

Part II

Background and evidence

3 The companies and the merger situation

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Introduction

3.1. In this chapter we present the financial performance of the companies involved in the merger situation between Vivendi and BSkyB. We first look at the financial position of BSkyB, its ownership and activities by its major shareholder (News Corporation/News International), followed by its business plan showing estimates of future performance, its conditional access technology, and its board representation. We then consider the financial position of Vivendi and the interests of its subsidiaries and associated companies (for example, Canal+ and SECA) in activities related to those of BSkyB and in pay-TV generally. We next look at the reasons for Vivendi making its acquisition of shares in BSkyB, its board's considerations of this and other matters, and the stages by which it acquired its investment. We also discuss the conditional access technology of the Vivendi group. We next note the comments by the parties on the effect of Vivendi's investment in BSkyB. We finally refer to Open which is a joint venture between BSkyB and others, supplying interactive services to the public, which began offering services in 1999. Appendix 3.1 shows diagrammatically the companies involved in the merger situation.

BSkyB

History and activities

3.2. BSkyB was formed in November 1990 following the merger of the satellite TV businesses, Sky Television plc (Sky TV), a company in which News International had majority ownership, and BSBH, owned by a consortium which included Pearson, Granada and Chargeurs.

3.3. In December 1994 BSkyB was floated on the London and New York Stock Exchanges via an initial global offering that represented 20 per cent of the enlarged share capital base. This valued the company at £4.5 billion. The market capitalization of BSkyB at the beginning of February 2000 was some £23 billion and it said that it was ranked as the twentieth largest company on the FTSE 100 by market capitalization. As shown in Table 3.7, BSkyB had a deficit of shareholders' funds of £625 million at 30 June 1999.

3.4. The activities of BSkyB are the distribution of TV programming via satellite and the creation of programming content for distribution via satellite, cable and DTT. BSkyB is an equity partner in a joint venture that since the end of October 1999 began offering digital interactive services to customers (Open). BSkyB distributes three of its channels and two joint venture channels outside the UK and the Republic of Ireland, where most of its activities are conducted.

3.5. BSkyB leases analogue and digital transponder capacity on the Astra satellite system, the footprint of which covers most of Western Europe. Most of the capacity is used for broadcasting its own encrypted services in the UK and the Republic of Ireland, but where it has spare capacity it sub-leases the satellite capacity to third parties. Such sub-leases are principally to channels retailed as part of the Sky packages, but include broadcasters whose channels are broadcast encrypted over Europe, such as QVC Germany, Bloomberg Germany, and TV shop.

3.6. Although the majority of programming content on the channels broadcast by BSkyB is acquired solely for distribution in the UK and the Republic of Ireland, it also acquires programmes on a more extensive basis and commissions its own programming. This enables BSkyB to license such programmes internationally, including to broadcasters in Continental Europe. In the year to 30 June 1999, revenues from such activities were relatively low at £[§] million in relation to BSkyB's total turnover of £1.54 billion. We asked BSkyB whether it expected this income to increase in the future. Its response was that it did not as a matter of course acquire programming for geographic markets other than the UK and the Republic of Ireland, and in practice such activities were currently *de minimis*.

3.7. The principal companies of the BSkyB group are:

- (a) *British Sky Broadcasting Limited*—which is the broadcaster and retailer/wholesaler of digital and analogue programmes to the public and other platform distributors, such as cable and ONdigital.

- (b) *Sky Ventures Limited*—which manages BSkyB’s interests in a number of joint ventures, such as Nickelodeon, Nick JR, Paramount Comedy Channel, National Geographic Channel, The History Channel, Granada Plus, Granada Breeze, Granada Men and Motors, Music Choice Europe, QVC The Shopping Channel, MUTV and Sky News Australia. Sky Ventures Limited also has responsibility for two wholly-owned channels—[.tv] and Sky Travel.
- (c) *Satellite Encryption Services Limited*—which provides conditional access services to broadcasters using Astra transponders, for analogue transmissions only. These broadcasters offer TV services directly (not as part of the BSkyB multi-channel package) to viewers in the UK and/or the Republic of Ireland and in a few cases to other countries, primarily to cable headends.
- (d) *Sky Subscribers Services Limited (SSSL)*—which provides customer management services to broadcasters using Astra transponders, for analogue and digital transmissions. It operates two subscriber management centres, whose function is more fully discussed in paragraph 3.17, for both BSkyB and other broadcasters which retail their services independently of the BSkyB multi-channel packages to homes with DTH reception equipment. In addition to providing subscriber management services for the encrypted BSkyB retailed analogue services for satellite reception in the UK and/or the Republic of Ireland, SSSL also provides conditional access and subscriber management services for other broadcasters. It also provides for BSkyB and other broadcasters a customer management service, which is not regulated. BSkyB informed us that BT, for example, could also provide these services, and the BBC would be moving this service to BT in 2000. Paragraphs 3.90 to 3.95 discuss further BSkyB’s rights to conditional access technology, which it licenses from a subsidiary of its major shareholder News International called NDS.
- (e) *Sky In-Home Services Limited*—which supplies and installs satellite receiving equipment in subscribers’ premises.

3.8. In this section we refer to both the digital and analogue services of BSkyB. Chapter 4 includes further information on the differences between the transmission formats.

Distribution

3.9. The distribution activities of BSkyB involve the packaging and marketing to DTH customers of subscription TV channels and channel packages delivered via satellite, and the ancillary services to support this activity which include:

- (a) operation of call centres to provide ongoing customer service and retention;
- (b) arranging manufacture and supply of satellite DTH receiving equipment; and
- (c) retail network and installation arrangements.

3.10. In analogue broadcasting, BSkyB offers one package of basic channels. In digital broadcasting, it offers a range of packages that include various combinations of ‘basic’ channels. These include six wholly-owned basic channels provided by BSkyB, nine channels in which BSkyB has an equity interest and 38 channels provided by third parties for which BSkyB has been appointed the DTH satellite retailer.

3.11. In addition to a basic package, the customer can purchase one or more ‘premium’ channels. BSkyB offers four premium channels (two sport and two film channels), two bonus premium channels and certain other premium channels provided by third parties (some of which have BSkyB as a joint venture partner). BSkyB has also launched Sky Sports Extra, an enhanced interactive service available as a free bonus channel to Sky Digital subscribers taking both Sky Sports 1 and Sky Sports 2. Sky Sports Extra allows viewers to view replays, match highlights, and access multiple camera angles and player statistics. In addition, certain ‘non-enhanced’ sports content is broadcast by BSkyB only on Sky Sports Extra.

3.12. All customers who take a Sky/DTH package are also able to access individual PPV TV film and events from Sky Box Office. BSkyB added that because the satellite platform was open to broadcasters, all viewers with DTH reception equipment were also able to access the competing PPV services provided by u>direct.

3.13. To send the satellite signal of its channels to its subscribers, BSkyB leases transponder capacity on the Astra satellite system, operated by the Luxembourg company, Société Européenne des Satellites SA (SES). Other broadcasters, including the third party channel providers whose channels are distributed by BSkyB, also lease transponder capacity from SES or from another broadcaster with spare capacity. Further information on the transmission of a satellite signal is contained in Chapter 4.

Subscribing to BSkyB

3.14. BSkyB currently provides free set-top boxes to subscribers (with dishes as necessary), regardless of whether customers subscribe to Sky services (provided that they enter into an interactive discount contract with Marketing Contributions Limited, which is a subsidiary of BiB—see paragraph 3.193), and connects their set-top boxes to a telephone line for a minimum of 12 months. There is now a £100 installation charge which is reduced to £40 for those taking a BSkyB subscription.

3.15. The requisite equipment consists of a satellite dish to receive the satellite signal and a set-top box which, when used together with a smart card, will decode the signal into a format that can be displayed on a standard TV screen. Retailers are paid two types of commission—one for handling a set-top box (regardless of whether a Sky subscription is taken) and one for a Sky subscription. The balance between boxes distributed by retailers and those distributed by BSkyB has changed because BSkyB has increased its direct sales operation significantly with the introduction of digital broadcasting. For example, in 1998/99 its subscriber management staff numbers increased to 5,700 from some 2,600 in the previous year. BSkyB said that the additional 3,100 staff identified had been recruited to perform several tasks and they should not be seen as all being recruited with a view to undertaking direct sales activities. BSkyB said that analogue subscribers considering upgrading to the digital platform were more likely to contact it directly than were new customers. For the five months to November 1999, BSkyB said that its installed bookings were distributed:

- (a) for new customers—75 per cent by retailers, 23 per cent by its direct sales operation, and 2 per cent by door-to-door service; and
- (b) for ‘transition’ customers, ie those moving from analogue to digital—49 per cent by retailers and 51 per cent by its direct sales operation.

Overall, retailers accounted for 63 per cent of distribution, the direct operation accounted for 36 per cent, and the door-to-door service accounted for 1 per cent.

Installation of the DTH equipment

3.16. The installation service is performed by a BSkyB subsidiary, Sky In Home Services Limited (SIHS), and by a number of installation contractors. SIHS’s engineers are responsible for the installation of the customer’s satellite DTH reception equipment. As part of the strategy to promote its digital DTH service, standard installation is currently at a fixed charge of £100 (reduced to £40 for those taking a BSkyB subscription). Maintenance of the equipment is the subscribers’ responsibility.

Customer management and conditional access

3.17. The customer management function is carried out by another BSkyB subsidiary, SSSL. This company operates the subscriber management centres at Livingston and Dunfermline. The functions performed by the centres include:

- (a) handling orders from subscribers;
- (b) administration and distribution of smart cards that enable decoding of encrypted broadcasts;
- (c) establishing and maintaining accounts;
- (d) telemarketing;

- (e) collection of revenues; and
- (f) administration of subscriptions.

3.18. Further information on conditional access and access control services is in paragraphs 4.110 to 4.112.

Programming

3.19. BSkyB provides programming for distribution on all pay-TV platforms. The programming covers the genres of sport, films, news and entertainment. BSkyB programming is also provided through its PPV TV service, Sky Box Office.

Sports channels

3.20. BSkyB provides three sports channels and a sports news channel (only available in digital), each broadcasting for up to 24 hours a day. Since 1992 BSkyB has featured more than 100 sports including FA Premier League football. BSkyB has also launched Sky Sports Extra as discussed in paragraph 3.11.

3.21. Programming resources not only go into coverage of the live sporting events, but also into support programming providing background information on the major sports that are covered, discussion and debate, preview programmes, highlights programmes and analysis.

3.22. BSkyB told us that the quality of its coverage of live sporting events had been recognized by the TV industry by way of a number of awards. For example, in 1999 it won:

- (a) the Best Live Outside Broadcast award from the Royal Television Society;
- (b) the Sports Award of the Year from the Royal Television Society;
- (c) the Favourite Sports Channel award (Sky Sports) from *Cable Guide*;
- (d) the Best Opening Sequence award from Sportel; and
- (e) the Favourite Sports Presenter award from *Cable Guide*.

3.23. The rights to cover live sporting events are purchased under contracts, generally for a period of up to five years, and are normally exclusive to the purchaser of those rights. The present English FA Premier League rights contract provides for BSkyB to show 60 live FA Premier League matches per season for four years. The rights to this package cost BSkyB £670 million and it is by far the most expensive package of rights that BSkyB has acquired for the UK and the Republic of Ireland. BSkyB noted its belief that Sport+ had acquired the European rights (ie outside the UK and the Republic of Ireland) to the FA Premier League from the FA Premier League in 1996 and had licensed them on a territory by territory basis. We discuss this further in paragraph 3.70, and the market for acquisition of sports TV rights is discussed more fully in paragraphs 4.60 to 4.88.

Film channels

3.24. The three main types of film channel provided by BSkyB consist of recent-release films from the major Hollywood studios, older library films and, like sports, a range of support programming that includes material produced by BSkyB. A pay-TV film release follows the release of the film in the cinema, on video and for PPV TV, but before terrestrial TV. The release on pay-TV occurs approximately 12 months after the first release in the cinemas.

3.25. Recent-release films are paid for on a per-subscriber basis subject to a minimum guarantee. For library films, which may have been shown many times on pay and terrestrial TV, only a flat fee is incurred.

3.26. To reduce its reliance on the major Hollywood studios for programming content, BSkyB has announced plans to begin production of original and exclusive content for its films channels. Around [30] per cent of the film programming budget will be spent on developing original British-made feature length films. It added that some of these films would be released in the cinema (such as 'Best' and 'Saving Grace'); but others might appear only on BSkyB's film channels.

News and general entertainment channels

3.27. News and general entertainment channels make up the core of the channels included in the basic packages offered by BSkyB to its DTH subscribers. The major basic channels owned by BSkyB are Sky News (a 24-hour live news service) and Sky One (the most watched satellite and cable channel in the UK).

3.28. As with films, BSkyB has increased its budget for spending on commissioned series for general entertainment channels, also to reduce its reliance on major programming sources. Around [30] per cent of the programming budget for Sky One is committed to British-originated commissioned programming.

Pay-per-view TV

3.29. BSkyB's PPV TV service, Sky Box Office has four analogue channels, and Sky Digital has 60 screens for Box Office films. The service carries mainly films that are available for viewing around six months before screening on BSkyB's film channels.

3.30. The digital PPV TV service offers DTH subscribers access to up to 15 films at any one time starting every 15 minutes and can be purchased using the remote control instead of making a phone call as required in analogue.

3.31. Other PPV TV offerings from BSkyB have in general been one-off events, such as music concerts and boxing matches.

Advertising

3.32. The programming activity carried out by BSkyB includes the sale of advertising on the BSkyB-owned channels. Advertising revenue is an important source of income to the company but is not as critical to the viability of BSkyB's operation as it is for commercial terrestrial TV companies. Advertising revenue for 1998/99 was £216 million compared with total revenues of £1,545 million for the year (14 per cent). Table 3.3 shows the growth of BSkyB's advertising revenues in the three years to 30 June 1999.

Interests in football clubs

3.33. BSkyB has obtained strategic interests of just under 10 per cent in a number of football clubs, which included Manchester United, Leeds United, Manchester City and Chelsea. BSkyB has also recently taken on the role of media agent to advise football clubs on the exploitation of their rights, broadcasting, sponsorship and advertising. However, BSkyB said that the agreements excluded it from advising on rights which were collectively sold, for example the FA Premier League.

Ownership of BSkyB

3.34. The major shareholders in BSkyB, prior to the investment by Vivendi, were:

- (a) News International (39.75 per cent);
- (b) BSBH (12 per cent), which in turn was owned equally by Pearson, Granada and Pathé; and
- (c) Pathé (17 per cent, being a direct interest of 13 per cent and an indirect interest via BSBH).

Vivendi acquired an interest of around 24.5 per cent in BSkyB by a series of transactions in 1999, first by acquiring the Pathé shareholding and then the shareholdings held by Pearson and Granada via BSBH (see paragraphs 3.166 to 3.178).

3.35. BSkyB provided us with information at 29 October 1999 on its remaining shareholders, who hold around 36 per cent of its issued capital. Of such shares held by the public, 23 holders (mainly institutional funds) accounted for interests totalling 21 per cent in BSkyB, and had investments between 0.39 and 2.33 per cent in BSkyB.

News International plc and The News Corporation Limited

3.36. News International is an indirect wholly-owned subsidiary of News Corporation. News Corporation also owns indirectly 80.2 per cent (representing 97.9 per cent of voting interests) of NDS, which provides conditional access systems to digital pay-TV broadcasters, including BSkyB which is one of approximately 25 broadcaster customers (see also paragraphs 3.90 to 3.95). News International is based in the UK and has other media assets including the newspapers *The Times*, *The Sun*, *News of the World* and *The Sunday Times*. News International's net operating income in the year to 30 June 1999 was £20.6 million and it had £409.2 million profit before taxation on ordinary activities (including a profit of £424.7 million made on the sale of the entire share capital of News Digital Systems plc which is engaged in digital broadcasting in contrast to NDS which provides conditional access systems).

3.37. The principal UK holding company within News Corporation group is Newscorp Investments (formerly Newscorp Investments Limited). The principal activities of Newscorp Investments are the printing and publishing of national newspapers in the UK and TV broadcasting. The other activities of Newscorp Investments include the publishing of books, development and sale of digital broadcast systems and conditional access software and the provision of financial services to other undertakings in the News Corporation group. Newscorp Investments' turnover for the year ended 30 June 1999 was £1.51 billion and it had profits on ordinary activities before taxation of £10.2 million.

3.38. News Corporation is approximately 30 per cent controlled by the Murdoch family by virtue of shares of News Corporation owned by corporations which are controlled by the trustees of settlements and trusts set up for the benefit of the Murdoch family, certain charities and other persons. Rupert Murdoch is a director of each of News Corporation, News International and BSkyB. At 18 August 1999 News Corporation reported that it had some 28,600 shareholders, of which 26,900 had less than 10,000 shares. Around 1,400 had holdings between 10,001 and 100,000 shares, and 298 shareholders had holdings exceeding 100,000 shares, of which the largest holding was 613 million shares. Its top 20 shareholders accounted for 88 per cent of its issued capital with the smallest holding in this group being 6.5 million shares.

3.39. News Corporation has a 49.9 per cent interest in Vox, the German free-to-air TV broadcaster (although News Corporation has entered a contract to dispose of this interest), in which Vivendi (via Canal+) has a 24.9 per cent interest and CLT-UFA, part of Bertelsmann AG (Bertelsmann), the German media group, has a 24.9 per cent interest.

3.40. News Corporation has an interest of approximately 82.7 per cent (which represents a voting interest of approximately 97.8 per cent) in Fox Entertainment Group Inc (Fox Entertainment). Fox Entertainment owns Fox Broadcasting Company and operates 22 regional TV stations in the USA, together with various other media interests under the FOX brand. News Corporation has TV media interests in the UK, Italy, Latin America, and Asia, including Australia and China (under the STAR TV brand), India and Japan. It owns Twentieth Century Fox film studios and its film and TV library, which is a source of content for BSkyB. BSkyB added that its film arrangement with Fox Entertainment was entered into on an arm's length basis and was broadly comparable to arrangements with other studios.

3.41. News Corporation has magazine and 'insert interests' (ie the publishing of promotional materials which are distributed to consumers through insertions in newspapers and magazines) in the UK and Canada, and its book-publishing interests comprise HarperCollins Publishers, which does business in the USA, Canada, the UK, Europe, Australia and Asia through various subsidiaries. Its newspaper interests are in the USA, the UK, Australia, New Zealand, Fiji and Papua New Guinea. It has 'new media' and Internet activities in the USA, the UK and Europe, Australia, Asia and China.

3.42. Table 3.1 shows highlights from News Corporation's published accounts for the four years to 30 June 1999. Total revenues increased by 66 per cent from A\$13.09 billion (some £5.0 billion¹) in 1995/96 to A\$21.78 billion (£8.3 billion) in 1998/99. The UK revenue for 1998/99 was A\$3.57 billion (£1.36 billion) and UK earnings before interest, tax, depreciation and amortization (EBITDA) was A\$770 million (£290 million) or 21 per cent of revenues.

TABLE 3.1 News Corporation profit and loss account highlights, 1996 to 1999

	A\$ billion				£ billion*
	Years ended 30 June				
	1996	1997	1998	1999	1999
<i>Revenues</i>					
USA	9.05	10.05	14.00	16.20	6.17
UK	2.33	2.67	3.09	3.57	1.36
Australasia	<u>1.70</u>	<u>1.67</u>	<u>1.85</u>	<u>2.01</u>	<u>0.76</u>
	13.08	14.39	18.94	21.78	8.29
<i>EBITDA:</i>					
USA	1.27	1.27	2.10	2.21	0.84
UK	0.43	0.58	0.72	0.77	0.29
Australasia	<u>0.18</u>	<u>0.17</u>	<u>0.24</u>	<u>0.28</u>	<u>0.10</u>
	1.88	2.02	3.06	3.26	1.23
					<i>per cent</i>
<i>Performance indicators</i>					
EBITDA as percentage of revenue:					
USA	14	13	15	14	14
UK	18	22	23	21	21
Australasia	10	10	13	14	14

Source: News Corporation.

*Translated as £1=A\$2.62.

3.43. At 30 June 1999, News Corporation reported total assets as A\$53.97 billion (£20.6 billion), and total debt of A\$26.2 billion (£10.0 billion).

3.44. The analysis of revenues for 1998/99 shows that filmed entertainment accounted for 33 per cent of revenues, TV 28 per cent, magazines 10 per cent, newspapers 19 per cent, book publishing 6 per cent and other activities 4 per cent.

3.45. News Corporation's published report and accounts for 1998/99 described both BSKyB and NDS. The report stated that BSKyB was the world's leading satellite pay-TV company, and that BSKyB had launched SkyDigital, the first UK digital platform, in October 1998, broadcasting 150 channels and services. It added that Sky Sports broadcast 25,000 hours of sports on five channels in the year, and launched Europe's first sports news channel (Sky Sports News) while continuing to broadcast 60 live FA Premier League games a season and more than 140 other football games.

3.46. News Corporation's 1999 annual report also referred to ownership of several technology companies linked to the 'revolution' in global communications. The 'Business Overview' section of its 1999 annual report referred to the fact that:

NDS, the company's UK and Israel-based designer and manufacturer of digital broadcasting systems, strengthened its position in the year. NDS also moved into the crucial new growth areas involving the intersection of digital broadcasting and the Internet. The year's

¹Translated at A\$2.6=£1 (being average for 1998). The average exchange rate in 1995 was A\$2.1=£1.

highlight for NDS was the UK launch of SkyDigital with more than 150 channels of programming. NDS supplied the advanced digital video compression, conditional access software and control solutions to the advanced Electronic Programme Guide that contributed to the success of the SkyDigital launch. In the USA leading broadcasters adopted NDS systems for the roll-out of advanced digital video compression systems.

Profitability of BSkyB

3.47. Table 3.2 shows a summary of BSkyB's consolidated profit and loss accounts from 1995 to 1999. Over the period, BSkyB produced consistent increases in profits each year until 1997. Operating profit increased from £245 million in 1995, peaking at £374 million in 1997 before falling to £341 million in 1998, and falling further to £185 million in 1999 (before exceptional costs of £456 million arising from the provision of subsidized set-top digital boxes). Similarly, profits after tax increased from £136 million in 1995 to £288 million in 1997, then fell to £249 million in 1998 and became a loss of £285 million in 1999. BSkyB added that these profit streams followed the lean years to 1994 when it was building its subscriber base, for example turnover in 1994 was £550 million and operating profits were £170 million, which compared with turnover in 1998 of £1.4 billion and operating profits of £341 million. Between 1998 and 1999, the number of employees increased by 78 per cent from 4,600 to 8,300, the main increase of 3,100 being in subscriber management numbers as discussed in paragraph 3.15. Although revenue increased in 1999 to £1.54 billion, operating profits declined to £185 million.

TABLE 3.2 BSkyB's consolidated profit and loss accounts, 1995 to 1999

	<i>Years ended 30 June</i>					<i>£ million</i>
	1995	1996	1997	1998	1999	
Turnover	776	1,001	1,249	1,434	1,545	
Net operating costs	(531)	(686)	(875)	(1,093)	(1,360)	
Operating profits on ordinary activities	245	315	374	341	185	
Share of associated companies' losses	(3)	(4)	(10)	(17)	(58)	
Exceptional items	(9)	-	-	-	(456)	
Profit/(loss) before interest	233	311	364	324	(329)	
Net interest payable	(78)	(54)	(50)	(53)	(60)	
Profit/(loss) before taxation	155	257	314	271	(389)	
Taxation charge/(credit)	(19)	(23)	(26)	(22)	104	
Profit/(loss) after taxation	136	234	288	249	(285)	
Dividends	(249)*	(95)	(103)	(103)	(47)	
Retained earnings/(loss)	(113)	139	185	146	(332)	
						<i>per cent</i>
<i>Performance indicator summary</i>						
Turnover growth	41	29	25	15	8	
Operating profit as a percentage of turnover	31	31	30	24	12	
Profit/(loss) before interest as percentage of turnover	30	31	29	23	(21)	
Profit after tax growth	46	72	23	(14)	(214)	
Average employee numbers (full-time equivalent)	3,054	4,205	4,580	4,634	8,271†	
Change in employee numbers (%)	27	38	9	1	78	
Turnover per employee (£'000)	254	238	273	309	187	

Source: BSkyB's published accounts and Commission calculations.

*This dividend includes £206 million that was paid to shareholders prior to the flotation of the company.

†The main changes were an increase of 3,057 in subscriber management personnel from 2,644 in 1998 to 5,701 in 1999. BSkyB's other personnel in 1999 were analysed as 751 in programming activities, 915 in transmission activities, 117 in marketing and 787 in administration.

3.48. The exceptional costs in 1999 included £450 million in respect of the estimated costs of BSkyB moving its analogue customers to the digital service DTH platform.

3.49. Table 3.3 further analyses turnover and costs that are deducted in arriving at operating profits for the three years to 1999. DTH subscription income for 1997 was £861 million (69 per cent of total

DTH at [30] in 1998, compared with [30] for cable subscribers. It suggested that the lower ratio achieved from cable customers was because cable was not sufficiently marketing its premium services, but an alternative view put forward by some cable companies was that cable customers were more price sensitive compared with BSKyB's DTH customer base. Therefore cable's core customer base was satisfied with cheaper bundled telephone/TV packages that the cable companies offered, which could include alternative programmes provided by the cable companies themselves. BSKyB disputed this view as speculative and noted that it had been allowed to conduct two small marketing trials/projects in selected cable districts in 1999 and the results of its efforts were promising in that it had managed to sell more premium channels to the cable base at a sum that covered the estimated cost of the exercise.

3.51. In addition, the cable companies generally were not happy with the rate card adopted by BSKyB for discounting its important channels to other platforms (see paragraphs 3.58 to 3.61).

3.52. BSKyB told us that it priced its packages at the level that the market would bear and that a large proportion of its DTH customers took its full package at £32 a month, which it ascribed to the value of its package, compared with terrestrial broadcasting services alone.

3.53. BSKyB's board paper conclusions regarding its accounts for 1999 said: 'The operating results fully reflect the investment in the digital service, with the short term decrease in earnings already having delivered a significant increase in digital subscribers following the offer'.

3.54. Set out below is an outline of how BSKyB's level of profitability has been achieved, as well as recent emerging trends that are likely to impact on BSKyB's future profitability.

Turnover

3.55. BSKyB told us that turnover growth has fallen from around 40 per cent in 1995 to 25 per cent in 1997 and 8 per cent in 1999, reflecting maturity of its customer base on the analogue platform. However, with the introduction of digital services in 1999, growth was expected to increase as shown in BSKyB's forecasts (see paragraphs 3.79 to 3.85). This level of growth also reflected the combined effect of growth in subscriber numbers and increases in prices.

Growth in subscriber numbers

3.56. BSKyB's total subscriber numbers in the UK and the Republic of Ireland (including cable and DTT) have increased from 3.9 million in 1994 to 7.4 million in 1999. The greatest growth has been in cable subscribers such that this category now makes up approximately 51 per cent of total subscribers for one or more channels broadcast by BSKyB in 1998 against 35 per cent in 1994. Table 4.3 shows the analysis of pay-TV subscribers from 1997 to 1999.

Increases in price

3.57. Each year from 1993 to 1997 BSKyB increased the price per month of every DTH subscription package (with one exception) by at least £1, and by as much as £5. There was no increase in prices in 1998 although the price per month for the packages that included either of the premium film channels changed by £1 or £2 (Sky Premier up by £1 or £2, Sky MovieMax down by £1 or £2) as part of a rebranding strategy. In October 1999, following a two-year price freeze, the price of one premium package only (ie the top tier of dual films and dual sports) was increased to £32 a month. BSKyB said that for top-tier subscribers (the majority), this represented a 6 per cent increase over two years. It added that as the range of services had expanded considerably, its DTH proposition now offered even greater value for money. It said that this was reflected by subscriber growth, ie if it was raising prices faster than improvements in value of the product, it would expect to see less take-up of the product through time, but it perceived that the opposite was occurring. BSKyB asserted that its prices reflected what the market would bear—the pricing was a reflection of the value of its premium pay-TV service to consumers compared with free terrestrial services, ie offerings of films and sports. For the top package of £32 a month (which around [30] per cent of BSKyB's DTH customers took in 1999), the subscribers would

pay £384 a year, additional to the BBC licence fee of £104 for colour reception, as from April 2000. BSkyB said that the value of the pay-TV services was not simply a function of the value which consumers placed on films and sports. Pay-TV also provided consumers with additional choice of a large number of thematic channels. Similarly it would be inappropriate to think that a premium sports service competed only with other sports offerings.

3.58. BSkyB told us that its wholesale prices were directly linked to BSkyB's retail price and have therefore been broadly subject to the same increases. BSkyB signed undertakings in 1996 with the Office of Fair Trading (OFT) (as an alternative to a scale monopoly reference to the Commission) which are revised from time to time. They comprise three broad elements:

- (a) supply of channels to cable operators on rate-card terms;
- (b) access to VideoCrypt; and
- (c) accounting separation.

The rate-card undertakings require BSkyB to supply on rate-card terms only those channels which BSkyB offers to cable operators and which are specified in the rate card, and the discount structure has to be approved by the DGFT. BSkyB emphasized that the rate card did not mandate the supply of channels in the first place. It added that the DGFT did not approve the actual price levels, which remained at BSkyB's discretion, but they were indirectly regulated by the OFT using an accounting separation exercise, as noted in paragraph 3.60. BSkyB has a notice period of 60 days for changes in the rate card. The undertakings require that all rate-card channels are available separately and restrictions are placed on the number of bonus channels that BSkyB may offer the cable operators. At the outset, the undertakings applied to all Sky channels. Since then, the basic channels (other than Sky One) have been removed from review. BSkyB said that in practice the cable operators refused to carry most of its basic channels and it was in discussion with the OFT to remove Sky One from the rate-card undertakings.

3.59. Regarding access to VideoCrypt, the undertakings require BSkyB to provide analogue conditional access services on reasonable and non-discriminatory terms to third party broadcasters using the DTH platform to distribute their programming. Conditional access services must be supplied separately from customer management services. BSkyB said that the undertaking was being superseded by the development of the digital satellite platform, which was not regulated by undertakings, but was subject to a class licence granted under the Telecommunications Act 1984, and enforced by OFTEL. The requirement was for its subsidiary SSSL to provide conditional digital access services on fair, reasonable and non-discriminatory terms.

3.60. The accounting separation undertaking requires BSkyB to submit separated accounts that identify the DTH distribution elements of BSkyB's business separately from its other businesses. The purpose is to enable the DGFT to confirm that the notional distribution business would make a reasonable profit, were it to be charged on the rate-card terms offered to cable operators. BSkyB emphasized that the accounts were notional and were prepared solely to discharge the regulatory function. It therefore did not consider that they were commercially meaningful or that the notional distribution and 'other' business represented sensible and discrete business units of BSkyB. It said that its business was not organized in the way envisaged by the accounting separation rules. BSkyB told us that under its present wholesale discount structure it alone qualified for the volume discounts, and none of the cable company customers to date met such criteria.

3.61. In January 2000 the OFT announced a review of the rate-card undertakings. Prices are discussed further in Chapter 4.

Operating margins

3.62. After a number of years of operating losses, before and after the merger of Sky TV and BSBH, BSkyB achieved operational break-even during 1992 and its first operating profit in 1993. The operating margin in that year was 16 per cent.

3.63. During the period 1994 to 1998, operating margins were consistently around 30 per cent except for 1998 when they fell to 24 per cent. This period to 1997 was the most profitable period of BSkyB's

history, and margins have fallen since then. A major factor in the achievement of those results was the price increases introduced by BSkyB and the growth in subscriber numbers during the period.

3.64. The Commission's 1999 report on BSkyB/Manchester United¹ stated in paragraph 3.49:

BSkyB told us that there were two reasons for the price increases:

- (a) initial prices were set low to attract subscribers at a time when the product was new and customers were uncertain about the value for money that BSkyB offered; and
- (b) the quality of the programming offered to subscribers had increased, with BSkyB adding significantly to the packages of channels offered.

BSkyB, however, did not agree with this. It told us that in response to indications by the Commission in the BSkyB/Manchester United inquiry that it was proposing to conclude that BSkyB enjoyed market power and was not constrained in its pricing (based on observations that prices had increased), it (BSkyB) pointed out that the Commission had failed to take account of the above-mentioned two factors, which it wanted to be included in the Commission's analysis as justifications for the price changes.

3.65. BSkyB told us that it has only one figure for operating profit, which is reported in its annual accounts. It does not separately identify operating profit for different lines of business or different types of customer, and sales revenue is analysed only to the extent of differentiating between revenues receivable from DTH customers, cable operators, the DTT operator ONdigital, advertisers and others. It said that the reason was because many costs and revenue lines were common to a series of activities and therefore there was no meaningful way to apportion costs across business areas or customer types. For example, it said that the majority of DTH subscribers who took film channels did so as part of the top-tier package which included four premium channels, more than 40 basic channels, access to PPV channels, etc. BSkyB said, therefore, that it was not possible to allocate the £32 a month price for this package between the different elements of the package. It added that even advertising revenues could not be matched to costs, and the same inability to allocate costs arose in respect of its marketing costs to subsidize the take-up of set-top boxes. In summary, BSkyB explained that its business was integrated as a whole and was complex.

3.66. BSkyB's largest operating cost is the cost of programming. Table 3.4 shows BSkyB's programming costs since 1995, and these costs as a proportion of turnover in this period.

TABLE 3.4 **BSkyB: programming cost and programming cost to turnover, 1995 to 1999**

	Years ended 30 June				
	1995	1996	1997	1998	1999
Programming cost (£m)	329	420	569	688	787
Programming cost to turnover (%)	42	42	46	48	51

Source: BSkyB published accounts and Commission calculations.

3.67. This rise in costs is likely to reflect the increased demand for TV rights in the period as pay-TV emerged as a major purchaser of rights, the extent to which free-to-air TV broadcasters have sought to compete for rights and the extent to which holders of rights have been able to obtain higher revenues as a result.

3.68. In 1998 this trend continued with programming costs increasing by 20 per cent (due to an increase in sports programming costs) and 14 per cent in 1999, compared with turnover increasing by 15 per cent in 1998 and 8 per cent in 1999. However, unlike previous years, where operating margin was around 30 per cent, it fell to 24 per cent in 1998 and 12 per cent in 1999 (see Table 3.2). The other major cost category contributing to this fall in margin was marketing. We looked at sports programming costs and marketing costs in more detail.

¹See footnote to paragraph 2.55.

Sports programming costs

3.69. Sports programming costs increased from £174 million in 1997 to £287 million in 1998, and £318 million in 1999. Of the £113 million increase in 1998, £92 million related to the new FA Premier League rights contract that came into effect in the 1997/98 season.

3.70. In 1997 the FA Premier League rights cost £39 million for the 1996/97 season. This represented 22 per cent of the sports programming cost for that year. In comparison, the FA Premier League rights cost £135 million for the 1997/98 season and represented 47 per cent of the sports programming cost. The FA Premier League rights make up 53 per cent of the annualized cost of all sports rights held by BSkyB—see paragraph 4.65. BSkyB commented on the significance of the FA Premier League rights when we discussed its business strategy. It said it recognized that it might not retain the rights (but they were included in its current plans), or the rights might be sold in quite a different manner from last time, and BSkyB might be required to pay more or less than £[30], should it obtain the rights (to screen, for example, 60 matches per season over four years).

3.71. Table 3.5 summarizes BSkyB's top sports investments by category for 1996/97 to 1998/99. In 1999 the greatest investment was in football rights which at £[30] million were [30] per cent of its top sports rights expenditures. When TV rights are acquired for transmission, they are then shown as stock with a corresponding liability, and the stock is amortized over the availability period (which can be up to 15 months for the transmissions to complete). Sports programme rights are accounted for at an event level, and the rights are recognized as stock and amortized over the duration of the event. BSkyB's total rights spending increased by 9 per cent from £256 million in 1998 to £280 million in 1999, [Details omitted. See note on page iv.].

TABLE 3.5 BSkyB: summary of its top sports rights investments, 1997 to 1999

£ million			
Years ended 30 June			
	1997	1998	1999
Football	*	[30]	[30]
Cricket	*		
Golf	*		
Rugby union	*		
Rugby league	*		
Boxing	*		
	—	257	281
Less: main sub-licence revenue*	*	[30]	[30]
	*		
Other	*		
Total	174	287	318

Source: BSkyB.

*Not available.

Marketing costs

3.72. Advertising and marketing costs increased during the period 1997 to 1999 and Table 3.3 shows the subscriber-related costs and marketing costs for the three years, which in aggregate increased from £194 million to £370 million, an increase of 90 per cent over two years.

3.73. BSkyB is planning a further increase in marketing and promotion activities over the next four years. Table 3.6 shows the forecast breakdown of marketing and promotion costs as taken from BSkyB's five-year business plan.

TABLE 3.6 BSKyB's forecast marketing costs, 2000 to 2003

		<i>£ million</i>			
		<i>Years ended 30 June</i>			
		2000	2001	2002	2003
Acquisition marketing costs	(
Subscriber retention costs					
Publicity					
Customer marketing					
Other					
Cost of free installations*					
Total					
Total less free installations)				

Figures omitted. See note on page iv.

Source: BSKyB.

*Free installations are offered as an incentive for customers to take up BSKyB's digital service. The costs of providing the installation service are normally recovered from an installation charge to the customer.

3.74. Table 3.6 shows total marketing costs continuing to increase. BSKyB told us that this was due in part to the introduction of the DTH digital service but also as a result of the increasing competition for retail customers between DTH, cable and DTT, and these platforms also compete against the free-to-air analogue terrestrial channels for customers.

Balance sheet and cash flow of BSKyB

3.75. Table 3.7 shows the summary balance sheets of BSKyB for the five years between 1995 and 1999.

TABLE 3.7 BSKyB: consolidated balance sheet, 1995 to 1999

		<i>£ million</i>				
		<i>As at 30 June</i>				
		1995	1996	1997	1998	1999
Tangible fixed assets		46	73	110	175	219
Investments		1	24	38	44	121
Stock and debtors less creditors		<u>16</u>	<u>20</u>	<u>125</u>	<u>54</u>	<u>105</u>
Net operating assets		63	117	273	273	445
Borrowings less cash		(769)	(659)	(628)	(517)	(665)
Dividend payable		(43)	(51)	(56)	(56)	-
Provisions		<u>(19)</u>	<u>(15)</u>	<u>(11)</u>	<u>-</u>	<u>(405)*</u>
Deficit of shareholders' funds		(768)	(608)	(422)	(300)	(625)

Source: BSKyB.

*The provision relates to costs connected with moving analogue DTH subscribers to the digital platform.

3.76. The net liability position of BSKyB is the dominant feature of the balance sheet. Large losses were incurred during the early stages of the company's development. It was not until 1992 that BSKyB achieved operational break-even, and in 1994 it achieved its first profit after tax.

3.77. Also in 1994 BSKyB undertook a capital restructure to enable it to pay future profits as dividends. This preceded the stock market listing in November of that year, the funds from which provided an injection of equity to strengthen the balance sheet and repay the shareholder loans that had provided much of the necessary finance up to that stage.

3.78. Between 1996 and 1998, the strong cash flows generated by BSKyB allowed the company to further strengthen the balance sheet through capital expenditure and repayment of debt while still

providing a dividend income stream to shareholders. In 1999 the cash flows reduced considerably because of the investment in digital DTH. Table 3.8 provides a summary of the BSKyB cash flows for the five years between 1995 and 1999. Gross cash flows were £106 million in 1995, ranged between £247 million and £295 million in the next three years, and in 1999 fell to £90 million. Over this five-year period, dividends between £86 million and £103 million were paid from 1996. BSKyB raised £821 million from its flotation in 1994/95, and from this and cash flows repaid borrowings mainly in 1994/95. In 1999 borrowings increased by £132 million.

TABLE 3.8 BSKyB: consolidated cash flow statement, 1995 to 1999

	Years ended 30 June					£ million
	1995	1996	1997	1998	1999	
Operating profit	237	315	374	341	185	
Depreciation	6	6	5	17	32	
Tax paid	(8)	(11)	(24)	(26)	(28)	
Net interest paid	(123)	(58)	(47)	(48)	(51)	
Changes in provisions and other non-cash items	(6)	(5)	(13)	(3)	(48)	
Gross cash flow	106	247	295	281	90	
Changes in working capital	16	(15)	(107)	50	69	
Dividend paid	-	(86)	(99)	(103)	(103)	
Net capital expenditure	(21)	(28)	(39)	(81)	(143)	
Investment in associated companies	(4)	(5)	(18)	(45)	(68)	
Net cash flow	97	113	32	102	(155)	
Equity raised	831	-	-	8	8	
Debt drawn down/(repaid)	(1,027)	(124)	(2)	(104)	132	
Net movement in cash	(99)	(11)	30	6	(15)	
Opening cash balance	139	40	29	59	65	
Closing cash balance	40	29	59	65	50	

Source: BSKyB.

Key performance indicators and BSKyB's business plan

3.79. We asked BSKyB to comment on its business plan. Overall, it said that its strategy was best encapsulated by the fact that it launched a digital DTH platform and was focussing effort on making that investment a success. It told us that it had a dynamic model to simulate various scenarios and therefore could not provide us with a definitive view of its strategy, which was continuously evolving, but reflected the general strategic direction, which was to move the analogue customer base to digital [*Details omitted. See note on page iv.*]. It added that its dynamic model was not the company's strategic plan but did reflect the general strategic direction of the company in several respects. BSKyB noted that:

- (a) such a plan forced it to make simple assumptions in relation to factors that were inherently highly uncertain and complex; and
- (b) the assumptions in the plan could not be interpreted as a statement of strategy.

3.80. Table 3.9 shows a summary of BSKyB's plan as shown on its model for the five years to June 2004. Overall it shows total revenues increasing from £[\pounds] billion in 1999/2000 to £[\pounds] billion in 2003/04, and operating losses for 1999/2000 of £[\pounds] million, and operating profits of £[\pounds] million in 2000/01, rising to £[\pounds] million in 2003/04. BSKyB estimated that the net present value of its forecast net cash flows in the six years to 2003/04, based on a discount rate of [$\%$] per cent and a terminal multiple of [\times] times, could be some £[\pounds] billion.

TABLE 3.9 BSkyB: summary of its 'fast growth' business plan, 2000 to 2004

£ million, out-turn price

	Years ended 30 June									
	2000	2001	2002	2003	2004					
Revenue from DTH	()	()	()	()	()					
Subscription—digital										
Subscription—analogue										
Total subscription										
Connection fees										
PPV										
Total										
<i>Revenue from cable companies</i>										
Subscription—digital										
Subscription—analogue										
Total subscription										
PPV										
Total										
<i>Other income streams</i>						()	()	()	()	()
Advertising										
DTT (ONdigital)										
Other revenue (mainly digital)										
Revenues from satellite installation										
Overall total revenues	()	()	()	()	()					
<i>Less costs</i>										
Programme costs										
Transmission costs										
Subscriber-related costs										
Operations and overheads										
Depreciation										
Total costs										
Operating profit/(loss)*										
										<i>per cent</i>
<i>Ratios of costs as percentage of turnover</i>	()	()	()	()	()					
Programme costs										
Transmission costs										
Subscriber related costs										
Operations and overheads										
Depreciation										
Total costs										
Operating profit/(loss)										

Source: BSkyB.

*[Details omitted. See note on page iv.]

3.81. We noted that BSkyB's plan showed a relatively small level of revenues from ONdigital (ie rising from £[] million to £[] million) compared with its total revenue streams over the next five years.

3.82. Table 3.10 shows BSkyB's forecast for its subscriber population over the five years to June 2004. In 1999/2000 it was forecast to have some [] million subscribers, which could increase to [] million by 2003/04.

TABLE 3.10 BSKyB: summary of its subscriber base on fast growth business plan, 2000 to 2004

	Years ended 30 June				million
	2000	2001	2002	2003	2004
Average subscribers	([[[]
DTH digital					
Analysed as					
Basic					
Premium					
DTH analogue*					
Total					
Cable subscribers taking Sky services					
Analysed as					
Digital					
Analogue*					
Total					
Difference†					
Total per Sky forecast					
<i>Figures omitted. See note on page iv.</i>					
Source: BSKyB.					

*[Details omitted. See note on page iv.]
 †Not explained.

3.83. Paragraph 3.65 discussed BSKyB’s inability to allocate costs by activity. However, it said that it was carrying out a process of identifying a series of key performance indicators for its business.

3.84. These include:

- (a) DTH subscribers—the target to 30 June 2000 is [] million for both digital and analogue subscribers, and reflects the importance of growing the digital subscriber base.
- (b) Total Sky TV subscribers—the target is [] million to 30 June 2000, assuming around [] million come from cable and [] million come from ONdigital. It emphasized that the level is set actively to target the growth of subscribers to the cable and DTT platforms, because as a channel provider it had an interest in the success of these platforms. It added that any view that it preferred to see zero growth in other platforms was not correct.
- (c) Average share of viewing—the target is [] per cent for 1999/2000, and comprises the combined viewing of Sky One, Sky News, the Sky Movie Channels and the Sky Sports channels, expressed as a percentage of all TV viewing in multi-channel homes (ie those having DTH, cable and DTT). It said that this ratio was important for realizing advertising revenues.
- (d) Sky Box Office films buy rate—the target is [] per cent for 1999/2000. It said that the buy rate was the number of Sky Box Office films bought in a month divided by the number of homes able to buy. It added that the target reflected the importance of new revenue streams to the economics of the transition from analogue to digital. PPV films had considerably greater potential in digital and were expected to carry some of the burden of the costs associated with the transition to digital.
- (e) SSSL grade of service—the target is [] per cent of calls answered in less than [] seconds. This target reflected the importance of quality of service at the interface with customers.
- (f) SHS installs per day—the target is [] per day per operative and relates to the need to be able to offer an acceptable time period between a subscriber’s request for digital equipment and the date of installation. It said that the current level was [] and the high targets noted above required the level to increase to [].
- (g) Joint ventures—the target of total losses is no more than £[] million for 1999/2000, excluding its investment in BiB.

3.85. At the beginning of February 2000, we noted BSkyB's announcement of a joint venture with Kingston Communications to offer TV and multimedia services by means of ADSL technology to consumers in the East Riding area of Yorkshire, which corresponds to the extent of Kingston Communications' telephony network. [

Details omitted. See note on page iv.

].

Investment in KirchPayTV

3.86. On 6 December 1999 BSkyB announced its proposed acquisition of a 24 per cent shareholding in KirchPayTV, which will involve the cash payment of some £320 million and the issue of approximately 78 million new BSkyB shares, which will represent approximately 4.3 per cent of BSkyB's enlarged share capital, to KirchPayTV. The total consideration would be DM2.9 million (about £1 billion). A condition for the transaction was regulatory clearance, which was given by the European Commission subject to undertakings on 21 March 2000.

3.87. BSkyB's press release said that KirchPayTV provides subscription TV services including premium films and sports events by cable and satellite in the German market. Following the acquisition of Premiere (a subscription TV operator) in May 1999 and the subsequent merging of the Premiere and DF1 operations, KirchPayTV currently operates as the major subscription TV service in Germany and Austria. It also has a 40 per cent ownership interest in Teleclub AG, which operates in Switzerland. At 1 October 1999, KirchPayTV had approximately 2 million subscribers via DTH and cable representing approximately 6 per cent penetration. BSkyB further said that the transaction would give it the opportunity to acquire a significant foothold in the German market. It believed that the consolidation of DF1 and Premiere into KirchPayTV, creating a single brand and a clear agenda to build the KirchPayTV business, combined with BSkyB's experience in building one of Europe's most successful subscription TV companies, would give significant opportunities for growth.

3.88. The press release also reported that for the year ended 31 December 1998, Premiere reported turnover of DM836 million (around £280 million), a loss before tax and exceptional items of DM362 million (£125 million), and net liabilities of DM101 million (£35 million). The audited accounts of KirchPayTV also for the year ended 31 December 1998 showed turnover of DM129 million (£45 million), a loss before tax and exceptional items of DM680 million (£230 million) and net liabilities of DM64 million (£22 million).

3.89. BSkyB noted that it would have certain minority protection rights including exit procedures and be involved in the development of the strategic direction of KirchPayTV. It added that KirchPayTV would have certain rights to avoid dilution of its prospective holding prior to completion of the transaction and, conditional upon completion, a senior executive of KirchPayTV would be appointed as a non-executive director of BSkyB. BSkyB reported in the press release that before amortization of goodwill, the transaction was expected to be dilutive of earnings per share for a number of years and it did not anticipate any synergies in conditional access technology or sports and films programming rights to arise from the transaction.

Conditional access technology

3.90. BSkyB said that it did not own its conditional access technology. This was licensed to SSSL from NDS Limited, which is a subsidiary of NDS Group plc (NDS), which in turn is partially owned as to 80.2 per cent by News Corporation (see paragraph 3.36). On 23 November 1999, 19.8 per cent of NDS was floated on the US NASDAQ and European EASDAQ exchanges. The shares were issued at a subscription price of US\$20 each valuing NDS at US\$1.045 billion.

3.91. NDS's accounts for the year ended 30 June 1999 showed turnover of £127.6 million from continuing operations (and £88.3 million from discontinued operations), operating profits of £18.7 million from continuing operations and £1.9 million from discontinued operations. News International told us that at 30 June 1999, NDS's net liabilities were £84 million, and NDS's total shareholders' funds showed a deficit of £86 million. At this time, NDS had roughly 830 employees in its continuing operations of which 285 were located in the UK.

3.92. Other channels (including BSKyB) can obtain conditional access services through SSSL, which is a licensee of the NDS technology. BSKyB said that as part of providing conditional access services, SSSL comes into possession of information concerning channel providers who use SSSL's conditional access services, which is confidential in nature. Such information cannot be disclosed by SSSL to any other company, including members of the BSKyB Group. BSKyB said that although it was a licensee of VideoGuard (for digital systems) and VideoCrypt (for analogue systems), it was in no position to obtain confidential information on its competitors who also license the technology from NDS. BSKyB said that NDS would have intimate knowledge of the technical aspects of the BSKyB group's business, but would not have any knowledge of the identity of BSKyB's customers (see also Chapter 6). BSKyB added that if NDS were to offer its technology to other platform providers in the UK, BSKyB would have no legal right to information on that other user. BSKyB emphasized that it did not believe that the licence by NDS of the VideoGuard technology and its use by SSSL in the provision of conditional access services resulted in any information about the relevant customers' businesses (for example, the BBC, Channel 4) accruing to NDS. BSKyB's agreements with NDS contain confidentiality provisions which commit NDS to treat information received from BSKyB as confidential.

3.93. BSKyB said that it paid £[] million to NDS under the agreement in 1997/98, £[] million in 1998/99, and £[] million in the period 1 July to 30 November 1999 in connection with the development of the systems for SSSL to provide Conditional Access and Access Control for digital services. In addition, since July 1997, BSKyB paid NDS fees of £[] million in connection with the acquisition of various licences for the technology used for the system. These licences were for [].

3.94. The future licensing costs consist of a cost per card issued and cost per card in use. There are three elements to these costs:

- (a) New access card fees: SSSL pays NDS this fee for each new access card issued.
- (b) Recurring access card fees: SSSL pays NDS a monthly recurring fee for each access card in use in each month.
- (c) Interactive access card fees: SSSL also pays NDS a monthly fee for each access card in use in each month for interactive services.

This fee structure reflects not only the costs of the periodic replacement of access cards (for security and other reasons), but also the replacement of faulty or damaged cards, and the ongoing system enhancements to the cards (for which BSKyB pays only the manpower costs).

3.95. BSKyB estimated that assuming cost levels remain the same and it achieved its growth targets, it would pay NDS, as card fees, around £[] million in 1999/2000, £[] million in 2000/01, and £[] million in 2001/02. Added to this would be sums payable for enhancements to the system. BSKyB said that SSSL paid certain other sums to NDS for administrative support, for example a [p] per card charge for personalizing cards, and other charges for actions taken by NDS to prepare cards for sending out to individual subscribers.

Representation on BSKyB's board

3.96. At the end of 1999, BSKyB had two executive directors, Mr Tony Ball (Chief Executive and Managing Director) and Mr Martin Stewart (Chief Financial Officer), and 13 non-executive directors (including the Chairman). The executive directors' background was as follows:

- (a) Mr Ball was appointed in June 1999. He was appointed President and Chief Executive Officer of Fox/Liberty Networks in October 1997, after serving as President and Chief Operating Officer of Fox Sports International, where he oversaw channels in North America, Latin America, Asia and Australia. He spent three years of his career with BSKyB in 1993 in the positions of Head of Production and Operations of Sky Sports and General Manager/ Broadcasting.
- (b) Mr Martin Stewart was appointed Chief Financial Officer and a director in May 1998. He previously served as head of Commercial Finance from March 1996. From 1991 to 1996 he was employed at Polygram, latterly at Polygram Filmed Entertainment where he was Finance Director for two years (part of EMI Group plc).

3.97. We discuss the non-executive board representation in the following paragraphs. At board level, News Corporation has the right (as written into the Articles of BSKyB) to appoint five of the members of the board of BSKyB. At October 1999, News Corporation's representatives were as follows:

- Rupert Murdoch, who was appointed as Chairman of BSKyB in June 1999 and a director since 1990. Mr Murdoch has been an executive director, Managing Director and Chief Executive of News Corporation since August 1991. He has been a director of News America Incorporated since 1973, a director of News International (News Corporation's principal subsidiary in the UK) since 1969, and a director of News Limited (News Corporation's principal subsidiary in Australia) since 1953. Mr Murdoch has also served as Chairman and Chief Executive Officer of Fox Entertainment and its predecessor companies since 1985. He has also been a director of STAR TV since 1993 and a director of Philip Morris Companies Inc since 1989.
- David DeVoe, who has been a director since December 1994. He has been an executive director of News Corporation since October 1990, Senior Vice President of News Corporation since January 1996, Chief Financial Officer and Finance Director of News Corporation since October 1990 and Deputy Finance Director from May 1985 to September 1990.
- Martin Pompadour, who was appointed on 15 October 1999. He has been Executive Vice President and President of News Corporation Eastern & Central Europe since June 1998.
- Arthur Siskind, who was a director from June 1992. He has been a Senior Executive Vice-President of News Corporation since January 1996 and an executive director and Group General Counsel of News Corporation since 1991. He has also been a director of News America Incorporated since 1991 and a director of STAR TV since 1993. Mr Siskind has also been Senior Executive Vice-President, General Counsel and a director of Fox Entertainment Group since August 1998. He has also been a member of the Bar of the State of New York since 1962.
- Leslie Hinton, who was appointed a director on 15 October 1999 (following the resignation on the same date of Mr Bruce McWilliams). Mr Hinton was appointed President of Murdoch Magazines in 1990, two years later becoming Chief Executive Officer of Fox Television Stations and in 1995 became Executive Chairman of News International plc, responsible for all newspapers in the UK. He is a member of the News Corporation Executive Committee. In 1996 he joined the board of the Press Association in Britain.

3.98. Other non-executive directors at the end of 1999 were:

- Eric Licoys (representative of Vivendi's interests via the BSBH interest), who was appointed in autumn 1999. He is Directeur Général (Chief Operating Officer) of Vivendi and Chairman and Chief Executive of Havas SA. In 1990 he was appointed director and Executive Vice President of Fonds-Partenaires-Gestion (Lazard Group) and became Chairman in 1995. M Licoys is also a director of a number of other major Vivendi subsidiary companies or companies in which Vivendi has a substantial interest, including Canal+, US Filter, Compagnie Générale d'Immobilier et de Services (the group's real estate holding company) and CGEA (the group's waste and transport business). He is also a director of Intermediate Capital Group PLC.
- Philip Bowman, who has been a director since December 1994. He is Chairman of Liberty plc and Chief Executive of Allied Domecq plc. He was previously a director of Coles Myer Ltd in Australia, and from 1991 to 1995 he was an executive director of Bass plc and Chairman and Chief Executive of Taverns Limited.
- Alan Leighton, who was appointed a Director on 15 October 1999. In March 1992, he joined Asda Stores Limited as Group Marketing Director and in September 1996 he was appointed Chief Executive. He is also a director of Wilson (Connolly) Holdings PLC and of Leeds Sporting Plc. BSKyB told us that Mr Leighton was not a non-executive director when BSKyB entered into its current arrangements with Leeds Sporting Plc—see paragraph 3.33.
- Dame Anne Mueller, who has been a director since 1991. She was Second Permanent Secretary to HM Treasury from 1987 to 1990, and previously Head of Management and Personnel Office in the Cabinet Office.

- Lord St John of Fawsley, who has been a director since 1991. He was Master of Emmanuel College, Cambridge, and has been Chairman of the Royal Fine Arts Commission since 1985.
- The Lord Stevenson of Coddham, who was a director from 1994 and resigned on 4 January 2000. He has been a director of Pearson PLC since 1986 and its Chairman from 1997. He is also Chairman of AerFi Group plc and Halifax plc. BSKyB said that Lord Stevenson was not appointed as a Pearson representative.
- John Thornton, who has been a director since December 1994. He joined Goldman Sachs & Co in 1980 and is now a President and co-Chief Operating Officer of the Goldman Sachs Group, Inc. He is also a director of Ford Motor Company, the Pacific Century Group and Laura Ashley Holdings plc. He serves as a member of the advisory board of the Yale School of Management, the Asia Society Board of Trustees, and the Yale Investment Committee.
- Morton Topfer was appointed a director in May 1999. He serves as Vice Chairman of Dell Computer Corporation. He shares the office of the Chief Executive Officer of Dell Computer Corporation with two other executives, including the founder, Michael Dell. Prior to 1994, Mr Topfer served as Corporate Executive Vice President of Motorola Inc and Motorola's Land Mobile Products sector. He is also on the board of Autodesk.

In summary, following the resignation of Lord Stevenson on 4 January 2000, the BSKyB Board had 14 members.

3.99. BSKyB said that a director may appoint any other director or any other person to act as his alternate (see also paragraph 3.101). An alternate director shall be entitled to receive notice of and attend meetings of the directors and committees of directors of which his appointer is a member and not able to attend. The alternate director shall be entitled to vote at such meetings and generally perform all the functions of his appointer as a director in his absence.

3.100. On the resignation of the appointer for any reason, the alternate director ceases to have this position. The appointer may also remove his alternate by notice to BSKyB revoking the appointment. BSKyB said that on 8 February each of the News Corporation appointees appointed the other appointees to act as their alternates. In addition, they also appointed the following as alternate directors:

- (a) Richard Linford, who has been Chief Financial Officer of News International since January 1995. He was BSKyB's Director of Finance from September 1991 to December 1994.
- (b) Elizabeth Murdoch, who joined BSKyB in March 1996 as General Manager, Broadcasting, and became an alternate director in June 1996. In August 1998, she was appointed Managing Director of Sky Networks. Prior to this, she was Chief Executive of EP Communications, which owned NBC affiliate TV stations KSBW and KSBY in Northern California. She began her career at The Nine Networks in Australia. She does not have a service contract with BSKyB.
- (c) Jay Itzkovitz, who replaced Mr Peter Stehrenberger. Mr Stehrenberger has been an executive director of News International since March 1984 and Company Secretary of News International since 1992.

3.101. Vivendi told us that at the end of January 2000 it had not appointed an alternate to M Licoys. It noted that BSKyB's Articles allowed Vivendi to appoint another director as an alternate, otherwise its nominee required approval by resolution of the existing board of BSKyB (see also paragraph 3.173).

3.102. BSKyB's Form 20-F filed with the SEC in the USA for the year to June 1999 included a summary of relevant provisions in its Articles concerning the directors. The Articles provide certain rights for News Corporation and its subsidiaries to appoint directors. Their rights depend upon the maintenance of beneficial share ownership levels. The following thresholds apply:

<i>Percentage of shares</i>	<i>Number of directors</i>
30% or more	5
Less than 30% but more than 25%	4
Less than 25% but more than 20%	3
Less than 20% but more than 15%	2
Less than 15% but more than 7.5%	1
Less than 7.5%	0

3.103. In addition, the Articles provide that for so long as BSBH remains a beneficial holder of not less than 7.5 per cent of the issued shares, it has the right to appoint one director. News Corporation exercises its rights via a subsidiary, News International Television Limited, which on current holdings gives it the right to appoint five directors from the current board of 15.

3.104. No director appointed by News International Television Limited or BSBH may vote on any resolution which relates to any material matter in which that principal shareholder or any affiliate is interested (see also Chapter 6).

3.105. BSKyB told us that traditionally the Chairman of the board rotated between the larger shareholders, and therefore when M Seydoux stepped down as Chairman, upon the sale of Pathé's interest to Vivendi, the board appointed Mr Murdoch as Chairman because he was News Corporation's senior appointee on BSKyB's board.

3.106. The Remuneration Committee of the board, until the resignation of Lord Stevenson on 4 January 2000, consisted of Messrs Stevenson, Murdoch, DeVoe and Topfer. It meets not less than once a year in order to approve and recommend to the board the hiring and remuneration of the executive directors and key personnel.

3.107. The directors are required (subject to shareholder approval) to restrict borrowing levels to below the higher of £1.5 billion and an amount equal to four times the aggregate turnover as shown in BSKyB's latest accounts.

Vivendi and the Vivendi group

History and activities

3.108. Vivendi was known until 1998 as Compagnie Générale des Eaux, and is quoted on the Paris stock exchange. Its headquarters are in France. Vivendi's total turnover in 1998 was €31,737 million (£20.6 billion¹) and at the end of 1998 it employed 260,000 people, of which 141,000 were in France and 24,000 in the UK.

3.109. Vivendi's market capitalization at 2 February 2000 was £46 billion. It has approximately 600,000 shareholders and told us that no shareholders owned more than 5 per cent of its shares, and its largest single shareholding was held by its employees.

3.110. Vivendi was founded in Paris in 1853 with the twin objectives of irrigating the countryside to help farming and supplying water to towns and cities in France. By the 1970s the company had diversified into civil engineering, construction and energy. It acquired a 15 per cent stake in Canal+ when the latter was established in 1983. In 1987 Vivendi created a subsidiary to take advantage of deregulation in the French mobile phone market.

3.111. In 1997 Vivendi strengthened its communications business by taking a 30 per cent stake in the French publishing company, Havas, and became a full service telecommunications operator. In 1998 it acquired by way of merger the balance of the share capital in Havas.

3.112. Vivendi is comprised of two major divisions:

- (a) Environmental Services—comprising activities in water, energy, waste management and transport; and
- (b) Communications—comprising activities in telecommunications, publishing and multimedia, and audio-visual services.

Until 1998 Vivendi was involved in construction and property activities which no longer form part of Vivendi's core activities and in respect of which certain divestitures were announced in 1999.

¹Unless otherwise noted, we have used a conversion rate of 1 euro = £0.65 throughout this chapter.

3.113. Table 3.11 shows a summary of Vivendi's reported group profit and loss accounts for the three years ended 31 December 1998 in euros. The table also shows the 1998 figures in pounds sterling, and Vivendi's turnover for the year was some £21 billion, operating income was £904 million, and net income was £729 million after tax.

TABLE 3.11 Vivendi: group profit and loss summary, 1996 to 1998

	Years ended 31 December			1998*
	1996	1997	1998	
			€ billion	£ billion
Turnover	<u>25.3</u>	<u>25.5</u>	<u>31.7</u>	20.6
			€ million	£ million
Operating income	586	636	1,390	904
Net financial income/(expenses)	(328)	(301)	9	6
Net exceptional income/(expenses)	(7)	504	40	26
Income tax and employee profit sharing	(221)	(236)	(149)	(97)
Equity in earnings of companies	211	104	43	28
Minority interests	<u>57</u>	<u>115</u>	<u>(212)</u>	<u>(138)</u>
Net income	298	822	1,121	729
<i>Performance indicators</i>				<i>per cent</i>
Operating income as percentage of turnover	2	2	4	4
Net income as percentage of turnover	1	3	4	4

Source: Vivendi.

*Translated as €1= £0.65.

3.114. Table 3.12 shows a summary of Vivendi's reported group balance sheets for the three years ended 31 December 1999 in euros and for 1998, the equivalent figures in pounds. At December 1998, its net operating assets were around £10 billion, and net assets were £6.6 billion.

TABLE 3.12 Vivendi: group balance sheet summary, 1996 to 1998

	€ billion			£ billion
	As at 31 December			1998
	1996	1997	1998	
Tangible assets	8.7	8.4	12.2	7.9
Intangible assets	1.7	1.7	3.3	2.2
Current assets	14.0	14.3	16.3	10.6
Current liabilities	<u>(13.2)</u>	<u>(14.0)</u>	<u>(16.1)</u>	<u>(10.5)</u>
Net operating assets	11.2	10.4	15.7	10.2
Investments	6.2	6.9	6.0	3.9
Goodwill	2.4	3.8	4.5	2.9
Net long-term borrowings	(8.9)	(6.4)	(9.2)	(6.0)
Deferred liabilities and provisions	<u>(5.0)</u>	<u>(6.1)</u>	<u>(6.8)</u>	<u>(4.4)</u>
Net assets	5.9	8.6	10.2	6.6
<i>Representing</i>				
Share capital and reserves	5.9	8.6	10.2	6.6
<i>Performance indicators</i>			<i>per cent</i>	
Operating income as percentage of average net operating assets	N/A	6	11	
Net income as percentage of average net operating assets	N/A	8	9	

Source: Vivendi.

3.115. We reviewed three recent analyst reports which made estimates for Vivendi to 2002. The analysts put the BSKyB and Canal+ investments at the time of their reports at roughly 7.5 per cent each of the total value of Vivendi. The focus of the analysts was more on Vivendi's telecommunications activities, rather than its media interests, and how it might maximize value from its various interests in different sectors either by disposals or consolidation. Among the analysts comments were that:

- (a) Vivendi was ‘criticized for having used its financial power for large acquisitions widely financed by new equity’.
- (b) Vivendi was criticized for a strategy that has lost clarity, and its desire to keep a conglomerate structure, rather than splitting the businesses.
- (c) ‘We are confident that Vivendi’s management will implement key strategic steps that would represent catalysts to the shares.’
- (d) ‘The group’s financial capacity remains strong’ ... ‘Management has so far demonstrated its ability to create value in buying assets at reasonable multiples and selling at multiples above the industry average.’

Vivendi’s activities in the communications sector

3.116. Vivendi Communications is the division of Vivendi that operates in media and telecommunication activities. Table 3.13 shows highlights from Vivendi Communications’ profit and loss account, converted to sterling, over the five years to 1998. During the period, turnover increased from £652 million in 1994 to £1.44 billion in 1997, and following the Havas acquisition, to £4.0 billion in 1998. However, operating losses were sustained in the four years to 1997, and modest profits were achieved in 1998 at £188 million. For the media activity, turnover was between £158 million and £226 million in the three years 1994 to 1996, when each year’s operating loss was roughly £60 million. In 1997, media turnover fell to £41 million and a loss of £9 million was sustained. In 1998, the turnover was £2.07 billion and an operating profit of £173 million was achieved. Vivendi said that these levels of profits reflect the significant investment that it has made in the communications sector.

TABLE 3.13 Vivendi Communications: profit and loss summary, 1994 to 1998

	<i>£ million*</i>				
	<i>Years ended 31 December</i>				
	1994	1995	1996	1997	1998†
<i>All activities</i>					
Turnover	652	801	924	1,445	4,005
Operating (loss)/profit	(150)	(167)	(196)	(172)	188
<i>Analysed as</i>					
Telecommunications turnover	494	575	742	1,404	1,938
Operating (loss)/profit	(94)	(107)	(137)	(163)	15
Media turnover	158	226	182	41	2,067
Operating (loss)/profit	(56)	(60)	(59)	(9)	173
<i>Performance indicators</i>					
Operating (loss)/profit as percentage of turnover for:					<i>per cent</i>
All activities	(23)	(21)	(21)	(12)	5
Telecommunications	(19)	(19)	(18)	(12)	1
Media	(35)	(27)	(32)	(22)	8

Source: Vivendi.

*The figures are reported in euros and are consolidated by the equity method.

†Havas was acquired in 1998.

3.117. Vivendi told us that Vivendi Communications has a direct and indirect interest of 44 per cent in Cégétel (the leading private telecommunications operator in France). Under the terms of its agreement with Vodafone, which were announced during our inquiry, Vivendi told us that Vodafone agreed that if successful in acquiring control of Mannesmann, it would procure the sale to Vivendi of an additional 7.5 per cent economic interest in Cégétel. Cégétel offers fixed voice and data telephone services, mobile phone services, and Internet access services for individual and business customers. Vivendi also has a 49 per cent stake in Canal+, a publicly quoted company.

3.118. Havas is active in:

- (a) educational and reference works publishing;
- (b) trade information (press publications, trade shows, books and multimedia covering all major business sectors); and
- (c) multimedia activities (educational reference, entertainment, and how-to software, CD-ROMs and educational and reference Internet sites).

3.119. Vivendi's interests as an Internet access provider in France are conducted through AOL France, of which Cégétel and Canal+ jointly hold 55 per cent. The balance of shares in AOL France is held by AOL Europe, a 50:50 joint venture between Bertelsmann and AOL. In 1999, Vivendi and Softbank Corporation (Softbank) created @VISO, which is to take significant minority positions, alongside the Japanese Internet parent company, in the European start-up subsidiaries. Vivendi and Softbank each committed \$50 million to the initial investment. Vivendi said that although Softbank did not have any direct link with News Corporation, Softbank had entered into a similar joint venture with News Corporation in respect of the UK and Australia. Vivendi added that, given the ownership structure of AOL France, the AOL/Time Warner merger announced in January 2000 will have minimal effect on AOL France.

3.120. In November 1999 Vivendi, Softbank, e-partners (an investment fund in which News Corporation is a significant shareholder) and the National Association of Securities Dealers announced the creation of a joint venture. The purpose of the joint venture is to prepare for the establishment of, and then operate, a NASDAQ exchange in Europe, to be based in England. The parties have not signed agreements but Vivendi told us that its interest could be between [30] and [35] per cent, e-partners would hold a similar interest, Softbank would have a [30] per cent interest, and the balance (the majority) would be held by the National Association of Securities Dealers. The position of the board is also not agreed.

3.121. Following its merger with Havas in 1998, Vivendi regrouped its main audio-visual activities in a 100 per cent wholly-owned holding company, SOFIEE. As well as Vivendi's stake in Canal+, SOFIEE holds 100 per cent of Havas Images and Media Overseas. Havas Images is party to a number of joint ventures, including some with Canal+, for the production of theme channels in France. Media Overseas provides Canal+ channels in French overseas territories and has no activities in Europe.

3.122. Vivendi holds directly a 38 per cent stake in Union Generale de Cinématographie (UGC) and it said that it did not exercise management control which was held by the two other shareholders. (15 per cent was held by Paribas and 47 per cent by others, including the Verrechia family.) Vivendi told us that there were no direct links between UGC and Canal+; however, in 1996, at which time Vivendi had a 19.2 per cent shareholding in Canal+, UGC sold ownership of its film catalogue to Canal+. UGC recently bought the Virgin cinemas chain from the Virgin Group. Vivendi also said that its investment in UGC was purely financial.

3.123. Vivendi had an 18 per cent interest in Audiofina which it sold in November 1999. Following this disposal, Vivendi said that it has no interest in free-to-air TV, other than Canal+'s 24.9 per cent share in Vox (a German free-to-air TV broadcaster). We were told that Audiofina had an interest in CLT-UFA which in turn had an interest in Channel 5 in the UK.

3.124. Canal+ has a 56.7 per cent interest in the football club Paris St Germain, and a 41.6 per cent interest in the Swiss football club, Servette de Genève. In 1991 Canal+ in collaboration with the Paris city authorities took over the running of Paris St Germain. Canal+ has only a minority of seats on the board and has agreed not to increase its stake above 58 per cent.

3.125. Through Canal+'s subsidiary Sport+, created in 1998, the Canal+ group engages in the buying and selling of international sports rights. Sport+ sells such rights to the various premium Canal+ channels as well as to other broadcasters (see also paragraph 4.75).

3.126. Vivendi told us that it has a UK subsidiary called Vivendi (UK) Limited which is a pure holding company. It does not trade and has no employees. Its Managing Director represents the corporate interests of Vivendi SA in the UK.

Canal+

Corporate governance and financial performance

3.127. Canal+ is a public company in which Vivendi currently has a 49 per cent interest (as explained below). The market capitalization of Canal+ at 2 February 2000 was £19 billion and its shares are quoted on the Paris Stock Exchange.

3.128. In 1998, following the merger of Havas and Vivendi, Vivendi became the largest shareholder in Canal+ with a 34 per cent interest. In 1999 Vivendi subsequently acquired a further 15 per cent from Compagnie Financiere Richemont AG (Richemont) and now owns 49 per cent of Canal+. Vivendi told us that under French law, no one person may own more than 49 per cent of the share capital or voting rights in a company with a national analogue terrestrial TV broadcasting licence. This limit of 49 per cent was increased in 1994 from 25 per cent. Vivendi added that Canal+ does not broadcast in the UK. Vivendi also announced that it desires to reduce its stake in Canal+ to 40 per cent in order to allow for the arrival of an international strategic partner. Vivendi drew our attention to comments made by its President in an interview with the French newspaper *Les Echos* in July 1999 in which he explicitly ruled out the possibility of News Corporation being that strategic partner. There are no other significant shareholders in Canal+ with interests exceeding 5 per cent.

3.129. Vivendi told us that it currently held a minority of the seats on the board of directors of Canal+ (six of 16 seats), as before the increase in its shareholding. The remaining seats are held by representatives of Richemont (three seats), representatives of Canal+'s management (three seats) and independent members (four seats). Vivendi added that neither itself nor Canal+ have announced any plans in relation to such seats. Vivendi emphasized to us that it did not take an imperial position regarding its investments and accordingly did not interfere in the management decisions of, for example, Canal+ (see paragraph 6.30).

3.130. Canal+ told us that, unlike most French companies, it has set up an elaborate system of corporate governance, based on 'Anglo Saxon' business practices, in order to safeguard the independence of the company's management. It said that this was essential, given the high exposure of the company to the sanctions of the stock market should the market judge its behaviour to be contrary to the interests of shareholders. Vivendi added that the independence of the Canal+ management as regards its shareholders had been at the heart of the company's culture, commercial success and dynamic nature, both in France and in its international operations.

3.131. Canal+'s system of corporate governance includes the Investment Committee, currently chaired by the Chief Executive Officer of Richemont, the Finance Committee, currently chaired by the Chief Executive Officer of Société Générale, the Agreements Committee, currently chaired by the Deputy Chairman and Chief Operating Officer of Canal+, and the Compensation Committee, currently chaired by the Honorary Chairman of Vivendi. Vivendi said that just as the chairmanships of the committees were established in a balanced manner, each of the committees maintained a balance of independent Canal+ management and Richemont and Vivendi representatives. The recommendations of the committees were adopted by a simple majority and were communicated to Canal+'s board of directors. Vivendi added that the need for independent management was also reflected within the Canal+ group. Because Canal+ needed to adapt its offering in each country in which it broadcasts to reflect the local taste and culture, it said that in practice it devolved to its local subsidiaries the decision-making regarding programme purchasing. Nevertheless, we note that Vivendi has a sufficient equity interest in Canal+ to be able to influence its policy, should it wish to do so.

3.132. The principal activity of Canal+ is the production and broadcasting of the Canal+ pay-TV channel. To do this, it buys and produces TV programmes as necessary. Canal+ has numerous subsidiaries and associated companies in pay-TV, theme channels, production and rights management, new technologies, and other activities. Appendix 3.2 shows its interest at 31 December 1998 as reported in its accounts in such entities and we further discuss relevant subsidiaries/associated companies below.

3.133. Canal+ was created in 1983 to establish a pay-TV channel in France. Vivendi told us that at 30 September 1999, Canal+ had some 4.8 million subscriptions in France, and its broadcasts were transmitted by cable, satellite and terrestrially. It estimated this level of customers to be a penetration level of 20 per cent. In France, the Canal+ channel is broadcast encrypted and, for certain programmes, free to air. In terms of audience shares, Vivendi said that Canal+ was in fifth position after the free-to-air

channels, Television Française 1 (TF1), France 2, France 3 and Métropole Télévision. Canal+'s premium channel programming concentrates on films and sporting events. It relied on 'first choice', novelty, diversity and exclusivity. However, programming was not simply limited to sport and blockbuster films. In France, almost 50 per cent of the films shown on Canal+ were never broadcast on 'generalist' channels. Moreover, Vivendi added that more than one-third of Canal+'s output was made up of documentaries and cartoons, talk shows and news.

3.134. At 31 December 1998, Canal+'s accounts reported that it had 11.6 million subscriptions, of which 5.4 million were analysed as international subscriptions (outside France). 40 per cent of Canal+'s international subscriptions were in Spain (2.2 million), 27 per in Italy (1.5 million), 11 per cent in Nordic countries, 6 per cent in Belgium, 6 per cent in Poland, and the remaining 10 per cent in the Netherlands and Africa.

3.135. Table 3.14 shows a five-year summary of Canal+'s group profit and loss account to 31 December 1998, converted to sterling. Over the period, its turnover increased from £1.1 billion in 1994 to £1.66 billion in 1998. Operating profits were £170 million for 1994, increased to around £185 million for each of the next two years, and since fell to £19 million in 1997 and £34 million in 1998. Canal+ said that the recent changes in the levels of profits represented the significant investments made by it in digital technology and the consequences in 1997 of the Nethold acquisition (which Canal+ noted as the second largest pay-TV operator in Continental Europe). In 1997 there was an exceptional profit of £292 million as a result of the sale of Canal+'s interest in Premiere to KirchPayTV. Canal+ paid dividends to shareholders of €13 million (£8 million) in 1996, €9 million (£6 million) in 1997, and €96 million (£63 million) in 1998. Canal+ explained that until 1997 shareholders had the option of taking dividends in the form of shares, and many did so. If the full value of the dividend was noted, rather than the cash amount actually paid, it said that the dividends for 1996 and 1997 would have been shown as €67 million and €94 million respectively.

TABLE 3.14 Canal+: group profit and loss summary, 1994 to 1998*

	<i>£ million</i>				
	<i>Years ended 31 December</i>				
	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Turnover	<u>1,127</u>	<u>1,289</u>	<u>1,455</u>	<u>1,798</u>	<u>1,662</u>
Operating profit	170	187	185	19	34
Net interest (paid)/received	<u>(3)</u>	<u>14</u>	<u>17</u>	<u>7</u>	<u>(2)</u>
Profit before taxation	167	201	202	26	32
Taxation	<u>(55)</u>	<u>(74)</u>	<u>(74)</u>	<u>(24)</u>	<u>(21)</u>
Profit after taxation	112	127	128	2	11
Losses from associates	<u>(30)</u>	<u>(32)</u>	<u>(31)</u>	<u>(102)†</u>	<u>(83)†</u>
Exceptional items	<u>(11)</u>	<u>(11)</u>	<u>(8)</u>	292	51
Minorities	11	10	12	22	12
Goodwill amortized	<u>(8)</u>	<u>(9)</u>	<u>(8)</u>	<u>(12)</u>	<u>(10)</u>
Profit/(loss) after exceptional items	74	85	93	202	(19)
<i>Performance indicators</i>	<i>per cent</i>				
Operating profit as percentage of turnover	15	15	13	1	2

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of average rates: 8.49FF=£1 in 1994, 7.88FF=£1 in 1995, 7.99FF=£1 in 1996, 7.56FF=£1 in 1997 and 9.77FF=£1 in 1998.

†The increase in losses from associates in 1997 resulted from the acquisition by Canal+ of Nethold.

3.136. Canal+ told us that Nethold was active in the pay-TV sector in the following countries:

- (a) in Italy through a 45 per cent minority interest in Telepiu (750,000 subscribers);
- (b) in Norway, Sweden, Finland and Denmark through Nethold Scandinavie (364,000 subscribers),
- (c) in Slovenia, Poland, the Czech Republic, Hungary, Croatia, and Slovakia through Nethold Europe Centrale (58,000 subscribers); and
- (d) in Belgium and Holland through Nethold Benelux (336,000 subscribers).

3.137. For 1998, Canal+ told us that its total investment on purchasing sports rights was €805 million (£523 million), of which € 300 million was sublicensed to leave a net cost of € 505 million. For film rights, the investment in 1998 totalled €500 million (£325 million). We consider Canal+'s investment in sports rights in greater detail in Chapter 4. Canal+'s accounts for 1998 showed that the annual charge for sports programming was €216 million, and €270 million for film programming.

3.138. Table 3.15 shows for Canal+ a five-year summary of its group balance sheet to 31 December 1998, converted to sterling. Net operating assets were £441 million in 1994, fell to £318 million in 1995, increased to £678 million in 1996 and increased further to around £1.17 billion in 1997 and 1998.

TABLE 3.15 Canal+: group balance sheet summary, 1994 to 1998*

	£ million				
	As at 31 December				
	1994	1995	1996	1997	1998
Tangible assets	384	415	398	418	526
Intangible assets	288	268	571	1,081	1,177
Current assets	450	494	618	1,180	1,009
Current liabilities	(681)	(859)	(909)	(1,507)	(1,539)
Net operating assets	441	318	678	1,172	1,173
Goodwill	52	53	32	177	187
Investments	304	403	379	621	641
Net cash/(long-term borrowings)	134	280	40	(809)	(849)
Net assets	931	1,054	1,129	1,161	1,152
<i>Representing</i>					
Share capital	52	58	55	63	68
Reserves	791	950	1,008	1,034	1,022
Minorities	88	46	66	64	62
	931	1,054	1,129	1,161	1,152
<i>Performance indicators</i>					
Operating profit as percentage of average net operating assets	N/A	49	37	2	3

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of closing rates: 8.34FF=£1 in 1994, 7.60FF=£1 in 1995, 8.90FF=£1 in 1996, 9.92FF=£1 in 1997 and 9.30FF=£1 in 1998.

3.139. For cable and satellite operations, Canal+ has developed certain wholly-owned theme channels, such as *Demain!*, which is dedicated to job hunting, and *iTV* which is a newly-launched news channel. Canal+ has interests in other channels such as *GameOne* which is dedicated to video games. Canal+ also has a minority interest of around 30 per cent in the company Multithématiques whose principal activity consists of the production of theme channels (documentaries, series and library films) for France and international operations. Havas Images (part of Vivendi) also has an interest of around 30 per cent in Multithématiques. Vivendi told us that KirchPayTV has no interest in Multithématiques. Vivendi accepted that it had veto rights on all main decisions relating to the management of Multithématiques through Havas Images and Canal+, but denied that it had effective control of the company. Each of the three major shareholders in Multithématiques (which included Liberty Media International with a 30 per cent interest) had veto rights on all main decisions relating to the management of Multithématiques; in addition there were ongoing discussions relating to the reconstruction of the capital of Multithématiques involving the introduction of a fourth major shareholder.

3.140. Kiosque is a subsidiary of Canal+ and offers films and major sporting events on a PPV basis, accessible via CanalSatellite, NC NumériCâble and certain other cable distributors of TV services in France. CanalSatellite was launched in 1992 to distribute pay-TV by satellite in France. Over 150 channels and services, the majority of which are not linked to Canal+, are available on the CanalSatellite digital platform. As at 30 September 1999 its total number of subscribers was around 1.25 million. It has recently announced that the Lagardère Group is to acquire all of Vivendi's shares in CanalSatellite, as well as shares from Canal+, so as to give it a 34 per cent stake at a cost of €842 million (around £550 million). Vivendi currently owns approximately 20 per cent of CanalSatellite, and Canal+ 80 per cent. Vivendi said that viewers could subscribe to CanalSatellite without having to subscribe to Canal+ and vice versa.

3.141. NC NumériCâble is a French cable operator in which Canal+ holds a 63 per cent shareholding. Nonetheless, Vivendi told us that control was exercised jointly by Canal+, Bank America and CDPQ (Caisse de Dépôt et Placement du Québec), an arrangement that had been recognized by the European Commission in its decision of 3 December 1998.¹ Vivendi said that as at 30 September 1999 there were 653,000 subscribers. NC NumeriCable has franchises in various cities in France.

3.142. Canal+'s premium channels are now broadcast in 12 countries, including the following EC countries: Belgium, Denmark, Italy, Finland, Spain, Sweden and the Netherlands, as well as France. In each country the channels are different; they are prepared in the country to reflect the taste and culture of the local population. Programming and purchasing discussions are devolved to the national level.

3.143. Other than the broadcast of premium and theme channels, Canal+ is also active in the following:

- (a) the distribution of TV services;
- (b) the production of films and audio-visual works—it is principally active in producing French films in cooperation with other producers: it also has a joint venture with Warner (called Bel Air) which aims to produce four to five films a year;
- (c) trading in broadcast rights to films, audio-visual works, and sporting events;
- (d) management of sports clubs; and
- (e) development of conditional access (through its holding in SECA) and interactivity software through Canal+ technologies.

3.144. Canal+ is involved in the management of sports clubs. Since 1991, it has been the operator of Paris St Germain, one of the premier football clubs in France. Canal+ also has a holding in PSG Omnisports which is involved in handball, basketball, judo and boxing events.

3.145. Canal+ is also a founding member of the Digital Video Broadcast group in which over 200 industrial operators, developers and broadcasters participate in working towards open common standards. Canal+ said that it had implemented this group's most recent decisions concerning conditional access and applications program interface.

3.146. We noted that Canal+ owns a 50 per cent interest in Nagra+, which owns the Syster analogue conditional access system. Canal+ told us that the other shareholder in Nagra+ was Kudelski SA which owned the Nagravision digital conditional access system. It added that there had not been any convergence between Mediaguard (see paragraphs 3.179 to 3.182) and Nagravision or collaboration between Kudelski SA and SECA which were direct competitors.

3.147. We looked at recent analyst reports covering Canal+ to gain an impression of how the company is currently regarded. One report in January 2000 assessed Canal+ as likely to outperform. The company was Europe's biggest pay-TV operator and was unique in being fully integrated. During the course of 2000 Canal+ was expected to have three initial public offerings for its lesser-known businesses. The establishment of independent valuations for these operations was expected to indicate an implied value per subscriber in the core TV business considerably below that of BSkyB and the value parameters set in recent pay-TV deals. News flow pertaining to the Canal+ group was expected to be very positive in 2000. However, any possible full merger between BSkyB and Canal+ was not expected by the analyst necessarily to mean real synergy benefits for either party.

CanalSatellite

3.148. CanalSatellite was launched in 1992 and distributes digital pay-TV by satellite in France. It transmits over 150 channels and services, the majority of which are not linked to the Canal+ group, and are available on the CanalSatellite digital platform. Vivendi told us that as at 30 September 1999 CanalSatellite's total number of subscribers was around 1,250,000 (see also paragraph 3.140).

¹IV/M. 1327.

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3.149. SECA is a joint venture company in which Canal+ and Bertelsmann each have a 50 per cent interest. It developed the Mediaguard conditional access technology which we discuss further in paragraphs 3.179 to 3.182. Its four-year profit and loss account to 1998 is summarized in Table 3.16. Over the period turnover increased from £7 million in 1996 to £22 million in 1998, in which year operating profits were £7.8 million. The recent operating profits, as a percentage of turnover, are in the region of 35 per cent.

TABLE 3.16 SECA: profit and loss summary, 1995 to 1998*

	<i>£ million</i>			
	<i>Years ended 31 December</i>			
	1995	1996	1997	1998
Turnover	<u>0.0</u>	<u>7.3</u>	<u>21.5</u>	<u>22.0</u>
Operating profit/(loss)	(0.3)	0.1	6.6	7.9
Net interest paid	<u>0.0</u>	<u>(0.3)</u>	<u>(0.4)</u>	<u>(0.1)</u>
Profit/(loss) before taxation	(0.3)	(0.2)	6.2	7.8
Taxation†	<u>0.0</u>	<u>0.6</u>	<u>0.0</u>	<u>0.0</u>
Profit/(loss) after taxation	(0.3)	0.4	6.2	7.8
<i>Performance indicators</i>				<i>per cent</i>
Operating profit as percentage of turnover	N/A	1	31	36

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of average rates: 8.49FF=£1 in 1994, 7.88FF=£1 in 1995, 7.99FF=£1 in 1996, 7.56FF=£1 in 1997, and 9.77FF=£1 in 1998.

†Tax is not payable because of historical losses.

3.150. Table 3.17 shows SECA's balance sheet summary for the five years to 1998. In 1998 its net operating assets were £12 million, and its return on average net operating assets was 68 per cent.

TABLE 3.17 SECA: balance sheet summary, 1994 to 1998*

	<i>£ million</i>				
	<i>As at 31 December</i>				
	1994	1995	1996	1997	1998
Tangible assets	0.0	1.0	0.9	0.9	0.7
Intangible assets	3.1	7.8	6.0	4.1	3.0
Current assets	0.6	4.8	6.6	10.2	13.4
Current liabilities	<u>(3.7)</u>	<u>(3.9)</u>	<u>(3.7)</u>	<u>(4.0)</u>	<u>(5.1)</u>
Net operating assets	0.0	9.7	9.8	11.2	12.0
Long-term borrowings	<u>0.0</u>	<u>(10.0)</u>	<u>(9.4)</u>	<u>(6.4)</u>	<u>(3.7)</u>
Net assets	0.0	(0.3)	0.4	4.8	8.3
<i>Representing</i>					
Share capital and reserves†	0.0	(0.3)	0.4	4.8	8.3
<i>Performance indicators</i>					<i>per cent</i>
Operating profit/(loss) as percentage of average net operating assets	N/A	(6)	1	63	68

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of closing rates: 8.34FF=£1 in 1994, 7.60FF=£1 in 1995, 8.90FF=£1 in 1996, 9.92FF=£1 in 1997, and 9.30FF=£1 in 1998.

†Share capital is less than £0.1 million.

3.151. Vivendi said that it had no access to valuation information about SECA. Canal+ said that if the opportunity arose, it would be interested in acquiring the Bertelsmann interest. Given the present circumstances, we consider that Canal+ has the ability to exercise considerable influence over SECA.

Eurosport International and Eurosport France

3.152. Canal+ also has a 33 per cent interest in Eurosport Sales Organisation (Eurosport International), which produces the Eurosport Channel outside France, including the UK. The other shareholders in Eurosport are TF1 (the French free-to-air broadcaster) with an interest of 34 per cent, and the Disney Group (Disney) with an interest of 33 per cent. TF1 has management control of Eurosport. Canal+, Vivendi, TF1 and Disney are also shareholders in TV Sport, which produces Eurosport France and is only broadcast in French-speaking territories. TV Sport is managed by Canal+.

3.153. Table 3.18 shows Eurosport International's profit and loss account summary for the five years to 1998. Over the period, turnover increased from £67 million in 1994 to £129 million in 1998, which compares with operating losses of £7 million in 1994, breakeven in 1996, and operating profit of £9 million in 1998.

TABLE 3.18 Eurosport Sales Organisation (Eurosport International): profit and loss summary, 1994 to 1998*

	<i>£ million</i>				
	<i>Years ended 31 December</i>				
	1994	1995	1996	1997	1998
Turnover	<u>66.8</u>	<u>85.6</u>	<u>120.7</u>	<u>142.8</u>	<u>128.8</u>
Operating profit/(loss)	(6.9)	(5.3)	(0.4)	6.9	9.1
Net interest (paid)/received	<u>(0.7)</u>	<u>(1.2)</u>	<u>0.7</u>	<u>1.1</u>	<u>0.3</u>
Profit/(loss) before taxation	(7.6)	(6.5)	0.3	8.0	9.4
<i>Performance indicators</i>					<i>per cent</i>
Operating profit/(loss) as percentage of turnover	(10)	(6)	0	5	7

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of average rates: 8.49FF=£1 in 1994, 7.88FF=£1 in 1995, 7.99FF=£1 in 1996, 7.56FF=£1 in 1997, and 9.77FF=£1 in 1998.

3.154. Table 3.19 shows Eurosport International's balance sheet summary for the five years to 1998. Net operating assets were around £1 million in 1998.

TABLE 3.19 Eurosport Sales Organisation (Eurosport International): balance sheet summary, 1994 to 1998*

	<i>£ million</i>				
	<i>As at 31 December</i>				
	1994	1995	1996	1997	1998
Tangible assets	0.2	0.3	0.2	1.3	1.5
Intangible assets	0.1	0	0.0	0.1	0.1
Current assets	23.1	93.4	49.9	52.0	57.5
Current liabilities	<u>(22.9)</u>	<u>(90.5)</u>	<u>(51.1)</u>	<u>(44.9)</u>	<u>(58.0)</u>
Net operating assets	0.5	3.2	(1.0)	8.5	1.1
Investments	1.9	2.1	1.7	1.6	3.2
Net long-term (borrowings)/cash	<u>(14.8)</u>	<u>(17.2)</u>	<u>(4.9)</u>	<u>(8.0)</u>	<u>6.0</u>
Net assets	(12.4)	(11.9)	(4.2)	2.1	10.3
<i>Representing</i>					
Share capital	0.4	0.4	0.3	0.3	0.3
Reserves	<u>(12.8)</u>	<u>(12.3)</u>	<u>(4.5)</u>	<u>1.8</u>	<u>10.0</u>
	(12.4)	(11.9)	(4.2)	2.1	10.3
<i>Performance indicators</i>					<i>per cent</i>
Operating profit/(loss) as percentage of average net operating assets	N/A	(286)	(36)	184	190

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of closing rates: 8.34FF=£1 in 1994, 7.60FF=£1 in 1995, 8.90FF=£1 in 1996, 9.92FF=£1 in 1997, and 9.30FF=£1 in 1998.

3.155. Table 3.20 shows Eurosport France's profit and loss account summary for the five years to 1998. Over the period, turnover increased from £17 million in 1994 to £29 million in 1998, which compares with an operating loss of £1.5 million in 1994, an operating profit of £1.2 million in 1996, and a profit of £4.6 million in 1998.

TABLE 3.20 **TV Sport (Eurosport France): profit and loss summary, 1994 to 1998***

		<i>£ million</i>				
		<i>Years ended 31 December</i>				
		1994	1995	1996	1997	1998
Turnover		<u>16.7</u>	<u>20.0</u>	<u>22.5</u>	<u>30.9</u>	<u>28.6</u>
Operating profit/(loss)		(1.5)	0.2	1.2	5.8	4.6
Net interest (paid)/received		<u>(0.2)</u>	<u>(0.2)</u>	<u>0.0</u>	<u>0.0</u>	<u>0.1</u>
Profit/(loss) before taxation		<u>(1.7)</u>	0.0	1.2	5.8	4.7
Taxation†		<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
Profit/(loss) after taxation		<u>(1.7)</u>	0.0	1.2	5.8	4.7
Exceptional items		<u>0.5</u>	<u>0.1</u>	<u>3.7</u>	<u>0.7</u>	<u>(2.8)</u>
(Loss)/profit after exceptional items		<u>(1.2)</u>	0.1	4.9	6.5	1.9
<i>Performance indicators</i>		<i>per cent</i>				
Operating profit/(loss) as percentage of turnover		(9)	1	5	19	16

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of average rates: 8.49FF=£1 in 1994, 7.88FF=£1 in 1995, 7.99FF=£1 in 1996, 7.56FF=£1 in 1997, and 9.77FF=£1 in 1998.

†Eurosport France paid no tax on profits in the years covered by the table above as it incurred losses between 1990 and 1995 which were offset against profits for tax purposes in later years.

3.156. Table 3.21 shows Eurosport France's balance sheet summary for the five years to 1998. Net operating assets were around £11 million in 1998. We asked Vivendi why Eurosport France had greater net operating assets in 1998 than Eurosport International (see Table 3.19). Vivendi told us that because it did not have operational control of Eurosport International, which was operated by TF1, it was unable to compare the two organizations.

TABLE 3.21 **TV Sport (Eurosport France): balance sheet summary, 1994 to 1998**

		<i>£ million</i>				
		<i>As at 31 December</i>				
		1994	1995	1996	1997	1998
Tangible assets		0.5	0.4	0.5	1.7	1.5
Current assets		7.8	9.0	10.0	14.6	20.6
Current liabilities		<u>(6.8)</u>	<u>(6.3)</u>	<u>(6.8)</u>	<u>(7.9)</u>	<u>(11.0)</u>
Net operating assets		1.5	3.1	3.7	8.4	11.1
Net long-term borrowings		<u>(5.1)</u>	<u>(6.9)</u>	<u>(2.6)</u>	<u>(2.5)</u>	<u>(2.9)</u>
Net assets		<u>(3.6)</u>	<u>(3.8)</u>	1.1	5.9	8.2
<i>Representing</i>						
Share capital		1.8	2.0	1.7	1.5	1.6
Reserves		<u>(5.4)</u>	<u>(5.8)</u>	<u>(0.6)</u>	<u>4.4</u>	<u>6.6</u>
		<u>(3.6)</u>	<u>(3.8)</u>	1.1	5.9	8.2
<i>Performance indicators</i>		<i>per cent</i>				
Operating profit/(loss) as percentage of average net operating assets		N/A	9	35	96	47

Source: Vivendi.

*The figures were reported in French francs and translated to pounds on the basis of closing rates: 8.34FF=£1 in 1994, 7.60FF=£1 in 1995, 8.90FF=£1 in 1996, 9.92FF=£1 in 1997, and 9.30FF=£1 in 1998.

3.157. In 1999, NTL (a major cable-TV and telephony operator in the UK) and Eurosport International formed a contractual joint venture to provide funding for the enhancement of British Eurosport in the UK. British Eurosport is further discussed in Chapter 4.

The merger situation

Background and rationale for the investment in BSkyB

3.158. Vivendi told us that it intended to be a long-term participant in European broadcasting, which it said was a sector undergoing significant and rapid consolidation, development and change. It added that it considered BSkyB to be one of the most innovative and dynamic participants in the sector and a leading force in the evolution of European pay-TV. Hence it took advantage of the opportunities to invest in BSkyB. Vivendi said that it was fanciful to consider that its investment in BSkyB was because of BSkyB's position as a successful English language broadcaster, and added that Canal+ already broadcast in nine European languages.

3.159. Vivendi said that it did not think its investment in BSkyB gave it the ability materially to influence the policy of BSkyB. It emphasized that this was because of News International's shareholding in BSkyB of 39 per cent, News International's representation on the BSkyB board, and the various contractual, personal and family links between BSkyB and the News Corporation Group. It added that BSkyB's proposed investment in KirchPayTV, announced in December 1999, would create another investor with a 4.3 per cent interest in BSkyB, which would further weaken any influence by Vivendi. Vivendi emphasized that it was not consulted prior to the announcement, nor was the transaction mentioned at the board meeting attended by Vivendi's director whilst he was in attendance, and he was asked to leave the meeting when the relevant discussions were held. It believed the investment in KirchPayTV reinforced the influence of News Corporation over BSkyB, and also the influence of Mr Rupert Murdoch who was appointed Chairman of BSkyB when Vivendi became a shareholder in 1999.

3.160. We noted minutes from Vivendi's board meeting on 22 July 1999, which it translated for us and is discussed in greater detail in Chapter 6. The relevant board minutes' section was headed 'Strengthening Vivendi's position in BSkyB and Canal+'. We set out below all the subparagraphs of this section which we have designated (a) to (i) for convenience. The 'paper' referred to in subparagraph (a) below is reproduced in Appendix 3.3 and is discussed in greater detail in Chapter 6. The minutes said:

(a) M Messier asked the Board to give its views on the two operations proposed to strengthen Vivendi's position in BSkyB and Canal+. A paper had been sent to each member prior to the meeting.

(b) He detailed the context and objectives of these operations as part of Vivendi's multi-media strategy. He explained that as a founding shareholder in Canal+, Europe's leading pay TV group, holding 34 per cent of its capital and following the announcement of the merger with Pathé, Vivendi now had a double opportunity to significantly strengthen its position in the world of pay TV with the acquisition of a 67 per cent holding in BSBH, itself an 11.8 per cent shareholder of BSkyB, giving it a total BSkyB holding of 24.5 per cent (the blocking minority at the general meeting) [*Details omitted. See note on page iv.*].

(c) In terms of BSkyB, it would provide an opportunity for the unhurried exploration of the possibility of joint projects with Canal+ in the fields of technology convergence, digital decoders, Internet.

(d) In addition, since the interests held by Pearson and Granada, 67 per cent shareholders in BSBH, [*Details omitted. See note on page iv.*].

(e) [*Details omitted. See note on page iv.*].

[

Details omitted. See note on page iv.

].

(f) [

Details omitted. See note on page iv.

].

(g) [

Details omitted. See note on page iv.

].

(h) M Messier asked for comments from the directors who congratulated him on these operations. Mr [named person] underlined the change in balance which had been achieved in one year. The Board approved all the draft agreements presented to it.

(i) M Messier returned to Vivendi's strategic plans which centred around the notion of the subscriber and emphasized the lessons which could be learnt from the behaviour of the subscribers and the techniques used at Canal+. He reported on [

Details omitted. See note on page iv.

].

These new plans would have to take into account as the prime factor confidence and security in relations with the customer/subscriber.

3.161. Vivendi told us that the paper mentioned in the minutes was prepared by one of its financial analysts at the request of the Finance Manager (Executive Vice President, Finance). The Finance Manager attends board meetings, but is not a member of the board. In 1999 Vivendi's board consisted of a Chairman and Chief Executive Officer, two Vice Chairmen, and 15 board members, including M Licoys, its representative on the BSKyB board who was appointed to the Vivendi board on 11 May 1999. Under the board is the General Management Group which has 11 members consisting of the Chairman and Chief Executive Officer; the Chief Operating Officer (M Licoys); a Senior Executive for Vivendi Environmental Services and Vivendi Communications; the Executive Vice President, Finance; the Company Secretary; and four other members. The Executive Vice President, Finance, is also a member of Vivendi's Executive Committee and its General Management Committee.

3.162. Vivendi's board minutes regarding the earlier discussions with BSKyB on a possible merger with Canal+ were dated 11 March 1999. It translated the relevant extract into English as follows: 'New World: M Messier (Chief Executive of Vivendi) informed the board of talks that took place, and then broke down, between Canal+ and BSKyB when Rupert Murdoch did not accept the pre-conditions put forward by Canal+.'

3.163. Vivendi told us that the preconditions related to the management of the merged entity and the relative shareholdings of the parent companies.

3.164. Canal+ told us that no written report was ever submitted to its board members on the possibility of an alliance ('rapprochement') between itself and BSKyB. This possibility was only mentioned once in its own board minutes at a meeting on 18 March 1999, which it translated into English as follows: 'M Pierre Lescure touched on the informal conversations between Canal+ and News Corp, the company owned by Rupert Murdoch, regarding a possible alliance ("rapprochement"), between Canal+ and BSKyB. This information did not give rise to any remark from the board members.'

3.165. We now consider in the paragraphs below the stages by which Vivendi acquired its current interest in BSKyB.

The Pathé investment

3.166. Pathé was a listed entity which floated on the Paris Stock Exchange in 1996. By the end of 1998, TF1, the largest French free-to-air broadcaster and a major competitor of Canal+, had acquired a significant stake in Pathé which in turn had a significant stake (about 20 per cent) in CanalSatellite, Canal+'s pay-TV subsidiary. Vivendi said that TF1 was also a founding stockholder in Télévision par Satellite, a direct competitor of CanalSatellite. Vivendi was concerned over TF1's intentions regarding Pathé and the further implications for CanalSatellite, and therefore in January 1999 it took advantage of the opportunity to acquire from the Bolloré group its 20 per cent stake in Pathé. By merging with Pathé, Vivendi ensured that TF1 was not able to acquire any influence over CanalSatellite. Vivendi and Canal+ also made open market purchases of Pathé shares which took their combined interests to around 29 per cent. At the same time, Canal+ and Vivendi entered into an agreement granting reciprocal pre-emption rights regarding Pathé with the group's majority stockholder, M Jérôme Seydoux and his family.

3.167. Vivendi said that whilst this strategic acquisition was satisfactory to Vivendi and Canal+ as a defensive manoeuvre to protect its interest in CanalSatellite, it was re-examined during the course of 1999 at the initiative of the Seydoux family. The resulting decision to merge Vivendi and Pathé had the double objective of allowing the Seydoux family to reacquire full control over the activities of which Pathé was the operator, and allowed Vivendi to transform its investment in Pathé into direct investments in CanalSatellite, Kiosque and BSkyB.

3.168. At the time of the Pathé merger, Vivendi said that Pathé was trading at a substantial discount to net asset value. This, combined with the tax-free status of the merger, allowed Vivendi effectively to acquire, via the merger, Pathé's direct and indirect BSkyB interests at what was in effect a substantial discount to BSkyB's then trading price. Vivendi emphasized that its desire for the transaction to be free of tax necessitated the cessation of Pathé, but a side-effect was its loss of Pathé's rights to board representation on BSkyB. Section 2 of Appendix 3.3 shows Vivendi's calculations on its investment in Pathé/BSkyB. It noted that the cost price of the 16.6 per cent beneficial interest in BSkyB acquired by the Pathé investment was [8€]p, which compared with a BSkyB share price at July 1999 of around 560p.

3.169. On 7 June 1999 Pathé and Vivendi agreed to propose to their respective shareholders the merger of the two companies. On 22 July 1999, Pathé and Vivendi entered into the merger agreement which was completed on 10 September 1999. Prior to that date, Vivendi and Canal+ had already acquired approximately 29 per cent of Pathé. Under the merger agreement, Pathé was absorbed into Vivendi by way of 'fusion-absorption', a legal operation which under French law results in the merger of the two corporate entities into one, ie Vivendi. As a result, Vivendi acquired all assets and liabilities of Pathé, which ceased to exist. There is no equivalent operation in English law. Vivendi said that a tax advantage was gained as a result of merging by way of a 'fusion-absorption'.

3.170. The Pathé shareholders received shares in Vivendi and as a result Vivendi acquired the following major assets:

- Pathé's shareholding (33.1 per cent) and convertible subordinated unsecured loan stock in BSBH;
- Pathé's direct shareholding in BSkyB; and
- Pathé's interest in a number of French companies, including CanalSatellite.

3.171. At 30 November 1999, BSBH had a stake of 11.78 per cent in BSkyB. The other two shareholders in BSBH were subsidiaries of Pearson and Granada, each of which held around 33 per cent. The BSBH shareholders acquired their interests in BSkyB when British Satellite Broadcasting merged with BSkyB. Pathé also had a direct shareholding in BSkyB of approximately 12.66 per cent. Thus as a result of the Pathé transaction, Vivendi's interest in BSkyB was a direct interest of 12.66 per cent, plus an indirect interest of 3.89 per cent, totalling 16.56 per cent.

3.172. The following interests of Pathé at the time of the transaction with Vivendi were immediately resold to Pathé's largest shareholder (M Jérôme Seydoux), who was also Chairman of BSkyB until the transaction was announced:

- chains of cinemas mainly in France and the Netherlands;

- the production and distribution of films and audio-visual works with operations located mainly in France and the UK;
- theme TV channels, mainly Voyage and Pathé sport, as well as interests in Olympique Lyonnaise (a football club) which is an extension of Pathé sport; and
- a share in *Libération* (a French daily newspaper).

3.173. Prior to the transaction, Pathé had been entitled under Article 100 of the BSkyB Articles to two seats on the BSkyB board. Vivendi said that that right was not assignable and therefore terminated when Pathé ceased to exist (for tax reasons, as discussed in paragraph 3.169). The two directors appointed by Pathé to the board of BSkyB have resigned from the board. Under the same Article, BSBH is entitled to appoint a single director to the BSkyB board, and on 17 October 1999 Vivendi exercised BSBH's right to appoint a director to the BSkyB's board by appointment of M Licoys, who is also a member of the Canal+ board. It told us, however, that it had not appointed an alternate to M Licoys.

Vivendi's acquisition of the Pearson and Granada interests in BSBH

3.174. Vivendi said that following the announcement of the pending Pathé merger, it learned that Pearson and Granada were interested in divesting their respective interests, totalling about 66 per cent in BSBH. A shareholders' agreement between the shareholders of BSBH and the Articles of BSBH provided certain rights of pre-emption in the event of transfer by any shareholder to a third party, and certain rights in favour of the other shareholders in the event of change of control of a shareholder. Vivendi added that, as a result of fundamental differences between English and French law, the application of these provisions to the merger between Vivendi and Pathé gave rise to considerable legal uncertainties, for example in respect of whether Vivendi could exercise pre-emption rights over Pearson and Granada's shares.

3.175. Vivendi explained its decision to enter into agreements with Pearson and Granada to acquire their BSBH interests because of:

- Pearson and Granada's stated desire to sell their BSBH stake to Vivendi or a third party which may or may not have been subject to Vivendi's pre-emption rights;
- the legal uncertainties relating to the BSBH shareholders' agreement; and
- the fact that even paying to Pearson and Granada a market price for their BSBH stake representing a relatively low premium to the then current trading price of BSkyB, the aggregate acquisition price for the direct and indirect 24.44 per cent BSkyB stake remained an attractive investment opportunity. Vivendi told us that the share price of BSkyB at the time was approximately 590p and that the shares acquired through the Granada and Pearson transactions were acquired for approximately 600p, a premium of less than 10p per share.

3.176. Vivendi entered into an agreement to acquire the Pearson interest in BSBH on 22 July 1999, which was held by an unlimited subsidiary. Accordingly, Vivendi acquired the shares in the unlimited company through one of its subsidiaries which held the shares on trust for Vivendi. The transaction was completed on 10 September 1999. On the same date, some 14.1 million £1 units of convertible unsecured subordinated loan stock in BSBH were transferred from Pearson to Vivendi, and were converted into BSkyB shares on 1 November 1999. The consideration for the acquisition of the Pearson interests was £408.2 million, which was satisfied by £189 million in cash and the balance by the issue of roughly 4.25 million Vivendi shares, which Pearson resold to receive payment in full. Granada's interest in BSBH was held by four subsidiaries of an intermediate holding company. Vivendi entered into the agreement with Granada on 22 July 1999. Completion of the transaction was on 1 October 1999 and the consideration was £416.7 million, which Vivendi satisfied in cash.

3.177. Vivendi said that it satisfied the cash payments of the Pathé and BSBH transactions from its existing resources and credit arrangements. Following the Granada and Pearson transactions, Vivendi's interest in BSkyB became 24.44 per cent, representing the original direct interest of Pathé in BSkyB of 12.66 per cent, and the 11.78 per cent interest held by shareholders of BSBH.

3.178. In summary, Vivendi said that it hoped the director that it had appointed would see all information on BSkyB because of his position on its board. Vivendi told us that it did not have an exact figure for the total cost of its investment in BSkyB and so was unable to confirm our estimate of £1.5 billion. Following the KirchPayTV transaction, it expected that its interest in BSkyB would be diluted to around 23.5 per cent. Vivendi told us that given BSkyB's strong position in the UK, it would have been prohibitively expensive for it (via Canal+) to have attempted to create its own UK pay-TV service in competition with BSkyB. It added that the investment in BSkyB had increased by a very significant factor since purchase last year (ie from around 400p a share to a level, at the beginning of February 2000, in the region of 1,300p), which demonstrated, on financial grounds alone, the soundness of its decision. We noted that the UK stock market in technology and media-related stocks has been very buoyant since the middle of 1999. We also note that stock market values reflect economic cycles, liquidity of a particular company's stocks, and expectations of future earnings. In the case of BSkyB, only around 32 per cent of the company's shares would be freely marketable after taking account of the prospective blocks controlled by News Corporation, Vivendi and KirchPayTV.

Conditional access and interactivity

3.179. Vivendi said that having identified the emerging importance of digital TV in the early 1990s Canal+ developed its own software for conditional access (Mediaguard) and interactive services (Mediahighway). The Mediaguard software had to be reliable and easy to use and support an open-ended platform that could integrate the interactive services and multimedia applications of the future. Mediaguard was developed and marketed by SECA (the company formed as a joint venture with Bertelsmann on a 50:50 basis). Vivendi said that the system offered optimal security and maximum flexibility for the introduction of multiple programme offerings to segmented audiences, coupled with efficient transaction management (PPV, e-commerce, etc). Mediahighway was a software platform that could interpret interactive applications written in different computer languages, such as Java and HTML. Vivendi said that the ability to interface with computer languages transforms a TV system into a powerful digital multimedia platform at the heart of the convergence between TV, information and telecommunications.

3.180. Vivendi said that there was no horizontal relationship between BSkyB and Canal+ in respect of conditional access technology ie they were not competitors because Canal+ promoted the Mediaguard technology whilst BSkyB was licensed to use the Videoguard technology by NDS. Vivendi emphasized that its investment in BSkyB would neither affect competition in the conditional access and interactive technologies market, nor in any way result in any change of competition in any other markets. Vivendi told us that recent figures at December 1999 for European users of its Mediaguard technology were as follows:

- Belgium—44,000 users;
- France—1.4 million users (compared with another system called ViaAccess accounting for 955,000 users);
- Italy—700,000 users (compared with another system called Irdeto accounting for 300,000 users);
- Poland—150,000 users (compared with another system called Cryptoworks accounting for 80,000 users);
- Spain—700,000 users (compared with another system called NagraCrypt accounting for 450,000 users): see also paragraph 3.146; and
- the UK—500,000 users (compared with the News International's VideoGuard system as used by BSkyB accounting for some 1.1 million users).

3.181. Vivendi said that in the USA, News International's VideoGuard system had 4.5 million users, compared with the Nagra system accounting for 3.5 million users, and two other systems (GI (General Instruments) which is owned by Motorola, and SA (Scientific Atlanta) which is listed on the New York Stock Exchange) accounting for 2 million users in total.

3.182. In Germany, Vivendi said that the Betacrypt/Irdeto system accounted for 850,000 users. The Netherlands had the Irdeto system, Portugal had the NagraCrypt system with 60,000 users, and Scandinavia had two competing systems (Conax and ViaAccess) with more than 250,000 users.

Benefits from the merger situation to Vivendi and BSkyB

3.183. In the following paragraphs we deal briefly with Vivendi's position as a significant shareholder of BSkyB, and the benefits that may arise from the merger situation. Chapter 6 deals more fully with the views of the parties on the merger situation, and Vivendi's emphasis that it regarded the stake in BSkyB as an investment rather than a merger situation.

3.184. Vivendi said that the investment in BSkyB would be accounted for on the equity method. We noted that under UK GAAP this accounting treatment would only be allowed if Vivendi was in a position to exercise 'influence' over BSkyB and the investment was for the long term. Vivendi told us that it was usual in France for the accounts of a company where there was a shareholding of more than 20 per cent to be consolidated, irrespective of whether there was any material influence over the company.

3.185. We asked Vivendi to comment on the earning streams or capital growth that it expects to earn from the investment over, say, the next four years. Vivendi said that it could not do so because it had no inside knowledge about BSkyB.

3.186. BSkyB did not indicate to us any benefits or disbenefits, or efficiency gains which could arise from Vivendi's investment.

3.187. Each company told us in response to our questions that there would be no efficiency savings from its investment and none was envisaged in the current situation; in other words, there was nothing that they could suggest on synergies and benefits between Canal+ and BSkyB that could accrue to them as a result of cooperation.

3.188. Vivendi said that it intended to be a long-term participant in European broadcasting markets. It believed that it was inevitable that the European pay-TV sector would undergo significant and rapid consolidation, development and change. This reflected its belief that TV companies would experience a dramatic increase in demand for their services.

3.189. It added that the process of cross-border evolution had already begun, as exemplified by CLT-UFA's 29 per cent stake in Channel 5 and BSkyB's announcement of its proposed acquisition of a 24 per cent stake in KirchPayTV in Germany. Canal+ was also actively pursuing opportunities to invest internationally, and already had operations in 12 countries worldwide. Vivendi added that it considered BSkyB to be one of the most innovative and dynamic participants in the pay-TV sector, and consequently wished to have an economic interest in BSkyB as well as Canal+.

3.190. Vivendi told us that early in 1999 there were merger discussions between BSkyB and Canal+ and their respective shareholders, but it became clear to Canal+ that there was no basis for an agreement between the two companies because of disagreement on the top management of the combined group—see also Chapter 6 on views of the main parties and paragraph 3.163. It said, however, that when the opportunity arose it did not want to forgo the financial and strategic benefits of being an investor in BSkyB—one of the likely leading forces in the evolution of European pay-TV. It therefore concluded that a minority investment in BSkyB offered it substantial potential benefit with very limited financial downside.

3.191. The negotiations and transactions with, respectively, Pathé, Granada and Pearson allowed it to build up a 24 per cent shareholding at an aggregate price below the then prevailing market price for BSkyB and without having to pay the sort of premium that one would normally expect to pay to acquire a 24 per cent shareholding. Vivendi said that the strong performance of BSkyB since the transactions were announced had demonstrated, on investment grounds alone, that the investment had improved in value. Moreover, the transactions addressed specific tactical and strategic threats to Vivendi's investments.

3.192. Vivendi said that a strategy of minority investments was common, not only in the media field but in the allied communication sector. It added that it was a widespread practice among fixed and especially mobile telecommunication operators to form consortia with operators taking minority stakes in different companies to expand their international portfolio and diversify risk. Over time, these stakes can and do change and realign to reflect either movement in local markets or changes in stakeholders' strategies. Vivendi noted that BSkyB and News Corporation had also been pursuing for some time a policy of seeking positions in European broadcasting outside the UK; a policy which it said, until the recent KirchPayTV transaction, had met with limited success.

BiB (Open) and BSkyB's joint venture interest

Subscriber interactive services

3.193. BiB has two wholly-owned subsidiaries, Marketing Contributions Limited and Open Interactive Limited. The former is responsible for providing contributions to the cost of set-top boxes. The latter operates an interactive service platform available to digital satellite DTH viewers (whether or not subscribers to BSkyB services). Open Interactive Limited trades as Open, but with BiB as the holding company. BiB is a joint venture consisting of BSkyB (32.5 per cent), British Telecommunications Holdings Limited (32.5 per cent), Midland Bank plc (20 per cent) and Matsushita Electric Europe (Headquarters) Limited (15 per cent). Open is aiming to provide its services to as wide an audience of viewers, and by means of as many distribution mechanisms, as possible. BSkyB said that Open had sought carriage on the closed cable networks, but to date had been refused carriage. It presumed the refusal was because the cable operators preferred to avoid competition for the digital interactive services that they planned to operate themselves. BSkyB added that it raised this issue in the parallel inquiry into the proposed acquisition by NTL of the cable business of CWC.

3.194. Through the addition of a telephone connection and a modem in the digital satellite set-top box, the customer will be able to order services and products directly from the TV screen using the remote control. The consortium partners have committed to invest £[30] million to subsidize the retail price of digital satellite set-top boxes. New customers will obtain the set-top box free, provided they enter into an interactive discount contract with Marketing Contributions Limited and connect their set-top box to a telephone line for a minimum 12-month period. Existing analogue BSkyB subscribers will pay for migrating to the digital platform, which includes Open at the rates discussed in paragraph 3.14.

3.195. Services to be offered by Open include home shopping, banking, travel services, interactive games and informational and educational services. The service will be available to owners of digital satellite equipment and was launched on 16 October 1999.

3.196. Open said that it had rights of access to BSkyB's digital customer base with DTH digiboxes, by reason of its payment of access control charges, which were approved by OFTEL. It added that these charges were not more advantageous for Open as compared with any other company, nor did it have greater or different rights of access.

3.197. At March 2000 Open reported in its press release that it had access to 2.6 million homes nationwide, it aimed to double its retail shops to 50 by the end of 2000, and that e-mail users hit 550,000. In its earlier press release of January 2000, Open reported that in the pre-Christmas period it enjoyed peak sales exceeding £1 million a week. It noted at least 8 million visits between launch and Christmas, and produced 128,000 orders. It also noted that 40,000 people were registered with the online banking service.