



IEA FUTURE OF BROADCASTING CONFERENCE
Speech by Mike Darcey, Chief Operating Officer, BSkyB
“Sustaining success in pay TV”

Thanks and good morning.

It's been an especially busy few months for Sky. There has been the runaway success of high definition, expansion onto new platforms like the iPad and a deal to acquire Virgin Media's basic channels. Not to mention the small matter of the latest stage in Ofcom's pay TV review.

And unless you've been living in a cave for the last couple of weeks, you probably also noticed a certain proposal from News Corporation. I'll spend precisely no time today discussing Sky's share price valuation, or the finer points of corporate governance.

Away from the media scrutiny surrounding News Corp's approach, most column inches have focused on the pay TV review.

Our appeal is now well underway and it would be a gross understatement to say that we are looking forward to our day in court, in front of an objective assessor of the evidence.

So it would be remiss of me not to spend some time today explaining why we think the regulator has got it badly wrong and setting out some of the potential consequences.

But I'm conscious that this is a topic which has loomed large at previous IEA conferences, so I don't want to dwell on it for too long again today.

Of greater interest, I believe, is a growing sense of disillusionment in the broad media sector with the free model as a means of monetising and so funding content, and the gradual re-discovery of the merits of a paid-for model.

So what I'd prefer to focus on today is outlining what I believe are the critical factors in sustaining success in paid-for television services, irrespective of market intrusion by regulators.

At Sky we're now 21 years into our story, and we've learned a fair bit along the way about what you need to do in order to encourage people to pay for content.

The pay TV opportunity

Let's start by looking at the UK marketplace today. What we see is that pay TV has never been in ruder health in the UK, with Sky, Virgin Media and even BT growing their customer bases, despite pressure on household budgets.

Collectively, we've reached the milestone of 50% of households subscribing to a form of pay TV. Not bad going for an industry which is just two decades old.

And the revenue earned by the TV businesses which harness both subscription and advertising now far exceeds that enjoyed by the commercial broadcasters who rely on advertising alone. And most now recognise that this gap is only going to grow over time.

Some sections of the industry were in denial about this change for a long, long time. But the penny now seems to have dropped, even if some are still grappling with the long-term implications and how they might adapt.

There is still a big prize on offer for companies that have aligned their business models to rise with the tide, instead of fighting against it.

Despite 21 years of continuous growth, there remain more than 12 million homes out there still getting by on Freeview, Freesat or analogue terrestrial, perhaps supported by a little bit of iPlayer and YouTube.

Those homes are ripe for conversion and the key is getting them to reappraise what pay TV offers, and to revisit a decision they thought they had already made.

So today, I want to focus on what I believe are two key factors which will sustain the ongoing success of pay TV. Namely:

1. continuing to invest in content to widen the gap between what you can get for free, and what you can get when you augment your viewing options with paid-for services; and
2. embracing innovation to enrich and liberate content, in the living room and beyond.

At Sky, we're sustaining our growth by a simple, relentless focus on these two priorities.

They are the common thread that runs through everything we do: whether it's live theatre on Sky Arts; the launch of Europe's first HD news channel, or putting a suite of Sky channels on the iPad.

In combination, it's this approach which gives us confidence that we will grow beyond our existing 10 million target, and that we can persuade more of our customers to take many more paid-for products and services from us.

Pay TV

But before I explore those themes in more detail, a quick assessment, as threatened, of the pay TV review.

While the real world is changing faster than ever, the parallel universe of regulation is stuck in a very different gear.

After more than 3 years of debate and literally thousands of pages of consultation documents, we have ended up pretty much where everyone expected we would.

So Ofcom's attempts to regulate the wholesale supply of premium sports TV channels are, I'm afraid, precisely the 1970s-style industrial planning that I predicted on this platform a few years ago.

Out in the real world, the walls are breaking down between previously separate segments of the marketplace.

The old categories of telco, broadcaster, hardware manufacturer, portal and publisher look increasingly old-fashioned. The nature of competition has changed forever.

But Ofcom still approaches pay TV as if it exists in a bubble, not far moved on from the OFT analytical framework in 1996. Its fixation with competition between broadcast platforms, ignoring even the now widespread bundling of pay TV with broadband and telephony, belongs more in the last decade than this one, let alone the next.

When we look at Ofcom's specific findings, we see a fundamental problem. We are saddled with a regulator:

- that undervalues our channels
- that takes for granted the level of risk and investment Sky makes year after year
- and has a naïve faith in its own ability to tinker in a complex, fast-moving market, thinking it can improve outcomes and that this can be done without unintended consequences.

Let's be clear, we want wide distribution for our channels – it's the obvious strategy for a set of channels that have high fixed costs and low per subscriber costs of distribution. But we also want to be fairly rewarded for the investment we make in those channels.

In investing around 1 billion pounds each year in Sky Sports alone, we simply ask that we have the opportunity to negotiate distribution deals with those who share an interest in sustaining that investment, and with whom we can grow, in aggregate, the reach of our channels - whether achieved through a wholesale or direct-to-consumer retail model.

This is not the same as Ofcom dictating that we need to offer our channels at reduced prices to all-comers, some of whom simply want to leverage that content to drive fat margins elsewhere, with no care for its sustainable value.

The effect of Ofcom's intervention is to give a leg up to those businesses with little or no interest in investing in content themselves.

Ofcom's move chips away at value in content investment in favour of content distribution - favouring the interests of simple resellers, and those who see content as a means to the end of selling other services, whether that's expensive broadband, online advertising or online gambling.

In Ofcom's world, whether or not this was their intention, it seems that Sky would even be forced to supply a business seeking to use discounted sports to drive traffic to an online adult site.

And I fundamentally believe that Ofcom has not made the case that there is such a problem in the market today that Sky should be stripped of its right, in respect of £1 billion of annual spend, to determine who it deals with and on what terms.

In practice, this translates to Ofcom making content retailing a more attractive business by squeezing the rewards available in the riskier and more expensive business of content creation.

So apparently we need more and more platforms, without limit, but there are no issues with sustaining investment in quality content, so we can take some risks there.

But if value shifts from content creation to content distribution as Ofcom proposes, it should set alarm bells ringing with everyone who has an interest in sustaining investment in content.

We know it. The sports governing bodies know it. And so, frankly, do other content owners, who are looking on wondering whether this is the thin end of the wedge. It makes you wonder what might be next.

Because once the conditions have been created for the terms of content supply to be set by the regulator, the direction of travel is clear. If Ofcom's intervention doesn't gift the beneficiaries the results that they're looking for, they'll be back in search of more subsidy and more regulatory breaks.

The evidence of this is already apparent, with both BT and Virgin Media having lodged appeals against Ofcom's decision in an effort to win even more breaks through intervention before we've even started.

And do you really think that Ofcom will be able to resist the temptation to tinker further if they don't get their desired outcome first time round?

The evidence suggests otherwise, despite the now laughable claims of being a light touch regulator, with a bias against intervention.

Beyond sport

So often in discussion of the Pay TV Review, the implicit assumption is that access to Sky Sports is pivotal to success in pay TV.

It's an argument that BT has often made in explaining the progress of BT Vision to date.

If that's a belief they genuinely hold, I think they're in for a rude awakening.

Looking towards sustaining pay TV success longer-term, it's not just about sport.

Yes, it continues to be an important piece of the pay TV jigsaw. And yes, it was the infamous 'battering ram' for pay TV in its infancy, when it needed to assert itself on the UK broadcasting landscape.

But the world has long since moved on – and although sports is still a major part of what helps define our service, there are many people for whom Sky Sports is not the only factor in their decision to subscribe.

And, for some, it is not even a factor at all. The reality is that millions of Sky homes happily subscribe for content other than our sports and movies channels.

That would suggest to me that there's value in investing across the schedule, so that you have content which appeals to all ages and interests.

The likes of UKTV, Viacom and Discovery would also probably agree with me that there's a very healthy market opportunity beyond sports and movies.

Breadth of content

As we at Sky have said many times before, the opportunity for pay TV lies in finding the gaps left by the steady retreat of the terrestrials and then super-serving the audiences to be found in those gaps.

With more and more pressure being applied to the free-to-air model, the dash to the commercially attractive mainstream of talent shows, celebrity TV and property porn is understandable.

But thanks to the durability of the subscription model - which doesn't dictate that we always head to the centre-ground in search of advertiser approval or public support and legitimacy - we are reaching new audiences through content differentiation.

Take just three examples:

- Sky1's ambitious home grown drama strategy has recently yielded the likes of Strike Back and Going Postal and our next production, Mad Dogs, starring John Simm and Philip Glennister, is well underway. Looking ahead to next year, we'll see the first results of Sky1's growing focus on original British comedy.
- The multi-award winning Sky Arts goes from strength to strength and is now reaching around 2 million individuals each month. Where else on TV do you find prime time opera, live theatre, outdoor art, nightly jazz, and the only show on TV dedicated to books?
- We're stepping up investment in Sky Sports News so that it can further grow and innovate as the home of quality sport news journalism in the UK. Later this year, it will become a pay exclusive channel, supported by an expansion in its editorial coverage and the launch of Sky Sports News HD.

A long term commitment

One of the points on which we disagree with BT is that we believe customers value all forms of pay TV, and particularly the quality channel brands that BT appears to have been quick to dismiss.

They seem to have based a commercial and regulatory strategy around an idea that there is little of value beyond premium sport, and that people want to buy sport in isolation, abandoning the rest of Sky, and pay TV generally.

It's an idea that suggests that Sky spends hundreds of millions of pounds a year on other content which is worthless.

I think that's plain wrong.

And so do our customers, who value all forms of pay TV. And our research proves it.

Live sport, and Premier League football in particular, is certainly popular, and does indeed enjoy the largest single audiences in pay TV homes – but even Premier League football accounts for less than 5% of all pay TV viewing in Sky homes.

So what value the other 95%? It seems that man does not live by football alone.

In addition to viewing data, we also speak to over 30,000 customers each month to seek their views on their Sky TV experience – and that research tells us that basic pay TV channels have enduring appeal to customers.

Take Sky1 for example. In Sky homes, customers rate it as their 4th favourite channel – a channel they say they “couldn't live without”.

More impressive still, in the 18-34 age demographic, it's the most popular entertainment channel – whether pay or free – on the entire Sky platform.

But perhaps a more significant metric for us is that, when asked which channels provide most value as part of their subscription package, customers talk about the basic channels.

In fact, in the top five we have three basic pay TV channels - Sky1, Discovery and Living.

And let's take another look at Sky Arts. We often hear that a monthly reach of 2 million viewers is a small number. And by X Factor standards it is.

But 9 in 10 Sky customers agree that “Sky Arts offers programming I can't get anywhere else”. That's a real endorsement for our strategy of finding the gaps left by terrestrials.

Breadth and depth of content is key.

That's why we support – to the tune of 400 million pounds per year – pay partners such as National Geographic, Nickelodeon, Disney and History, to help connect customers to the rich choice of programmes they demand.

Innovation

Beyond content, innovation will also continue to sustain pay TV's growth.

Just look at how quickly 3D TV has risen up the agenda – it's just two years since we recorded our first live 3D event and 18 months since we successfully demonstrated a 3D broadcast on our platform.

Fast forward to today and hundreds of thousands of football fans have watched live 3D football in pubs nationwide, though sadly not the World Cup; the launch of Europe's first

dedicated 3DTV channel is coming soon; and Sir David Attenborough is working on our first 3D commission.

With the support of manufacturers of TVs, games consoles and Blu Ray DVD players, we get the sense that 3D is heading for something special.

Of course our ambitions in this area have been supported by the foundation laid by our HD infrastructure and our Sky+HD box, which is 3D Ready and already in 2.5 million homes.

Now some people are not convinced about 3D, believing it to be a passing fad, a bit of a gimmick. That's fair enough, and they are entitled to their view.

But I suspect that they are roughly the same industry sages who were questioning the significance of HD in the not too distant past.

That time around, while many in the industry were sceptical, Sky took an early bet on HD and we bet big. So far, we've invested around £500 million to build Europe's leading HD offering.

From a standing start four years ago, and despite the economic downturn, a quarter of our customers already choose to pay an extra £10 for our HD package.

We already have 40 HD channels and plan to reach 50 by Christmas, by which point Freeview will already be creaking under the bandwidth strain of just a handful of HD channels – and that's a "handful" in the sense of someone who is missing two of their fingers.

As important, our HD box also enables us to connect our customers to broadband, with a comprehensive video-on-demand service called Anytime+ launching later this year.

Beyond the living room

But in 2010, innovation cannot be limited to the living room. Increasingly customers are not satisfied with getting the content they pay for on just one screen, but are demanding access across a range of devices and locations.

From mobile devices to broadband-enabled TVs, we are making 'TV anywhere' a reality and today our customers can enjoy Sky content on a wide range of devices.

Crucially, the pay content model supports this kind of innovation, as there's the ability to monetise, simply through adding to the core subscription relationship, the improved experience we're offering customers.

The development of our relationship with Apple is a good illustration of our appetite to distribute our channels widely. It also demonstrates the dynamism of the market – good old fashioned commercial negotiation – in delivering good outcomes for consumers.

More choice, more flexibility, more innovation.

I'm delighted to announce that from next month onwards, Sky TV customers who subscribe to Sky Sports will be able to enjoy our coverage in more ways than ever.

As well as watching Sky Sports in their living room at home, they will be able to access our channels on a range of additional screens and devices, whether it's the iPad, iPhone, Xbox, PC, Mac or 3G mobile phone.

What's more, all of this will come at no extra cost for the rest of the year as we encourage even more customers to sample the control and flexibility of truly multi-platform television.

There's a real incentive for Sky to move first with this kind of innovation, so that we can continue to set the pace and create real value for customers.

Optimistic for the future

So looking to the future, and beyond the outcome of the pay TV appeal, and that's a year into the future, I'm optimistic about the continued growth prospects for pay TV generally and the opportunity for Sky within that.

Our innovation roadmap is as dynamic as ever, and our early commitment to HD is beginning to pay real dividends as customers respond in ever-increasing numbers and we get our best box into millions of homes.

Our belief in the value of content – a broad range of quality content – remains strong. This business was founded on a belief that people wanted a better choice of TV, and would be prepared to pay a fair price for it.

Continual improvement in the range and quality of our on-screen offering remains central to our ambition as a business.

We want to satisfy existing customers better, and reach out to more and more new customers over time.

So we will continue to focus on widening the gap between free and pay TV, but perhaps focusing more on content areas where the regulator has not yet stepped in to tell us who we should deal with and at what price.

For continued growth in pay TV, I would argue that an offering built solely around premium sport should not be the limit of our ambitions.

For us, unlike some others, I'm glad to say it's not. We'll continue to strive to meet our customers' needs right across the schedule.