

CONFIDENTIAL



22 June 2011

The Rt. Hon Jeremy Hunt, MP
Secretary of State for Culture, Olympics, Media and Sport
2-4 Cockspur Street
London
SW1Y 5DH

Colette Bowe
Chairman
Ed Richards
Chief Executive

Dear Jeremy,

News Corporation / BSkyB proposed merger: further advice on proposed undertakings in lieu

We are writing in response to your letter of 18 March 2011 following on from our report of 31 December 2010 and our previous letters of advice to you of 11 February and 1 March 2011.

You requested Ofcom to advise you on the extent to which proposed undertakings in lieu of a reference to the Competition Commission ("UILs") address the potential impact on plurality identified in our 31 December report¹ as arising from the proposed acquisition by News Corporation of the shares in Sky it does not already own.

Background

In the light of our 31 December 2010 report, you announced that you intended to refer the merger to the Competition Commission, subject to considering UILs offered by News Corporation.

We advised on an initial draft of the proposed UILs on 11 February 2011 and then on a revised version on 1 March 2011. We advised that the revised version would, with reference to the points set out in our letter, address the plurality concerns identified in our report of 31 December 2010.

You held a public consultation seeking views on those revised UILs. In your letter of 18 March 2011, you asked us to review our earlier advice in the light of some of the representations you had received in response to the consultation. In view of those representations, we have agreed with News Corporation a number of changes to the proposed UILs dated 14 June 2011, attached.

¹ A non-confidential version of this is publicly available at:
http://www.culture.gov.uk/images/publications/OfcomPITReport_NewsCorp-BSkyB_31DEC2010.pdf.

You also asked us to engage with News Corporation as necessary in relation to the drafts of the carriage and brand licence agreements contemplated by the proposed UILs of 1 March, with a view to advising you whether these agreements, once finalised, were consistent with the UILs as they have now been amended and Ofcom's previous advice with regard to media plurality

In parallel, the OFT has similarly been reviewing its advice to you on the practicality and financial viability of the UILs including the carriage and brand licence agreements and we have seen a copy of its advice to you. We are aware that you have taken independent legal advice on the terms of the draft carriage and brand licence agreements.

For the reasons set out below and in our previous letters, our advice is that the revised proposed undertakings would address the plurality concerns identified in our report of 31 December 2010.

Consultation responses

1. We have reviewed all of the submissions received from your officials². Overall, we do not consider that the points raised in the submissions require us to change our previous advice. The consultation responses provided a number of comments on the proposed UILs. We address these below.

Changes in the UILs

2. In the light of the consultation responses, we have agreed with News Corporation a number of amendments to the UILs.
3. The proposed UILs require News Corporation to establish Newco with Articles of Association which provide that Newco's Sky News, TV and any closely related services will abide by the principle of editorial independence and integrity in news reporting. News Corporation now offers an additional undertaking not to attempt to cause Newco to act in breach of its Articles of Association (UIL 3.3).
4. The proposed UILs require News Corporation to establish Newco with Articles of Association which require it to have an independent director with senior editorial and/or journalistic experience. News Corporation now offers an additional undertaking that the Articles will provide that when considering editorial or journalistic matters, meetings of each of the Board and the corporate governance and editorial committee are only

² BECTU, BT, [X], Virgin Media, Slaughter and May (representing an alliance of media groups), DLA Piper (representing Avaaz), DMOL, Jewish Funds for Justice, Media Matters for America, National Union of Journalists, [X], Patricia Holland, [X], TUC, UK Coalition for Cultural Diversity and the Campaign for Press and Broadcasting Freedom.

considered quorate if an independent Board member with senior editorial and/or journalistic experience is present (UIL 3.1 (iii)(C) and (ix)(E)).

5. Consultation responses expressed concerns about the level of protection for Sky News from editorial influence by News Corporation in the interim period between News Corporation's acquisition of shares in Sky and the spin off of Newco. A number of additions to the UILs have been included in the light of these comments:
 - The UILs now provide for a monitoring trustee to be appointed, to monitor News Corporation's compliance with the undertakings during this interim period (UIL sections 6 to 10).
 - An additional undertaking requires that in effecting the spin off of Newco, News Corporation will take no action that would prevent Newco being placed in an overall position of editorial, governance, commercial and financial independence in which it will continue to contribute to plurality as Sky News did before the transaction (UIL 2.1).
 - An additional undertaking requires that the arm's length terms of the operational agreements to be entered into between News Corporation and Newco be fair and reasonable (UIL 5.1).
 - An additional undertaking requires News Corporation not to attempt to influence the editorial decisions of the Sky News business prior to spin off (UIL 13.1(iv)).
6. Today, Sky News benefits from cross promotion and marketing of its services on other Sky channels. News Corporation has agreed to include a commitment in the UILs to provide continued cross promotion of the Sky News service for as long as Newco and Sky are party to the carriage agreement to a level and in a manner comparable with such cross-promotion for the period of 12 months prior to the date of your acceptance of the UILs (UIL 4.9).
7. Consultation responses identified a risk that News Corporation might establish Newco with Articles of Association which limited its ability to operate (e.g. to borrow) such that it would not be sufficiently independent to contribute to plurality. The proposed UILs now provide for the Secretary of State to approve the Articles prior to acceptance (UIL 3.1(ii)).
8. We can also confirm that we are satisfied that the draft Articles of Association provided to us on 10 May 2011 (attached) are consistent with the UILs and our previous advice.

Duration

9. Some consultation respondents considered that the UILs were insufficient in that both the duration of the carriage agreement and the prohibition on acquisition by News Corporation of further shares in Newco last for 10 years. In particular, the argument was made that plurality may decline over the next 10 years and that as a matter of principle

UILs relating to a proposed merger should not be accepted in circumstances where they do not remove permanently the risk the merger poses to plurality.

10. As we have previously advised, we agree that the proposed UILs are not a permanent solution and that their effectiveness may start to diminish in the run up to the end of the 10 year period. We consider that a carriage agreement of a 10-year term in the context of industry dynamics in this sector is long term. This is because we consider there is likely to be significant evolution of the market and consumers' use of news and current affairs over the next decade. As a result, the situation with regard to plurality may be significantly different in 10 years time.
11. As set out above, at the end of the 10 year period, the prohibition on acquisition and the carriage agreement come to an end. If News Corporation wished to acquire the remainder of the shares in Newco after the end of the 10 year period, a media public interest test may be triggered if the threshold criteria in the Enterprise Act 2002 are met.
12. In order for the Secretary of State to have sufficient flexibility for dealing with plurality issues we would, however, refer to our previous advice that the Government should consider undertaking a wider review of the statutory framework to ensure plurality in the public interest in the longer term. We believe that the current system is deficient in failing to provide for intervention to be considered where plurality concerns arise in the absence of a relevant corporate transaction involving media enterprises, for example as a result of organic growth.

Governance arrangements

13. There were a number of further comments in the consultation responses, in the light of which we did not consider it necessary to make further amendments to the UILs. In particular, while we have made the changes set out above in relation to monitoring of the UILs, we did not reflect every comment made in this area.
14. In addition, a number of consultation respondents raised concerns about the ongoing relationship between News Corporation and Newco under the proposed UILs. They noted Newco would be dependent on News Corporation for a substantial proportion of its revenues. It was argued that Newco's independent shareholders and directors may perceive it to be in Newco's best interests to fall in with News Corporation's wishes and that individuals may consider their own job security to be dependent on their conduct as regards News Corporation. Some consultation respondents suggested changes to the UILs, for example, to reduce News Corporation's voting rights.
15. We consider that the UILs must be assessed against the fact that the plurality concerns we identified arose out of a change in the degree of control News Corporation has over Sky. We do not consider it necessary to establish Sky News in a position where News Corporation has no relationship with it at all, because today News Corporation controls 37.19% of Sky.

16. We consider that the proposed UILs and associated contracts provide for Newco to be able to take independent decisions for the long term. Key to this is the carriage agreement, which in our view provides for sufficient certainty over Newco revenues and overall profitability for 10 years.
17. The UILs provide for structural separation of Newco from News Corporation and for the formation of an independent Board. The Directors will have to abide by the principle of editorial independence and integrity in news reporting required in the Articles of Association. The Chairman of the Newco Board will be an independent director. The UILs provide for a corporate governance and editorial committee comprising a majority of independent directors to oversee Newco's compliance with the provisions relating to the principle of editorial independence and integrity in news reporting. The committee will consider any representations made by the Sky News Editor relating to compliance with these provisions. Newco's annual report will include a statement on the committee's activities and oversight functions.

Perceptions of the credibility of past undertakings

18. A number of consultation respondents expressed the view, by reference to commitments previously given by News Corporation or related persons in relation to The Times and the Wall Street Journal, that the UILs may be ineffective or that News Corporation may breach them.
19. For the reasons set out in our advice, we consider that the terms of the UILs address the potential impact on media plurality we have identified. In this context we note in particular that Newco will be a separate company, in which News Corporation controls only 37.19% of the total votes. The Chairman of the Newco Board will be an independent director. Newco will have a majority of independent shareholders and directors. We are not in a position to take a view on the reasons for the effectiveness or otherwise of commitments given in other circumstances.

Obligation to distribute required

20. Consultation responses expressed a concern that the UILs do not specifically require News Corporation to distribute Sky News. We do not believe it is necessary to place this obligation on News Corporation.
21. Under the operational agreements identified in section 5.1(iv) of the UILs, (play-out , uplink, satellite capacity, Digital Terrestrial Television ("DTT") capacity, online distribution, mobile distribution), Newco will be able to secure the transmission of its service via DTT, satellite, mobile and internet. News Corporation has committed to providing Newco with an Electronic Programme Guide listing on its satellite platform no worse than Sky News' today (UILs section 4.5(iv)). In addition, in the carriage agreement, Sky is under an obligation to distribute any encrypted high definition version of the service (carriage agreement section H.1), and unencrypted (standard or high definition) services will

necessarily be available to all customers of the Sky platform as a free to air service. In addition, we believe News Corporation will have a significant incentive to continue to distribute the Sky News service in order to realise value from its carriage agreement with Newco.

22. News Corporation has also committed within the UILs to use all reasonable endeavours to procure that the carriage agreement between Sky and third parties (including Virgin Media) for the distribution of Sky News on cable will be transferred to Newco (UIL 4.3 (i)). How this commitment may be realised is a matter of commercial negotiation between the relevant parties. In any event, we do not believe that such distribution is of critical importance to the ongoing viability of Newco, or that the loss of distribution on cable would have a significant effect on plurality given the availability of Sky News on satellite, DTT, mobile and the internet.

Competition issues

23. Within the consultation, a number of wider concerns were raised by respondents relating to News Corporation or Sky. These wider concerns generally related to potential competition issues, either current or as a result of the transaction. The UILs, and associated agreements, are concerned only with addressing the potential impact on media plurality identified in Ofcom's report of 31 December 2010. We have not considered any competition-related concerns within our engagement with News Corporation, refinement of the UILs or review of the carriage agreement or brand licence.

Review of the carriage agreement and brand licence in respect of our potential plurality concerns

24. We have reviewed and discussed the draft carriage agreement and brand licence with News Corporation in relation to plurality. As set out above, the OFT in parallel considered the draft agreements in relation to their advice on the practical and financial viability of the UILs. We understand that you have taken independent legal advice on the draft agreements.
25. The versions of the draft carriage agreement and brand licence provided to us on 21 March 2011 were incomplete and did not reflect the UILs in all respects. We believe the revised drafts of the carriage agreement (dated 15 June 2011) and the brand licence (dated 16 June 2011) are consistent with the proposed UILs as amended, and our previous advice with regard to media plurality.

Opportunities for diversification by Newco

26. It is important to note that diversification, while desirable, is not in our view necessary to ensure Newco continues to contribute to plurality as it did prior to the transaction. We believe it is unlikely that any of the diversification opportunities below are likely to replace the carriage agreement as Newco's main revenue source.

27. However, we note that the carriage agreement and brand licence include provisions which limit Newco's ability to diversify in some respects. In particular:

- they create a right for Sky to take any new Sky News branded services made available by Newco, without additional payment. We believe this to be a reasonable position in the light of the terms and value of the carriage agreement being offered; and
- they create a right for Sky to take any new service offered by Newco in future, on terms which are no less favourable to Sky than those offered to any third party. We understand News Corporation's position to be that Newco's ability to invest in new products and services results from the carriage agreement. We believe this is a reasonable position, but that News Corporation should be required to pay for such access on terms no less favourable than those offered to third parties.

28. In this context we note News Corporation has identified the diversification opportunities for Newco as including:

- non-Sky News branded news channels, programming blocks, apps or websites, including national and local news services, using substantially new content;
- syndicated content on a non-packaged basis of raw content broadcast or distributed by Sky News;
- a service similar to the Channel 5 service to other third parties (e.g. ITV, Channel 4); and
- syndication of Sky News branded content to other websites within agreed fair use limitations.

29. Internationally, Newco would also have opportunities for diversification, including [X<]

Advice

For all the reasons set out above and in our previous letters of advice, we consider that the revised proposed undertakings offered by News Corporation would address the plurality concerns identified in our report of 31 December 2010.

Yours ever,

[Redacted]

[Redacted]

Colette Bowe

Ed Richards

cc. Clive Maxwell, Executive Director, OFT