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Preserving Incentives for Content Investment

1. Introduction

With ITV, the BBC, Five and Sky taking their turns on the platform this morning, you can rest assured that we’re going to hear contrasting prescriptions for the future of the broadcasting industry.

But if there’s one thing that we can all agree on, it’s that market conditions have been tough in the last year:

- with turbulence in the global economy
- the UK economy in recession
- the highest rates of unemployment for 12 years
- and a deep and prolonged advertising downturn.

A year ago, you would have been forgiven for assuming that pay-TV would be hit hard.

After all, it’s a business which depends on consumers making a free choice about what to do with their discretionary spending.

Things haven’t worked out that way.

Conditions have certainly been challenging, and they still are. But Sky has continued to perform well:

- growing faster than a year ago, not slowing down
- increasing investment in content, not cutting back
- and pushing harder with premium products like high definition, not relying on a TV equivalent of Aldi to entice down-shifting customers.

So I’d like to spend some time this morning considering:

- why pay-TV has proved more resilient in a downturn than many people expected
- why the long-term prospects are better than ever
- and why the continued reliance on the free model elsewhere in the industry may come at a cost

In light of Ofcom's proposed intervention in pay-TV, I'd also like to explore the potential implications for content investment going forward.

2. Customers are making careful choices

When talking about the relative resilience of pay-TV, the first thing I should say is that we're not complacent.

No one is immune from a downturn. And we never forget at Sky that customers have a choice.

But what we've found is that customers are using that choice carefully.

They're not giving up spending altogether, but they're choosing to spend their money on the things they really care about. And they're unwilling to give those things up without a fight.

That puts us in a good position. Because we know that people are spending more time at home.

And we know that they value the kind of products that we offer: great entertainment for the whole family, increased control and flexibility in how they watch, and the superior picture and sound quality of high definition.

Rather than a binary choice between free-to-air and pay-TV, the decisions that customers are making in the real world involve a much broader set of comparisons.

So, it's not just a question of Sky or Freeview – it's a question of what's the most cost-effective way to entertain the family.

And in that respect, pay-TV is very good value relative to the other everyday choices that people are making.

Even our top-tier package, including all our sports and movie channels, costs less for a whole month than the price of taking the family out for a single meal.

At the other end of the scale, you can choose a package of basic TV channels for as little as 54 pence a day.

And that's before considering the value that we can offer when customers switch their phone and broadband.

For many people, saying goodbye to BT and moving to Sky Broadband and Sky Talk can save £200 a year.

That's a nice sum either to put back in your pocket or to use to upgrade to HD.

3. Sky is making careful choices too

Our approach to managing the business through a downturn is all about making careful choices.

For us, that means focusing on what matters to the customer, while pushing hard to drive efficiency behind the scenes.

Sky's decision at the start of this year to accelerate the growth of Sky⁺HD is the perfect illustration of how this works in practice.

The background is that we see the migration towards HD-quality video as one of the most significant changes that will take place in broadcasting over the next few years.

For some time now, we've been positioning our business to take advantage. For a number of reasons, Sky is well positioned to lead the UK's shift to HD.

The bandwidth requirements of HD broadcasting are ideally suited to the huge capacity of satellite. And we are delighted to be announcing today that we have agreed a long term extension of our partnership with Astra.

We've assembled the best HD content offering in the UK by far, with 33 HD channels and growing.

And we have a business model that provides an incremental return for investment in HD.

But what makes the biggest difference to the timing of our HD push is efficiency behind the scenes.

Since the acquisition of Amstrad in 2007, we've been able to bring down significantly the cost of HD boxes in our supply chain.

By passing those savings on to customers, we are able to make HD more accessible to everyone and increase our lead even further.

While one or two people questioned the wisdom of backing a premium product in the midst of recession, and others have been unconvinced of the value of HD per se, we backed our belief in that product.

The results have been spectacular: sales of Sky⁺HD rose five-fold last quarter, taking the total number of paying customers past one million.

But we're only getting started, and we think HD is well on the way to becoming a new standard for TV, with far reaching implications for broadcasters who choose not to get on board.

4. Long-term prospects are good

Looking further ahead, it is our belief that the prospects for the continued growth of pay-TV are good.

This rests on the strong foundation of two closely-related trends.

i) Willingness to pay

First, more and more customers are willing to pay for the content they value.

As we know, consumers place a high value on entertainment.

They have higher levels of disposable income than ever before, but more time pressures in their busy lives.

As a result, they are increasingly prepared to pay to get the most out of their precious leisure time.

So, there is an odds on chance that by the end of this year, the number of homes which choose to take some form of subscription TV will outnumber those which don't.

It's a significant milestone and there is no sign of demand letting up, particularly as the range of content and services available from pay platforms continues to grow.

Put simply, we believe more people will be prepared to pay for quality, choice and service.

And we intend to keep investing to drive continual improvement in the content and products that we offer.

ii) Investment in quality content

This takes me to the second point, which is about funding for content investment.

As the number of households subscribing to pay-TV continues to grow, so does the ability of pay broadcasters to invest in distinctive, high quality content.

The pay-TV industry has always been good at identifying gaps in the free-to-air offering, most notably in the early days with news, sport and movies.

Building on that foundation, pay channels are now investing more money and targeting a wider variety of genres.

Sky, for example, has identified drama and the arts as two genres where we think we can expand our own offering and reach out to new audiences, meeting needs that are increasingly less well served by the free-to-air terrestrials.

That's why we've expanded the Sky Arts portfolio to include two dedicated channels, each with a simulcast in HD, and with a total reach of over 1.5m viewers each month.

And the next opening looks to be drama, with the terrestrials starting to cut their budgets in this area.

So we see a real opportunity here and Sky1 is continuing its commitment to original UK drama with this month's critically acclaimed adaptation of Martina Cole's 'The Take', and with more productions in the pipeline.

In acquired content, 'House' is the latest example of a quality US drama that has moved into the pay universe.

And we're hugely excited about next year's premiere on Sky Movies of HBO's 'The Pacific', the follow-up to the outstanding Band of Brothers, which was such a success on the BBC.

In parallel, the programme budgets of free-to-air broadcasters are being squeezed as the advertising model comes under pressure and as political support for an ever-increasing licence fee seems to be past its peak.

On the advertising side, the challenges are certainly made more acute by the current cyclical downturn. But there are structural factors in play as well.

In recent years, we have seen audiences fragment as viewers embrace multi-channel TV.

Advertising inventory has expanded dramatically, driving down prices, and competition from the internet, especially search, has intensified.

Even when the current downturn comes to an end, it is difficult to envisage long-term real growth in aggregate television advertising revenues.

Inevitably, these pressures must feed through to what goes on the screen.

Yes, free-to-air networks will continue to provide some great TV and deliver the very biggest audiences.

But budgets will come under continued pressure and there will be a gradual narrowing of the range of content that free-to-air TV can support.

You can already start to see this with ITV's recent undoubted audience successes being largely confined to the reality genre – Britain's Got Talent, X-Factor, I'm a Celebrity, and so on.

All good stuff, and required viewing in my house at least, but like chocolate, would you want to live on it?

What this means is that the gap will continue to grow, in more and more areas, between what's available free, and what you can get if you subscribe to pay TV.

And as fewer families come to rely on free-to-air as their sole source of TV, the relative strength of pay broadcasters will continue to grow.

5. The cost of free

These changes are both visible and, to some degree, predictable.

You would perhaps expect by now to have seen an adjustment from the UK's terrestrial broadcasters.

But not one of the commercial terrestrial broadcasters currently has any presence in pay broadcasting at all.

After 20 years of continuous growth in pay TV, that is curious to say the least.

And especially ironic that it is only the BBC among the FTA terrestrials that has a presence in pay TV through UKTV.

The actions of the commercial PSBs suggest a belief that future success lies in finding even more ways of giving expensive content away for free, rather than taking the opportunity to consider other means of monetisation.

The latest example of this approach is to throw all content – current and archive – on the web for free.

This looks like a disastrous idea, transferring audience to an environment where advertising revenues are lower, and so leading to cannibalisation.

To say nothing of the wilful destruction of other potential revenue streams such as DVD exploitation and a pay TV window.

So I would argue that blind loyalty to the free model, while touching, comes at a significant cost.

For terrestrial broadcasters to turn their backs on pay means a lost opportunity:

- the opportunity to secure a new revenue stream,
- to participate in the growth of subscription over time,
- and to acquire a degree of protection against the kind of advertising downturn we're experiencing today, and which will inevitably happen again.

6. The policy context

It is possible that a one-dimensional reliance on the free model was appropriate for an analogue world with just a handful of channels.

But that world ended years ago and it's time to move on.

We should consider why it is that so much of the commercial broadcasting sector has failed to move on.

The reason is deeply rooted in the culture of the public service broadcasting system which binds the broadcasters together with those responsible for UK broadcasting policy.

In this complex system of privileges and obligations, the fortunes of the terrestrial broadcasters have been reliant on winning the support of regulators and politicians.

The consequence is a culture of dependency which shapes the mindset and strategies of the licensed broadcasters.

To be successful, they have to persuade the policymakers that they are vital contributors to public policy goals.

This remains true today, as we have seen with the frantic lobbying over the Digital Britain report.

It remains the case that UK broadcasting policy is geared almost exclusively around the free model.

So it is no coincidence that the attitudes of the commercial PSBs should be so closely aligned with those of the people who can make or break their businesses.

The focus of policymakers on advertising as the core means of funding public service content beyond the BBC has remained unshakeable despite the evidence of the sustained challenges facing the terrestrial broadcasters.

And despite the fact that more and more people are enjoying public service content from a range of providers, both free and paid-for.

The notion that something can only be of "public service value" if it is free at the point of use, would be laughable if it was not so deeply entrenched in the broadcasting policy mindset in the UK, and if it were not so dangerous.

No-one thinks it is the case in theatre, newspapers, books or even internet access. In music, the policy focus is rightly on making sure people do pay for the content.

Only in television does this anachronistic view prevail.

And it's at risk of causing real damage to the industry and to consumers as Government and regulatory policy skews towards perpetuating a challenged model in the face of common sense and basic economics.

Speaking on this platform two years ago, Ed Richards listed investment in high-quality programming first among his priorities for a future regulatory framework.

Since then, much energy has been spent debating the future of the institutions of public service broadcasting.

But not enough thought has been given to how investment from other sources – including pay television – can help to provide the quality and range of content that consumers value.

Or to how intervention – “industrial activism” as it is now known – should be directed in a way that does not undermine commercial incentives for investment.

You know, I stood up here two years ago and made a reference to a culture of industrial planning akin to the failed policies of the 1970s.

This outraged some at the time who vehemently denied it was the case.

But no-one is bothering to pretend any more, industrial planning is all the rage.

And as usual when such ideas take hold, it is all motivated by the repeated claim that the issues are just all too important to be left to chance.

I think we've been here before.

7. The future of content investment

Before concluding, a general word of warning about content investment.

Last week, Ofcom published the latest consultation document in its Pay TV market investigation.

It proposes that Sky should be required to wholesale its premium sport and movie channels to other pay-TV platforms, and that Ofcom will set the price at which these channels will be sold.

Needless to say, it proposes a significant discount of up to 30% to the wholesale prices currently in effect and which comply with the OFT test of 2002.

As we said in our immediate response, we disagree fundamentally with Ofcom's approach, analysis and conclusions.

We intend to pursue a legal challenge through the courts if the Ofcom consultations ever reach a firm conclusion.

I don't propose to use this platform for a line-by-line rebuttal of Ofcom's proposals. Given that the document weighs in at 650 pages including annexes, you will no doubt be grateful for small mercies.

But I do want to highlight here today one aspect of Ofcom's approach which has broad implications for future investment in content.

For the record, Sky does want to see its channels distributed widely on a range of platforms. We have only ever had two conditions.

First, the platform needs to be technically secure and comply with the requirements of our key rights partners.

And second, the terms of distribution need to be such that we can see a prospect of a fair and reasonable return on our investment in content.

So the debate here is not about distribution, it is about the terms of that distribution and who gets to set those terms.

In essence, Ofcom's proposal is that Sky should sell its content for prices that do not fully reflect the underlying costs and the high levels of risk in our content business.

In effect, this is a proposal for subsidy, at our expense, for BT and Virgin Media, two companies which have shown very little appetite for content investments of their own.

In proposing to force down the price of content, Ofcom appears motivated principally by a desire to promote investment in new delivery platforms.

Ofcom wants to make pay-TV retailing a more attractive business and is prepared to squeeze margins in content creation in order to achieve that goal.

One of the many things that is remarkable about the proposals is the ease with which Ofcom feels able to undermine incentives for continued investment in high-quality content.

Ofcom seems to assume that Sky will just go on putting around £1.3 billion at risk in sports and movie rights every year, even though it has damaged our ability to make a reasonable return.

And it appears to assume that its intervention will do nothing to deter investment in other areas of our business.

The assumption is that Sky will go on finding the incentives and resources to expand its content offering into new areas of programming, as with drama and the arts at present, or bringing forward new innovations for the benefit of consumers.

When Sky pioneered the launch of HD in the UK a few years back, it was greeted with widespread scepticism – but we pushed ahead and invested hard.

If we had known then that Ofcom, a few years later, having seen some initial success, would impose detailed price regulation on our new HD channels, it might just have coloured our enthusiasm for investment in the first place.

By the same token, Ofcom risks undermining the incentive of BT and Virgin Media to go out and bid for content rights themselves.

After all, why go to all that risk and expense when you can rely on Sky to do it for you and Ofcom to deliver it at a risk-free, knock-down, per-subscriber price?

Judging by the Premier League's immediate reaction, the potential for reduced competition for rights has not been lost on Richard Scudamore and his colleagues.

There is a consistent theme in both the Ofcom consultation and the Digital Britain report earlier this month.

It is a theme that should cause concern for anyone whose business rests on monetising content investments and anyone else who wants to see a vibrant creative economy in the UK.

Both documents are greatly taken by the idea of investment in infrastructure but pay scant attention to the creation of content and services to run over those platforms and the economics and process by which this comes about.

In Stephen Carter's language, there's too much about the "pipes" and not enough about the "poetry".

I'm pleased to see that yesterday's Digital Economy Bill goes some way to addressing the gaps in the Digital Britain report by giving Ofcom a specific duty to promote investment in both infrastructure and content.

It will be interesting to see how Ofcom manages to square its proposed intervention in pay TV with its new found role as a champion for content investment.

The pay-TV review is focused quite narrowly on Sky, so many here might be tempted to feel that it has little to do with them.

But it raises broader questions about the value of content, the balance of power between content creator and distributor, and the role of the regulator in managing the tensions that can arise between different parts of the value chain.

If Ofcom's actions were to undermine the incentives for content investment, then the UK will be all the poorer for it.

And it may find that take-up of those shiny new platforms to be more of a struggle than it bargained for.

We may disagree with the BBC about many things, but we do have one central belief in common – we care deeply about content.

Customers don't care about pipes, platforms or plumbing. What they care about is great TV. And we're proud of the part Sky plays in delivering that.

Can the same be said of BT and Virgin?

8. Conclusion

To conclude, we will continue to back our belief in the pay model as a source of growth for our business.

In difficult economic times as well as good, we're confident that we can continue to persuade more people to join Sky for quality, choice and value.

And we continue to believe that the growth of pay television can create good outcomes for customers and for the UK more broadly as a growing source of content investment.

Undoubtedly everyone likes something for free. But we need to consider how to maintain investment in content over the long term.

It costs money to produce quality, whether in journalism, drama, sport or any other genre.

The commercial incentives for investment need to be understood and preserved.

A wise person once said, "What you get free costs too much." I suspect it may be time to give that some serious thought.

Thank you.

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