



Seven Network Limited

*ACCC's report on emerging market structures in the
communications sector*

SUBMISSION

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Executive summary

Pay Television

- The pay TV industry requires urgent reform. There is no effective competition and its current integrated structure denies any prospect of competition developing.
- Seven supports the ACCC's recommendation to require Telstra to divest its 50% interest in Foxtel and its HFC network.
- However, this recommendation will not completely address competition issues in pay television because:
 - it does not cover non-cable pay TV delivery platforms, particularly satellite;
 - it does not achieve complete separation of content and all aspects of carriage in pay TV;
 - the consequences of removing Telstra from Foxtel require further consideration, particularly if Foxtel is then controlled by News and PBL alone. These are not sufficiently addressed in the ACCC report;
 - in particular, issues relating to conflicts of interest between pay television and FTA interests for PBL in the context of rights acquisition need close consideration.
- Seven strongly believes that, at a minimum, pay TV reform must require:
 - the full separation of content from all pay TV carriage platforms (both satellite and cable); and
 - the full separation of content from other carriage functions such as customer access (including set top units (SMS), subscriber management systems (SMS), Service Information (SI), and any other service or functionality that forms part of the carriage supply chain that delivers a content service to the customer.)
- Seven agrees with the ACCC's statements that access regimes alone do not and cannot deliver effective competition in industries with significant vertical integration of the most powerful players.
- As demonstrated by the experience of C7, the Part XIC access rules have failed to deliver competition in the pay TV sector. Structural reform addressing all industry elements – infrastructure, content and customer access - is needed to deliver any level of competition in pay television.
- Access rules to correct market failure must be effective if they are to be of any assistance in promoting competition. Deficiencies in access frameworks (whether Part XIC or through undertakings) should be addressed.

Multichannelling

- Seven supports the introduction of multichannelling for FTAs. This mechanism would assist in promoting take-up of FTA digital television and go some way to address competition concerns in relation to pay television. The Government should move to permit multichannelling by FTAs immediately.

1 Introduction

This submission from the Seven Network focuses on three critical areas considered in the ACCC Report:

- the recommendation that Telstra divest its 50% shareholding in Foxtel and its HFC network;
- competition concerns in pay TV more generally;
- multichannelling for FTA broadcasters.

Other issues considered by the report and relevant to Seven such as anti-siphoning, review of the moratorium on new commercial television licences and retransmission have been addressed in separate submissions.

Some of the issues raised by the Commission's report also arise in proceedings commenced by Seven (and its subsidiary, C7) in the Federal Court.¹ Seven does not propose to canvass the allegations made in those proceedings in this submission, but to the extent that Seven does not comment on any matters in the Report, it should not be taken that those matters are accepted by Seven.

2 Removal of Telstra from Foxtel

Seven strongly supports the recommendation that Telstra divest its HFC cable and 50% interest in Foxtel, which it considers will deliver a range of competitive benefits to a number of industries, including the pay TV industry.

A proper competition analysis reveals the complete absence of effective competition in pay TV. Without structural reform the barriers to entry are such that the marketplace is highly unlikely to deliver any real or sustainable competition in the future.

However, the recommendations concerning Telstra's interest in Foxtel and its HFC network are only a partial solution because:

- they do not address all the carriage platforms used to supply pay TV, in particular satellite, which is the growth area for pay TV distribution;

¹ Federal Court proceedings no. N1223 of 2002.

- structural reform must extend beyond infrastructure and also cover the provision of content. The Commission's proposal that the Government, for the time being at least, focus upon a content access regime denies the reality that the negotiate/arbitrate model in Part XIC of the *Trade Practices Act, 1974 (TPA)* has totally failed to achieve Parliament's objectives; and
- they do not sufficiently address the consequences of allowing pay TV to be fully controlled by a News Limited/PBL partnership. The implications of this require further consideration from a competition perspective, including the vertical integration between these two partners and channel providers, as well as PBL's interests in FTA and pay TV.

The divestiture of Telstra's Foxtel interests and HFC network would bring Australia's telecommunications regime in line with that of several OECD countries which have prevented incumbent telecommunications companies from owning cable networks.² It reflects an approach similar to that of the European Commission, which has made objections to mergers between traditional telecommunications companies, cable companies and content providers on the grounds that they allow foreclosure of key input to competitors and leverage of market power from one market to another.³

In a report in 2001, the OECD indicated that it favoured requiring structural separation as a most effective regulatory device for addressing the incentive of an incumbent telecommunications operator to engage in anti-competitive behaviour.⁴ It argued that access regulation is a behavioural approach, (as opposed to ownership separation which is a structural approach) that struggles to address the incentives of an incumbent to devise ways to minimise competition.⁵ Even a well-resourced, persistent and vigilant regulator is unlikely to achieve an outcome that would provide as much competition as would likely arise where there is no incentive to restrict competition. In 2001, the OECD Council of Ministers adopted a recommendation on structural

² In only 9 out of the 29 OECD countries with cable and standard telecommunications networks does the incumbent telecommunications carrier own both the standard telecommunications network and a cable network. In four of those nine cases the incumbent does not own the largest cable network. In each of Germany, Ireland, Mexico, the Netherlands and Sweden the cable network previously owned by the incumbent has been divested: Report, pages 55 to 56.

³ Report, pages 35 and 64.

⁴ OECD, Directorate for Financial, Fiscal and Enterprise Affairs, Committee on Competition Law and Policy, *Structural Separation in Regulated Industries – Report by the Secretariat*, 10 April 2001 (DAFFE/CLP (2001) 11), (**OECD Report**) pages 48 and 49.

⁵ Ibid.

separation of regulated industries, in which it urged member countries to give serious consideration to structural reform.⁶

The recommendation also reflects the National Competition Council's 2002 assessment that:

“the Government should further consider the structure of Telstra, including the option of structural separation of the fixed network.”⁷

Seven supports the Commission's view that, in the pay TV industry, the competitive benefits which would flow from such divestiture would include:

- the removal of incentives for the HFC cable owner to thwart attempts by retail pay TV operators to gain access to the cable for provision of pay TV services;
- the removal of incentives for the HFC cable owner to supply access to retail pay TV operators on less favourable terms than Foxtel;
- the introduction of increased infrastructure competition in the supply of telecommunications services, including the provision of wholesale pay TV services; and
- increased competition in the provision of retail pay TV services, with flow-on effects for competition in the market for the acquisition and supply of retail pay TV content.⁸

These are benefits which cannot be achieved through measures short of structural separation. Regulatory mechanisms such as access frameworks and accounting separation are not able to overcome underlying incentives for anti-competitive behaviour.⁹

Consequences of Removing Telstra

The ACCC report does not give sufficient consideration to the consequences of removing Telstra from the Foxtel mix. While the change may promote some competition particularly between telecommunications providers by giving Foxtel increased incentive to supply its pay TV content

⁶ A December 2002 draft working paper produced by the communications section of the OECD expressed some reservations about the effect and practical difficulties of structural separation, but the Ministerial resolution still stands as the expression of agreed OECD views.

⁷ National Competition Council 2002, *Assessment of governments' progress in implementation of National Competition Policy and related reforms, Volume 1: Assessment, August 2002*, AusInfo, Canberra Chapter 14, page 14.14.

⁸ Access to content is addressed in the following section of this submission.

⁹ In its 2001 report, the OECD noted that regulatory devices such as accounting separation, management separation and corporate separation do not address the incentive of powerful incumbents to resist competition. The report observes that:

“These approaches are therefore not effective in promoting competition in themselves. The point has been made many times in many different industries.” (OECD Report, pages 48 and 49)

to other network operators, it does not address the remaining issues of competition between content providers in the newly structured Foxtel.

The Report seems to anticipate that the removal of Telstra from the Foxtel mix would simply leave the News/PBL partnership to run the operation. Seven believes that this would have serious anti-competitive effects.

This is because Foxtel would still control key access bottlenecks of the STUs and Service Information.

Such a structure would also exacerbate difficulties in achieving any competition between content providers. The cross ownership of Fox Sports by News and PBL as well as PBL's interests in both Nine, Foxtel and Fox Sports means that they would have a strong incentive to preclude new pay TV content providers from gaining access to the Foxtel platform.

At the same time, the ownership of almost all premium content rights by the Foxtel partners means that new content aggregators to compete with the Foxtel platform are unlikely to emerge in the medium term. In the case of sporting rights ownership of key premium rights has been achieved through denying third parties access to the Foxtel platform.

Seven believes that these concerns can only be addressed, as a first step, by making the Telstra interest in Foxtel available to third parties unrelated to the Foxtel partners. The continuing vertical integration in customer access, content and FTA by the remaining Foxtel partners, News and PBL, should also be addressed.

Satellite delivery

It must also be noted that the Commission's recommendations in respect of the Telstra cable only partly address the conflict of interest that arises where a single party controls both content and carriage. To achieve this, any solution must address all the carriage platforms used to supply pay TV. It is therefore critical that satellite be considered in this context.

Currently, 51% of Australian pay TV subscribers receive their service via satellite, and the largest growth rate in new subscribers is those who take their service via satellite. Foxtel knows that the future of pay TV is dependent upon having satellite delivery – as is evident from Foxtel's own use of satellite and News Corporation's attempts to acquire a global satellite network.

The undertakings concerning the content supply arrangements between Foxtel and Optus deliberately excluded satellite transmission, ensuring that no other pay TV operators compete

with Foxtel. The cable rollouts by Foxtel and Optus have stopped and all indications are that they will not continue. At the same time, Foxtel has acquired almost 75% of the capacity on Optus' C1 satellite, which will be the dominant mode of delivery of pay TV to Australians.

In order for there to be a more thorough separation of carriage from content, it is necessary to ensure that all carriage platforms, including cable and satellite, are separated from content to ensure that no party is involved in the supply of both carriage and content services. The separation should be technology neutral.

To this end, in Seven's view, the Commission's recommendation should have required that any party who is involved in the provision of a carriage service to pay TV, regardless of the form of the delivery technology, should be prevented from having any interest in the provision of any content services. This, of course, would also apply to the Optus satellite platform.

Other infrastructure bottlenecks

The issue of customer access – the 'digital gateway' issue – is considered by the Commission but attracts no recommendation at all. The Commission's apparent reliance upon market forces to avoid any serious gateway issue flies in the face of the competition problems besetting the industry. Seven is strongly of the view that the concerns warrant new legislation aimed at mandating effective access to the whole of the pay TV supply chain. This must include Foxtel's STUs as well as what has now become a critical part of the supply chain to the customer, the Service Information function.

3 The state of competition in Australian pay TV

The provision of pay TV involves a combination of infrastructure (delivery platforms), content and access to customers. The development of competition in pay TV is affected by the interrelationships between each of these factors and by the nature and extent of competition in their provision. A credible competition analysis of pay TV requires having close regard to these interrelationships. While the Commission has addressed each of these issues in its Report, its recommendations fail to meet the competition concerns which are readily identifiable. These concerns are seen in practice and are not merely theoretical.

The Report acknowledges that Telstra is the most vertically and horizontally integrated telecommunications operator in the world. The vertical and horizontal relationships between the main players are extensive. The reality is that, in Australia there are now complex relationships between:

- the two largest telecommunications carriers (Telstra and Optus);
- the three operators of the infrastructure by which most Australians receive pay TV (by both cable and satellite) (Telstra, Austar and Optus);
- the world's largest provider of proprietary digital conditional access systems (NDS, majority owned by News);
- the three largest pay TV companies (Foxtel, Austar and Optus);
- the largest free-to-air television network (Nine);
- major content producers (including PBL, Fox Sports (50/50 News/PBL), XYZ (50/50 Foxtel/Austar), Fox Studios (News Ltd), NRL (50% News Ltd) and the print and electronic media arms of PBL and News); and
- the largest newspaper proprietor and the largest magazine publisher (News).

The various elements of influence of the Foxtel partnership over the industry reinforce each other and facilitate the perpetuation of its market power.

The dominance afforded by this combination of elements - namely, the alignment between the Foxtel shareholders, their respective content arms, the electronic distribution platforms controlled by Telstra and Optus (both satellite and cable) and the digital gateway to the home – was underlined by Telstra's CEO last year stating that, if the Foxtel/Optus content sharing agreement were to proceed, it would forge “the pre-eminent media organisation in Australia”.¹⁰ In substance, he was saying the firm would be so strong that competition would no longer be an issue for it.

The implementation of the content sharing arrangements between Foxtel and Optus have cemented Foxtel's dominant position in all aspects of pay TV. There is presently minimal competition:

- the bulk of pay TV services offered to Australian consumers are offered by three major players - Foxtel, Optus and Austar - with some niche and/or local services offered by much smaller operators;

¹⁰ This statement was made by Telstra's CEO, Ziggy Switkowski to a JP Morgan Australian investment conference on 6 October 2002: see “Switkowski points to stronger News Link”, *Australian Financial Review*, 7 October 2002, page 14.

- Austar’s service is confined to regional areas. Austar and Foxtel do not compete in overlapping areas as a result of certain programming arrangements, thereby decreasing competition in content acquisition. With these arrangements, and numerous joint investment arrangements in content creation companies, Austar is effectively a mere franchisee of Foxtel. Austar is the sole provider of pay TV services in a number of regions;
- Optus provides services in parts of Brisbane, Sydney and Melbourne only;
- the majority of Australian homes therefore do not have a choice of retail pay TV provider;
- the content sharing agreement between Foxtel and Optus provides for Foxtel to supply its pay TV basic package to Optus. It gives Foxtel considerable control over the means by which that content is presented. It also requires Optus to offer any newly acquired content to Foxtel. Any new content acquisitions by Optus have to go on a tier – this discourages any content acquisition by Optus;
- at a retail level, the agreement effectively reduces Optus to a Foxtel ‘clone’ and removes incentives for Optus to engage in independent content acquisition. The result is that Optus has significantly reduced *capability* as a competitive force in retail pay TV. As the Commission recognises in its Report, the similarity of services offered by Foxtel and Optus will mean that customers see little choice in programming and pricing.¹¹ Add to this the programming and ownership inter-relationships with Austar, and Foxtel is practically the only acquirer of content in the market. This was predictable given the relationships, and it is in fact occurring;
- the Commission itself found that the agreement:
 - *“strengthened Foxtel’s ability to dictate the prices and terms for the supply of content (including positioning/tiering of programming, viewing times, exclusivity, relative splits of revenue between suppliers and Foxtel) and to largely determine who gets access to content”¹²; and*
- two of the three Foxtel partners, News and PBL, are major content providers. As a result, there is an incentive for Foxtel to discriminate against independent content providers. Again, this was predictable given the relationships, and it is in fact occurring.

¹¹ Report, page xii.

¹² Report, page 27.

The problems arising from the high concentration and complex relationships at the retail level, and in respect of both infrastructure and content, are compounded by the existence of high barriers to market entry. The Commission itself has acknowledged several entry barriers.¹³ However the Report appears to primarily focus on these as they relate to competing infrastructure providers.

When pay TV was introduced, it was also envisaged that there would be competition between content package providers. This has not eventuated to date despite serious and persistent attempts by at least one aspiring entrant to the market, C7.

Given the failure of the access regime to deliver competition by aspiring pay television entrants it is expected that content competition in pay television can only occur at the channel provider level in the medium term.

In addition to ensuring that access to the Foxtel platform is available to third parties, the Government must also consider the role of Foxtel's basic package as a barrier to entry for content providers. Under the arrangements in place following the content sharing agreement, potential pay TV operators wishing to gain access to customers using Foxtel's STUs will face a bundling requirement – in order for an access seeker to provide a channel using a Foxtel STU, its customer will be required to acquire Foxtel's basic package.¹⁴

As a result, the new entrant's channel can only ever be a tier channel in addition to the Foxtel basic package. This tying requirement results in an effective increase in the new entrant's retail charges to the consumer making the offer less competitive. It also means that the competing channel provider competes only for the residue of the pay TV household discretionary spend after the price of the Foxtel basic package has been paid. This is a significant barrier to entry.¹⁵

Examination of pay television industries in other countries shows that Australia has the highest entry price for a basic pay television package in the major international pay television markets. The high basic entry-level package will leave potential independent channel providers competing for a diminishing discretionary consumer spend. Consumers in other countries who do not have such high initial payments for pay TV have more cash left to

¹³ Report, section 2.2.3.

¹⁴ See clause 4.1(c) of the Analogue Access Agreement annexed to Foxtel's undertaking to the Commission dated November 2002.

¹⁵ Generally, consumers will experience diminishing marginal utility of pay TV services. They will be less likely (and less willing) to acquire both Foxtel basic and the access seeker's channel than acquire the access seeker's channel alone. It is to be noted that Foxtel's basic package price is exceptionally high by international standards.

purchase additional channels and premium content. A copy of the executive summary of a report prepared by Spectrum Strategy Consultants demonstrating these findings is attached.

Independent content providers in Australia are therefore competing for the residual discretionary pay TV household spend of \$5-10 per channel on a tier. Even for those content providers who are able to gain access to the infrastructure necessary to deliver their service, the size and cost of the basic package means that they are unlikely to be able to effectively compete with content provided as part of the Foxtel basic package. Foxtel also has the option to include channels of a similar genre in the basic package if the tiered service proves popular.

Consumers are unlikely to effectively pay twice to receive the same type of content – where similar content is already available in the Foxtel basic package it is highly unlikely that a consumer will pay an additional amount to receive the additional content. Legislative change is therefore required to prevent the structure of the basic package from operating to inhibit competition.

In summary, Seven believes that effective competition is only possible if:

- there is access to the full suite of necessary elements in the pay TV supply chain including set top units and associated services such as conditional access and subscriber management systems; and
- the basic package is not used as an impediment to effective competition. That is:
 - either all access seekers should have the opportunity to supply a channel offering that is not contingent on taking the basic package; or
 - the size and price of the basic package should be effectively regulated.

The dominance of Foxtel also has effects in other markets. This is most clearly seen in relation to content markets beyond pay TV. The fact that Foxtel is dominant in pay TV delivery will make it the naturally preferred acquirer of any content synergistically related to pay TV. Examples may include free-to-air broadcasting rights and internet rights. The strong incentive for any content provider would be to seek a relationship with Foxtel because, as the dominant pay TV firm, the synergies and distribution power cannot be matched by firms which are not aligned with Foxtel. Without a guarantee of access to the Foxtel platform, content acquirers cannot bid for content – they will simply not be confident of being able to onsell the pay TV rights for an economic price.

This is further compounded by joint ownership arrangements between Foxtel, PBL and Fox Sports.

4 The failure of access regimes

A proper competition analysis in the pay TV industry requires some assessment to be made of the effectiveness of access regimes and the telecommunications-specific access regime in particular. It is relevant both to the effectiveness of competition at the present time as well as possible solutions going forward. The need for this assessment is even greater given the Commission's reliance on access as the panacea for future competition in the market.

The access regimes introduced following the Hilmer report¹⁶ and its acceptance by Australian governments had high objectives. Those objectives have not been reached despite detailed legislative provisions. After several rounds of amendments and wide powers bestowed upon the Commission as regulator, the telecommunications specific access regime has failed. The regime has proved itself unable to address the underlying economic incentives of powerful vertically integrated incumbent players to resist providing effective access to competitors.

Part XIC of the TPA, like the general access regime in Part IIIA, is based on the negotiate/arbitrate model. It was thought that, once access to the relevant infrastructure was "declared" for access, negotiations would follow. Failing a negotiated outcome, an access dispute could be notified and the Commission could arbitrate. It would do so "speedily" and "quickly".¹⁷ Express powers to make interim determinations and to backdate final determinations were introduced to ameliorate the consequences of delay and to dampen the incentives to cause delay.

The experience since 1997 has departed significantly from the design. Seven's subsidiary C7, has experienced inordinate delay and "staunch resistance"¹⁸ in respect of its quest for access to the Foxtel pay TV service – the analogue pay TV declaration was challenged on legal grounds; and it has taken several years to achieve an interim determination, compliance with which has been met with a series of technical and legal issues.

Seven is not alone in this experience. The delay associated with dispute resolution under Part XIC has attracted significant attention. It was a key area of concern for industry participants in

¹⁶ National Competition Policy, Report by the Independent Committee of Inquiry, August 1993. See, in particular, Chapter 11.

¹⁷ Both terms are used in Part XIC – section 152DB provides that the Commission, in arbitrating a dispute, must act as "speedily as a proper consideration of the dispute allows, having regard to the need to carefully and quickly inquire into and investigate the dispute and all matters affecting the merits, and fair settlement, of the dispute"; and section 152DC gives the Commission a power to "give all such directions, and do all such things, as are necessary or expedient for the speedy hearing determination of the access dispute".

¹⁸ C7 Pty Limited v Foxtel Management Pty Limited [2001] FCA 1864 at paragraph 42.

their submissions to the Productivity Commission review¹⁹ and prompted the Productivity Commission to make several recommendations aimed at increasing the speed of the regulatory processes.²⁰

Disputes about access are inevitable given the potential for conflict of interest between access seekers and access providers.²¹ The vertically integrated nature of the access providers and the status of the access seekers as downstream competitors reinforces the potential for conflict. There is also a powerful incentive for vertically integrated access providers to *cause* delay.²²

This has implications for the promotion of competition – access is required for competition to develop in a downstream market, such as the provision of pay TV services. Delay invariably means that an access seeker will face uncertainty about an input. This inhibits both business development (commitments to customers to win business or to content providers to secure content cannot responsibly be given) and business planning (it is not possible to undertake any sensible strategic planning if there is significant uncertainty about securing access to important inputs).

The root cause of delay – and the regime being a failure – is widely acknowledged to be the underlying economic incentives to resist competition which flow from vertical integration between powerful business units. The Commission clearly appreciated this problem of incentives in making its divestiture recommendations in respect of Telstra. History has shown that the Government cannot rely on access regimes; structural change is the only real option.

If the Government is serious about facilitating facilities based competition on access platforms, it should intervene to actively foster facilities based competition in the provision of access infrastructure. For example if alternative infrastructure such as wireless broadband services are

¹⁹ Productivity Commission 2001, *Telecommunications Competition Regulation*, Report No. 16, AusInfo, Canberra, page 329.

²⁰ See Productivity Commission 2001, *Telecommunications Competition Regulation*, Report No. 16, AusInfo, Canberra, Chapter 10.

²¹ Phillips Fox, Review of Telecommunications Arbitration Processes, 18 April 2002, page 10.

²² This incentive is widely recognised. See, for example, Professor Allan Fels, Telecommunications: Competition Effective Regulation in Investment, ATUG Industry Seminar, 2001. The existence of an ability to limit or constrain effective competition in this way does not as a matter of economic theory mean that the ability will be used. However, an incentive will arise for the vertically integrated firm in circumstances where, as in telecommunications, there are barriers to entry at the level of the access seeker. Those barriers will give established access seekers a degree of market power and the potential to earn monopoly profits which would otherwise accrue to the vertically integrated firm. This incentive appears to have been recognised by the Productivity Commission (Productivity Commission 2001, *Telecommunications Competition Regulation*, Report No. 16, AusInfo, Canberra, page 45). An added incentive can arise if, instead of focusing purely upon profit maximisation, the incumbent were seeking to maximise the size of its business or market share.

to emerge they must be protected from predatory pricing and other anti-competitive practices during their infancy to assist them to achieve sustainability.

5 Content

Access to content is critical for viable entry into the pay TV market. The Commission recently acknowledged the critical role of content when it said:

“Pay TV programming is not usually thought of as an essential facility in the same way as an electricity transmission grid or rail network. Yet it does exhibit some of the same characteristics. Like a major infrastructure facility, it is often difficult, if not impossible, to duplicate. There is, for example, only one major Australian rules football competition to broadcast. There are only so many premium movies to show. If one person has the rights to broadcast a package of premium movies, it is extremely difficult to economically duplicate this product by, for example, making more premium movies. Similarly, access to such programming is crucial to competition in downstream markets.... It can therefore be argued that there is a case for regulating access to pay TV programming by imposing some form of access obligation.”²³

The Productivity Commission also accepted the critical importance of access to content.²⁴ It is also recognised in overseas jurisdictions.²⁵

The exclusivity of access to premium content consistently reinforces itself. As Ofcom has observed:

“It is of course the case that the key content rights come up for auction at periodic intervals. It is possible for new entrants to bid for such rights and, if successful, to launch new premium services. However, there are a number of significant hurdles which such a new entrant would need to overcome:

- *there are significant incumbency advantages. An operator with a significant existing distribution base is likely to be both able and willing to bid more than new entrants. Its bid is also likely to carry greater credibility with rights holders. There is also a significant incentive to engage in strategic behaviour to deter entry;*

²³ Australian Competition and Consumer Commission, *Supplementary Submission to the Productivity Commission Review of Telecommunications Specific Competition Regulation in – Pay TV And Regional Telecommunications*, August 2001, page 20.

²⁴ See generally Chapter 17 of Productivity Commission 2001, *Telecommunications Competition Regulation*, Report No. 16, AusInfo, Canberra.

²⁵ The Commission based certain aspects of its proposed rules for program access on the regime introduced in the United States in 1992. That regime prohibits certain exclusive content contracts: see Australian Competition and Consumer Commission, *Supplementary Submission to the Productivity Commission Review of Telecommunications Specific Competition Regulation in – Pay TV And Regional Telecommunications*, August 2001, Part B. See also Federal Communications Commission, Report and Order, FCC 02-176, released 28 June 2002 which deals with the upcoming sunset of the exclusive contract prohibition in the US. The FCC decided by a majority to extend the prohibition for a further five years.

- *it would seem difficult to build a successful sports channel with rights to one series of sporting events alone. The ability to enter with a new sports channel (or a premium channel which combined sports and other premium programming) would depend on the ability to acquire a series of rights which would be unlikely to be available simultaneously.*²⁶

Seven welcomes the Commission's focus on access to content as part of its competition analysis.²⁷ The Commission has, however, stopped short of dealing with the source of the competition and efficiency concerns.

The Commission has proposed a form of prohibition on exclusive content arrangements. It has also proposed the imposition of access to content measures in the form of an access regime, although it proposes that the regime could only be used by network providers.²⁸ It does not make any recommendation regarding the separation of ownership interests in content and carriage, despite acknowledging that such measures:

*"...would likely improve the incentives for distribution of premium pay TV content."*²⁹

The Commission's stated reasons appear to be that it believes a prohibition against exclusive contracts would be necessary in any event and that:

"the costs of separating content and carriage are unclear..."

It therefore recommends that the Government's focus should be on implementing the proposed access to content regime.

In Seven's view, this approach is inconsistent with that adopted by the Commission in respect of access to infrastructure. The Commission's recommendations regarding infrastructure reflect a view that it is necessary to address the source of potential competition concerns by focusing on incentives and ownership interests.³⁰ Despite apparently recognising that the same dynamics apply in respect of access to content,³¹ the Commission is content to rely upon access regulation.

²⁶ See Oftel, "Bundling in the pay television market", Submission by the Director of Telecommunications to the Independent Television Commission, paragraph 3.32.
(http://www.oftel.gov.uk/publications/1995_98/broadcasting/itc1297.htm)

²⁷ Chapter 6 of the Report is devoted to access to content. The Commission has shown considerable interest in the issue of access to premium pay TV content (generally speaking, sport and movies).

²⁸ Report, pages 125 to 126.

²⁹ Report, page 129.

³⁰ Report, section 4.5.

³¹ Report, page 128.

The approach is flawed because each of the two reasons given by the Commission is unsatisfactory. First, if a separation of content and carriage is achieved, and the incentive for discriminatory treatment is removed, exclusivity should be less of a competition concern. Not all exclusive agreements are bad for competition. Many assist with avoiding inefficiency³² or promoting desirable investment. If the incentive for anticompetitive conduct is removed, it should be possible to allow exclusive contracts to be examined under the general competition law rather than to prohibit them outright.

Secondly, the rejection of an option because the costs of its implementation are unclear is unsound. Doubt about potential costs is an insufficient reason to reject an otherwise available and compelling regulatory solution.

Importantly, reliance on access regimes has been demonstrated by recent experience to be misplaced. Seven's experience is referred to above. Certainly, an access regime cannot be relied upon to achieve results in the short term. No commercial enterprise would rationally invest on the strength of a content access regime being introduced. Given Australia's experience with access regulation, the Commission's approach of focusing on an access regime and subsequently reviewing the position is a luxury the industry can ill afford.

A more effective regulatory approach would be to focus on separating ownership interests between content and carriage. As the Commission has recognised, such a proposal could see a prohibition on PBL and News Corporation holding interests in both Foxtel and channel suppliers. The costs of that type of ownership separation should be the subject of government study and advice, similar to the recommendation made by the Commission in respect of infrastructure - although Seven firmly believes the benefits of structural reform will outweigh any such costs.

6 Access to customers

Control of STUs

At issue here is access to households for the provision of digital interactive services. The Commission addresses the issue in chapter 7 of its Report. In Seven's view, the Commission has failed to appreciate the significance of Foxtel's control of its STUs.

³² It is widely recognised that vertical exclusive contracts have a role to play in reducing transaction costs and negative externalities.

There is a significant risk of Foxtel's STUs becoming the 'digital gateway' to the household. The risk arises in this way:

- most of the digital STUs to be located in pay TV households will be Foxtel STUs given the first mover advantage accruing from its dominance of analogue pay TV. That will be a consequence of Foxtel's dominant market share;
- those digital STUs placed in households by Optus will have to be compatible with Foxtel's digital pay TV content because, upon digitisation of HFC network, Optus will be required to take all of Foxtel's digital pay TV content; and
- households which have a Foxtel (or Foxtel compatible) STU will be highly unlikely to acquire another STU, especially if its provision to the household is not subsidised. If proprietary technology is used, alternative sources may not even be a possibility.

Foxtel's STUs will therefore be the means by which interactive services will be provided to pay TV households. Access to those STUs will be required if interactive services other than Foxtel's are to be delivered to the home. Foxtel's digital STUs will not be subject to a statutory access regime as the relevant undertakings are conditional upon Foxtel obtaining exemption orders under the revised legislation.

The terms of the Digital Access Agreements, that have been offered by Foxtel and Telstra as conditions for their applications for exemptions for digital services, are important elements to be taken into account in considering the most appropriate and effective response to this access issue.

However, there are fundamental problems with the Agreements. In particular, the Agreements provide that the 'excluded services' relating to Foxtel digital STUs include the return the path and interactive functionality. Access seekers will therefore not be able to distribute interactive services, including interactive pay TV, pursuant to the terms of this undertaking.³³

The consequence will be that the developers of interactive services will align themselves with Foxtel. In addition, it will simply not be possible for them to be assured of gaining access to the market by any route other than Foxtel.

It is essential, particularly given these flaws with the Agreements, that open access to the complete pay TV delivery supply chain, is achieved. Seven repeats its previously stated view that new legislation is required to ensure that there is adequate access to STUs. For reasons

³³ Clause 4.2(a)(vi).

already mentioned, it is plainly insufficient for the Government to continue to rely upon the existence of an access regime in the absence of structural reform.

Service Information function

Inherent in the regulatory strategy of separation of carriage from content is the aim of ensuring that the whole pay TV supply chain is cleared of all (potential) bottlenecks or opportunities for any party to assume a ‘gatekeeper’ control of the path to the customer. However, the Commission’s recommendations have overlooked a functionality in the pay TV supply chain that has now become the pay TV equivalent of the ‘last mile’ challenge.

Foxtel retains control over what is known as the ‘Service Information (SI) function’. SI is data inserted into the transport stream along with content which defines key attributes of the service received by the consumer, such as tuning, navigation between channels and services and program viewing entitlements (conditional access attributes).³⁴ SI data is also used for the provision of Electronic Programming Guide (EPG) services and interactive services.

The strategic importance of the control of SI data is very significant. The entity which controls the SI data management effectively controls the ‘gateway’ to digital and interactive services for all STU consumers. All access seekers will be dependent on Foxtel as the controller of the SI services. This is crucial because there will be no commercial incentive for Foxtel to enter a commercial arrangement with access seekers for the supply of interactive services. It will be in Foxtel’s interests to retain a monopoly.

Foxtel’s control of the conditional access function also means that Foxtel has unfettered access to access seekers’ customer information. This is inappropriate when Foxtel is a competitor of access seekers.

Thus, while the Commission’s recommendations appear to attempt a separation of carriage from content, in Seven’s view, the Commission’s recommendations should have also addressed critical functionality by requiring that any party who has an interest in any form of functionality that is part of the supply chain to the customer should be prevented from having any interest in the provision of any content services, for the reasons acknowledged by the Commission itself in its Report.

³⁴ Schedule 1 Part B Foxtel access agreement.

7 Multichannelling

Seven continues to strongly support the introduction of multichannelling for commercial broadcasters and welcomes the ACCC's views in support of multichannelling. Seven agrees with the Commission that multichannelling could increase the potential for competition both within the FTA sector and between the pay TV and FTA sectors. Given the monopoly position now occupied by Foxtel, the overall lack of competition in the pay TV sector and the barriers to entry in that sector, the introduction of multichannelling (both FTA and subscription) for FTA broadcasters offers real benefits.

Set top box uptake is currently at about 80,000. While this is a good start, not all consumers will be attracted by the widescreen high quality pictures and CD quality sound alone. Others will need a different reason to purchase a set top box. Additional content is the only proven consumer driver internationally and will provide this.

The UK experience with Freeview demonstrates our long held view that program choice rather than picture quality is a key driver of digital take-up. Freeview is now available in over 1 million UK homes.

While Seven believes that multichannelling is key to the future viability of free-to-air television, we support the right of other broadcasters to choose the business model that they believe will deliver the service of greatest interest to viewers, be that HDTV or additional Standard Definition digital content. Ultimately, we believe that the consumer will benefit from the choice offered by broadcasters.

Allowing commercial broadcasters to offer multichannelled services would help promote digital television through the offer of increased choice to viewers. While the small number of consumers with access to digital television means that the quantity of additional services may be restricted in the short term, programming quality and quantity could build up as the digital audience increases.

The HDTV mandate should also be removed or at the very least modified. Seven believes there is only limited interest in this technology in Australia or internationally. If there is a niche market for HDTV services, it should be left to commercial interests how this niche market should be serviced. Removing the mandate would reduce the costs of digital commitments by consumers and investors and provide broadcasters with greater flexibility in developing and delivering digital services.

In the case of the national broadcasters, the removal of the HDTV mandate could yield savings from Commonwealth financial assistance provided to the ABC and SBS for digital conversion (to the extent that this assistance supports HDTV costs). These savings could be redirected to support multichannelling initiatives by ABC and SBS.

Seven believes that in order to maximise the quality content offering both free and subscription multichannel services should be permitted on the digital terrestrial platform. However, to address pay TV concerns we would support the initial introduction of free-to-air multichannelling with a moratorium on subscription services until 2007. We do not support content restrictions on multichannel services.

Seven does not object to a base level requirement in relation to use of the digital spectrum provided there is some flexibility in how this is to be applied. For example a broadcaster may elect to provide certain minimum amounts of either HDTV or multichannel content.

The rationale for preventing commercial broadcasters from multichannelling in 1998 was stated to be to protect the “fledgling subscription television industry”. The situation has now changed dramatically:

- pay TV in Australia has in excess of 1.5 million subscribers;
- pay TV generates revenues in excess of \$A1.2 billion annually, more than any commercial TV station;
- pay TV is extremely profitable in Australia although it would claim otherwise. The majority of revenues are paid to its core program providers, News Corp and PBL, for the movie and sports channels;
- pay TV is viewed by almost 1 in 4 Australian households;
- Foxtel is the dominant Pay TV operator in Australia;
- Optus is gradually exiting the industry following its recent programming deal with Foxtel;
- Foxtel partners News Corp and PBL control all major sports rights - Australian Rules, Rugby League, Rugby Union and Cricket - and use this market power to dictate what sports will be watched, when they will be watched and on what platform;
- Foxtel also owns and controls all major movie rights through the Premium Movie Partnership (News and PBL are part owners) and the recent Foxtel / Optus deal.

The justification for continuing the ban on multichannelling clearly no longer exists and the policy should be immediately reviewed. If it is delayed, the opportunities for multichannels to establish themselves against a monopoly pay television provider may well be lost.

ATTACHMENT

PRICING of PAY TV PACKAGES

SPECTRUM STRATEGY CONSULTANTS

Pricing of pay-TV packages

5 October 2002

Spectrum Strategy Consultants

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1 Executive summary

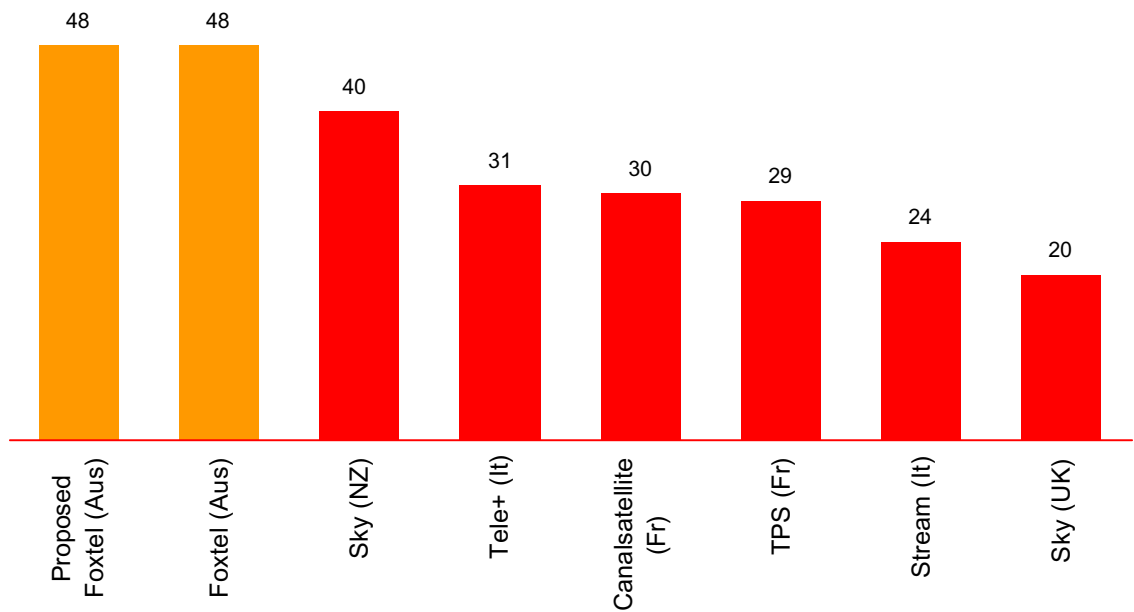
The Australian competition regulator, the ACCC, is currently considering a proposal for Optus and Foxtel to merge and is seeking comment from interested parties in the coming weeks.

Foxtel and Optus have offered a number of undertakings that are intended to overcome the anti-competitive concerns in relation to the deal. However, under the proposed arrangement it is feared that the high basic entry-level package price will leave potential independent channel providers competing for a diminishing discretionary consumer spend.

Australia already has the highest entry price for a basic pay-TV package across the seven selected markets, for both satellite and cable networks.

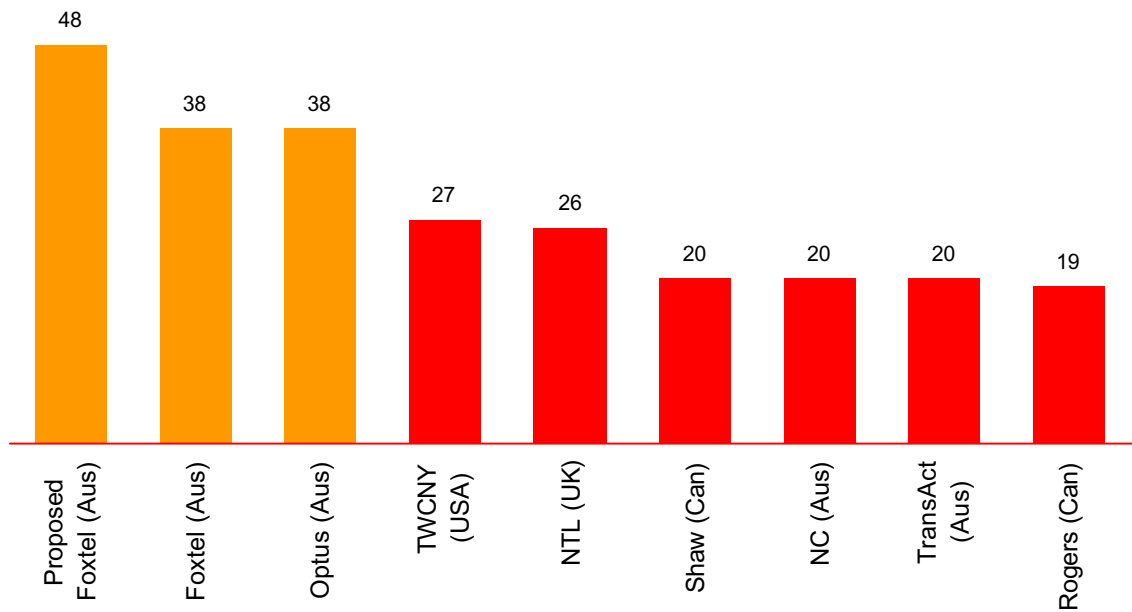
The proposed Foxtel package price of \$47.95 per month will leave Australian subscribers with one of the highest pay-TV rates in the world.

Exhibit 1: Basic entry-level package prices – satellite, Aus \$ (cost adjusted)



Source: Company data, Spectrum analysis

Exhibit 2: Basic entry-level package prices – cable, Aus \$ (cost adjusted)



Source: Company data, Spectrum analysis

These high basic prices have several negative effects on the Australian pay-TV market:

- firstly, the high basic price inhibits overall penetration
- secondly, it leaves consumers with less disposable income to spend on additional premium or independent channels
- thirdly, it could prevent the pay-TV market from evolving into a dynamic and content-rich environment offering a wide diversity of programme channels

Pay-TV markets typically develop in the following way:

- **Developing market:** penetration is low. Early adopters artificially inflate ARPUs by subscribing to a large number of premium channels.
- **Maturing market:** pay-TV uptake and penetration increase, often prompted by growing competition resulting in more attractive consumer propositions. ARPUs decrease as lower value customers enter the market.
- **Mature market:** Penetration levels begin to peak. ARPUs start to increase once more, as subscribers become more demanding in their consumption of pay-TV and are encouraged to “buy through” to a richer variety of premium channels.

By allowing consolidation to occur at the **developing market** phase, the Australian pay-TV market risks inhibiting development of the pay-TV market in terms of consumer uptake and spend.

The proposed merger will also have several negative effects on the pay-TV market from a competitive perspective:

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- It will add to the pressures to raise subscription prices for the consumers, as has occurred in other markets
 - It will raise the cost of content, as dominant pay-TV operators acquire the premium content
 - It could inhibit platform access to independent channels or give preferential treatment to in-house or “family-owned” channels
 - A dominant pay-TV operator can also exert undue pressure on channel providers to push down their per subscriber rates or remove them from the basic pay-TV package altogether
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