"KANGAROO" JOINT VENTURE BETWEEN BBC WORLDWIDE, ITV AND CHANNEL 4

INTRODUCTION

I. The OFT referred the Kangaroo joint venture between BBC Worldwide, Channel 4 Television Corporation and ITV plc to the Competition Commission ("CC") for further investigation on 30 June 2008. [***CONFIDENTIAL***] British Sky Broadcasting Group plc's ("Sky's") [***CONFIDENTIAL***].

II. [***CONFIDENTIAL***] Part A of this paper [***CONFIDENTIAL***] provides Sky's views in response to certain of the comments made by the OFT in its decision to refer the merger to the CC, published on 14 July 2008 ("OFT Decision"), as well as (where relevant) comments on the CC's Statement of Issues.[1] [***CONFIDENTIAL***].

III. [***CONFIDENTIAL***].

PART A: SKY'S CONCERNS ABOUT KANGAROO

1. Introduction

1.1 In the sections below Sky sets out its supplementary views in relation to jurisdiction, market definition and the competitive effects of the Kangaroo merger.

2. Jurisdiction

2.1 At the time of making its submission to the OFT, and for the reasons set out in that submission, Sky considered that the formation of the Kangaroo joint venture, if carried into effect, would be likely to result in the creation of a "relevant merger situation" within the meaning of section 23 of the Enterprise Act 2002.

2.2 Sky continues to hold this view, noting that information in the OFT Decision would support this.

2.3 Accordingly, Sky considers that the CC has jurisdiction to consider the merger and recommend appropriate remedies to address any substantial lessening competition to which it may give rise.

3. Market definition

3.1 Sky's views on market definition differ from certain of the views of the OFT as set out in the OFT Decision.[2] Sky agrees with the OFT that for the purposes of market definition at the retail level it is inappropriate to segment catch-up and archive content. Sky also

[1] CC "Statement of Issues", 8 August 2008.

[2] In particular, Sky does not agree that "*premium movie rights are not sufficiently constrained by viewing of mainstream content*" (paragraph 33 OFT Decision). Sky notes also that Ofcom's consultation document in its pay television investigation did not "*confirm*" that this is the case, as the OFT suggests. That consultation document did not reach any firm conclusions on market definition, being a consultation document and not a final decision.

agrees that distinguishing between internet and TV based VOD at the retail level is not necessary. Whilst the OFT considers it an "open question" as to whether US-originated TV content acts as a sufficient constraint on UK-originated TV content to warrant inclusion in the same product market, Sky considers that all forms of audiovisual content are substitutable from the perspective of viewers. This does not mean, however, that the proposed joint venture could not give rise to concerns at the retail level. It was generally accepted by the OFT and third parties[3] that currently content on linear television channels drives demand for VOD, and the parties have very strong positions in UK-originated television content, as well as hard to replicate advantages such as the ability to cross-promote their services on universally available public service channels. We address these concerns further at paragraph 4 below.

3.2 At the wholesale/syndication level, the OFT found "*regardless of the precise boundary of the relevant product market, by combining close competitors, Kangaroo therefore raises unilateral effects concerns as the joint venture may be able to exert enhanced market power and raise syndication prices as a result*".[4]

3.3 Since potential concerns arise at both retail and wholesale levels of the market irrespective of the precise market definition adopted, Sky does not propose to deal further with market definition in this submission.

4. Competitive effects of the merger

4.1 The CC's Statement of Issues identifies three ways in which the Kangaroo merger might result in a substantial lessening of competition. These are specified as:

> "*(a) Loss of competition in the supply of VoD content rights at the wholesale level. If there are few effective substitutes for the parties' VoD content, and the parties competed absent the JV, the JV might offer worse terms (eg price, quality, innovation) for the wholesale supply of content rights to VoD retailers. This would be likely to result in viewers paying higher prices and/or receiving lower quality or less innovative offerings than would otherwise be the case.*
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> *(b) Loss of competition in the supply of VoD content at the retail level. As a result of the JV, the parties may have less incentive to compete with one another on the terms of their online offerings, resulting in viewers paying higher prices and/or receiving lower quality or less innovative offerings than would otherwise be the case.*
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> *(c) Loss of competition at the retail level through partial or total foreclosure at the wholesale level. The JV may give the parties the ability and incentive to offer worse terms for VoD content rights or cease to supply them altogether to one or more rival retailers, resulting in viewers paying higher prices and/or receiving lower quality or less innovative offerings than would otherwise be the case.*"

4.2 Sky sets out its views on these "theories of harm", and other theories that Sky considers may be relevant, in the sections below.

(a) Loss of competition in the supply of VOD content rights at the wholesale level

4.3 VOD services are undergoing a period of rapid growth and rapid change. At the current stage in the development of the VOD sector, the content which wins large numbers of viewers on a VOD basis, and which drives use of VOD services, will consistently be the

[3] OFT Decision, paragraph 27.
[4] OFT Decision, paragraph 121.

same content that wins large numbers of viewers when delivered via more traditional methods, such as on linear television channels.

4.4 It is beyond dispute that the joint venture parties are the three market leaders in the provision of linear television channels. Together, the parties account for around 70% of television viewing in all homes in the UK. [5] In Freeview homes this figure rises to 90%. Even in homes that subscribe to pay television services, the linear television channels provided by the parties account for around 64.7% of all television viewing, a figure that increased during 2007.[6] Out of the most popular 100 programmes broadcast on television in the UK in 2007, every single one was broadcast by the joint venture parties.[7]

4.5 Due to their significant in-house production facilities, the BBC and ITV own large libraries of rights to the content broadcast on their channels (with BBC Worldwide having a right of first refusal over the BBC's entire archive library). In addition, all three joint venture parties control VOD rights in libraries of content produced by third party production companies and acquired by the parties for broadcast on their channels.

4.6 Accordingly, it is highly likely to be the case that the parties are each currently at or near the top of the list of choices for most retailers of VOD services wishing to acquire VOD content. [***CONFIDENTIAL***]

4.7 Sky understands that, under the terms of the joint venture, subject only to certain undisclosed "*carve outs*" permitting the parties to continue to supply their content to retailers in specific circumstances, all VOD rights currently owned or otherwise held by the BBC, ITV and Channel 4, other than VOD rights in a 0-7 day "catch-up" period in respect of content from the BBC (which will remain available through BBC iPlayer), will be supplied exclusively to Kangaroo. Kangaroo will then itself syndicate such content to VOD retailers.

4.8 As a result, it is likely that Kangaroo will combine VOD retailers' top choices for VOD content. The joint venture will, therefore, result in an immediate loss of the competition between three close competitors in the provision of VOD rights to VOD retailers. In Sky's view, this loss of competition may well be significant given the closeness of the parties as competitors and their significant positions in the provision of both linear and VOD content.

4.9 As noted by the CC in its Guidelines on Merger references ("CC Merger Guidelines"), the merger of firms producing differentiated products in the same market (as is the case here) can lead to a significant lessening of competition where it allows the merged firm to unilaterally to increase the price of one or more products. The CC also notes that "*this is particularly likely when a large proportion of customers of the… firms view the… products as close substitutes, e.g. their first and second best choices*".[8] Given that, as set out above, Kangaroo will almost certainly involve the merger of three operators whose content is at or near the top of retailers' choices for VOD rights, there appears to be a considerable risk that Kangaroo will result in a worsening of the terms for the wholesale supply of VOD rights as compared with the terms that would exist absent the joint venture. Such

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5 OFT Decision, paragraph 28.

6 Ofcom Communications Market Report, 14 August 2008, figure 3.80 (page 222). In the Communications Market Report for 2006 the same figure was 63%.

7 Source: BARB.

8 CC Merger Guidelines, paragraph 3.29.

terms could include price and other terms such as, for example, the duration of licences and terms relating to user-interfaces.[9]

4.10 As a result of the factors above, Sky considers that the formation of Kangaroo raises legitimate concerns about unilateral effects in the provision of VOD content rights.

(b) Loss of competition in the supply of content on a VOD basis at the retail level

4.11 In relation to the potential loss of competition at the retail level, the CC should consider not just (as it is proposing to do) the potential for loss of rivalry between the parties, but also the potential for loss of future competition from third parties in the provision of VOD services. For the reasons set out below, Sky considers that both a loss of existing rivalry between the parties, and a loss of future competition, are far more likely than (it appears) is envisaged by the OFT.

Effects arising from a loss of competition between the parties

4.12 As noted in our response to the OFT, Channel 4 and ITV each already provide successful VOD services to viewers. Whilst BBC Worldwide does not currently provide such services, it is clearly an important potential future competitor who would, absent the joint venture, start providing VOD services in the near future. In addition, its parent company, the BBC, provides the hugely successful BBC iPlayer.

4.13 The formation of Kangaroo will result in a loss of existing and potential future rivalry between the parties' existing VOD offerings because:

(i) the parties will set the prices for their VOD content collectively through Kangaroo, rather than individually;

(ii) due to the exclusive supply arrangements between the parties and Kangaroo, ITV and Channel 4 will (we understand) significantly reduce the content available via their existing VOD portals;

(iii) BBC Worldwide will not, as would be expected in the near future absent the merger, start to provide a VOD offering of its own; and

(iii) each party's incentive to attract viewers to their own content (though investment in quality, innovation, amount of output able to be provided and so on), whether inside or outside Kangaroo, will be reduced, as each of them will receive a financial benefit when any of their content is viewed via the Kangaroo service.

4.14 As a result, Kangaroo will result in an immediate loss of competition between the parties, who, absent Kangaroo, would have competed vigorously against one another in a range of parameters, including on price. When quantifying this loss of competition the CC should take into account:

(i) the fact that merger would occur at a key time in the development of the VOD sector: Ofcom, for example, predicted in 2006 that linear TV viewing may fall 20-

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9 The BBC, for example, is currently pursuing a strategy of requiring that the user experience enjoyed by viewers of its VOD content on other platforms is as close as possible to the user experience enjoyed by users of BBC iPlayer online.

30% over five years, to be replaced largely by increased use of on-demand services;[10]

(ii) the parties' obviously strong position in linear TV broadcasting (see paragraph 4.4 above); and

(iii) the parties' clear success to date with their existing VOD offerings.

4.15 In light of these factors, there would appear to be a substantial risk that Kangaroo would result in a distortion of competition at a key time in the development of VOD services.

Effects arising from a loss of competition from third parties

4.16 The parties enjoy a number of unique advantages in building a VOD offering. These include:

(i) access to direct and indirect state funding which is used for the acquisition and production of content which is to be made available through Kangaroo;[11]

(ii) direct access to VOD rights to the vast libraries of content shown on the parties' linear television channels. As noted above, those channels account for 70% of television viewing in the UK, and thus include a huge range of extremely attractive, popular, well known programmes;

(ii) in respect of at least ITV and Channel 4, the ability to cross-promote the availability of Kangaroo on the parties' linear television offerings. Whilst the parties' ability to cross-promote their service is barely mentioned in the OFT Decision, in practice the ability to cross-promote their service from their linear channels gives the parties a key advantage over other VOD providers, who would have to expend significant amounts in order to achieve a similar level of awareness of their own offerings;[12] and

(iii) very strong, and long-held, brand reputations, due to their very large market shares in providing audiovisual content to end users via their linear television channels.

4.17 To a large extent, these privileges are non-replicable by other existing or potential providers of VOD services at the retail level. It may be expected that the parties will work together to make Kangaroo the primary destination for VOD viewing by UK audiences; viewers are likely to be attracted to the parties' linear channels by popular programming subsidised by public funds, from where Kangaroo will be promoted, from where other programming found on the parties' channels will be promoted, and so on. In this context, Sky notes that, whilst catch-up content available on the BBC iPlayer is not covered by Kangaroo, and whilst it may be the case that the BBC will not directly promote Kangaroo on its linear channels,[13] it is proposed that the Kangaroo portal online

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10 Ofcom's Market Impact Assessment in relation to the BBC's on-demand proposals, 23 January 2006, paragraph 1.9.

11 See, further, Sky's submission to the OFT, paragraph 5.20.1.

12 See, further, Sky's submission to the OFT, paragraph 5.20.3. As noted therein, Ofcom has explicitly acknowledged that discrimination in cross-promotions has the potential to have a material impact on competition between digital retail TV services.

13 Sky notes that the BBC Editorial Guidelines state that the BBC "*must not use [its] publicly funded channels or services to promote any BBC commercial services. All references to commercial services such as websites, international channels or any international or UK-based joint venture channel must be clearly editorially justified on publicly funded output. Publicly funded services should not*

will provide a link into the BBC iPlayer in some way. Depending on how the BBC iPlayer is integrated into Kangaroo, Sky anticipates that viewers may make Kangaroo their first VOD destination, knowing that from there they can directly browse catch-up content from ITV and Channel 4 and all archive content for all of the parties as well as the third party content that Kangaroo is planning to acquire, but can also browse, through the link into the BBC iPlayer, the BBC's catch-up library. It is anticipated that viewer inertia will contribute to Kangaroo's success.

4.18 Whilst the OFT recognises the advantages held by the parties (noting that "*The BBC and ITV provide unmatched archive content, C4 a strong brand and demographic, and ITV and C4 provide significant catch-up content and potential for cross-promotional activities*"),[14] it does not appear to have placed any weight on these advantages. It appears that the parties have quite successfully persuaded the OFT that Kangaroo will face competition from a range of competitors such as Apple, Sky, BT, Virgin, Tiscali and Top Up TV, who have "*strong customer bases to which they can offer VOD content*". The parties also appear to have submitted that these entities have advantages over Kangaroo, such as existing customer bases, the ability to offer triple-play propositions, established brands and internet traffic to their websites.[15] However, this overplays the importance of competition from rival VOD offerings and underplays the huge advantages enjoyed by the joint venture parties. In particular, the number of viewers who watch the parties' channels daily far outweighs any benefit Sky may have from being able to market its VOD services to its "*triple-play*" customers (in this respect, the CC should note that, currently, only around 1 in 10 of Sky's customers take television, broadband and telephony from Sky). For so long as use of VOD is driven by popular linear content, the parties will have a unique ability to capture VOD audiences.

4.19 Accordingly, the CC should carefully probe the parties' claims about potential competitors, as they do not seem credible; in particular, the parties' claim that they have a "*limited*"[16] ability to compete individually with new and current providers of VOD is completely implausible.

4.20 Kangaroo's existence may reduce the likelihood of expansion of VOD offerings by existing competitors and potentially decrease the likelihood of new entry. Sky considers that, if the unique privileges enjoyed by the joint venture parties result in Kangaroo becoming the primary destination for VOD viewing, with a very large number of users of the service, it is possible that: (i) existing operators would find it harder to expand their own VOD offerings (for example, they may have to spend more on marketing to counter the cross-promotional power and strong brand image of the parties, which may result in lower spend on content, or they may have to spend more on syndicated content from Kangaroo due to the unilateral price effects identified in paragraph 4.9 above, and as a result have less to spend on marketing their services; and (ii) potential new entrants, being aware of these barriers to expansion, may be deterred from providing new VOD offerings at all.

Non-price effects

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run trails for commercial channels, services or programmes." The BBC's Fair Trading regime should also preclude such cross-promotion.

14 OFT Decision, paragraph 136.

15 OFT Decision, paragraph 15.

16 OFT Decision, paragraph 15.

4.21 The OFT has stated that it has placed "*no weight*" on non-price effects in reaching its conclusions.[17] Sky finds it extremely difficult to understand why this is the case, as there does appear to be a risk that the formation of Kangaroo will result in such effects.

4.22 In respect of the potential for the joint venture to result in less innovation, the OFT has contended that it is difficult to conclude that the parties' incentives to reduce functionality and quality of the browsing or viewing experience would be "*profit maximising*". However, the correct test is not whether limiting innovation in this manner would be profit-maximising, but whether it is more likely to occur in light of the merger, as against the counterfactual of each of the parties operating its own VOD portal. If Kangaroo becomes a primary destination for VOD viewing, Sky considers that there is a substantial risk that the joint venture parties' incentives to continue to invest in hardware and software innovation, and indeed other forms of innovation, will be reduced. It seems irrelevant to Sky that (as the OFT asserts) innovation "*takes place on a global scale*"[18] if the UK audiences turn to Kangaroo to meet their demand for VOD viewing.

4.23 The OFT also takes an excessively narrow view of relevant innovation; Sky considers that there is a risk that the formation of Kangaroo will result in less innovative content packaging and less innovative marketing and presentation.

4.24 In light of this, the CC should not discount the risk that the merger will result in non-price effects.

(c) Loss of competition at the retail level through partial or total foreclosure at the wholesale level

4.25 Sky notes that the OFT has been largely dismissive of concerns about vertical effects. This is surprising, however, because the OFT also admits being "*unclear on the parties' cost structures upstream and downstream*".[19] The questions of whether the joint venture parties will, as a result of the merger, have an incentive to foreclose competitors, or to raise their costs are very much dependent on the particular circumstances of the supply of VOD services – including upstream and downstream cost structures – so it is not possible to form a proper view of potential vertical effects in the absence of knowledge about such issues. Accordingly, Sky considers that these are matters to which the CC should give careful further consideration.

5. Conclusion

5.1 The market for the supply of audiovisual content to end users is undergoing rapid change. The supply of VOD content is a nascent but increasingly important segment of that market: Ofcom, for example, has predicted that by the completion of digital switch over, "*VOD could represent a substantial proportion of viewing, with important consequences for the strategies and business models of the major broadcasters*".[20] The formation of Kangaroo comes at a pivotal stage in the development of this sector.

5.2 Sky has set out a number of factors above which would tend to suggest that there is a significant prospect that the formation of Kangaroo might be expected to result in a substantial lessening of competition. Given the early stage of development of the provision of VOD services, it is particularly important that such services are allowed to develop without distortion. The costs of clearing the merger in terms of consumer

[17] OFT Decision, paragraph 44.
[18] OFT Decision, paragraph 145.
[19] OFT Decision, paragraph 132.
[20] Ofcom, "Public service broadcasting post switchover", 27 July 2006.

detriment in the context of a sector of the market which is new but rapidly developing may be significant.

PART B: [***CONFIDENTIAL***]

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