

**RESTRICTED – COMMERCIAL AND
MARKET SENSITIVE**

The Rt. Hon Jeremy Hunt, MP
 Secretary of State for Culture, Olympics,
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Date	22 June 2011	Email	clive.maxwell@oft.gsi.gov.uk

Dear Secretary of State

Advice from the Office of Fair Trading on undertakings in lieu offered by News Corporation relating to the anticipated acquisition by News Corporation of British Sky Broadcasting Group plc

1. I refer to your letter of 18 March 2011 following our report to you of 11 February 2011 (the February Report) and our advice to you of 1 March 2011 (the March Advice).
2. In your letter, you asked us to review our advice on the practical and financial viability of the undertakings in lieu (UIL) offered by News Corporation (News) in light of the representations that you had received from certain respondents¹ to the consultation on the UIL proposed by News on 1 March 2011 and published for consultation on 3 March 2011 (the 1 March UIL). You asked us to let you know whether, having considered these representations, it would be appropriate for the 1 March UIL to be amended in any respect.
3. You also asked us to engage with News in relation to drafts of the carriage agreement and brand licensing agreement² contemplated by the 1 March UIL

¹ [redacted]

² Your letter in fact refers also to 'certain operational agreements which are referred to in the proposed UILs'. However, none of the operational agreements detailed in paragraph 5 of the UIL are required to be approved prior to the Effective Date and hence have not been submitted by News for approval of



with a view to advising you whether these agreements, once finalised, are consistent with the 1 March UIL (as subsequently amended in the light of the consultation) and the OFT's previous advice with regard to their practical and financial viability.

4. Your letter asked that we continue to work closely with Ofcom in respect of the above.
5. Since receiving your letter of 18 March, the OFT – alongside Ofcom – has engaged with News extensively in relation to both the proposed UIL of 1 March and the draft carriage agreement and brand licensing agreement. This process has led to a revised set of UIL submitted by News on 14 June 2011 (the Revised UIL), and revised forms of the carriage agreement submitted by News on 15 June 2011 (the Revised Carriage Agreement) and brand licensing agreement submitted by News on 16 June 2011 (the Revised Brand Licensing Agreement), copies of which are attached as Annexes 3, 4 and 5 respectively to this letter.
6. I note that your assessment of the Revised UIL will be in the context of their ability to resolve media plurality concerns. The advice and recommendations that I provide in this letter are based on the remit to the OFT originally set out in your letter of 27 January 2011. The OFT is advising on whether the Revised UIL are practically and financially viable and has considered if there are any practical issues which could undermine the operation of the Revised UIL and whether they would be effective over the medium and long term. To the extent that the OFT has been concerned with 'effectiveness' of the Revised UIL, this relates to their mechanical and operational effectiveness.
7. I set out first below advice in relation to the key changes that have been made from the 1 March UIL to the Revised UIL in light of the Reviewed Responses. I then discuss the Revised Carriage Agreement and Revised Brand Licensing Agreement.

Advice in relation to the Revised UIL as a result of the Reviewed Responses

8. The OFT advised in its March Advice that '*the [1 March] UIL are likely to be practically and financially viable in the short and medium term (that is, no more than 10 years).*' It also advised that '*... it would be appropriate for you to test*

for review by the OFT at this point. (Note: certain operational agreements do require the approval of the Secretary of State prior to the Spin-off of Newco.)

further the viability and robustness of the commitments offered during the statutory public consultation process.'

9. The OFT has carefully assessed the Reviewed Responses with a view to determining whether they cast doubt on the fundamental practical and financial viability of the proposed UIL or whether they provide suggestions that would improve the practical and financial viability of the proposed UIL.
10. The Reviewed Responses do not, individually or collectively, provide reasons for the OFT to change the fundamental tenor of its March Advice.
11. However, the Reviewed Responses do provide suggestions as to how the 1 March UIL could be improved so as to improve the practical and financial viability of the proposed UIL. The OFT has discussed these improvements with News, and News has been willing – ultimately – to accept all of the amendments which the OFT regards as material and desirable. The most significant of these amendments in terms of practical and financial viability are that the Revised UIL provide that:
 - the Articles of Association of Newco now be subject to approval by the Secretary of State prior to the Effective Date; this change reflects the importance of the Articles of Association of Newco in ensuring the effectiveness of the proposed UIL and provides the Secretary of State with a greater degree of comfort in this regard; the OFT has reviewed draft Articles of Association of Newco provided by News on 10 May 2011 (attached as Annex 6 to this letter) and confirms that these are consistent with the Revised UIL and the OFT's previous advice with regard to their practical and financial viability;
 - in effecting the spin-off of the Sky News business in accordance with its obligations in paragraph 2.2 of the UIL, News shall not *'take any 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 prior to the Transaction'*; this principle, amongst other things, provides guidance for the Monitoring Trustee in relation to his / her monitoring of the spin-off and his / her review of the operational agreements; and
 - a Monitoring Trustee be appointed prior to the Closing Date to review News' compliance with the Revised UIL; this provides a greater degree of comfort that the provisions of the Revised UIL will be adhered to, and

is designed to ensure that the main cost of monitoring of the Revised UIL is borne by News.

12. A full list of the amendments made to the 1 March UIL so as to result in the Revised UIL are detailed in Annex 1 to this letter, complete with reasons for their inclusion.³
13. There were a number of other suggestions or comments in the Reviewed Responses potentially related to the practical and financial viability of the 1 March UIL that the OFT has not elected to take forward with News. The reasons for not taking forward those suggestions are variously that:
 - the issue raised has already been covered in the OFT's February Report or March Advice; or
 - the OFT does not believe that the concern that a suggestion seeks to remedy is in fact present or justified on the basis of its review; or
 - the concern that a particular suggestion seeks to remedy has been remedied by an alternative mechanism in the Revised UIL.
14. The OFT advises the Secretary of State that the Revised UIL are likely to be practically and financially viable in the short and medium term (that is, no more than 10 years).
15. The OFT also advises the Secretary of State that none of the amendments made to the Revised UIL in light of the Reviewed Responses addresses the essential structural limitation identified in the Report, that the UIL offered are unlikely to be practically and financially viable over the long term.

Advice in relation to the Revised Carriage Agreement and Revised Brand Licensing Agreement

16. News provided first drafts of the carriage agreement and brand licensing agreement to you on 21 March 2011, which were passed to the OFT for review. The OFT understands that you have also taken advice from external legal advisers on the draft carriage agreement and brand licensing agreement.

³ A limited number of drafting changes relate to requests by News to amend the 1 March UIL. These changes are not considered material and do not impact on the OFT's advice. In addition, a limited number of changes relate to requests by DCMS and its external advisers to amend the 1 March UIL.

17. The OFT has reviewed and discussed the draft carriage agreement and brand licensing agreement with News with a view to ensuring that the provisions of the agreements are compliant with the letter and spirit of the Revised UIL, in particular – from OFT's perspective – that the terms of the carriage agreement and brand licensing agreement are such that Newco will be practically and financially viable for the lifetime of the carriage agreement.
18. The discussions with News have resulted in a number of changes to the initial drafts of the carriage agreement and brand licensing agreement of 21 March 2011 such as to result in the Revised Carriage Agreement and Revised Brand Licensing Agreement. The most significant of these amendments in terms of practical and financial viability are that:
- the Revised Carriage Agreement will be a full-form agreement, and not merely a 'heads of terms'; this should provide a greater degree of comfort and is arguably required by paragraph 4.4 of the 1 March UIL (and the Revised UIL); and
 - the Revised Carriage Agreement provides for both Newco's revenue (in relation to SD and HD subscriptions) and its costs (that are attributable to News / Sky) to be CPI index-linked, subject to a stepped, symmetric upper cap in both cases;⁴ this provides an enhanced degree of financial security for Newco than the drafts of 21 March 2011, as set out in more detail in Annex 2.
19. In light of the changes made, the OFT advises that the Revised Carriage Agreement and Revised Brand Licensing Agreement are consistent with the Revised UIL and the OFT's previous advice with regard to their practical and financial viability.

Yours sincerely,



Clive Maxwell
Executive Director, OFT

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⁴ The upper cap is reflected in the revision to paragraph 5.3(iii) of the Revised UIL.

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Colette Bowe, Chairman, Ofcom
Ed Richards, Chief Executive, Ofcom

Annex 1 – Changes made from the 1 March UIL to the Revised UIL

Revised UIL paragraph reference	Change from UIL of 1 March	Effect and rationale for change
2.1	Amendment to require that in effecting the spin-off of the Sky News business in accordance with paragraph 2.2 of the UIL, News shall not take any 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 prior to the Transaction	To provide context for the Monitoring Trustee's assessment of News' fulfilment of its obligations in relation to the spin-off of Newco
2.1	Amendment that shares in Newco shall be distributed or otherwise issued or transferred to the shareholders of Sky	News' amendment to provide News with the flexibility to ensure that the spin-off of Newco is conducted in a tax efficient manner for the benefit of both News / Sky and Newco
2.2(i)	Amendment to delete the word 'public' from the requirement for the formation of Newco	To allow News, for practical reasons, initially to form Newco as a private company to be registered as a public company prior to spin-off
3.1(ii)	Requirement that the Articles of Association be in a form to be approved by the Secretary of State prior to the Effective Date	Importance of the Articles of Association to Newco justifies upfront approval, prior to acceptance of UIL, by the Secretary of State
3.1(iii)	New requirement that the meetings of the board of Newco shall be quorate in respect of the consideration of editorial or journalistic matters only if an Independent Director with senior editorial and/or journalistic expertise is present	See Ofcom advice of 22 June 2011

Revised UIL paragraph reference	Change from UIL of 1 March	Effect and rationale for change
3.1(ix)(E)	New requirement that the meetings of the corporate governance and editorial committee shall be quorate in respect of the consideration of editorial or journalistic matters only if an Independent Director with senior editorial and/or journalistic expertise is present	See Ofcom advice of 22 June 2011
3.3	New requirement that News shall not attempt to cause Newco to act in breach of its Articles of Association	Inserted to provide additional comfort that News will not seek, or attempt to seek, to cause Newco to act in breach of its Articles of Association (which includes a commitment to abide by the principles of editorial independence and with the Ofcom Broadcasting Code) See also Ofcom advice of 22 June 2011
4.2	Extension of the non-solicitation period to begin on the Closing Date and end 24 months after the date of spin-off	Extension on non-solicitation provision to cover the period between Closing Date and spin-off
4.5(iii)	Amendment that the Carriage Agreement shall be terminable (apart from in the event of material breach that has not been cured) in the event that the Brand Licensing Agreement expires or terminates (rather than if Newco ceases to provide output which is branded "Sky News")	Clarification sought by DCMS
4.6	Change from 'an initial seven year term, with an automatic renewal for a further seven years' to 'a fourteen year term'	To simplify the drafting and avoid any ambiguity about the initial term of the Brand Licensing Agreement

Revised UIL paragraph reference	Change from UIL of 1 March	Effect and rationale for change
4.7(iii)	Insertion that the Brand Licensing Agreement shall be terminable (apart from in the event of a material breach that has not been cured and/or in the event of a change in Control of Newco) in the event that Newco ceases to provide output which is branded "Sky News"	Clarification sought by DCMS
4.8	Replacement of 'News' with 'Newco'	Correction of a typographical error in 1 March UIL
4.9	New obligation on News to continue, through Sky, to cross promote Sky News for the duration of the Carriage Agreement	See Ofcom advice of 22 June 2011
5.1	Insertion of requirement that the operational agreements referred to in paragraph 5.1 be on terms that are fair and reasonable	To provide context for the Monitoring Trustee's assessment of News' fulfilment of its obligations in relation to the terms of the operational agreements
5.3(iii)	Insertion of a cap (of six per cent plus 50 per cent of the incremental increase in CPI between 6 per cent and 10 per cent) on the rate at which charges to Newco in relation to the agreements at 5.1(iii), 5.1(iv) and 5.1(v) may be annually increased by CPI	Capping of the CPI-related charges payable by Newco to News provides an enhanced degree of financial security for Newco than having costs uncapped
5.3	Insertion of audit rights for Newco in relation to usage levels, savings or cost increases	The provision of audit rights for Newco with respect to the operational agreements

Revised UIL paragraph reference	Change from UIL of 1 March	Effect and rationale for change
5.4	Extension of the dispute resolution mechanism in paragraph 4.8 to cover the lease agreement in paragraph 5.1(ii) and the agreements in relation to services described at paragraphs 5.1(iv)(A), 5.1(iv)(B) and 5.1(iv)(C)	Insertion of dispute resolution principles in relation to the key operational agreements (that is, those requiring prior approval by the Secretary of State) analogous to those already provided for in the Carriage Agreement and Brand Licensing Agreement
6-10	Insertion of clauses regarding the appointment, functioning, remuneration and reporting of a Monitoring Trustee	Monitoring Trustee will help ensure that News is complying with its obligations under the UIL and will provide advice to the Secretary of State in relation to his review of the key operational agreements requiring his prior approval
13.1(i)	Clarification that the Sky News business refers to the business as at the Closing Date	Clarification that the Sky News Business means the business assessed at the Closing Date
13.1(iii)	Extension of the interim obligation regarding maintenance and preservation of the Sky News business to cover its facilities and goodwill	Clarification provides additional comfort in relation to the maintenance and preservation of the Sky News business
13.1(iv)	Insertion of an interim obligation requiring that News shall not attempt to influence the editorial decisions of the Sky News business prior to the completion of spin-off	New interim obligation to ensure that News will not attempt to influence Sky News in editorial matters whilst News is preparing to spin-off Sky News See also Ofcom advice of 22 June 2011
13.2	Insertion of information obligation on News in relation to monitoring of compliance with the UIL	Information obligation provision on News

Revised UIL paragraph reference	Change from UIL of 1 March	Effect and rationale for change
Definition of Material Transaction	Clarification that any renewal of or material amendment to the lease agreement described in paragraph 5.1(ii) or the agreement(s) in relation to services described at paragraph 5.1(iv)(A), 5.1(iv)(B) and 5.1(iv)(C) would be deemed to be a material transaction	Extension of the definition of Material Transaction to cover the key operational agreements (that is, those requiring prior approval by the Secretary of State)
Definition of Monitoring Trustee and Monitoring Trustee Functions	Insertion of new definitions relating to the Monitoring Trustee (see above)	Required for the operation of the provisions relating to the Monitoring Trustee
Definition of Working Day	Insertion of a definition of Working Day	Required for time periods in relation to the appointment of a Monitoring Trustee

Annex 2 – Financial analysis of Newco in the light of the Revised Carriage Agreement and Revised Brand Licensing Agreement

1. Following receipt of the draft carriage agreement and brand licensing agreement from News, the OFT has been able to review the financial position of Newco in greater detail than it was able to do in the February Report and the March Advice. The OFT has been able to address some concerns that it initially identified on receipt of the draft carriage agreement and brand licensing agreement from News, notably:
 - the effect of higher inflation on Newco's financial viability; and
 - indexing of costs relating to services provided by Sky to Newco.
2. The OFT summarises below the changes that have been made since the February Report, which should be considered alongside that analysis (and in particular the 'Analysis of Revenue and Cost Projections' set out in the Annexe).

Carriage agreement payments

3. The original proposal made by News, as commented upon in the February Report, envisaged payments to Newco per subscriber per month (pspm) related to total Sky subscribers (index linked); plus an additional payment for HD subscribers (increasing at two per cent fixed per annum) and a fixed HD exclusivity premium.
4. Those original proposals have since been slightly modified, such that the pspm payments have been uplifted to meet in full some additional costs that were identified. Indexation of the payments is now based on full indexation for each element up to six per cent growth in CPI and 50 per cent compensation for inflation between six per cent and 10 per cent (the ceiling).

Costs and indexation of costs

5. Following review of the draft carriage agreement and brand licensing agreement from News, a limited number of additional technical costs were identified that relate to Newco and a more accurate estimate of equipment and fixed assets to be transferred was carried out, impacting on depreciation charges. The relevant tax rate was also reassessed. These effects are

included in the latest projections and the pspm payments were adjusted, as commented above.

6. To provide some symmetry between Newco's costs and revenue payments under the carriage agreement, the same formula for price indexation has been applied to Sky-related costs in the Revised Carriage Agreement. This would ensure that such core costs would be covered by the revenue stream. This has been reflected in paragraph 5.3(iii) of the Revised UIL relating to the permitted cost increases for the agreements listed at paragraphs 5.1(iii), 5.1(iv) and 5.1(v) of the Revised UIL.
7. ~~]~~To provide a similar symmetry to the indexation for revenue, an index-related element of the calculation also uses the same formula for price indexation as for subscription payments.
8. Overall, by way of summary, the changes to the additional technical costs and reassessed tax costs referred to above have been fully compensated for in the Revised Carriage Agreement by an increase in the subscription payments. A similar basis for inflation has now been used for Sky-related costs, for ~~]~~ and for subscription payments.

Sensitivity of the latest projections

9. A comparison has been made for profit and cash flow under different inflation assumptions, comparing the projection used for the February Report with the proposal under the Revised Carriage Agreement. Under the base case assumptions, with annual CPI at three per cent, six per cent, eight per cent and 10 per cent, both profit and cash flow are higher under the Revised Carriage Agreement than under the proposals modelled for the February Report. The improvement in these scenarios relative to the projection used for the February Report is more marked for the higher inflation situations than for the lower inflation situations.
10. To check Newco's sensitivity to risk of unfavourable events, ~~]~~.
11. This scenario was also explored under higher inflation assumptions, while making an adjustment for advertising revenues. ~~]~~.
12. The latest proposals in the Revised Carriage Agreement appear to be more resilient to the effects of inflation, up to CPI inflation of 10 per cent, than the original proposals.

Assessment

13. As the OFT previously assessed, while it is possible to imagine a combination of unfavourable events that could cause the financial viability of Newco to be threatened, this is not considered to be very likely. The assumptions made in the projections for Newco continue to appear to be reasonable and there is some flexibility to handle unforeseen problems. The benefit of the assured income from the Revised Carriage Agreement strengthens the financial position of Newco and while this agreement operates, and based on the evidence seen, the OFT continues to have no reason to expect that Newco would not be financially viable.

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Annex 3 – The Revised UIL submitted by News on 14 June 2011

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**Annex 4 –
The Revised Carriage Agreement submitted by News on 15 June 2011**

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**Annex 5 –
The Revised Brand Licensing Agreement submitted by News on 16 June 2011**

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**Annex 6 –
Articles of Association of Newco submitted by News on 10 May 2011**