 to 569.

the task of a rival seeking to attract those consumers harder, these are not necessarily the result of anticompetitive conduct or, consequently, the concern of competition law. Neither Application adequately distinguished the limits of competition on the merits from abusive conduct. Both concentrated on the increased difficulties faced by rivals.

209. Despite careful consideration of the Applications, the OFT does not withdraw or vary its conclusions set out in Part Twelve of the Decision, that there was insufficient evidence to conclude that BSkyB's mixed bundling infringed the Chapter II prohibition.

**PART FOUR      INCREMENTAL PRICING OF PREMIUM CHANNELS AT THE DISTRIBUTION LEVEL**

210. BSkyB is vertically integrated and offered channel packages at both retail level to consumers via its digital satellite platform, and to third party distributors such as the Applicants at channel provision or wholesale level. At the retail level, BSkyB supplied its premium channels only bundled with a basic channel package, at a combined price.
211. During the period investigated, BSkyB's wholesale premium channel package prices were calculated as a percentage of the price of the equivalent retail package (when combined with BSkyB's largest basic package). For such wholesale price, third party distributors acquired only the relevant premium channels.
212. If such retail prices were the maximum price that the Applicants could sell a particular premium channel package, then the price increment that a BSkyB subscriber had to pay for moving from a basic to a premium package was often less than the wholesale price at which BSkyB offered the Applicants such additional premium channels.

**1.      NTL's submission**

213. NTL requested the OFT to vary the Decision to take account of the effect of BSkyB's incremental pricing policy on competition at the retail level.<sup>221</sup> It contended that the wholesale prices charged by BSkyB were unfair and excessive, and that the effect of BSkyB's incremental pricing policy for premium channels was to foreclose NTL from the retail market.
214. In particular, NTL argued that the OFT failed to take account of the fact that NTL incurs an incremental loss each time one of NTL's basic family subscribers chooses to take a premium channel package. This meant, according to NTL, that it was more profitable for it to sell a basic-only package to a subscriber, than a basic plus BSkyB-premium channel package, so that it would 'lose' money every time such a subscriber traded up to a premium package.

**2.      ONdigital's submission**

215. ONdigital cited the same issue as an example of the OFT failing to assess the effects of the margin squeeze in its economic context.<sup>222</sup> It stated that it considered that BSkyB's incremental pricing represented an anticompetitive strategy to increase its distribution market share at the expense of rivals and demonstrates that the effect of the margin squeeze employed by BSkyB was most keenly targeted at distorting competition between distributors of premium channels.

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<sup>221</sup> NTL Application, paragraphs 42-49.

<sup>222</sup> ONdigital Application, paragraphs 3.4.11-3.4.14.

### **3. BSKyB's submission**

216. BSKyB stated first that ONdigital was incorrect in stating that the OFT had failed to take into account this aspect of BSKyB's conduct (i.e., the incremental prices between BSKyB's retail packages compared to the wholesale prices charged to distributors) in its Decision.<sup>223</sup> While ONdigital had now labelled this issue as an effect of the margin squeeze, it had previously submitted the issue as one requiring a second margin squeeze test, which the OFT had dealt with in Decision paragraphs 425–427.
217. BSKyB's principal argument is that margins on subscriptions to premium packages are positive for all distributors and there are therefore powerful incentives for all distributors to attract and retain premium subscribers. Upgrade and downgrade activity (i.e., switching between packages containing, and not containing, premium channels) by subscribers between any particular services makes no material contribution to competition between distributors. Further, the Applicants could have addressed their alleged lack of incentive to upgrade basic-only subscribers by altering their own retail prices (as they could, for instance, reduce the price of their basic packages to ensure that the increment between the prices of their basic and their premium channel packages covered the wholesale price of BSKyB's premium channel packages).<sup>224</sup>

### **4. The OFT's analysis**

218. The failure of BSKyB's implied incremental retail prices (between its basic and premium channel packages) to cover BSKyB's wholesale prices for the relevant premium channel packages was not identified as a possible infringement of the Chapter II prohibition in the Rule 14 notice issued to BSKyB on 17 December 2001. The OFT did, however, consider this issue in Decision paragraphs 423-428.
219. The OFT considers that the key test for foreclosure from the relevant distribution market is whether BSKyB's wholesale prices allow third party distributors to retail premium packages profitably if they are as efficient as BSKyB's distribution business, DisCo. This is the subject of the margin squeeze analysis in Part Eleven of the Decision. The OFT considers that it is possible for BSKyB to offer different profit margins on different packages without necessarily infringing the Chapter II prohibition. If there is a profit margin on a particular premium package, it is profitable for a distributor to distribute such package and to compete for BSKyB's customers, regardless of the incremental losses claimed by the Applicants.<sup>225</sup>

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<sup>223</sup> BSKyB submission dated 9 April 2003, section 6.1.

<sup>224</sup> BSKyB submission dated 9 April 2003, section 6.

<sup>225</sup> The OFT did not conduct a margin squeeze analysis on a premium package-by-premium package basis, as this would have involved sufficient arbitrary cost allocations to undermine confidence in any results obtained.



220. Further, the Applicants' analyses implicitly assume that all basic-only customers who do not trade up to BSkyB premium channel packages would continue to subscribe to a basic package: in such a situation, it would follow that the Applicants' profitability would decrease if such customers traded up to premium packages.
221. However, even if this were the case, it is possible that unless the Applicants offered BSkyB premium channels, new or existing customers would not take any Applicant package (because, for instance, they subscribed to a competitor to obtain BSkyB premium channels). Equally, the Applicants' assessments ignore whether it is profitable for them to win BSkyB customers who will only switch if they continue to have access to BSkyB premium channels.
222. The OFT therefore does not consider that the incremental relationship between wholesale and retail prices described above forecloses the distribution market to NTL (or foreclosed the market to ONdigital), and neither does it consider that the Applicants' assessment is the appropriate way to calculate channel package distribution profitability.
223. Accordingly, the OFT concludes that the critical and relevant test for assessing foreclosure to the retail market is the one covered by the margin squeeze analysis.

#### **PART FIVE CONCLUSION**

224. On the grounds set out above, the OFT rejects both Applications to vary or withdraw the Decision.

**John Vickers**  
**Chairman**  
**29 July 2003**

## Annex 1

<b>Cost items included under subscriber management in B SkyB's Form 20-Fs</b>	<b>Allocation in the Decision</b>
Install Costs (unsubsidised element)	Allocated directly to DisCo - within marketing costs
Bad debt	Allocated directly to DisCo – accounted for in DTH revenue calculation
Smartcard costs	Allocated to CACo (and indirectly to DisCo via CA charges)
STB costs (unsubsidised element)	Allocated to CACo (and indirectly to DisCo via CA charges)
Subscriber handling	Allocated to CMSCo and CACo (and indirectly to DisCo via CMS and CA charges)
Depreciation	Allocated to CMSCo (and indirectly to DisCo via CMS charges)

See section 3.5 of the B SkyB submission dated 9 April 2003.