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## **RESPONSE TO THE PUBLIC CONSULTATION ON THE DRAFT COMMUNICATION FROM THE COMMISSION ON THE APPLICATION OF STATE AID RULES TO PUBLIC SERVICE BROADCASTERS**

SKY Italia (SKY) welcomes the opportunity to provide comments on the European Commission's draft Communication on the Application of State Aid Rules to Public Service Broadcasters (PSBs).

SKY supports the continuing evolution in the application of the State Aid rules in the media sector, in order to encourage future economic growth, pluralism and innovation. SKY welcomes the Commission consultation and proposal which, despite shortcomings, is needed in order to alleviate the legal uncertainty surrounding state intervention in the media sector. However, SKY urges the Commission to take into consideration the potentially serious market distorting effects of allowing PSBs to operate within an under defined remit.

SKY's responses are based on its specific characteristics as a pay-TV and platform operator in Italy. In the first Section, a range of general concerns relating to PSBs will be addressed, while Section 2 focuses on one of the key sources of market problems linked to PSBs operations, that is, a lack of clear remit for them. Section 3 describes how the funding methods used in each Member State can compound the problems described. Section 4, finally, provides an illustration of how many of these problems can lead to an outcome which should be of concern to the Commission as it involves structural and long-lasting changes of the television market in Italy.

### **1. General considerations**

SKY operates in a market where it competes for audience against well-resourced and entrenched incumbents. Unlike those incumbents, and in general different from any terrestrial broadcaster, SKY does not enjoy any privileged access to public resources such as spectrum, nor does it enjoy a guaranteed right of carrying the terrestrial channels which make use of that spectrum. Therefore, SKY does not benefit from any type of public support, be it direct or indirect, having chosen to be funded solely by the customers choosing to subscribe to its programs.

The combined effect of greater market opportunities and the lack of clarity on how PSBs' behaviour is going to be assessed increases the potential competitive harm that can arise from their activities. There are several ways in which PSB activity can pose substantial competition concerns.

First, as PSBs have increasing opportunities to raise revenues from the commercial exploitation of their publicly funded assets, for example as a result of licensing content for commercial exploitation in secondary markets, there is the need to ensure that appropriate measures are adopted to take into adequate account these potential revenues when dealing with

compensation out of public funds. Second, as the number and type of commercial activities in which PSBs engage are dramatically increasing, it is necessary to reassess the fundamental issues of what is the basic market failure, based on which PSBs activities should be warranted.

In general, the Commission should be concerned about all those situations throughout the EU where the activities of PSBs directly result in, or can be used for, a structural change in the market which leads to substantial distortions in the competitive process and to indirect or direct harm or benefit for specific commercial operators.

## **2. The role of PSBs and the Importance of a Clearly Defined Public Service Remit**

The reason why a PSB remit should be clearly defined lies in the structure of the television market. Television is a two-sided market which involves not only viewers/listeners, but also advertisers, who generate surplus for commercial broadcasters. In other words, television can be thought of as a public good that is “consumed” by two types of agents: viewers/listeners who receive a direct benefit from the broadcast, and advertisers who, by advertising in the programs, receive an indirect benefit from contacting potential customers.

Economic literature on market failures and two-sided markets in television<sup>1</sup> suggests that a purely commercial television market might end up providing sub-optimal levels of public service programming, thus showing that there is a rationale for public intervention. In particular, popular programmes, which raise high amounts of advertising revenues, would be excessively duplicated, while other, special types of programming would tend to be scarcely provided or not provided at all, as presumably considered too risky and/or unprofitable from the perspective of commercial broadcasters.

This should be the starting point to define the remit of PSB activities. The issue of definition is particularly important as clarity in the scope of the PSBs activities plays a critical role in investment decisions of commercial broadcasters which have to compete with them. Such decisions are all the more difficult in a world where PSBs offer a wide variety of programmes and face increasing opportunities to raise commercial revenues, as in the current period of switch to digital technology.

In SKY’s opinion, the PSBs’ remit should cover in principle solely those activities susceptible of being identified as *public goods* and the production of which would be therefore underprovided due to market failure. This is not in contrast with article 86(2) of the Treaty on services of general economic interest. The implicit approach behind the article is based upon a presumption that a market failure exists in the provision of such services, making some form of public support acceptable.

To prevent loose public services remit definitions by Member States, the new proposal could make mandatory the indication, by means of a positive list, of the type of programming reckoned to fulfil public service obligations. Such a provision would complement the negative list of programmes which cannot be considered by their nature public service.

This does not necessarily imply that PSBs cannot engage in any other activities outside of those listed in their PSB remit. PSBs should be entirely free to be involved in other activities. However it is essential and a prerequisite for avoiding substantial and long-lasting distortions of the market that any such involvement be clearly funded and operated by commercial arms of the PSBs,

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<sup>1</sup> See for example, Steiner (1952), Spence and Owen (1977), Owen and Wildman (1992), Brown and Cave (1992), Cornes and Sandler (1996), Berry and Waldfogel (1999).

clearly defined as such, and at least functionally, but preferably structurally, separated from the rest of the company.

All new services which the PSBs intend to offer should therefore be subject to *ex ante* evaluation. This is especially true for proposed new media services, where rigorous *ex ante* evaluation becomes essential.

The same definition approach described above should clearly be applied to the increasing number of services which PSBs in the EU are seeking to offer to take advantage of the opportunities offered by the rapidly developing technology. In new and emerging sectors, the scale and financial weight of a PSB could crowd out private investment at a very early stage and before commercial models are able to establish themselves. In some cases, even the expectation of entry by a PSB may have adverse effects on its development.

In this respect, despite calling for an *ex ante* evaluation of the inclusion of new media services in the public remit, the draft Communication fails to provide sufficient details on the basic principles to be used in such evaluation.

Failing to implement, or at least properly address, the issue highlighted above means that there is a substantial risk of PSBs using public money to provide services which may otherwise be provided by commercial operators. In a worse-case scenario, PSBs may crowd private investment out of certain services, either entirely or substantially, so as to lead to a long-lasting distortion in the market dynamics and potentially hindering future investment and innovation.

The worst-case scenario arises when PSBs are used as a vehicle to fund through public money projects and/or infrastructure which is instrumental in pursuing private interests, thereby maximising the distortion to the competitive process and directly harming and/or benefiting specific operators.

### **3. Funding of public service broadcasters**

The distortions caused by the provision of commercial service by PSBs are compounded in those cases where they are funded not only through the licence fee, but also by selling advertising space. The dual-funding mechanism unavoidably leads to commercial activities carried out by PSBs also benefiting from state aid through direct and indirect cross-subsidization.

The first-best scenario is a situation in which PSBs are prevented from providing services of commercial interest, as that implicitly eliminates the risk of cross-subsidies. However, failing that, the proposal should contain a requirement for at least functional, and preferably structural, separation between public and commercial services. Such separation would minimize the risk of cross-subsidization and other forms of distortion of competition.

Functional separation is the minimum guarantee for being able to effectively implement transparency and proportionality conditions. However, the cost allocation between public and non-public service activities can be particularly problematic especially for the common costs. Common costs may not be severable in a proportionate manner.

Paragraph 84 of the Commission's proposal states that, whenever the same resources are used to perform both public service and non-public service tasks, the costs that are entirely attributable to public service activities but are also of benefit to commercial ones, need not be apportioned between the two and can be entirely allocated to the fulfilment of the public service remit. Based on the analysis above, this criterion appears to be in contrast with basic regulatory principles commonly applied to other sectors, such as electronic communications.

The first problem is that all costs should be decreased by an amount equal to advertising revenues and, in general, to all commercial revenues. A second issue is efficiency. PSBs are under no obligation to be efficient, and in general they have no incentives to do so. PSBs should therefore be asked to provide evidence of effective use of their resources to justify their economic activities vis-à-vis commercial broadcasters. A third issue is that any common cost between activities within the PSB remit and commercial activities should be treated as such and therefore allocated proportionally to those activities, by applying established regulatory principles.

From this perspective, the application of the proportionality test should be conducted so as to ensure that PSBs are not overcompensated for the public services they provide. SKY is in favour of a clear definition of parameters for determining the level of compensation. In particular, SKY would request the Commission to provide guidelines for Member States on how to prevent overcompensation as a result of an inefficient pursuit of commercial revenues by the PSB.

#### **4. How PSBs' Operations Can Distort the Competitive Process**

Italy provides an interesting example of PSB set-up and operations. State-owned RAI is a PSB which is dual-financed by both advertising revenues and a mandated licence fee which must be paid for the mere fact of having a screen or projector or other device capable of showing audiovisual signals.

In addition to that, the definition of its remit as a PSB is drawn in a service-level contract ("Contratto di Servizio") which is renewed every three years under the guidance of the Ministry of Communications (now within the Ministry for Economic Development) and AGCOM, and subject to the final approval of the same Ministry of Communications.

RAI is in a very strong market position and generates slightly more audience share than its main commercial competitor, Mediaset. In particular, RAI had an average audience share of 41.4% in 2008 against Mediaset's 39.5%, while the two operators had respectively 41.8% and 40.5% in 2007.<sup>2</sup> When it comes to the TV advertising market, however, Mediaset has a larger market share and is in control of about 55% of the market while RAI has a share of about 29%.<sup>3</sup> The two companies can thus be considered collectively dominant in the TV advertising market or, as the Italian Antitrust Authority AGCM put it in its 2004 Review of the TV Advertising Market, "the sector is characterised by an oligopolistic structure, with two operators, Fininvest and RAI, controlling the majority of it."<sup>4</sup> In terms of total resources in the TV market, including pay-TV revenues, RAI is still the largest operator with around 35% of overall TV revenues, or €2.7bn.<sup>5</sup>

Far from having a clearly specified remit and tight controls on the nature and number of the services which it can launch, RAI is free to operate in any way it sees fit within the obvious constraint of making an attempt at breaking even, considering the overall amount of resources which it can use.

While many of RAI's activities and agreements of a commercial nature can be deemed to be beneficial to Italian viewers and to the competitive process in the TV market, being based on mutual benefits for all parties involved and not resulting in distortions of the competitive process, there are however some cases which should be of concern precisely from those points of view.

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<sup>2</sup> Source: Auditel.

<sup>3</sup> See AGCOM, *Rapporto Annuale*, 2008.

<sup>4</sup> See AGCM, *Indagine sulla raccolta pubblicitaria televisiva*, 2004. Fininvest is the holding company which controls Mediaset.

<sup>5</sup> Source: AGCOM, *Rapporto Annuale*, 2008.

A telling such example is provided by the imminent launch of a new satellite platform in Italy called Tivù. Tivù is a joint venture between the three main terrestrial broadcasters and television incumbents, RAI (with a 48% stake), editor of channels RAI 1, RAI 2 and RAI 3, Mediaset (48%), editor of channels Canale5, Rete 4 and Italia 1, and TIMedia (4%), editor of channel La7.

The platform is expected to operate on satellite technology and to make use of a conditional access system to prevent unauthorised viewers from accessing programmes. This implies that a considerable investment will have to be made in infrastructure to be used in the context of the platform's operations, an infrastructure which is controlled by the main actors in the Italian terrestrial TV sector.

In the absence of clear rules on the type of commercial investments allowed to PSBs, RAI may thus be willingly or unwillingly used as a vehicle for the pursuit of commercial interests which make substantial use of public funds. Such funds will be invested in infrastructure which may in the near future be used to further the interests of SKY's competitors, or to directly damage SKY's interests. For all purposes, the Tivù platform leads to a structural change in the TV market which will empower its stakeholders with the possibility to carry out actions which have the potential to produce substantial harm to the competitive process and to their competitors. Such actions may include, for example, the provision of pay TV services, or the indirect provision of such services through the broadcasting of encrypted programmes and of the technological devices needed to access them (e.g. platform-specific set top boxes and smart cards), for which a substantial investment must be made.

There is, in other words, a high degree of risk that the investments needed to set up, launch, operate and manage the platform will be borne by RAI, a PSB in Italy, but that the effects of the platform's activities will have a detrimental impact on competition and may directly harm the stakeholders competitors, such as SKY.

This scenario seems to be confirmed by the statements made by Luca Balestrieri, Tivù's President, who was recently reported as saying that "competition in the future will take place between platforms and free to air TV needs a space of its own to compete on satellite technology."<sup>6</sup>

This situation would mirror the outcome created by the 2003 Italian government decision to fund digital terrestrial technology by subsidising specific models of set top boxes at the retail level. That decision was challenged by SKY based on the fact that an apparently harmless subsidy was in fact laying the ground for commercial operators to benefit from an increasingly larger installed base for them to be able to provide pay TV services using subsidised set top boxes. In that case, the Commission found that SKY's concerns were founded,<sup>7</sup> and that the subsidisation scheme set up by the Italian government resulted in a structural change in the market which was ultimately of benefit to SKY's competitors.

A similar situation seems to be arising in this case. Public funds and a state-controlled company are being used to change the structure of the market in a way which may lead to opportunities for SKY's competitors to harm SKY's interests and produce substantial and long-lasting detriment to the competitive process.

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<sup>6</sup> Reported by wire agency APC in its 18:08 release of 20 January 2009 entitled "Digital TV/In June satellite launch for RAI-Mediaset-Timedia". In the same release it is reported that Tivù "could become the alternative to SKY which currently re-transmits on satellite the channels of RAI, Mediaset and Telecom Italia Media."

<sup>7</sup> European Commission Decision C 52/2005 on State Aid to Digital Decoders.

As such, this is a good example of how the lack of clear guidelines on the PSBs' ability to launch new services can lead to serious and long-lasting distortions of the TV market.