Margin Squeeze - BskyB

Presentation by Dr Ed Smith

Competition Week, Beijing

The views expressed in these slides are those of the author, and should not be taken as the views of the OFT

OFFICE OF FAIR TRADING

BSkyB

- NTL, Telewest, ITV Digital and BSkyB all distributing BSkyB's premium pay (sports and films) TV channels
- NTL, Telewest & ITV Digital alleged BSkyB had exercised a margin squeeze on their distribution
- OFT test for margin squeeze *'whether an undertaking <u>as efficient</u> in distributing as BSkyB can earn a normal profit when paying the wholesale prices charged by BSkyB to its distributors....tested by reference to BSkyB's own costs of transformation'* [emphasis added]
  - Rivals benefit from test if more efficient

Margin squeeze test on BSkyB – BoardCo and DisCo

BSkyB BroadCo, owner of premium programmes (wholesale)

'upstream'

transfer price

wholesale price

BSkyB DisCo, distribution of programmes (retail)

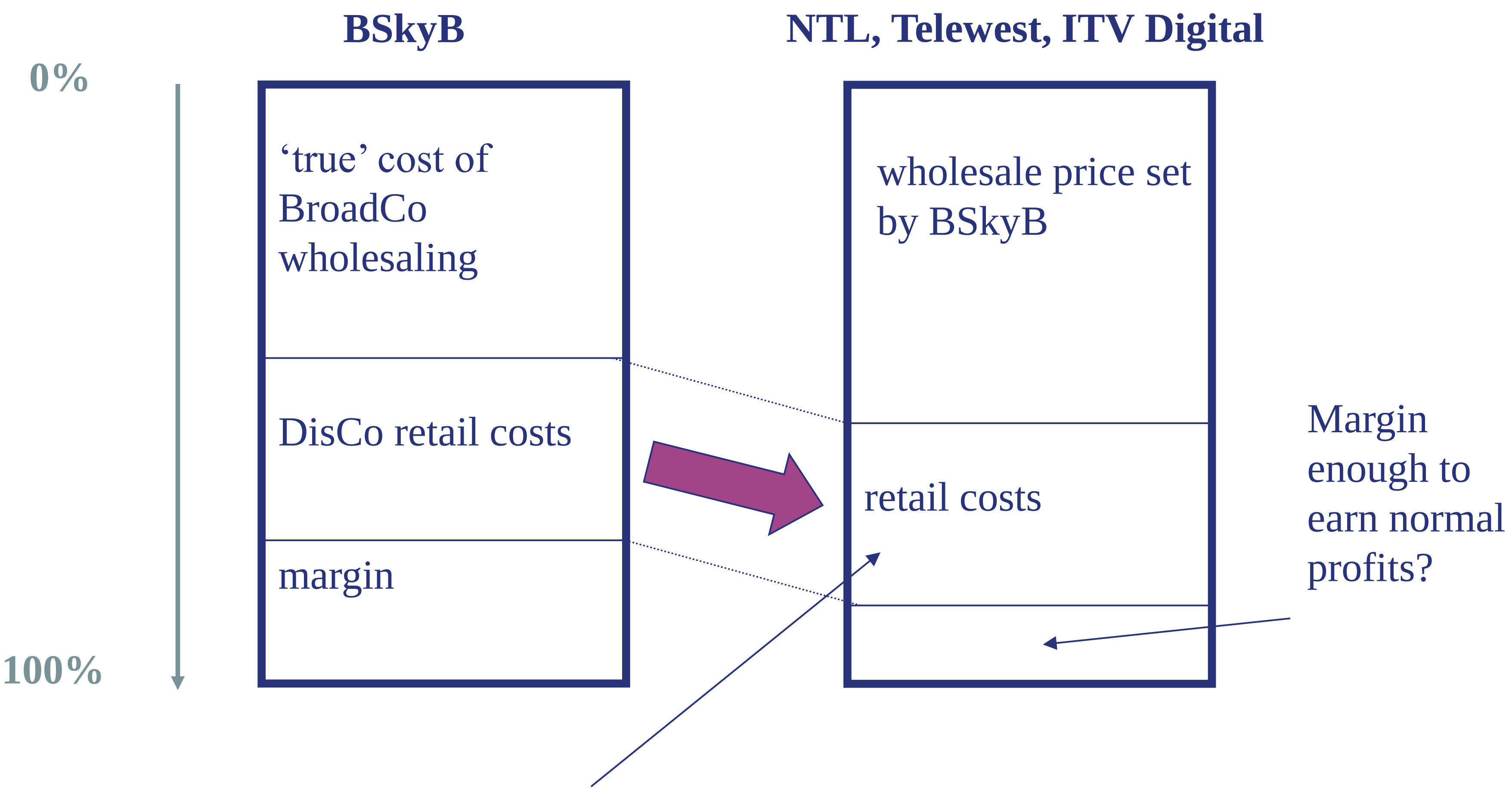
NTL, Telewest, ITV Digital, rival retailers

'downstream'

Final consumers

- **BSkyB** vertically integrated, separate accounts for upstream and downstream businesses
- Margin squeeze test on DisCo. **Proxy for 'as efficient competitor'**

Breakdown of price



DisCo’s costs used as proxy for costs of **as efficient competitor**

Key issues

- **Issues in modelling DisCo's costs and profitability [emerging market issues]**
  - DisCo is not in a steady state
  - How to treat capital costs?
- **Issues in conducting margin squeeze test**
  - Appropriate return DisCo needs to earn to avoid margin squeeze?
  - Method of allocating revenues, costs and investment expenditures?

DisCo not in steady state

- Since 2000 BSkyB moving from analogue to digital transmission system for distributing channels
- Investment in equipment. Largest investment incurred in acquiring new subscribers and persuading existing ones to switch to digital system
- Margin squeeze test must take account of losses resulting from investment that will be recouped in later years
- Forward looking assessment difficult

How to treat capital costs?

- **Alternatives**
  - Calculate present value of net cash flows of DisCo, adjusted for their timing and risk (NPV approach)
  - Match costs and revenues by amortising investment expenditures over accounting life of product (historical)
- **BSkyB favoured NPV**
  - But need subjective forecasts of future cash flows
  - Positive result could come from averaging period of margin squeeze followed by strong profits
- **OFT took historical approach**
  - OFT recognised some uncertainty too with this test
  - OFTEL used NPV in *Freeserve*

Appropriate return?

- Which is better to assess appropriate return for DisCo to avoid margin squeeze
  - Return on turnover (ROT)?
  - Return on capital employed (ROCE)?
- ROCE generally greater economic significance
- But DisCo has small capital employed, largely working capital. Generally variable. ROCE unreliable
- Use return on turnover
- Need comparator with similar capital structures and high % bought in services. Difficult to find

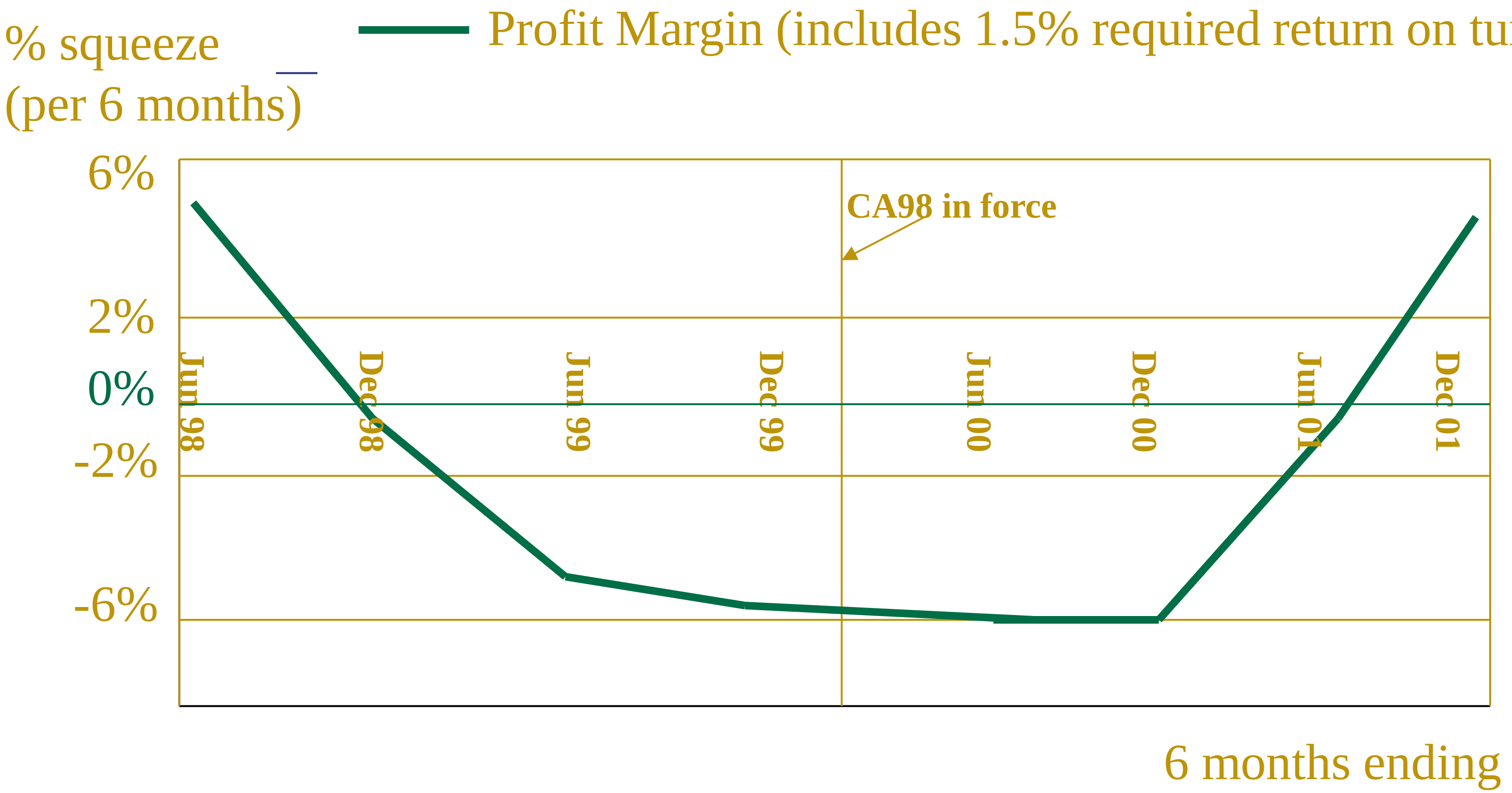
Allocation of revenues, costs and investment expenditure?

- Numerous detailed assumptions required to allocate revenues and costs between BroadCo and DisCo. Similarly for investment expenditure
  - See pages 105-132 of decision

Conclusion

- *'Limited and temporary losses after charging the required return on turnover'*
- No margin squeeze

DisCo's profitability assuming prices charged to ITVDigital



Results for NTL and Telewest showed smaller losses and bigger profits