



**Australian  
Competition &  
Consumer  
Commission**

# **Assessment of Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service**

**Final Decision**

March 2007

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## Abbreviations

ACSD	active customer smartcard database
Act	Trade Practices Act 1974 (Cth)
Capex	capital expenditure
CA	conditional access
CAPM	capital asset pricing model
Capex	capital expenditure
CRA	Charles River Associates
CSP	carriage service provider
Commission	Australian Competition and Consumer Commission
DAA	digital access agreement
EPG	electronic program guide
EPMU	equi-proportionate mark-up
ECPR	Efficient Components Pricing Rule
Foxtel	Foxtel Management Pty Ltd and Foxtel Cable Television Pty Ltd
IBAC	installed base acquisition costs
LTIE	long-term interests of end-users
MRP	market risk premium
NECG	Network Economics Consulting Group
NERA	National Economic Research Associates
Opex	operating expenditure
PSTN	public telephone switched network
PwC	PriceWaterhouseCoopers
RAPM	Regulatory Accounting Procedures Manual
RNE	required network enhancements

SAOs	standard access obligations
SAU	special access undertaking
SI	service information
STU	set top unit
Tribunal	the Australian Competition Tribunal
TSLRIC	total service long run incremental cost
ULLS	unconditioned local loop service
WACC	weighted average cost of capital

# Executive Summary

## 1.1 Background

FOXTEL Management Pty Ltd and FOXTEL Cable Television Pty Ltd (together ‘Foxtel’) lodged a special access undertaking (‘the Undertaking’) pursuant to s.152CBA, Division 5, Part XIC of the *Trade Practices Act 1974* (‘the Act’) with the Australian Competition and Consumer Commission (‘the Commission’) on 1 December 2006. The Undertaking specifies the terms and conditions upon which Foxtel undertakes to supply the “Digital Set Top Unit Service”.

A digital set top unit (‘STU’) is a device located at a customer’s premises that is used for the reception and decryption of digital subscription TV signals.

Foxtel had previously lodged a special access undertaking in relation to the Digital Set Top Unit Service on 6 October 2005 (the ‘October 2005 Undertaking’). The Commission issued its draft decision (‘Draft Decision’) to reject the October 2005 Undertaking on 1 September 2006. Foxtel subsequently withdrew the October 2005 Undertaking on 1 December 2006, and submitted a revised special access undertaking, which is now the subject of this Final Decision (‘Final Decision’).

The Undertaking is in substantially the same terms as the October 2005 Undertaking except that Foxtel has incorporated amendments designed to address the concerns of the Commission as expressed in its Draft Decision.

The Commission has previously considered the issue of third party access to Foxtel’s digital STU in some detail in the context of accepting s.87B undertakings arising in relation to the content-sharing arrangement entered into between Foxtel and Optus in 2002, and Foxtel’s subsequent application for an anticipatory individual exemption order under s.152ATA of the Act.

In response to the Commission’s final decision to accept Foxtel’s exemption order application on 12 December 2003, the Seven Network lodged an application for review of the Commission’s decision with the Australian Competition Tribunal (‘Tribunal’). On 30 September 2004, the Tribunal issued its decision to refuse the application for exemption by Foxtel.

Even without the exemption order, the s.87B undertakings submitted by Foxtel and Telstra include a commitment that if the parties commence supplying a digital pay TV service at any time prior to 31 December 2007, third party access will be provided in accordance with the terms and conditions contained in the Foxtel and Telstra Digital Access Agreements. Foxtel commenced supplying a digital pay TV service on 14 March 2004.

Foxtel’s s.87B undertaking, as varied on 18 December 2003 as part of the exemption application process, currently provides access seekers with access to Foxtel’s digital

STUs for the supply of a digital subscription television service on the terms and conditions in its Digital Access Agreement ('DAA').

## 1.2 Legislative criteria

Under s.152CBA of the Act, a special access undertaking ('SAU') can be lodged by a person who is, or expects to be, a carrier or a carriage service provider ('CSP') supplying specified services, so long as the service is not an active declared service.

A service in respect of which a person has given the Commission a SAU and which the Commission has accepted, is a declared service under s.152AL(7) of the Act.<sup>1</sup> However, the Commission may still declare a service under s.152AL(8) even if the service is to any extent covered by a SAU.

Section 152CBD of the Act specifies that the Commission must not accept the SAU unless:

- the Commission is satisfied that the terms and conditions set out in the undertaking are consistent with the standard access obligations ('SAOs') under s.152AR;
- the Commission is satisfied that the terms and conditions set out in the undertaking are reasonable;
- the Commission is satisfied that the undertaking is consistent with any Ministerial pricing determination; and
- the Commission has:
  - published the undertaking and invited people to make submissions to the Commission on the undertaking; and
  - considered any submissions that were received within the time limit specified by the Commission when it published the undertaking.

The Act provides that the Commission must, after considering a SAU, either accept or reject it. The Commission has limited discretion to consider amendments/variations to a SAU once it is lodged with the Commission for assessment. Accordingly, Foxtel's proposed changes to its October 2005 Undertaking resulted in the lodgement of a new SAU which in turn required the Commission to undertake a new assessment process.

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<sup>1</sup> Under Part XIC of the Act, the Commission may declare carriage services and related services to be declared services. Carriers and carriage service providers who provide declared services are required to comply with standard access obligations ('SAOs') in relation to those services. The SAOs facilitate the supply of declared services by access providers to access seekers, in order that access seekers can provide carriage services and/or content services.

### **1.3 The Commission's assessment**

On 15 December 2006, the Commission published the Undertaking on its internet web page at [www.accc.gov.au](http://www.accc.gov.au). On the same date, the Commission published a Discussion Paper which set out the key terms of the Undertaking, and invited people to make submissions to the Commission about the Undertaking.

This Discussion Paper focused on the amendments made in the revised Undertaking and provided the Commission's preliminary views on the amendments.

In addition, in light of extensive work already undertaken in assessing the October 2005 Undertaking and in the making of the Draft Decision, the Discussion Paper provided the Commission's preliminary views on whether to accept or reject the Undertaking.

In response to the Discussion Paper, the Commission received submissions from the submitting party (Foxtel) and one interested party (Seven Network).

The Commission has considered these submissions in deciding whether to accept or reject the Undertaking. Where requested by the submitting party, the Commission has also taken into account all the submissions previously put forward by interested parties in the assessment of the October 2005 Undertaking.

A list of the submissions, as well as other documents that the Commission has examined in the course of making its Final Decision is provided in Chapter 10.

#### **Final Decision**

##### ***Reasonableness of terms and conditions in the Undertaking***

The Commission is satisfied that the terms and conditions specified in the Undertaking are reasonable as required by s.152CBD(2)(b).

On balance, the Commission considers that the Undertaking provides a potentially effective form of access for content provider access seekers wanting to provide services to Foxtel's existing subscribers in competition with Foxtel's tier channels i.e. niche channel providers.

In particular, accepting the Undertaking provides access to the 'minimum bundle of assets' that a niche channel provider (who intends to provide tier channels to Foxtel's subscriber base) requires in order to provide its subscription television services to end-users. That is, the Undertaking provides access to Foxtel's subscribers (the key obstacle for content providers), as well as access to modem services and inclusion in the EPG.

The Commission considers that there is value in niche channel providers having a mechanism for gaining distribution on Foxtel's digital platform, given Foxtel's market power in the acquisition of subscription television content and the scale of its existing subscriber base. In this respect, the Commission notes that the Undertaking would provide improved terms and conditions of access compared with Foxtel's current



operative s.87B undertaking, including provision of access to modem services and EPG services.

The Commission notes that Foxtel's TSLRIC-based pricing methodology will result in access prices based on costs, and that Foxtel will be allowed to recover the costs (operating, capital, and some common costs) incurred in providing the service, plus a normal return on capital. Therefore, the Commission considers that the pricing methodology will lead to efficient access prices and encourage economically efficient investment in infrastructure. Further, the Commission considers that this methodology takes proper account of the direct costs Foxtel incurs in providing access to its Digital Set Top Unit Service.

In addition, the Commission is satisfied that the non-price terms and conditions in the Undertaking are in the LTIE and give due regard to the interests of Foxtel as the access provider and the interests of access seekers.

### ***Consistency with the SAOs***

In regards to the consistency of the Undertaking with the applicable SAOs, the Commission notes that the Undertaking is limited to the Digital Set Top Unit Service as a bundled service (unlike the October 2005 Undertaking), without any attempt to cover stand-alone access to its unbundled component elements.

Further, the tying clauses meet with the obligation to supply the active declared service whether or not the tying clauses are treated as limitations on the service. The Commission is satisfied that the Undertaking is consistent with the obligation to supply the active declared service.

## **1.4 Conclusion**

Overall, the Commission is satisfied that the terms and conditions specified in the Undertaking are consistent with the applicable SAOs to the extent that those obligations would apply to Foxtel if the relevant service were treated as a declared service as is required by s.152CBD(2)(a).

The Commission is satisfied that the terms and conditions specified in the Undertaking are reasonable as required by s.152CBD(2)(b).

As a result, the Commission's Final Decision is to accept the Undertaking.

## **1.5 Structure of this report**

This Report is structured as follows:

- **Chapter 2** provides background on the Digital Set Top Unit Service;
- **Chapter 3** sets out the relevant legislative framework that the Commission is required to work within when assessing a SAU;

- **Chapter 4** summarises the price and non-price terms and conditions contained in the Undertaking;
- **Chapter 5** assesses the *price* terms and conditions of the Undertaking against the relevant statutory criteria;
- **Chapter 6** assesses the *non-price* terms and conditions contained in the Undertaking against the relevant statutory criteria;
- **Chapter 7** assesses the reasonableness of the Undertaking as a whole;
- **Chapter 8** assesses the consistency of the terms and conditions in the Undertaking with the applicable SAOs;
- **Chapter 9** contains the Commission's Final Decision on the Undertaking; and
- **Chapter 10** lists the documents considered by the Commission in reaching its Final Decision.

## 2. Background

### 2.1 The core competition concerns

In declaring the predecessor ‘Analogue Pay TV service’ in 1999, the Commission considered that declaration would be in the long term interests of end-users as it would promote competition in the market for retail pay television services. In particular, declaration would facilitate the suppliers of niche services (eg. ethnic programming) gaining entry in the market for retail pay television services. This would likely lead to low prices for these services as well as a broader range of choice for consumers. In this regard, it was noted that:

The Commission considers the barriers to entry in this market, **including the lack of availability of premium programming** and the cost and limitations of alternative means of carrying the services, to be significant. In addition, the vertical integration between the retail pay television service providers and the providers of the cable carriage service provide an incentive for the latter to restrict access to their cables. If the service is not declared, it is likely that a narrower range of programming would be available, and at higher prices, than would otherwise be the case.<sup>2</sup> (emphasis added)

In particular, in relation to Foxtel, the Commission was concerned that as a result of its control of significant amounts of premium programming, combined with the fact that customers generally only buy one basic subscription television package and accompanying STU, Foxtel controlled the distribution channel to the primary customer base for subscription television services in Australia. Providers of niche programming would find it hard to distribute their product to customers.

Accordingly, the Commission subsequently accepted an ordinary access undertaking from Foxtel for the distribution of niche programming channels to the members of its customer base via its analogue STUs.

The Commission does not consider that situation has changed with the transition to digital. If anything, there are additional constraints including access to new features such as interactivity and the digital electronic program guide (‘EPG’), as identified by the Australian Competition Tribunal in *Seven Network Limited (No 4)* [2004] A Comp T 11 (23 December 2004). Accordingly, the Commission welcomes Foxtel’s decision to submit a SAU proposal for distribution of programming to its customer base via its digital STUs.

In relation to access to means of carrying the service to Foxtel’s customer base, especially the situation where a carrier is vertically integrated or otherwise associated with Foxtel, the Commission notes that this may or may not remain an impediment to effective competition. However these matters are not directly relevant to the

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<sup>2</sup> ACCC, Declaration of Analogue Subscription Television Broadcast Carriage Service, A report on the declaration of an analogue-specific subscription television broadcast carriage service under Part XIC of the Trade Practices Act 1974, August 1999, p 40.

assessment of this undertaking from Foxtel and are or may be addressed where necessary through other undertakings or other parts of the Act.

## **2.2 What is the Digital Set Top Unit Service?**

A Digital STU is a component of the network architecture and systems used for the provision of subscription television services to end-users.<sup>3</sup>

Broadly speaking, there are three network elements to the supply of digital subscription television services to end-users:

- 1) The digital play-out centre – this involves content being aggregated before being sent to the headends (for cable) or the uplink station (for satellite) for distribution of the signal. Two operations are performed on the content stream as it is distributed:
  - encryption by the Conditional Access ('CA') system which specifies how the content can be accessed; and
  - Service Information ('SI'), which specifies how the content is arranged within the broadcast transport streams, is added.
- 2) Distribution paths – either cable or satellite – to take the signals to customers.
- 3) STUs – these are devices used for the reception, decryption and display of content (including interactive content) at the end-user premises.

Specifically, digital STUs provide for the delivery of the subscription television signals from the wall plate to the customer's television or video recorder. STUs are installed with smartcards which, in conjunction with the CA System, unscramble and control each subscriber's access to services (i.e. channels that may be accessed under a purchased package). The SI System produces network, service and event based data that informs the STU as to the services available, upcoming events, and where on the network those services are located.<sup>4</sup>

The Digital Set Top Unit Service is a service for the distribution of programming to Foxtel's customers via its digital STUs, including the ancillary functions and services such as CA/ SI services required to ensure that distribution.

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<sup>3</sup> Digital pay TV is a service that delivers a wider range of channels, including interactive and enhanced services, as well as better picture and sound in comparison to previous (analogue) pay TV services.

<sup>4</sup> Refer to FOXTEL MANAGEMENT PTY LIMITED, Foxtel Engineering, Peter Smart and Ron Higgins, *Report prepared for special access undertaking by Foxtel*, 4 October 2005, p.7.

## **2.3 Commission's previous consideration of access to digital set top units and related services**

### **2.3.1 Section 87B undertakings and digital exemption application**

In November 2002, the Commission accepted s.87B undertakings from various parties, including Foxtel, in order to address competition concerns arising in relation to a content-sharing arrangement entered into between Foxtel and Optus.

These undertakings included a proposal by Telstra to invest in and to commence supplying a digital subscription television carriage service, and for Foxtel to invest in and commence supply of digital STU and related CA services.<sup>5</sup>

The proposal to undertake the digital investment was contingent, amongst other things, on Foxtel and Telstra first obtaining anticipatory individual exemption orders under s.152ATA from the Commission in relation to the supply of a digital cable and digital satellite subscription television service. Towards that end, the undertakings also included a commitment from Foxtel and Telstra to apply for exemption orders in relation to the proposed digital investment within 28 days of the relevant legislation commencing.<sup>6</sup>

Telstra and Foxtel provided undertakings to commence supplying digital pay TV services within 12 months of obtaining an exemption order. Upon the commencement of the supply of digital pay TV services, access would be in accordance with the terms of the proposed DAAs that accompanied and formed part of the exemption applications.

The applications for exemption were lodged by Foxtel and Telstra in late December 2002. After undertaking a public inquiry, the Commission made a final decision to accept Foxtel's and Telstra's applications, subject to certain conditions, on 12 December 2003.<sup>7</sup>

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<sup>5</sup> See generally clause 6 of the Telstra section 87B undertaking and clauses 4 and 5 of the Foxtel section 87B undertaking in relation to the proposal for digital investment and a digital access regime.

<sup>6</sup> At the time the section 87B undertakings were given, the legislative regime under which Telstra and Foxtel would apply for their anticipatory individual exemption orders had not been passed. The legislative scheme under which the exemption orders were sought was passed on 10 December 2002 and commenced on 19 December 2002.

<sup>7</sup> Section 152ATA(6) establishes that the Commission must not grant an exemption order unless the Commission is satisfied that the making of the order will promote the long-term interests of end-users of carriage services or of services provided by means of carriage services ('the LTIE'). The matters that the Commission must have regard to when determining whether a particular thing promotes the LTIE are set out in s. 152AB of the Act.

In accepting Foxtel's and Telstra's applications, the Commission concluded that granting the exemptions would promote the long-term interest of end-users ('LTIE') because the investment in a digital service was more likely to occur with an exemption order than without one. The Commission was satisfied that the exemptions would facilitate the investment and therefore lead to the efficient investment in infrastructure. Further, a primary part of whether competition would be promoted was whether there would be an effective access regime in place. The Commission considered that granting the exemptions would promote competition because Foxtel's DAA and Telstra's Access Agreement would provide for a more effective form of access, with the additional conditions specified in the final exemption decision, compared with the original access terms proposed by the parties in their s.87B undertakings.

While the general form and content of the proposed DAAs were available to the Commission as part of its consideration of the s.87B undertakings, the exemption process provided an opportunity to clarify and refine many aspects of the DAAs.

### **2.3.2 Tribunal's decision to refuse exemption applications**

Subsequent to the Commission making its final decision to accept Foxtel's and Telstra's applications, Seven Network lodged an application for review of the Commission's decision with the Tribunal. On 30 September 2004, the Tribunal issued its decision to refuse the applications for exemption by Foxtel and Telstra. The reasons for that decision were released on 23 December 2004.

In reaching its decision to refuse the applications for exemption by Foxtel and Telstra, the Tribunal emphasised that the test to be applied in making an exemption decision under s.152ATA is that the making of the order is in the LTIE, and stressed the importance of focusing on the criteria provided by s.152ATA(6), rather than the reasonableness of conditions of access.

The Tribunal rejected the applications because it concluded that Foxtel and Telstra were committed to proceeding with the investment even without the exemption order; consequently, the Tribunal reached the view that it could not be said that granting an exemption order would promote the LTIE.

In addition, the Tribunal expressed concerns about the following non-price terms and conditions in Foxtel's undertaking:

- the exclusion of interactivity from the digital services offered by Foxtel;
- the tie of access to the basic package under Foxtel's terms and conditions; and
- the period of the undertakings and the length of the exemption period.

In relation to the pricing methodologies put forward by Foxtel and Telstra, the Tribunal concluded that it was generally satisfied with Foxtel's methodology, as modified by the Commission. It did consider, however, that a more rigorous verification of the cost inputs would be appropriate.

### **2.3.3 Existing provisions for access to digital STUs**

Even without exemption orders, the s.87B undertakings submitted by Foxtel and Telstra include a commitment that if the parties commence supplying a digital pay TV service at any time prior to 31 December 2007, third party access will be provided in accordance with the terms and conditions contained in the Foxtel and Telstra DAAs.

Foxtel commenced supplying a digital pay TV service on 14 March 2004. This factor, in combination with the Tribunal's decision to refuse Foxtel's and Telstra's anticipatory exemption applications, means that access seekers can use Foxtel's access undertakings pursuant to s.87B to gain access to Foxtel's STU and related services.

As noted above, Foxtel's s.87B undertaking was varied on 18 December 2003 as part of its exemption application process. The varied versions of the Foxtel undertaking and related DAA are those that are currently in force. These are available on the Commission's web site at <http://www.accc.gov.au/content/index.phtml/itemId/451865>.

### **2.3.4 Commission's Draft Decision to reject the 2005 Undertaking**

On 6 October 2005, Foxtel lodged a SAU with the Commission in relation to the proposed supply of Digital Set Top Unit Services.

On 1 September 2006, the Commission issued its Draft Decision to reject the October 2005 Undertaking. This Draft Decision was based on the view that the Commission could not be satisfied that the bundling provisions specified in the October 2005 Undertaking were consistent with the obligation imposed by s.152AR(3)(a) to supply the declared services to an access seeker on request.

The Commission was, however, satisfied that the terms and conditions specified in the October 2005 Undertaking were reasonable pursuant to s.152CBD(2)(b).

The Commission noted some minor concerns with the non-price terms and conditions relating to indemnities and liabilities, and the access provider's ability to change the terms of the DAA. The Commission also noted that it would prefer to have further information regarding the cost base that Foxtel has used in calculating the Installed Based Acquisition Cost ('IBAC') and the marketing costs to be included in future periods as part of its pricing methodology.

Notwithstanding these concerns, the Commission's draft view was that, on balance, it was satisfied that the terms and conditions specified in the October 2005 Undertaking were reasonable.

The Commission received one submission (from Seven Network Ltd) in response to the Commission's Draft Decision. This submission noted that Seven Network does not propose to provide any further submissions to the process and that it relies on its previous submission of 17 February 2006 in response to the Commission's Discussion Paper about the October 2005 Undertaking. Therefore, the Commission was not provided with any further views from interested parties other than those previously before it at the time of making its Draft Decision.

Having noted the Commission's concerns, Foxtel withdrew the October 2005 Undertaking on 1 December 2006 and lodged a revised SAU on that same date, prior to the Commission making its final decision on the October 2005 Undertaking. The revised SAU is the subject of this assessment process.



### 3. Legislation relevant to assessing access undertakings

This chapter sets out:

- A consideration of SAUs within the framework of Part XIC of the Act;
- the criteria the Commission is required to apply in assessing an undertaking; and
- the relevant procedural matters that apply to the Commission's assessment of an undertaking.

#### 3.1 Special access undertakings in the regulatory framework

##### 3.1.1 Purpose

In 2002, two new mechanisms were added to Part XIC of the Act<sup>8</sup>:

- Anticipatory exemption orders ('AEOs'); and
- SAUs.

The provisions of the Act relating to AEOs and SAUs were inserted by way of the *Telecommunications (Competition) Bill 2002 (Cth)*. It is clear from the Explanatory Memorandum to this Bill that Parliament's intention in inserting these sections was to give regulatory certainty to investors in telecommunications facilities as to the access obligations that would apply to them, should they undertake their proposed investment.

The Explanatory Memorandum stated at 16:

This option would extend the existing provisions in part XIC to enable the ACCC to grant exemptions and approve undertakings for services that are not yet declared or supplied. This would provide certainty for investors and thus encourage investment by allowing the ACCC to rule on whether a service should be exempt from declaration or whether the terms of a proposed undertaking are acceptable prior to the investment being made.<sup>9</sup>

The Explanatory memorandum notes in relation to SAUs:

As noted above, currently, potential investors in telecommunications services or infrastructure are unable to gain the certainty of an undertaking until the service that is proposed to be supplied becomes an active declared service. When the service becomes an active declared service, the standard access obligations apply to that service. This provides a disincentive for investment as it means potential access providers cannot obtain regulatory certainty as to the terms and conditions under which they would be required to provide access should the service be declared. In particular, where "risky investments" are

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<sup>8</sup> *Telecommunications (Competition) Act 2002 (Cth)*

<sup>9</sup> *Telecommunications (Competition) Bill 2002 (Cth)* Explanatory Memorandum, p. 16.

subject to potential declaration, the investment may be rendered uneconomic as a result of this uncertainty.<sup>10</sup>

The Explanatory Memorandum also noted:

The purpose of the proposed amendments is to provide certainty for potential investors in telecommunications infrastructure and services in relation to access to that infrastructure or service in the future by allowing the ACCC to rule on whether the terms of a proposed undertaking are acceptable prior to the investment being made.<sup>11</sup>

### 3.1.2 Differences between AEO and SAU

While AEOs and SAUs have a purpose in common, there are several significant differences between the test used in assessing whether to accept an AEO, and the test applied by the Commission in deciding whether to accept a SAU.

First, the AEO mechanism provides a means by which access providers may avoid the operation of the SAOs, while the SAU mechanism embraces the SAOs. This was clearly enunciated by the Tribunal in *Seven Network Limited (No 4) [2004] ACompT 11*:

Section 152ATA and s 152CBA cover quite different areas and each section starts from a different premise...the two provisions refer to, and contemplate, different scenarios and different propositions. Indeed, the statutory criteria that need to be satisfied in the two cases are quite different. In relation to an application under s. 152ATA the governing criterion is that the Tribunal must be satisfied that the exemption sought is in the long-term interests of end-users. In an application under s. 152CBA, there are different criteria to be satisfied that are set out in subs (2) of s. 152CBD...*The consequence of an application succeeding under s. 152ATA is that the standard access obligations are excluded either in whole or in part, whereas in an application under s. 152 CBA, the standard access obligations are embraced and other criteria, such as reasonableness, are applied to the access conditions.* [emphasis added]

Second, the test for granting an AEO is confined to consideration of the LTIE. By contrast, when the Commission assesses a SAU, it considers whether the terms and conditions of the SAU are reasonable. In considering whether particular terms and conditions are reasonable, the “reasonableness” test includes consideration of the LTIE, but extends beyond this to a range of factors outlined in s.152AH. Furthermore, s. 152AH(2) provides that the range of factors which the Commission may consider in applying the “reasonableness” test is not limited to those actually enumerated in s. 152AH(1).

Third, the Commission is restricted to either accepting or rejecting a SAU. This is in contrast to AEO’s, in respect of which the Commission may impose limitations or conditions.<sup>12</sup>

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<sup>10</sup> *ibid.*, p. 81.

<sup>11</sup> *ibid.*, p. 72.

<sup>12</sup> The Commission’s power to impose such limitations or conditions is contained in s.152ATA(4) of the Act.

## 3.2 Criteria for assessing an undertaking

Under s.152CBA of the Act a SAU can be lodged by a person who is, or expects to be, a carrier or a CSP, so long as the service is not an active declared service.

A service supplied by a person who has given the Commission a SAU and which the Commission has accepted, is a declared service under s.152AL(7) of the Act.<sup>13</sup> However, the Commission may still declare a service under s.152AL(8) even if the service is to any extent covered by a SAU.

Section 152CBD of the Act specifies that the Commission must not accept the SAU unless:

- the Commission is satisfied that the terms and conditions set out in the undertaking are consistent with the SAOs under s.152AR;
- the Commission is satisfied that the terms and conditions set out in the undertaking are reasonable;
- the Commission is satisfied that the undertaking is consistent with any Ministerial pricing determination; and
- the Commission has:
  - published the undertaking and invited people to make submissions to the Commission on the undertaking; and
  - considered any submissions that were received within the time limit specified by the Commission when it published the undertaking.

The approach of the Commission to assessing each of these matters is considered in turn below.

### 3.2.1 Consistency with SAOs

The SAOs are set out in s.152AR of the Act. Subject to class or individual exemptions made by the Commission, a carrier or CSP must comply with the SAOs in regard to declared services it supplies either to itself or to other persons.<sup>14</sup> In summary, if requested by a service provider, an access provider is required to:

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<sup>13</sup> Under Part XIC of the Act, the Commission may declare carriage services and related services to be declared services. Carriers and carriage service providers who provide declared services are required to comply with SAOs in relation to those services. The SAOs facilitate the supply of declared services by access providers to access seekers, in order that access seekers can provide carriage services and/or content services.

<sup>14</sup> Refer to ss.152AS and 152AT of the Act.

- supply an active declared service to the service provider in order that the service provider can provide carriage and/or content services;
- take all reasonable steps to ensure that the technical and operational quality of the service supplied to the service provider is equivalent to that which the access provider is supplying to itself;
- take all reasonable steps to ensure that the service provider receives, in relation to the active declared service supplied to the service provider, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself;
- permit interconnection of its facilities with the facilities of the service provider for the purpose of enabling the service provider to be supplied with active declared services in order that the service provider can provide carriage and/or content services;
- take all reasonable steps to ensure that the technical operational quality and timing of the interconnection is equivalent to that which the access provider provides to itself;
- if a standard is in force under section 384 of the *Telecommunications Act 1997*, take all reasonable steps to ensure that the interconnection complies with the standard;
- take all reasonable steps to ensure that the service provider receives interconnection fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself;
- provide particular billing information to the service provider; and
- supply additional services in circumstances where a declared service is supplied by means of conditional-access customer equipment.

The assessment of whether the Undertaking is consistent with the applicable SAOs is considered in Chapter 8 of this report.

The Commission will assess whether the terms and conditions provided by the Undertaking are consistent with the SAOs, as they would apply to Foxtel if the Digital Set Top Unit Service were an active declared service.

### **3.2.2 Terms and conditions are reasonable**

An important part of the access regime is the terms and conditions of access (including the price or a method for ascertaining the price). Under Part XIC of the Act, the Commission cannot accept an undertaking unless it is satisfied that the terms and conditions specified are reasonable. The Commission does not determine reasonableness in a vacuum. The terms and conditions are always referable to the objectives of Part XIC set out in section 152AB and the reasonableness criteria under

section 152AH.<sup>15</sup> In determining whether particular terms and conditions are reasonable, regard must be had to the following matters:

- whether the terms and conditions promote the LTIE;
- the legitimate business interests of the carrier or CSP concerned, and the carrier's or CSP's investment in facilities used to supply the declared service concerned;
- the interests of persons who have rights to use the declared service concerned;
- the direct costs of providing access to the declared service concerned;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and
- the economically efficient operation of a carriage service, a telecommunications network or a facility.<sup>16</sup>

This does not, by implication, limit the matters to which regard may be had.<sup>17</sup>

The Commission considers that in order to have 'regard' to particular matters, it is required to take those matters into account and give weight to them as fundamental elements in making its determination.<sup>18</sup>

The Commission notes that it is required to determine whether the terms and conditions are reasonable, not whether they are the best possible terms and conditions or whether they could be improved. This approach is supported by the Tribunal which noted in its decision in respect of *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006), that:

In this analysis we are limiting ourselves to asking whether Telstra's charge term and its cost allocation method is reasonable having regard to the statutory matters. We are not concerned to enquire whether any other price term or cost allocation method is more reasonable.<sup>19</sup>

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<sup>15</sup> *Optus Mobile Services [2006]* ACompT 8, 22 November 2006 at [19]

<sup>16</sup> Section 152AH(1) of the Act.

<sup>17</sup> Section 152AH(2) of the Act.

<sup>18</sup> In its decision in respect of *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006), the Tribunal stated, at paragraph [68] that 'when ss 152AH and 152AB require the Tribunal to have "regard" to certain matters, the Tribunal is required, in the words of Mason J, to take those matters into account and to give weight to them as fundamental elements in making its determination: *The Queen v Hunt; Ex parte Sean Investments Pty Ltd* (1979) 180 CLR 322 at 329. The Commission considers that these words are equally applicable to the Commission's decision in the first instance.

<sup>19</sup> *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006) at [150].

In respect of the price terms, the Commission notes the view expressed by the Tribunal in *Telstra's Line Sharing Service [2006] ACompT 4* (2 June 2006), that:

[A] charge above the efficient costs of supply would be unlikely to be reasonable. This proposition was not controversial.<sup>20</sup>

The Commission recognises that there is no one correct figure in determining reasonable costs as this will entail matters of judgement. The Commission's task is to determine if the submitting party's method or approach to calculating its costs is reasonable having regard to the statutory criteria set out in s.152AH and the objectives of s.152AB.

However, in coming to a decision on whether or not a price term is reasonable, the Commission must look at the means by which the price term was derived and to consider whether the method adopted was reasonable. This will require the Commission to consider the method by reference to the ss.152AH and 152AB.<sup>21</sup>

Against that background, the Commission believes that:

- it is the terms and conditions of the Undertaking as a whole that must be taken into account in assessing the reasonableness of the Undertaking; and
- any methodology or means used to establish or determine the terms and conditions must be considered against the matters set out in subsections 152AH(1) and 152AB(2).

Further, reasonableness is not determined by reference to what would exist if the undertaking was not accepted. In this sense, there is no "with and without" test in applying the reasonableness test.<sup>22</sup> It may be appropriate to apply the test to individual criteria or in specific circumstances, but ultimately, the reasonableness test is applied as a stand-alone test.

The *price* terms and conditions in the Undertaking are considered in Chapter 5, while the non-*price* terms are considered in Chapter 6. The reasonableness of the terms and conditions as a whole are then considered in Chapter 7.

Set out below is a summary of the key phrases and words used in the above matters. It should be noted that only some of the criteria have been judicially considered, and in other contexts. Accordingly, in taking these matters into account, it is necessary for the Commission to form its own view as to what they mean.

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<sup>20</sup> *Telstra's Line Sharing Service [2006] ACompT 4* (2 June 2006) at [69].

<sup>21</sup> *Telstra's Line Sharing Service [2006] ACompT 4*, 2 June 2006 at [63-64]

<sup>22</sup> *Optus Mobile Services [2006] ACompT 8*, 22 November 2006 at [93]

### ***Long-term interests of end-users ('LTIE')***

The term “long term interests of end-users” embodies three main objectives. These are discussed below. In relation to the terms that make up LTIE, the Australian Competition Tribunal has stated as follows.

Having regard to the legislation, as well as the guidance provided by the Explanatory Memorandum, it is necessary to take the following matters into account when applying the touchstone – the long-term interests of end-users:

End-users: “ end-users include the actual and potential (users of the service)

Interests: the interests of end-users lie in obtaining lower prices (than would otherwise be the case), increased quality of service and increased diversity and scope of product offerings. This would include access to innovations ... in a quicker timeframe that would otherwise be the case

Long-term: the long-term will be the period over which the full effects of the ... decisions will be felt. This means some years, being sufficient time for all players (being existing and potential competitors ... ) to adjust to the outcome, make investment decisions and implement growth - as well as entry and / or exit – strategies.<sup>23</sup>

The Commission has published a guideline explaining what it understands by the phrase ‘long-term interests of end-users’ in the context of its declaration responsibilities.<sup>24</sup> The Commission considers that a similar interpretation would seem to be appropriate in the context of assessing an access undertaking.

In the Commission’s view, particular terms and conditions promote the interests of end-users if they are likely to contribute towards the provision of goods and services at lower prices, higher quality, or towards the provision of greater diversity of goods and services.<sup>25</sup>

To consider the likely impact of particular terms and conditions, the Act requires the Commission to have regard to whether the terms and conditions are likely to result in the achievement of the following objectives:

- the objective of promoting competition in markets for carriage services and services supplied by means of carriage services;
- for carriage services involving communications between end-users, the objective of achieving any-to-any connectivity; and
- the objective of encouraging the economically efficient use of, and economically efficient investment in

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<sup>23</sup> *Seven Network Limited (No 4)* [2004] ACompT 11, 23 December 2004 at [120]

<sup>24</sup> ACCC, *Telecommunications services — Declaration Provisions: A Guide to the Declaration Provisions of Part XIC of the Trade Practices Act*, July 1999.

<sup>25</sup> *ibid.*, p. 32-33.

- the infrastructure by which listed carriage services are supplied; and
- any other infrastructure by which listed services are, or are likely to become, capable of being supplied.<sup>26</sup>

### *Promotion of competition*

In considering whether competition will be promoted in the markets for carriage services and services supplied by means of carriage services, ss.152AB(4) and 152AB(5) of the Act provide that:

(4) In determining the extent to which a particular thing is likely to result in the achievement of the objective referred to in paragraph (2)(c), regard must be had to the extent to which the thing will remove obstacles to end-users of listed services gaining access to listed services.

(5) Subsection (4) does not, by implication, limit the matters to which regard may be had.

Both Foxtel and Seven Network make reference to the interpretation adopted by the Tribunal in *Sydney International Airport [2000] ACompT 1* (1 March 2000) in discussing the concept of promotion of competition.<sup>27</sup> The Tribunal noted:

The [Australian Competition] Tribunal does not consider that the notion of “promoting” competition in s 44H(4)(a) requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of “promoting” competition in s 44H(4)(a) involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.<sup>28</sup>

However, the Commission notes that Foxtel appears to advocate a different interpretation in its Supplementary submission.<sup>29</sup>

The Commission has previously expressed the view that the key issue in determining whether a regulatory decision will promote competition is whether the decision will assist in establishing conditions by which an improvement in competition will be likely to occur. As noted above, this is also the approach used by the Tribunal in the context of Part IIIA of the Act. The Commission considers it appropriate to adopt this interpretation of promotion of competition for the purpose of assessing the reasonableness of the Undertaking.

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<sup>26</sup> Section 152AB(2) of the Act.

<sup>27</sup> Foxtel, *Submission to the Australian Competition and Consumer Commission, Foxtel Special Access Undertaking in support of the Undertaking*, 6 October 2005, p.64 and Seven Network, *Submission by Seven Network Limited in relation to Foxtel's special access undertaking in relation to Digital Set Top Unit Service*, p.3.

<sup>28</sup> *Sydney International Airport [2000] A CompT 1*, para. 106.

<sup>29</sup> Foxtel, *Supplementary Submission to the Australian Competition and Consumer Commission, FOXTEL Special Access Undertaking in support of the Undertaking*, 29 March 2006, p. 11.



An important benchmark in assessing whether competition will be promoted is the consistency of the proposed terms of access with the principle of non-discriminatory access between downstream suppliers of a service. Ultimately, a proposal for access must represent an opportunity for effective access by an access seeker to the particular service. An effective form of access should lead to the promotion of competition and contribute toward an efficient use of infrastructure.

*Economically efficient use of, and economically efficient investment, in infrastructure*

In the Commission's view, the phrase 'economically efficient use of, and economically efficient investment in ... infrastructure' requires an understanding of the concept of economic efficiency. This concept consists of three components:

- *Productive efficiency* – This is achieved where individual firms produce the goods and services that they offer at least cost;
- *Allocative efficiency* – This is achieved where the prices of resources reflect their underlying costs so that resources are then allocated to their highest valued uses (i.e. those that provided the greatest benefit relative to costs); and
- *Dynamic efficiency* – This reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.

The Tribunal in *Telstra's Line Sharing Service [2006] ACompT 4* (2 June 2006) noted that:

The inclusion of the term "economically" in s.152AH(1)(f) suggests that the concepts of allocative, productive and dynamic efficiency should be considered. Allocative efficiency will be best promoted where the price of a service reflects the underlying marginal cost of providing the service.<sup>30</sup>

Subsection 152AB(6) lists the matters the ACCC must have regard to in determining the extent to which the terms and conditions of an undertaking is likely to result in the achievement of this objective. These matters are:

- Whether it is, or likely to become, technically feasible for the services to be supplied and charged for, having regard to:
  - the technology that is in use, available or likely to become available; and
  - whether the costs that would be involved in supplying, and charging for, the services are reasonable or likely to become reasonable.

The Tribunal in *Telstra's Line Sharing Service [2006] ACompT 4* (2 June 2006) noted that:

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<sup>30</sup> *Telstra's Line Sharing Service [2006] ACompT 4*, 2 June 2006 at [94]

The inclusion of the term “economically” in s.152AH(1)(f) suggests that the concepts of allocative, productive and dynamic efficiency should be considered. Allocative efficiency will be best promoted where the price of a service reflects the underlying marginal cost of providing the service.<sup>31</sup>

Subsection 152AB(6) lists the matters the ACCC must have regard to in determining the extent to which the terms and conditions of an undertaking is likely to result in the achievement of this objective. These matters are:

- Whether it is, or likely to become, technically feasible for the services to be supplied and charged for, having regard to:
  - the technology that is in use, available or likely to become available; and
  - whether the costs that would be involved in supplying, and charging for, the services are reasonable or likely to become reasonable; and
  - the effects, or likely effects, that supplying, and charging for, the services would have on the operation or performance of telecommunications networks
- the legitimate commercial interests of the supplier or suppliers of the services, including the ability of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope;
- the incentives for investment in:<sup>32</sup>
  - the infrastructure by which the services are supplied; and
  - any other infrastructure by which the services are, or are likely to become, capable of being supplied.

The intention of these latter provisions is to:

“ensure that the incentives for investment in new infrastructure by which services under consideration may be supplied, and the risk of making such an investment, is one of the matters to which regard should be had”.<sup>33</sup>

The Commission will need to ensure that the access regime does not discourage investment in networks or network elements where such investment is efficient. The access regime also plays an important role in ensuring that existing infrastructure is

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<sup>31</sup> *Telstra’s Line Sharing Service* [2006] ACompT 4, 2 June 2006 at [94]

<sup>32</sup> Subsection 152AB(7A) was assented to the Act in September 2005 (Act No 119 of 2005). This section requires that the ACCC, in determining incentives for investment, must have regard to the risks involved in making the investment.

<sup>33</sup> *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, Explanatory Memorandum, p.7

used efficiently where it is inefficient to duplicate investment in existing networks or network elements.

(i) *The technical feasibility of supplying and charging for particular services*

This incorporates a number of elements, including the technology that is in use or available, the costs of supplying, and charging for, the services and the effects on the operation of telecommunications networks.

In many cases, the technical feasibility of supplying and charging for particular services given the current state of technology may be clear, particularly where there is a history of providing access. The question will be more difficult where there is no prior access, or where conditions have changed. Experience in other jurisdictions, taking account of relevant differences in technology or network configuration, will be helpful. Generally the Commission will look to an access provider to demonstrate that supply is not technically feasible.

(ii) *The legitimate commercial interests of the supplier or suppliers, including the ability of the supplier to exploit economies of scale and scope*

A supplier's legitimate commercial interests encompass its obligations to the owners of the firm, including the need to recover the cost of providing services and to earn a normal commercial return on the investment in infrastructure. The Commission considers that allowing for a normal commercial return on investment will provide an appropriate incentive for the access provider to maintain, improve and invest in the efficient provision of the service.

A significant issue relates to whether or not capacity should be made available to an access seeker. Where there is spare capacity within the network, not assigned to current or planned services, allocative efficiency would be promoted by obliging the owner to release capacity for competitors.

Paragraph 152AB(6)(b) also requires the Commission to have regard to whether the access arrangement may affect the owner's ability to realise economies of scale or scope. Economies of scale arise from a production process in which the average (or per unit) cost of production decreases as the firm's output increases. Economies of scope arise from a production process in which it is less costly in total for one firm to produce two (or more) products than it is for two (or more) firms to each separately produce each of the products.

Potential effects from access on economies of scope are likely to be greater than on economies of scale. A limit in the capacity available to the owner may constrain the number of services that the owner is able to provide using the infrastructure and thus prevent the realisation of economies of scope associated with the production of multiple services. In contrast, economies of scale may simply result from the use of the capacity of the network and be able to be realised regardless of whether that capacity is being used by the owner or by other carriers and service providers. Nonetheless, the

Commission will assess the effects of the supplier's ability to exploit both economies of scale and scope on a case-by-case basis.

*(iii) The impact on incentives for investment in infrastructure*

Firms should have the incentive to invest efficiently in infrastructure. Various aspects of efficiency have been discussed already. It is also important to note that while access regulation may have the potential to diminish incentives for some businesses to invest in infrastructure, it also ensures that investment is efficient and reduces the barriers to entry for other (competing) businesses or the barriers to expansion by competing businesses.

There is also a need to consider the effects of any expected disincentive to investment from anticipated increases in competition to determine the overall effect of declaration on the LTIE. The Commission will be careful to ensure that services are not declared where there is a risk that incentives to invest may be dampened, such that there is little subsequent benefit to end-users from the access arrangements.

*(iv) Other*

The ACCC is not limited to these matters in its assessment of the extent to which a particular undertaking is likely to achieve the objective of encouraging efficient use of infrastructure.<sup>34</sup>

***Legitimate business interests***

The Commission is of the view that the concept of legitimate business interests should be interpreted in a manner consistent with the phrase 'legitimate commercial interests' used elsewhere in Part XIC of the Act. Accordingly, it would cover the carrier/ CSP's interest in earning a normal commercial return on its investment.

This does not, however, extend to receiving compensation for loss of any 'above-normal' economic profits that occurs as a result of increased competition.<sup>35</sup> In this regard, the Explanatory Memorandum for the Trade Practices Amendment (Telecommunications) Bill 1996 states:

... the references here to the 'legitimate' business interests of the carrier or carriage service provider and to the 'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market.<sup>36</sup>

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<sup>34</sup> *Trade Practices Act*, ss.152AB(7)

<sup>35</sup> In its decision in respect of *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006), the Tribunal stated, at paragraph [136] that 'We do not consider that Telstra's legitimate business interests extend to it achieving a higher than normal commercial return.'

<sup>36</sup> Explanatory Memorandum for the *Trade Practices Amendment (Telecommunications) Bill 1996*, p. 44.

Furthermore, in its decision in respect of *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006), the Tribunal noted:

We consider that a carrier's legitimate business interests is a reference to what is regarded as allowable and appropriate in commercial or business terms. ... When looked at through the prism of a charge term and condition of access and its relationship to a carrier's cost structure, it is a reference to the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital.<sup>37</sup>

The Commission also views this criterion as requiring an assessment of the broader commercial interests of the carrier/CSP in conducting its own business affairs. A carrier/CSP, as an owner or controller of particular facilities, should not, simply because it is under an obligation to provide access to its service, be unduly compromised in the conduct of its own legitimate business interests. For instance, a carrier/CSP must have the right to make reasonable decisions about modifications and upgrades to its network or the right to set reasonable requirements for billing and the payment of accounts. Generally speaking, a carrier/CSP is entitled to have some legitimate control over its relationship with an access seeker to the extent reasonably required to protect its business concerns.

When considering the legitimate business interests of the carrier or CSP in question, the Commission may consider what is necessary to maintain those interests. This can provide a basis for assessing whether particular terms and conditions in the undertaking are necessary (or sufficient) to maintain those interests.

***Interests of persons who have rights to use the declared service***

Persons who have rights to use a declared service will, in general, use that service as an input to supply carriage services, or a service supplied by means of carriage services, to end-users. In the Commission's view, these persons have an interest in being able to compete for the custom of end-users on the basis of their relative merits. Terms and conditions that favour one or more service providers over others and thereby distort the competitive process may prevent this from occurring and consequently harm those interests.

In assessing the Undertaking, the Commission notes that there is no 'declared service' currently in existence and that SAUs in general apply to persons who are, or expect to be supplying a service that is not an active declared service. Section 152AH(1)(c) of the Act requires the Commission to have regard to the interests of persons who already have rights to use the declared service in question. The Commission is of the view that under s152AH, it may consider the interests both of persons who currently have rights to use the service that is the subject of the undertaking and the interests of persons who may wish to use the service in question in the event that that service is declared.

In respect of the interests of persons who may wish to use the service in question in the event that that service is declared, the Commission's focus is not on any one particular access seeker, but all potential access seekers who may seek to use the service.

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<sup>37</sup> *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006) at [89].

The Commission's approach is to recognise that simply because an access provider is the owner or controller of a facility and provider of the particular service, this does not mean that the provider can dictate the terms of access such that the form of proposed access does not represent a commercially feasible business model for the access seeker. This is about ensuring that the ability of an access seeker to compete in the supply of a service in a dependent market is based on the cost and quality of its service relative to its competitors, rather than about ensuring that an access seeker is able to conduct a profitable business. As noted above in terms of non-discriminatory treatment of downstream users, an access seeker should not be subject to overly onerous commercial terms simply because of its status as an access seeker.

On this basis, from a non-price perspective, the Commission would, for example, expect an access seeker to have reasonable rights in relation to proposed changes to a facility or service that affects its business interests or be given reasonable opportunity in relation to billing and credit matters, unjustified intrusion into the business affairs of the access seeker, suspension of services, and other facets of a business where its customer relationship may be impacted.

### ***Direct costs***

The Commission's Access Pricing Principles note that 'direct costs' are those costs necessarily incurred (caused by) the provision of access. As stated in the Explanatory Memorandum:

... 'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market.<sup>38</sup>

The Commission's Access Pricing Principles also note that this requires that the access price should not be inflated to recover any profits the access provider (or any other party) may lose in a dependent market as a result of the provision of access. In particular the Efficient Components Pricing Rule ('ECPR') may be inconsistent with this criteria.

Finally, the Commission's Access Pricing Principles notes that this criterion also implies that, at a minimum, an access price should cover the direct incremental costs incurred in providing access. It also implies that the access price should not exceed the 'stand-alone costs of providing the service', where this is defined to mean:

... costs an access provider will incur in producing a service assuming the access provider produced no other services.<sup>39</sup>

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<sup>38</sup> Explanatory Memorandum for the Trade *Practices Amendment (Telecommunications) Bill 1996*, p.44

<sup>39</sup> ACCC, *Access Pricing Principles – Telecommunications: A Guide*, July 1997, p. 10.

### ***Safe and reliable operation of a carriage service, a telecommunications network or a facility***

Similar to the criterion relating to the legitimate business interests of the carrier or CSP above, this criterion requires the Commission to take into account the need for the safe and reliable operation of a network or facility.

A carrier or CSP will generally seek to have in place operations and procedures designed to ensure the integrity of a network or facility is not harmed. Non-price terms and conditions such as these are considered necessary and essential to safeguard the business interests of both the carrier/CSP and access seeker, provided they are reasonable. In this regard, the Commission would be concerned to ensure that any non-price terms and conditions, purportedly in relation to the safe operation of a network, are not used as a barrier to effective access.

### ***Economically efficient operation of, and investment in, a carriage service***

In the Commission's view, the phrase 'economically efficient operation' embodies the concept of economic efficiency set out above. It would not appear to be limited to the operation of carriage services, networks and facilities by the carrier or CSP supplying the declared service, but would seem to include those operated by others (e.g. service providers using the declared service).

To consider this matter in the context of assessing an undertaking, the Commission may consider whether particular terms and conditions enable a carriage service, telecommunications network or facility to be operated in an efficient manner. This may involve, for example, examining whether they allow for the carrier or CSP supplying the declared service to recover the efficient costs of operating and maintaining the infrastructure used to supply the declared service under consideration.

In general, there is likely to be considerable overlap between the matters that the Commission takes into account in considering the LTIE and its consideration of this matter.<sup>40</sup>

### **3.2.3 Consistency with Ministerial pricing determination**

Division 6 of Part XIC provides that the Minister can make a written determination setting out principles dealing with price or a method of ascertaining price relating to the SAOs. Section 152CI(1) of the Act provides that if a provision of an access undertaking is inconsistent with any Ministerial pricing determination, the provision will have no effect to the extent of the inconsistency.

The Minister has not made a pricing determination in relation to the Digital Set Top Unit Service.

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<sup>40</sup> Relevantly, and as noted above, in considering whether particular terms and conditions will promote the LTIE, the Commission must have regard to their likely impact on the economically efficient use of, and the economically efficient investment in, the infrastructure by which listed carriage services are supplied and any other infrastructure by which listed services are, or are likely to become capable of being supplied.

### **3.2.4 Public process**

Sections 152CBD(2)(d)(i) and (ii) of the Act require the Commission to publish the Undertaking, invite submissions on it and consider any submissions that were received in response to it.

For the purposes of ss.152CBC(6)(a) and 152CBD(2)(d), the Undertaking was published by the Commission on the same date that the Commission's Discussion Paper in relation to the Undertaking was released, 15 December 2006.

This Discussion Paper focused on the amendments made in the Undertaking to the October 2005 Undertaking and provided the Commission's preliminary views on these amendments.

The Discussion paper noted that the Undertaking is substantially the same as the October 2005 Undertaking except that Foxtel has incorporated amendments designed to address the concerns of the Commission expressed in its Draft Decision to reject the October 2005 Undertaking.

In light of extensive work already undertaken in assessing the October 2005 Undertaking and in the making of the Draft Decision, the Discussion Paper also provided the Commission's preliminary views on whether to accept or reject the Undertaking. Nevertheless, the Discussion Paper sought interested parties' views on all aspects of the Undertaking and the supporting submissions.

In response to the Discussion Paper, the Commission received submissions from Foxtel and the Seven Network. These submissions were published on the Commission's website on 6 February 2007 and 13 February 2007, respectively.

The Commission has considered these submissions in deciding whether to accept or reject the Undertaking. The Commission has also taken into account all the submissions previously put forward by interested parties in the assessment of the October 2005 Undertaking in deciding whether to accept or reject the Undertaking.

A list of the submissions received is at Chapter 10 to this report. The Commission has considered these submissions in reaching its Final Decision.

## **3.3 Procedural matters**

### **3.3.1 Confidentiality**

The Commission recognises that the public consultation and its own decision-making process in relation to the undertaking should be as transparent as practicable. That said, the Commission is aware of the need to protect certain elements of a provider's information where disclosure of such information may harm that provider's legitimate commercial interests.

The Commission notes, however, that unless it can corroborate commercial-in-confidence information in some way, it is constrained in the weight that it can give to the information. Accordingly, in order to balance the possible harm to a provider from



the disclosure of sensitive information and the harm that interested parties may suffer if they are unable to comment on matters affecting their interests, the Commission considers that a more limited form of disclosure of the commercially sensitive information may be appropriate through the use of confidentiality undertakings.

This would allow the confidential information to be disclosed for the purposes of making submissions in this process, but at the same time preserve the confidentiality of the information. On this basis, interested parties should have an opportunity to access confidential information through the use of confidentiality undertakings.

In certain limited circumstances, in order to allow for confidential information to be independently corroborated, the Commission may supply the information to interested parties so as to allow its scrutiny. Conversely, there may be occasions where the Commission may decide that the disclosure of confidential information is not required.

### **3.3.2 Statutory decision making period**

The Commission has a six-month statutory time frame in which to make a decision to either accept or reject an access undertaking. If the Commission does not make a decision within this six-month statutory timeframe, s.152CBC(5) of the Act stipulates that:

... the Commission is taken to have made, at the end of that 6-month period, a decision under subsection (2) to accept the undertaking.

For the purpose of calculating the six-month time frame, certain periods of time are disregarded. Specifically, s.152CBC(6) of the Act states that in calculating the six-month timeframe, the Commission should disregard:

(a) if the Commission has published the undertaking under paragraph 152CBD(2)(d) – a day in the period:

(i) beginning on the date of publication; and

(ii) ending at the end of the time limit specified by the Commission when it published the undertaking; and

(b) if the Commission has requested further information under section 152CBB of the Act in relation to the undertaking – a day during any part of which the request, or any part of the request, remains unfulfilled.<sup>41</sup>

Notwithstanding the six-month time limit, and those days which are to be disregarded as outlined above, the Commission notes that section 152CBC(7) of the Act states that:

The Commission may, by written notice given to the carrier or provider, extend or further extend the 6-month period referred to in subsection (5), so long as:

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<sup>41</sup> In relation to information requests about the undertaking, section 152B(2) of the Act states that ‘the Commission may request the carrier or provider to give the Commission further information about the undertaking, while section 152BU(3) states that ‘the Commission may refuse to consider the undertaking until the carrier or provider gives the Commission the information’.

- (a) the extension or further extension is for a period of not more than 3 months; and
- (b) the notice includes a statement explaining why the Commission has been unable to make a decision on the undertaking within that 6-month period or that 6-month period as previously extended, as the case may be.

The decision-making period in relation to the Undertaking submitted by Foxtel is discussed below.

### **3.3.3 Calculating the decision-making period for the Undertaking**

The Commission received the Undertaking from Foxtel on 1 December 2006.

On 15 December 2006, the Commission released a Discussion Paper and called for submissions on the Undertaking. The closing date for submissions was 5 February 2007.

The Discussion paper noted that if, prior to the expiry of this period, the Commission makes a request of the access provider, under s.152CBB, for further information about the Undertaking, the period would be extended by the time taken for the request to be fulfilled.

Since that date, the Commission has not made any requests for further information under s.152CBB of the Act.

In the Commission's view, the Undertaking 'clock' was stopped during the consultation period being between the 15 December 2006 and 5 February 2007.

Accordingly, the six-month statutory time frame in which to the Commission must make a decision to either accept or reject the Undertaking is set to expire at 23 July 2007.

### **3.3.4 Use and disclosure of confidential information in this report**

In relation to this report, the Commission has relied upon commercially sensitive information supplied by Foxtel and interested parties in arriving at its final view. The Commission has assessed this sensitive information having regard to its policy on the treatment of information,<sup>42</sup> and where applicable, has determined that this information should not be reproduced in this report.

Accordingly, where information that is commercially sensitive has been relied upon in reaching a conclusion in this report, it has either been aggregated to a level such that it is no longer commercially sensitive or, where this is not possible, it has been masked with the designation [c-i-c]. Unless it is otherwise indicated, the information masked with [c-i-c] is information provided by Foxtel, or an interested party, over which it has made a confidentiality claim.

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<sup>42</sup> ACCC, *Collection and Use of Information*, 2000.

### **3.3.5 Documents examined by the Commission**

Under s.152CGA of the Act, where the Commission:

- makes a decision under s.152CBC(2) accepting or rejecting an access undertaking; and
- the Commission gives a person a written statement setting out the reasons for the decision

The Commission must specify the documents that the Commission examined in the course of making the decision.

In its assessment of the Undertaking, the Commission has relied upon the supporting submissions provided by Foxtel and the submissions provided by interested parties in response to the Discussion Paper. The Commission has also relied upon all the submissions previously put forward by Foxtel and interested parties in the assessment of the October 2005 Undertaking in deciding whether to accept or reject the Undertaking.

Further, the Commission has relied upon an expert consultancy report prepared for the Commission by Convergent Consulting. Public versions of these reports are available on the Commission's website at [www.accc.gov.au](http://www.accc.gov.au).

Where relevant, other documents relied upon by the Commission are referenced in the body of this report.

## **4. Summary of Foxtel's Undertaking**

This Chapter outlines the key terms of the Undertaking.

### **4.1 Structure of the Undertaking**

In clauses 2.1 and 2.2 of the Undertaking, Foxtel:

- agrees to be bound by the SAOs under s.152AR of the Act to the extent that those obligations would apply to Foxtel if the Digital Set Top Unit Service were treated as an active declared service; and
- undertakes to supply the Digital Set Top Unit Service on the terms and conditions specified in the DAA.

The Undertaking includes three appendices:

- Appendix 1 provides a service description of Foxtel's Digital Set Top Unit Service.
- Appendix 2 comprises the Foxtel DAA which sets out the price and non-price terms and conditions of access to its Digital Set Top Unit Service.
- Appendix 3 attaches a Confidentiality Deed which sets out the terms of any disclosure of confidential information between Foxtel and access seeker pursuant to the DAA.

The Undertaking also includes provisions relating to:

- commencement and duration (the Undertaking expires 8 years after it is accepted by the Commission);
- variation of the DAA;
- capacity for the supply of the Digital Set Top Unit Service to access seekers; and
- conditions precedent for Foxtel entering into a DAA with an access seeker.

### **4.2 Scope of the Undertaking: service description**

A person cannot provide a SAU under s.152CBA of the Act unless the person is, or expects to be, a carrier or a CSP supplying a listed carriage service or a service that facilitates the supply of such a service (and the service is not an active declared service). The SAU may be without limitation or may be subject to such limitations as are specified in the SAU (s.152CBA(5)). Under s.152AL(7), the service that is the subject of the SAU, is deemed to be a declared service. If the SAU is subject to limitations, the service is a declared service only to the extent to which the service falls within the scope of the limitations.

Foxtel's Undertaking is expressed to be in relation to the Digital Set Top Unit Service which is defined in Appendix 1 to the Undertaking as follows:

- (a) Set Top Unit Services which are the provision of services for the reception and decryption of signals for a digital Subscription Television Service and a Related Service in customer premises by means of CA Customer Equipment and Customer Cabling;
- (b) CA Services which consists of:
  - (i) CA Services which are the services that allow a service provider to determine the entitlement of customers to receive particular signals for a digital Subscription Television Service and a Related Service through CA Customer Equipment and Customer Cabling;
  - (ii) Service Information Service which is the processing of information necessary to be received by CA Customer Equipment which permits the reception of a digital Subscription Television Service and a Related Service;
  - (iii) Smartcard Authorisation Verification Information Services which is the provision of information necessary to enable a service provider to verify which of its digital Subscription Television Services and Related Services are enabled on a Smartcard;
- (c) EPG Services which consists of the incorporation of data relating to programs transmitted on a service provider's digital Subscription Television Service into an electronic program guide; and
- (d) Modem Services which consist of services using a modem integrated with CA Customer Equipment which enable a customer to send to the provider of the content a reaction of the customer to that content.

Clause 2.7 of the Undertaking specifies that the Undertaking is only in relation to the supply of the Digital Set Top Unit Service and is not an undertaking in relation to the supply of each component service.

This contrasts with Foxtel's approach in the October 2005 Undertaking in which it considered the service the subject of the SAU to be not only the bundled service (Digital Set Top Unit Service), but also each of the component services specified in the definition of Digital Set Top Unit Service.<sup>43</sup>

One further aspect of the Undertaking should be noted. Subsection 152CBA(5) provides that a SAU may be without limitations or may be subject to such limitations as are specified in the undertaking. Subsection 152AL(7) provides that if a person gives the Commission a SAU in relation to a service, then that service will become a declared service once the undertaking is in operation and the person commences supply of the service.

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<sup>43</sup> See Foxtel letter (24 April 2006) in response to a request for further information issued by the ACCC on 13 April 2006 and Foxtel Submission to Australian Competition & Consumer Commission, FOXTEL Special Access Undertaking, 1 December 2006, p.24-25

Subsection 152AL(7) goes on to provide that:

“... if the undertaking is subject to limitations, the service supplied by the person is a declared service only to the extent to which the service falls within the scope of the limitations.”

Clauses 4.1(c)(i), 4.1(f), 11.1(d) and 11.1(e) of the DAA provide that Foxtel is only obliged to supply the Digital Set Top Unit Service where the Digital Set Top Unit to which the Digital Set Top Unit Service is to be supplied is actually in use by a subscriber for the reception of Foxtel’s digital subscription television services.

However, Foxtel contends that the Undertaking is in respect of the service not only in relation to end users who are Foxtel subscribers, but also those end users who are currently not Foxtel subscribers. The Commission understands that Foxtel does not regard any of the above clauses as limitations upon the scope of the service for the purpose of subsections 152CBA(5) and 152AL(7).<sup>44</sup>

### 4.3 Digital Access Agreement (DAA)

Foxtel’s DAA sets out the price and non-price terms and conditions of access to Foxtel’s Digital Set Top Unit Service.

The DAA as part of the Undertaking is substantially the same as that which formed part of the October 2005 Undertaking, except that Foxtel has made a number of amendments designed to address the concerns of the Commission expressed in its Draft Decision to reject the October 2005 Undertaking. The changes to the DAA are outlined in Table 1 below.

**Table 1 - Changes to the October 2005 Undertaking DAA**

Issue	Amendments in the revised undertaking
Indemnities and liabilities	Clause 23.3 of the DAA has been amended to make exclusions of liability apply to both parties rather than just the access seeker.
Access provider’s ability to change the Digital Set Top Unit Service and terms of the DAA	<p>Clause 4.4(b) of the DAA has been amended to extend the required notice periods before a Change can be enacted (from 1 month to 2 months and from 3 months to 6 months in sub-clauses (b)(ii) and (iii) respectively).</p> <p>Clause 11.2(b) of the DAA has been amended to provide that reasonable prior notice of a Modification is not less than 1 month's notice.</p>
Charges for faults	Clause 6 in Schedule 2 of the DAA is amended to separately deal with faults caused and contributed by the access seeker and faults not caused and contributed by the access seeker so that where a Fault is notified by the access seeker and it is not caused nor contributed to by Foxtel or the access seeker, then the costs will be shared equally between Foxtel and the access seeker.

<sup>44</sup> Foxtel has not made explicit submissions to this effect. Therefore the Commission has assumed that Foxtel would interpret these provisions in the same way it interprets the ‘bundling’ provisions.

EPG	Clause 5.2 (e) in the DAA has been deleted to allow all subscribers to view the Access Seekers channels listing on Foxtel's EPG.
Pricing methodology	<p>Clause 2.6 has been inserted in the undertaking to provide that Foxtel will arrange for an independent review of:</p> <p>(a) the calculations made pursuant to the DAA used to prepare the Rate Card; and</p> <p>(b) the process undertaken by Foxtel management to identify and separate general marketing costs from channel specific and other specific marketing costs for the purposes of ascertaining the Defined Capital Expenditure in Schedule 3 of the DAA, after the first 12 months and thereafter every 3 years and will provide a copy of the report to the Commission.</p> <p>The definition of "Defined Capital Expenditure" in Schedule 3 of the DAA has been amended to exclude marketing devoted to a single Subscription Television Service on Foxtel's tier.</p> <p>Clause 3.5(c) of Schedule 3 to the DAA has been amended to exclude marketing solely devoted to a single Subscription Television Service on Foxtel on a tier from the marketing costs to be depreciated over 3 years.</p> <p>The cable and satellite IBAC costs pools have been updated in Schedule 3 of the DAA.</p>
Attributable costs categorisation	<p>The definition of Attributable Capex Costs in Schedule 3 of the DAA has been amended to specify that Attributable Capex Costs does not include the cost of:</p> <ul style="list-style-type: none"> <li>• any Required Network Enhancements paid by the Access Seeker pursuant to clause 9.1(ii)(B); or</li> <li>• any Satellite Enhancements paid by the Access Seeker pursuant to clause 9.2(g)(i).</li> </ul>
Confidentiality Deed	An appendix 3 has been added to the DAA to include a Confidentiality Deed to deal with the disclosure of confidential information between Foxtel and access seeker under the DAA.

The amendments to the terms and conditions relating to charges for fault repairs and EPG services were previously proposed by Foxtel in the context of the October 2005 Undertaking assessment process and considered by the Commission in reaching its Draft Decision.

#### **4.4 Non-price terms and conditions of access**

##### ***Bundled service***

Clause 2.7 of the Undertaking specifies that the Undertaking is only in relation to the Digital Set Top Unit Service (as a bundled service) and not the individual component services that comprise the service.

Clause 4.1(c)(ii) of the DAA provides that Foxtel is only obliged to supply Digital Set Top Unit Services to the Access Seeker 'as a total package and not as one or more component parts'.

### ***Restriction of provision of the Digital Set Top Unit Service to Foxtel homes***

Clause 4.1 of the DAA relevantly provides that:

- Foxtel is only obliged to supply and continue to supply the Digital Set Top Unit Service to the Access Seeker where the digital STU is actually in use by a Subscriber for reception of Foxtel's digital Subscription Television Services (or, in the case of services broadcast via satellite, expanded digital Subscription Television Services) (cl 4.1(c)(i)(A) and (c)(i)(B)) (see also clauses 4.1(c)(iii) and 4.1(e)); and
- Foxtel has no obligation to supply any of the Digital Set Top Unit Service to a location where the digital STU is not in use by a Subscriber for reception of Foxtel's digital Subscription Television Services (clause 4.1(f)).

Clauses 11.1(d) and (e) provide that the Access Seeker acknowledges and agrees that:

- the DAA does not limit Foxtel's rights to 'demand that the Subscriber return the Digital Subscriber Equipment, to remove any Digital Subscriber Equipment from Subscriber Premises or otherwise to deal with the Digital Subscriber Equipment, including upon that Subscriber ceasing to Subscribe to Foxtel's digital Subscription Television Service'; and
- Foxtel will have no liability to the Access Seeker if Foxtel exercises these rights.

However, this right is limited by clause 11.5 which provides that Foxtel:

- must not remove any Digital Subscriber Equipment from Subscriber Premises by reason solely of the fact that the Subscriber is receiving digital Subscription Television Services from the Access Seeker; and
- must give to the Access Seeker such notice as is reasonably practicable having regard to Foxtel's usual business practices of Foxtel's intention to remove a Digital STU from a Subscriber Premises.

As noted above, Foxtel does not regard clauses 4.1(c) and (f) of the DAA (the tying clauses) as a limitation on the Undertaking for the purpose of ss.152CBA(5) and 152AL(7) of the Act. On this interpretation, the deemed declared service pursuant to subsection 152AL(7) would be the Digital Set Top Unit Service to all end-users.<sup>45</sup>

If the Commission were to accept the Undertaking and an access dispute was notified under s.152CM in respect of Foxtel's Digital Set Top Unit Service, the Commission would be precluded by s.152CQ(5) from making an arbitration determination that was inconsistent with the Undertaking. The Commission understands that Foxtel would

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<sup>45</sup> This aspect of the Undertaking is discussed in more detail in Chapter 8.



considers that a determination could not oblige Foxtel to provide services or extend the facility to non-Foxtel homes.<sup>46</sup>

These provisions in the DAA, in effect, mean that Foxtel is not required to provide the Digital Set Top Unit Service unless there is a digital STU in use by a Foxtel subscriber. If that person ceases to be a Foxtel subscriber, Foxtel is not required to continue to supply the Digital Set Top Unit Service even if the subscriber wishes to continue to receive the access seeker's service. Given that Foxtel subscribers must take Foxtel's basic package to receive the Foxtel service and be provided with an STU, access seekers are only able to supply their services as a tiered channel to Foxtel's Basic Package.

### ***EPG Services***

Clauses 5 and 10 of the DAA include the terms and conditions of access to EPG Services for access seekers' channels. Foxtel's submission of 6 October 2005 states that EPG Services involve incorporating the access seeker's channel information into the Foxtel EPG. The terms and conditions specifying the provision of these services include matters relating to:

- the need for access seekers to provide certain information (eg date, time, title, classification and genre) in respect of all programming and channels to be included in the EPG, in specified formats and timeframes; and
- the ability of Foxtel to allocate an access seeker's listings in the EPG according to genre, at Foxtel's discretion.<sup>47</sup>

Foxtel states that the inclusion of the terms and conditions governing access to EPG Services in the DAA is intended to provide greater certainty for access seekers.

### ***Modem Services***

Clause 6 of the DAA relates to the supply of Modem Services. Modem Services are defined in Appendix 1 to the Undertaking and Part D of Schedule 1 to the DAA as a service which:

consists of services using a modem integrated with Conditional Access Customer Equipment which enable a customer to send to the provider of the content a reaction of the customer to that content.

Foxtel notes in its submission of 6 October 2005 that the Modem Services it will supply to an access seeker will comprise:

- access to the modem hardware installed within the Digital STU;

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<sup>46</sup> Section 152CP(2) of the Act provides that a determination may, for example, require a party to extend or enhance the capability of a facility by means on which the declared service is supplied.

<sup>47</sup> The procedures for allocation of EPG listings are outlined in Schedule 9 of the DAA.

- provision of specifications to enable access seekers to develop interactive applications specific to the channel or program being viewed;
- the ability of the Digital STU to download interactive applications through the cable or satellite ‘forward path’ from the access seeker to the subscriber; and
- the ability of the Digital STU to activate the modem to dial a number using the PSTN.<sup>48</sup>

Clause 6.3 of the DAA specifies that Foxtel’s obligation to provide Modem Services does not extend to the supply of return path services – access seekers will need to supply their own point of presence on the PSTN network to receive the customer's response from the Digital STU via the return path.

***Term of the DAA***

Clause 1.2 of the DAA allows the Access Seeker to elect a term of between 5 years and 8 years. Access seekers have the right to terminate the DAA on one month’s notice.<sup>49</sup> Foxtel does not have a similar right to terminate.

***Other non-price terms and conditions***

Other non-price terms and conditions include:

- Bank Guarantees (clauses 2 and 3)
- Maintenance and faults (clause 8) (as noted in Chapter 3 above, Foxtel, in a letter dated 29 March 2006 identified changes to clause 6 of Schedule 2 the DAA dealing with charges for faults)
- Ownership of Network Enhancements (clause 9.1(b))
- Operational Procedures (clauses 4.5, 4.7(d), 8.1(a) and 12(e))
- Access seeker equipment (clause 12)
- Subscriber contracts (clause 14.5)
- Liability to pay if any service interruption (clause 15.11)
- Payments – billing inquiries (clause 15.5(b))
- Payment – incorrect payment and retrospective charges (clauses 15.6 and 15.9)
- CPI provisions (clause 15.12)
- Use of confidential information (clause 16)

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<sup>48</sup> Foxtel submission, 6 October 2005, p.21.

<sup>49</sup> DAA clause 24.4(d).

- Privacy (clause 17)
- Defamation (clause 20.3)
- Indemnities and liability (clauses 22 and 23)
- Intellectual property (clause 18)
- Suspension and termination (clauses 24 and 25)
- Dispute resolution procedures (clause 27)

These terms and conditions are broadly similar to those contained in Foxtel's current operative s.87B undertaking.

#### **4.5 Price terms and conditions**

The Undertaking specifies the price terms and conditions under which Foxtel will supply the Digital Set Top Unit Service to access seekers. Schedule 3 of the DAA describes the pricing methodology by which Foxtel will calculate annual access charges payable by access seekers.

The Commission notes that Foxtel has proposed a *methodology* for calculating annual access prices, rather than a price list.

In its submission of 6 October 2005, Foxtel states that the price for the Digital Set Top Unit Service will be calculated by reference to the pricing methodology submitted in the context of the digital exemption application in 2002. Foxtel refers to two papers by NECG and attached to its submission which describe and explain the methodology.<sup>50</sup> Foxtel submits that the methodology proposed in that exemption application continues to be relevant to this Undertaking.

In this Undertaking, Foxtel has included in the service description of the Digital Set Top Unit Service two additional services – EPG Services and Modem Services. This inclusion impacts on Foxtel's cost base as part of its pricing methodology and is discussed in Attachment 1 to its submission of 6 October 2005.<sup>51</sup>

Foxtel contends that the methodology is based on a total service long-run incremental cost (TSLRIC) approach and is consistent with international practice.

A summary of Foxtel's pricing methodology to determine access charges is provided below.

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<sup>50</sup> Attachment 7: NECG, *Foxtel Explanatory Material in relation to STU Pricing. Part A: STU Access Pricing* dated 4 June 2002. Part B: *Access Pricing Model for Digital Cable and Satellite STUs: Description of cost based pricing methodology* dated 30 August 2002.

<sup>51</sup> Attachment 1: CRA International, *Adjusted access pricing model for digital STUs*, October 2005.

1. Foxtel will use a “building block” methodology to establish cost bases or “cost pools”. These four cost pools are:
  - Capex Pool – a pool of capital costs forecast to be incurred every year;
  - IBAC Pool – a pool of installed base acquisition costs;
  - Opex Pool – a pool of operations and maintenance costs forecast to be incurred every year; and
  - Overhead Pool – a pool of corporate overhead contribution costs forecast to be incurred every year.
2. Each of these cost pools will be annualised or spread over yearly periods.
3. The costs for each yearly period will be summed up to arrive at total annual costs for each period.
4. The total annual costs for each year will be allocated, when appropriate, among all users of the service (access seekers and Foxtel) and classified as specific costs, attributable costs, or shared costs.
5. Finally, the total annual costs will be translated into annual access charges. The annual access charge will be the sum of :
  - annual specific costs;
  - allocated annual attributable costs; and
  - allocated annual shared costs.

The access charge will be payable for each Subscription Television Service delivered by an access seeker using the Digital Set Top Unit Service.

Foxtel will calculate and produce an access seeker Rate Card specifying the access charge payable by the access seeker.

A detailed description of Foxtel’s pricing methodology is set out below.

### ***The Cost Pools***

#### ***Capex Pool***

The capex pool is composed of capital expenditure incurred by Foxtel in providing the Digital Set Top Unit Service to itself and to access seekers, and includes expenditure on Digital STUs, Smartcards, CA System, and SI system.<sup>52</sup>

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<sup>52</sup> Definitions of terms are set out in Schedule 10 of the DAA.

The capex forecasts for each year will be assigned to periods for recovery by annualising these costs over the economic life of the asset. All of the items in the capex pool are deemed to have an economic life of either 3 or 5 years.

Depreciation of assets will be calculated on a straight-line basis.

The annualised capex will be determined based on Foxtel's return on capital, asset base, and depreciation.

The return on capital will be calculated by Foxtel as a post-tax nominal return on capital and will be calculated from time to time but at least every three years. Foxtel's estimate of its return on capital in the first period is 13.975 per cent, based on certain assumptions.<sup>53</sup> The return on capital is estimated on the basis of a weighted average cost of capital ('WACC') framework, with the use of the capital asset pricing model ('CAPM') to determine the cost of equity.

### *IBAC Pool*

The installed base acquisition cost (IBAC) pool consists of Foxtel's costs of acquiring the installed analogue customer base which is migrated to the digital platform. In the October 2005 Undertaking, Foxtel included in the cost base an amount of \$280 million for Cable IBAC and \$115 million for Satellite IBAC. In the revised Undertaking, Foxtel updated these amounts to \$287.6 million for Cable IBAC and \$105.6 million for Satellite IBAC.<sup>54</sup>

In response to the Tribunal's concerns regarding the verification or audit of IBAC, Foxtel engaged PricewaterhouseCoopers ('PwC') to perform Agreed Upon Procedures in relation to the components of the IBAC Input Costs schedules.<sup>55</sup>

Recovery of IBAC will be smoothed over a ten-year period to produce a smoothed annual IBAC for each of the Cable IBAC and the Satellite IBAC. The smoothing will be based on distributing over a ten-year period the net present value of cable and satellite IBAC on the basis of forecast demand for cable and satellite STUs.

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<sup>53</sup> Foxtel's proposed parameter values are outlined in section 3.4 of Schedule 3. The Commission has a different estimate of Foxtel's WACC in the first period, which is 14.0%. (See discussion in section 5.2.4 of this paper.)

<sup>54</sup> CRA International, *Revised Cable and Satellite IBAC Estimates*

<sup>55</sup> See Attachments to Foxtel's Submission in support of the Undertaking: Attachment 8: PwC: Report on Cable IBAC Cost Schedules dated 13 July 2005 [confidential]; Attachment 9: PwC: Report on Satellite IBAC Cost Schedules dated 13 July 2005 [confidential]; Attachment 10: PwC: Independent Audit Report on the Schedule of Gross Capital Purchase Costs of Satellite Set Top Units (STUs) dated 13 July 2005 [confidential]; Attachment 11: PwC: Report on Gross Purchase Cost of Cable Set Top Units (STUs) dated 19 January 2001[confidential];

### *Opex Pool and Overhead Pool*

The opex pool is composed of operational expenditure incurred by Foxtel in providing the Digital Set Top Unit Service to itself and to access seekers. The overhead pool is composed of corporate overhead costs expressed as a percentage of the annual opex cost (and will be no less than 10.89 per cent<sup>56</sup> of annual opex cost.)

The annual opex cost forecast to be incurred in each year will be calculated.

### Total annual costs

The total annual cost in each year is the sum of:

- the annual capex cost;
- the annual IBAC cost;
- the annual opex cost; and
- the annual overhead cost.

In each year, Foxtel may recover from access seekers a proportion of the total annual costs.

### Allocation of total annual costs

Each of the components of the total annual costs will be categorised into three cost categories:

- annual specific costs;
- annual attributable costs; and
- annual shared costs.

### *Specific Costs*

Specific costs are actual costs (capital and/or operating expenditure) incurred by Foxtel as a result only of activity by a particular access seeker for the provision of access to that access seeker. Annual specific costs will be charged to the particular access seeker whose activity incurred those costs.

### *Attributable Costs*

Attributable costs are costs (capital and/or operating expenditure) incurred by Foxtel as a result of the provision of access to access seekers. Annual attributable costs will be

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<sup>56</sup> This percentage figure appears to be based on the historical cost proportion of Foxtel's corporate overhead costs to its operating expenses.

allocated equally across all access seekers independently of the number of channels used, revenue share or Ratings. If there are fewer than five access seekers, the maximum that can be charged to each access seeker is 20 per cent of the total attributable costs.

#### *Shared Costs*

Shared costs are costs (capital and/or operating expenditure) incurred by Foxtel for activity that benefits both the access seekers and Foxtel.

The majority of total costs, according to Foxtel, is expected to be shared costs.

Annual shared costs will be allocated based on both revenues and ratings.

#### Access Charges

The access charge will be the sum of annual specific costs, allocated annual attributable costs, and allocated annual shared costs. It will be payable for each Subscription Television Service delivered by an access seeker using the Digital Set Top Unit Service.

Foxtel will calculate and produce an access seeker Rate Card which specifies the access charges payable by access seekers. The Rate Card will be produced by Foxtel from time to time, but at least annually.

## **5. Assessment of price-related terms and conditions of the Undertaking**

The Commission is required to assess the reasonableness of the terms and conditions of the Undertaking. The Commission has, for the purposes of its analysis, divided the Undertaking into price terms and conditions and non-price terms and conditions. This chapter contains the Commission's consideration of the price terms and conditions set out in Foxtel's Undertaking, having regard to the matters set out in s.152AH of the Act. Chapter 6 contains the Commission's consideration of the non-price terms and conditions set out in the Undertaking.

This chapter includes an overview of the price terms and conditions specified in the Undertaking, and the Commission's consideration of the information and views provided by Foxtel and interested third parties with regard to the price terms and conditions.

The following discussion outlines the terms of the revised Undertaking proposed by Foxtel on 1 December 2006. When appropriate and for purposes of clarity, the discussion also refers to amendments that Foxtel has made to the October 2005 Undertaking.

### **5.1 Overview of the price terms and conditions**

The Undertaking specifies the price terms and conditions under which Foxtel will supply the Digital Set Top Unit Service to access seekers. Schedule 3 of the DAA describes the methodology by which Foxtel will calculate annual access charges it will charge access seekers.

In its submission in support of the October 2005 Undertaking, Foxtel proposed that the access charge for the Digital Set Top Unit Service will be calculated by reference to the costing methodology submitted in the context of its digital exemption application in 2002. The Commission notes three documents in relation to that application that are relevant to the current consideration of price terms and conditions in the Undertaking:

- *ACCC, Draft Decision (October 2003) – Section 151ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by FOXTEL Management Pty Limited*
- *ACCC, Final Decision (December 2003) – Section 151ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by FOXTEL Management Pty Limited*
- *Australian Competition Tribunal, Seven Network Limited (No 4) [2004] ACompT 11, 23 December 2004.*



Foxtel refers to two papers by NECG that are parts of Attachment 7 to its submission of 6 October 2005 and which describe and explain Foxtel's proposed pricing methodology:

- Attachment 7: NECG, *FOXTEL Explanatory Material in relation to STU Pricing, Part A: STU Access Pricing dated 4 June 2002*; and
- (same Attachment 7) *Part B: Access Pricing Model for Digital Cable and Satellite STUs: Description of cost based pricing methodology dated 30 August 2002*.

Foxtel submits that the pricing methodology proposed in its digital exemption application continues to be relevant to this Undertaking.

Foxtel contends that the methodology is based on a total service long-run incremental cost (TSLRIC) approach and is consistent with international practice.

In this Undertaking, Foxtel has included in the service description of the Digital Set Top Unit Service two additional services –EPG Services and Modem Services. This inclusion impacts on Foxtel's cost base that forms part of its pricing methodology and is discussed in Attachment 1 to Foxtel's submission of 6 October 2005.<sup>57</sup>

A summary of Foxtel's pricing methodology is contained in section 4.5.

## **5.2 Discussion and assessment of price terms and conditions**

The following sections contain the Commission's discussion and analysis of the price terms and conditions set out in the Undertaking. The discussion includes consideration of Foxtel's amendments to its October 2005 Undertaking that are now embodied in the revised Undertaking.

The Commission has conducted its consideration of the price terms and conditions having regard to the relevant legislative criteria in s.152AH(1) of the Act. The discussion also includes consideration of all the submissions made by Foxtel and interested parties in relation to particular price terms and conditions as part of the assessment of the October 2005 Undertaking. The Commission did not receive any submission in relation to price terms and conditions in response to the Discussion Paper.

While the Commission has considered all of the price terms and conditions of Foxtel's Undertaking, it considers the following matters as the key issues in its analysis of the Undertaking's price terms and conditions:

- the pricing methodology;
- the measurement and verification of the installed base acquisition cost;

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<sup>57</sup> Attachment 1: *CRA International, Adjusted access pricing model for digital STUs*, October 2005.

- the method of allocating shared costs; and
- the appropriate WACC for Foxtel.

### 5.2.1 Pricing methodology

#### *Foxtel's submission*

Foxtel proposes a methodology for estimating charges to access seekers using the Digital Set Top Unit Service based on the report by NECG in Attachment 7.<sup>58</sup> Foxtel proposed the same methodology when it applied for its digital exemption application in 2002.<sup>59</sup> Foxtel submits that the same methodology is relevant in this Undertaking.

With the introduction of Foxtel's digital services in March 2004, EPG services and Modem Services are now included in the Digital Set Top Unit Service and in the pricing methodology.

Foxtel's price terms and conditions propose a methodology by which annual access prices will be calculated, rather than a list or schedule of access prices. The calculated access prices will be presented in a Rate Card, and the Rate Card will specify the annual access charges payable by access seekers based on the access seeker's revenue or rating.

The methodology primarily involves a cost-based approach which allows Foxtel to recover the costs (capital, operating and some overhead) it incurs in supplying the Digital Set Top Unit Service, and including a return on investment in the digital subscription TV system commensurate with the risks being carried. The methodology involves aggregating cost pools, with costs categorised as either specific to an access seeker, attributable to an access seeker, or to be shared across all users of the service (including Foxtel). The majority of total costs, according to Foxtel, are expected to be shared costs.

The shared costs will be allocated among Foxtel and access seekers in proportion to the benefit derived by these parties. Revenue – either actual revenue or imputed revenue – is used to represent the benefit derived by each access seeker.

Foxtel submits that this methodology is based on a total service long-run incremental cost (TSLRIC) approach usually adopted by the Commission. Foxtel contends that this methodology is fair and ensures that access seekers contribute to the fixed costs of the access provider. It argues that TSLRIC pricing will ensure that Foxtel and access seekers will be able to compete fairly, with neither party required to subsidise the costs of the other party. Foxtel further argues that a TSLRIC methodology will ensure that

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<sup>58</sup> Attachment 7: NECG, *Part A: STU Access Charging*, 4 June 2002; *Part B: Access Pricing Model for Digital Cable and Satellite STUs: Description of cost based pricing methodology*, 30 August 2002.

<sup>59</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003

Foxtel's retail pricing is not altered unnecessarily, which may otherwise distort demand for pay-TV services.<sup>60</sup>

The methodology is described in detail in Schedule 3 of the proposed DAA.<sup>61</sup> It is also described in much greater detail in PwC's independent review report on Foxtel's Regulatory Accounting Procedures Manual ('RAPM') in Attachment 12.<sup>62</sup>

Foxtel also engaged PwC to audit Foxtel's Digital Access Pricing Model in order for PwC to form an opinion on whether the model is, in all material respects, prepared in accordance with the RAPM. PwC's audit report is attached as Attachment 13 to Foxtel's submission.<sup>63</sup> PwC's audit opinion states that the model has, in all material respects, been fairly prepared and presented in accordance with the Digital Rate Card RAPM for the first-year period representing the financial year ending 30 June 2004.

With the inclusion of EPG and Modem Services in the defined Digital Set Top Unit Service, Foxtel proposes that the costs of these additional services will be added to the appropriate pools of costs (capital expenditure, operating expense, or overhead) and allocated in the same manner (either specific, attributable, or shared cost) as the other costs of the Digital Set Top Unit Service under the same methodology. The Rate Card produced will accordingly reflect the costs of these two new services.

Regarding the allocation of the shared costs of these two additional services, CRA (on behalf of Foxtel) considers several alternative bases for cost allocation, including:

- interactive revenue and ratings approach;
- a charge per modem hit;
- a charge per channel; or
- a charge per application broadcast

for Modem Services, and

- total revenue and ratings approach; or
- a charge per channel

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<sup>60</sup> Foxtel submission, 6 October 2005, p. 46.

<sup>61</sup> Foxtel Special Access Undertaking, Appendix 2: Digital Access Agreement, Schedule 3: Access Charges and Pricing Methodology for Digital Set Top Unit Services, 6 October 2005.

<sup>62</sup> Attachment 12: PricewaterhouseCoopers, *Independent Review Report on Foxtel's Digital Rate Card Regulatory Accounting Procedures Manual*, 13 July 2005. (part confidential)

<sup>63</sup> Attachment 13: PricewaterhouseCoopers, *Independent Audit Report on Foxtel's Digital Access Pricing Model dated 13 May 2005, version 6, for the T1 period*, 13 July 2005. (part confidential)

for EPG services.

CRA concludes that bundling the costs of EPG and Modem Services with other Digital Set Top Unit Service shared costs and allocating these on the same basis of subscription revenue and ratings is the most appropriate cost allocation method.<sup>64</sup>

### ***Views of interested parties in response to the October 2005 Undertaking***

Ten Network submits that the pricing methodology proposed by Foxtel is ‘unnecessarily complicated’ and ‘lacking in transparency’. Ten Network contends moreover that the application of this pricing methodology will result in charges to an access seeker that are ‘difficult to ascertain with certainty’ and are ‘likely to be prohibitive’.<sup>65</sup> However, Ten Network did not elaborate on its views regarding the alleged complexity, lack of transparency or uncertainty in Foxtel’s proposed methodology.

In support of its view that Foxtel’s access charges are ‘likely to be prohibitive’, Ten Network submits that [c-i-c]. Therefore, Foxtel’s pricing methodology results in a significant barrier to entry for access seekers, Ten Network contends.

Seven Network submits that the pricing methodology is not reasonable because access seekers are charged for access to the Digital Set Top Unit Service but are not allowed to use all the facilities.<sup>66</sup> Seven discusses the access seeker’s lack of access to or use of the digital STU flash memory as an example. As access seekers do not have access to this memory (combined with lack of access to the constant forward feed path), Foxtel is able to offer a better service to its own subscribers because it can store on-demand videos on the flash memory while access seekers can not. Foxtel’s subscribers can therefore view Foxtel programs at a time of their choice, while subscribers of access seekers cannot do it as easily.

Seven Network appears to refer to one of the Excluded Services specified in Foxtel’s proposed DAA.<sup>67</sup> Seven contends that since an access seeker will be charged for access to the Foxtel STU, it should be entitled to access to all the functionality of the STU.

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<sup>64</sup> Attachment 1: CRA International, *Adjusted access pricing model for digital STUs, October 2005*, p. 18, 21.

<sup>65</sup> Network Ten Holdings Limited, *Foxtel special access undertaking in relation to the Digital Set Top Unit Service: submission by Ten Network Holdings Limited to the Australian Competition and Consumer Commission*, 21 February 2006., p. 7.

<sup>66</sup> Seven Network Limited, *Submission by Seven Network Limited in relation to Foxtel’s special access undertaking in relation to Digital Set Top Unit Service*, 14 February 2006. , section 8.2 at p. 34.

<sup>67</sup> Foxtel DAA, section 4.2 refers to services Foxtel has excluded from the Digital STU Service subject of this Undertaking such as call centre services, subscriber management, digital STU functionality including return path functionality, access to or use of the flash memory, content creation, marketing, etc.

### ***Foxtel's supplementary submission to the October 2005 Undertaking***

Foxtel submits that Ten Network did not provide any evidence to support its assertion that Foxtel's pricing methodology is unnecessarily complicated and lacking in transparency. Foxtel contends that the methodology is clearly set out in Schedule 3 of the DAA and is very transparent.<sup>68</sup>

Foxtel submits that it will publish from time to time, but at least annually, its access seeker Rate Card based on that methodology. The Rate Card will specify the annual access charges payable by access seekers based on the access seeker's revenue or rating.<sup>69</sup>

### ***Foxtel's submission to the revised Undertaking***

In its Draft Decision in relation to the pricing methodology proposed by Foxtel the Commission considered that, having regard to several factors, the use of a 'recovery of actual costs' methodology rather than a TSLRIC method would be appropriate. However, the Commission stated that:<sup>70</sup>

For the removal of doubt, if the Commission were to accept this Undertaking, the Commission would require that a periodic, independent audit of Foxtel's actual incurred costs should be conducted to determine if expenditures are necessary and if they are efficient.

Foxtel submits that such an audit is unnecessary, costly and problematic. In particular, Foxtel makes the following arguments against such an audit:

- There are several factors that are likely to constrain Foxtel from investing or spending inefficiently in respect of its network. These are:
  - continued competition from free-to-air television;
  - increasing competition from new technologies or platforms used to deliver entertainment content (such as broadband TV); and
  - the high likelihood that most of the pool of 'shared costs' will be shouldered by Foxtel and not allocated to access seekers.
- An audit would require a methodology that would compare Foxtel's actual costs with those of a hypothetical, efficient pay-TV network operator and there is no single way that this hypothetical network can be modelled.

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<sup>68</sup> Foxtel, supplementary submission, 29 March 2006, p. 25.

<sup>69</sup> Foxtel Special Access Undertaking, Appendix 2: Digital Access Agreement, Schedule 3: Access Charges and Pricing Methodology for Digital Set Top Unit Services, 6 October 2005, clause 1.

<sup>70</sup> ACCC, *Assessment of Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service – Draft Decision* August 2006, p. 49.

- The costs of such an audit are likely to be substantial and would have to be shared with access seekers.

Foxtel also responds to the Commission's views in its Draft Decision in relation to categorisation of costs of required network enhancements ('RNE'). The Commission stated that:<sup>71</sup>

In relation to cost categorisation by Foxtel, the Commission is concerned with the lack of clarity in terms of the method and objective basis by which Foxtel will categorise the costs of required network enhancement referred to in clause 9 of the DAA, and how these costs will be differentiated from 'attributable costs' category as part of Foxtel pricing methodology.

The Commission understands that under Foxtel's proposed pricing methodology, an access seeker should face costs that are properly categorised and without duplication. However, Foxtel may want to clarify the basis upon which network enhancement costs will be categorised – in particular, whether any of these could be 'attributable costs' and, if so, how they will be distinguished from this cost category.

Foxtel submits that:

- an RNE is different from an attributable cost in that an RNE involves an upfront and one-off modification to Foxtel's network to enable an access seeker to have access and Foxtel requires an upfront payment from the access seeker for the RNE;
- if an RNE is already paid for, it will not be classified as an attributable cost and, therefore, there will be no double counting. To make this clear, Foxtel has amended the definition of "attributable capex costs" in Schedule 3 of the DAA.
- [c-i-c]

In relation to the periodic review of the Rate Card, Foxtel has included a new clause 2.6 in its Undertaking to specify an independent review of the Rate Card after the first year and every three years thereafter.

### ***The Commission's view***

The Commission accepts Foxtel's submission in regard to its pricing methodology to determine its charges for access to the Digital Set Top Unit Service.

The proposed pricing methodology is based on TSLRIC and enables Foxtel to recover the costs it incurs in providing the service, including the return of capital and a reasonable return on capital.

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<sup>71</sup> ACCC, *Assessment of Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service – Draft Decision*, August 2006, p. 50.

As the Commission discussed in its Access Pricing Principles,<sup>72</sup> TSLRIC is the incremental or additional cost the firm incurs in the long term in providing a service, assuming all of its other production activities remain unchanged. It is the cost the firm would avoid in the long term if it ceased to provide a service. The TSLRIC of supplying a service is the sum of the operating and maintenance costs and the capital costs (including depreciation and the cost of capital) that the firm incurs in providing the service.

The Commission accepted Foxtel's pricing methodology in approving Foxtel's digital exemption application in 2003. In that decision, the Commission considered that a TSLRIC-type approach as proposed by Foxtel for the pricing of the STU Service was justified.<sup>73</sup>

Similarly, the Tribunal took the view that 'in the general case where access prices need to be regulated, unless pricing is on a TSLRIC basis, efficient investment is unlikely to be encouraged'.<sup>74</sup> The Tribunal was 'generally satisfied with the pricing methodology (including cost allocation) adopted by Foxtel, as modified by the Commission'.<sup>75</sup>

TSLRIC is based on forward-looking costs, which are ongoing costs of providing the service in the future using the most efficient means possible and commercially available. This usually means basing costs on the best technology in commercial use and valuing inputs using current prices.

In cases where the service is well developed in the market and necessary for competition in dependent markets, and where the forces of competition do not work well to constrain prices to efficient levels, TSLRIC pricing is appropriate and desirable.

The Commission has used TSLRIC to price declared services, such as the domestic PSTN originating and terminating access services and the unconditioned local loop service ('ULLS'). For such services, the Commission considered TSLRIC appropriate because an access price based on TSLRIC would usually best promote the LTIE. TSLRIC pricing would, among other things:

- promote efficient entry and exit in dependent markets since prices are based on long-term costs;
- encourage economically efficient investment in infrastructure by providing for a normal commercial return on efficient investments in infrastructure; and

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<sup>72</sup> Australian Competition and Consumer Commission, *Access Pricing Principles: Telecommunications – A Guide*, July 1997.

<sup>73</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003.

<sup>74</sup> *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) at [136].

<sup>75</sup> *ibid.*, at [326].

- allow efficient access providers to fully recover the costs of producing the service, and promote the legitimate business interests of the access provider.<sup>76</sup>

In light of the above likely effects of TSLRIC-based access prices, and the view of the Tribunal as noted above, the Commission considers that the TSLRIC methodology is the preferred pricing principle to be applied to access pricing issues whenever it is appropriate to do so.

It may be argued whether Foxtel's proposed pricing methodology conforms in all aspects with a TSLRIC methodology as described above. The Commission notes that Foxtel's proposed methodology would result in access prices based on costs, and that Foxtel would be allowed to recover the costs (operating, capital, and some common costs) incurred in providing the service, plus a normal return on capital. Therefore, the methodology leads to efficient access prices. However, it may be contended that the methodology:

- utilises actual costs,<sup>77</sup> not forward looking costs, and Foxtel may not have the incentive to minimise its costs or to invest efficiently;
- is not based on a hypothetical efficient network or optimised pay TV network, and therefore unlikely to calculate efficiently-incurred costs; and
- does not involve best-in-use technology but merely assumes Foxtel's actual chosen technology.

For the purposes of this Undertaking, the Commission considers that Foxtel's proposed pricing methodology is acceptable, whilst recognising the question over whether Foxtel's actual costs are efficient costs. The Commission's view is guided by the following considerations taken all together:

- Foxtel's prices will be cost-based, and the firm will be allowed to recover its costs including a normal return on capital. The methodology therefore gives regard to the legitimate business interests of the service provider and its investment in the facilities used to supply the service. Further, it gives regard to the direct costs of providing access to the services.
- Foxtel commenced providing its digital retail pay TV service in March 2004. The roll out of digital services is expected to occur over three years. Therefore, actual historic costs are costs that have been recently incurred. It is likely that these recently incurred costs closely approximate the replacement costs of modern

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<sup>76</sup> ACCC, *Access Pricing Principles – Telecommunications, A Guide*, July 1997. p. 28-30.

<sup>77</sup> That is, costs are forecast for a ten-year period. At the end of each year, the difference between the amount of costs forecast and actually incurred will be calculated. This difference will be used to adjust the following year's opening balance of unrecovered costs. Effectively, over time, Foxtel will recover actually-incurred costs. (Foxtel, Schedule 3 to DAA, p 66).



equivalent assets. This satisfies a significant requirement of the TSLRIC methodology, which is the use of forward-looking, efficient costs.

- The Commission recognises that the informational requirements for a TSLRIC model of a digital pay TV network would be immense, time-consuming and costly. A pricing methodology largely based on TSLRIC (albeit not satisfying strictly all the requirements and definitions of TSLRIC) is a second-best alternative in this circumstance.
- The Commission understands that the domestic pay TV sector including Foxtel has incurred large financial losses since the launch of pay TV services. In submissions to the Commission in the course of the digital exemption application in 2002, Foxtel claimed that:

To date, \$8 billion has been invested in the industry and none of the subscription television operators have reached profitability. All operators (Foxtel, Optus and Austar) have made, and continue to make, substantial losses. Foxtel, for example, has made an aggregate loss of approximately \$1 billion, including approximately \$100 million last year...<sup>78</sup>

The Commission understands that these losses were likely due to expensive contract prices for the supply of pay TV content and the lower than expected take-up of pay TV by retail subscribers. Given these accumulated losses by Foxtel, the Commission believes that, in digitising its network, Foxtel has no incentive to overspend on its network and has every incentive to minimise its costs. This would have the benefit of conserving its cash flows and in shortening its payback period as much as possible (i.e. from a negative accumulated cash position to a positive accumulated cash position).

The recent announcement by Foxtel of its first profit after a decade of operation more likely refers to accounting profit, and the Commission does not believe that it means Foxtel has achieved a turn-around into a positive return on investment or positive cash flows. Thus, the incentive to minimise costs is likely to remain.

- The majority of Foxtel's actual costs (capex and opex) are expected to be in the pool of shared costs. The pool of specific and attributable costs is expected to be relatively small. Further, the Commission expects that Foxtel's access services would not necessarily be sought by many access seekers, unlike access services in telecommunications such as PSTN origination/termination or ULLS. These two factors imply that the majority of shared costs are likely to be shouldered by Foxtel and would not be allocated to access seekers. Foxtel therefore has the incentive to minimise costs and to find the least-cost way of supplying digital subscription television services.

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<sup>78</sup> *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) at [207].

- The Commission accepted Foxtel's s. 87B undertaking in 2002, and that undertaking remains operative until 31 December 2015. Under this currently proposed Undertaking, Foxtel has proposed the same pricing methodology. If the Commission were to accept this Undertaking, it would be difficult not to accept the same methodology while the s. 87B undertaking remains operative. If the Commission does otherwise, the two undertakings, which refer to essentially the same service, would be inconsistent. And secondly, the Tribunal review decision, which found the pricing methodology adopted by Foxtel as modified by the Commission acceptable, cannot be ignored by the Commission.

In light of the above considerations taken all together, the Commission takes the view that the use of actual costs in Foxtel's pricing methodology in this Undertaking is acceptable.

In relation to the addition of EPG and Modem Services in the defined Digital Set Top Unit Service, the Commission considers acceptable the consequent addition of their relevant costs in the four pools of costs, and the allocation of their shared costs in the same manner as all other shared costs are allocated (i.e. on a revenue or ratings basis). If the shared costs of EPG and Modem Services were allocated on a basis different from the revenue or ratings basis, there are likely to be difficulties<sup>79</sup> with regard to the alternative measures (charge per channel, or charge per modem hit, etc.) that could represent the benefit gained by the access seeker. Further, a different allocation basis for EPG and modem shared costs is likely to add unnecessary complexity to Foxtel's proposed pricing methodology. The Commission therefore takes the view that there is no sufficient justification to treat the costs of provision of EPG and Modem Services differently if these services are provided as part of the Digital Set Top Unit Service.

With regard to Seven Network's submission that since the access seeker will be charged for access to the Foxtel STU, it should have access to the entire STU, the Commission notes that Foxtel has excluded certain services in defining the Digital Set Top Unit Service it offers pursuant to the Undertaking.<sup>80</sup> The Commission inquired with Foxtel that it seems reasonable to expect that access seekers should not share in the costs associated with the excluded services as the access seekers do not acquire any benefit from the absence of these services. Foxtel confirmed with the Commission that the costs associated with these excluded services are excluded from the base of shared costs that are used to calculate the Rate Card for access seekers.<sup>81</sup>

Whether it is reasonable to exclude certain services from the Digital Set Top Unit Service is a separate question. This matter is discussed as part of the Commission's assessment of non-price terms and conditions.

In relation to cost categorisation of RNEs by Foxtel, the Commission accepts Foxtel's

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<sup>79</sup> Such as measurement problems or lack of economic justification

<sup>80</sup> Foxtel, Appendix 2 Digital Access Agreement, section 4.2.

<sup>81</sup> Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 8.

submission that RNEs will be distinguished from attributable costs and there will be no double charging to access seekers of RNE costs. The Commission notes that Foxtel has amended the definition of 'attributable capex costs' in Schedule 3 of the DAA to exclude RNEs and satellite network enhancements.

The Commission notes Foxtel's arguments in relation to the difficulties involved in undertaking an audit to properly assess the prudence and efficiency of Foxtel's actual incurred costs as part of its access pricing methodology. However, Foxtel has included a new clause 2.6 in its Undertaking to give effect to Foxtel's commitment to arrange for an independent review of its Rate Card calculations. This is likely to provide greater confidence to the Commission and access seekers that Foxtel is calculating its Rate Card in accordance with the pricing methodology.

Specific prices for individual access seekers calculated using Foxtel's pricing methodology will obviously vary depending on variables such as share of ratings and other factors.

However, by way of example, Foxtel's proposed approach, using assumptions drawn from Foxtel's submission entitled 'MK1 to the statement of Michelle Kvello'<sup>82</sup> would have resulted in the following indicative cable access seeker charges for 2004:

- Approximately \$300,000 for an access seeker channel with a 1 per cent share of ratings assuming the access seeker's share of revenue was 1 per cent or less of Foxtel's actual subscription revenue<sup>83</sup> – equivalent to the ratings achieved by National Geographic or Fox Footy in total pay TV households during 2004;<sup>84</sup> and
- Approximately \$700,000 for an access seeker channel with a 2 per cent share of ratings assuming the access seeker's share of revenue was 2 per cent or less of Foxtel's actual subscription revenue<sup>85</sup> – equivalent to the ratings achieved by Showtime or UKTV in total pay TV households during 2004.<sup>86</sup>

In 2004, the large majority of pay TV channels had shares of viewing less than 2.0 per cent.<sup>87</sup>

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<sup>82</sup> Attachments to Foxtel confidential supporting submission of 1 December 2006: A statement of Michelle Kvello and MK1 to the statement of Michelle Kvello and CRA International, *Revised Cable and Satellite IBAC Estimates*

<sup>83</sup> MK to the statement of Michelle Kvello, p.1.

<sup>84</sup> Australian Film Commission << <http://www.afc.gov.au/gtp/wptvtopptv.html>>>

<sup>85</sup> MK to the statement of Michelle Kvello, p.1.

<sup>86</sup> Australian Film Commission << <http://www.afc.gov.au/gtp/wptvtopptv.html>>>

<sup>87</sup> *ibid.*

## 5.2.2 Installed base acquisition costs

### *Foxtel's submission*

The IBAC pool consists of Foxtel's costs of acquiring the installed analogue customer base that is migrated to the digital platform.

Foxtel argues that these are costs associated with developing Foxtel's analogue pay-TV subscriber base that were not recovered or will not be recovered prior to the termination of the analogue pay-TV business. According to Foxtel, these costs represent the minimum amount that a digital subscription television business would need to pay the analogue business to purchase its subscriber base to make the analogue subscription business willing to cease operations.

In a report by NECG attached to Foxtel's submission, NECG argues that:

The installed base that FOXTEL will make available to itself and to access seekers will in part be inherited from the current analogue network. This installed base has been acquired by making substantial, currently unrecovered, outlays in customer acquisition and management. These costs are now sunk. ...

From an economic point of view the costs associated with the new service's opening base of installed premises are a shared cost between the analogue and digital services. ... It is appropriate for these costs, in so far as they have not already been recouped, to be recovered from the digital services.<sup>88</sup>

NECG justifies the recovery of these unrecovered costs by arguing that:<sup>89</sup>

- it is consistent with economically efficient pricing, as costs are recovered over time in line with associated revenues
- not allowing full recovery of these unrecovered amounts would have harmful effects on efficiency and investment
- it is consistent with competitive neutrality, as only 'non-Foxtel brand' related expenses will be claimed by Foxtel as part of IBAC
- it is consistent with the expectations that would characterise a properly constructed contestable counterfactual.

NECG presents the counterfactual as a case of the owner of a hypothetical analogue-only network that would not have accepted to stop operating and to transfer its installed customer base to the owner of a hypothetical digital-only network, unless it is paid an amount no less than the present value of unrecouped expenses for expanding its platform to current size.

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<sup>88</sup> NECG, *Foxtel explanatory material in relation to STU pricing, Part A: STU Access Pricing*, 4 June 2002, p. 5.

<sup>89</sup> *ibid.*, p. 5-9.

The IBAC amounts that Foxtel submitted for the October 2005 Undertaking consist of an amount of \$280 million for cable TV and \$115 million for satellite TV,<sup>90</sup> or a sum of \$395 million. These were the same IBAC amounts as those included in Foxtel's digital access exemption application and accepted by the Commission in 2003.

In the revised Undertaking, Foxtel has updated these amounts to \$287.6 million for cable TV and \$105.6 million for satellite TV, based on new estimates by its consultant.<sup>91</sup> The updated total IBAC is \$393.2 million.

For cable TV, Foxtel initially estimated an IBAC amount of \$858 million, consisting mainly of installation costs (net of installation revenues), sales and marketing allocated costs, service calls and other common costs. Foxtel argued that all the costs of Foxtel's analogue phase are relevant costs to the digital environment and should be included in the digital cost base. However, in the assessment of Foxtel's digital exemption application, the Commission disallowed Foxtel's claim for certain costs incurred in the analogue phase. In its decision, the Commission stated that:

The Commission does not accept the proposition that all these costs should be included in the IBAC. In particular, the capital costs of the STUs and smartcards are not relevant cost items in a digital environment. Fundamentally, NECG's in-principle approach appears to be a departure from a standard access pricing approach, where the relevant asset base is that which reflects costs that would be incurred by an efficient entrant. The costs the hypothetical digital STU provider incurs to generate a customer base are those costs related to customer acquisition, as well as the capital costs of new digital STUs and smartcards. A new entrant that only provided digital services would still have to incur the costs of developing a subscriber base, but would not require expenditure on obsolete STUs.<sup>92</sup>

The end result of the Commission's methodology for assessing the cable-TV IBAC was to reduce the IBAC amount claimed by Foxtel from \$858 million to \$280 million. This lower amount is the cable-TV IBAC Foxtel similarly submitted for the October 2005 Undertaking.<sup>93</sup> There were no adjustments made to the satellite-TV IBAC claimed by Foxtel as digital satellite TV services have been supplied to Foxtel subscribers since 1999.

The cable-TV IBAC mainly comprises [c-i-c], whilst the satellite-TV IBAC consists primarily of [c-i-c].

Recovery of IBAC will be smoothed over a ten-year period to produce a smoothed annual IBAC amount for both the cable and satellite IBAC. The smoothing of IBAC basically involves calculating the net present value of IBAC with a discount factor equal to Foxtel's WACC. The IBAC net present value will then be distributed over the

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<sup>90</sup> Foxtel submission, 6 October 2005, p. 46-7.

<sup>91</sup> CRA International, *Revised Cable and Satellite IBAC Estimates*, p. 4.

<sup>92</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 52-3.

<sup>93</sup> Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 4-6.

ten-year forecast period based on forecast demand each year for digital STUs. There are separate forecasts for demand for cable STUs and satellite STUs.<sup>94</sup>

To support its Undertaking and to address the Tribunal's statement in 2004 that 'more rigorous verification of the inputs [*of the pricing methodology*] (including the IBAC costs and any recovery thereof would be appropriate',<sup>95</sup> Foxtel engaged PwC to perform audit or audit-related services in relation to components of IBAC costs. The following PwC reports, and the type of service PwC conducted, are:<sup>96</sup>

- Cable IBAC cost schedules – Agreed Upon Procedures
- Gross capital purchase cost of cable STUs – Audit
- Other costs related to cable STUs – Agreed Upon Procedures
- Satellite IBAC cost schedules – Agreed Upon Procedures
- Gross capital purchase cost of satellite STUs – Audit.

Foxtel explains that PwC, in undertaking the Agreed Upon Procedures, referred to Foxtel's audited accounts and reconciled the IBAC costs with these accounts. On this basis, Foxtel submits that the Agreed Upon Procedures reports are sufficient. It submits that a 'full audit of the costs by looking at the underlying records would have caused unjustifiable expense and delay'.<sup>97</sup>

In relation to sales and marketing costs included in the IBAC, Foxtel notes that the Tribunal accepted the inclusion of the IBAC in the cost base, provided Foxtel-specific marketing costs were excluded. In its proposed Undertaking, Foxtel submits that the IBAC costs do not include Foxtel-brand marketing costs but only sales and marketing acquisition costs and retention marketing costs.<sup>98</sup> Further, Foxtel submits that non-branded marketing makes up 68 per cent of all marketing costs. To support these claims, Foxtel engaged PwC (as mentioned above) during 2005 to perform Agreed Upon Procedures covering various cost schedules, including sales and marketing costs.

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<sup>94</sup> Foxtel Special Access Undertaking, Appendix 2: Digital Access Agreement, Schedule 3: Access Charges and Pricing Methodology for Digital Set Top Unit Services, 6 October 2005, p 69-70.

<sup>95</sup> *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) at [326].

<sup>96</sup> See attachments to Foxtel's Submission, Attachment 8: PwC: *Report on Cable IBAC Cost Schedules* dated 13 July 2005; Attachment 9: PwC: *Report on Satellite IBAC Cost Schedules* dated 13 July 2005; Attachment 10: PwC: *Independent Audit Report on the Schedule of Gross Capital Purchase Costs of Satellite Set Top Units* dated 13 July 2005; Attachment 11: PwC: *Report on Gross Purchase Cost of Cable Set Top Units* dated 19 January 2001.

<sup>97</sup> Foxtel submission, 6 October 2005, p. 47.

<sup>98</sup> Foxtel submission, 6 October 2005, p. 47.

### *Views of interested parties in response to the October 2005 Undertaking*

Seven Network submits that Foxtel has failed in its verification of IBAC costs to sufficiently address the Tribunal's concerns. The Commission notes that Seven Network appears to refer to the engagement of PwC by Foxtel during 2005 to conduct 'Agreed Upon Procedures' only – and not an audit as the Tribunal stated – on cable and satellite IBAC. Seven Network argues that:

the extent to which the Commission or any other interested party could rely on the purported verification process is questionable. The Tribunal expressly stated that it "would have been more comfortable if the IBAC costs had been supported by audited accounts". FOXTEL has submitted reports from various personnel at PricewaterhouseCoopers (PwC) in respect of the costs that it wishes to include in the access pricing. These reports, however, are of limited value.<sup>99</sup>

Seven Network claims that the failure of Foxtel's verification exercise calls into question all of the costs that Foxtel seeks to claim.

In relation to marketing costs, Seven Network submits that Foxtel has failed to address the Tribunal's concern that Foxtel-specific marketing costs be excluded from the IBAC. Seven argues that, whilst it has not had access to the underlying documents that support Foxtel's IBAC estimates, on the face of available documents Seven Network has identified errors including:

- the inclusion of Foxtel-specific marketing costs in the IBAC; and
- the inclusion of Foxtel-specific marketing costs in the ongoing costs to be allocated to access seekers.

In relation to the first point – the inclusion of Foxtel-specific marketing costs in the IBAC – Seven Network argues that PwC did not actually verify the basis for the inclusion of 68 per cent of Foxtel's total marketing costs in the IBAC. Seven Network contends that PwC's findings from Agreed-Upon Procedures reported in Attachment 11<sup>100</sup> give rise to several issues.

First, Seven Network argues that PwC has not performed an actual verification of the estimate of 68 per cent as the appropriate percentage in the 2000-01 financial year but simply relied on Foxtel's assertion. Second, that percentage is based on budgeted costs in 2000-01 rather than actual costs. Third, Seven Network submits that it is not aware of any Foxtel advertisements in the 2000-01 period or in any prior or subsequent period that did not carry the Foxtel brand, and therefore all of Foxtel's marketing expenses are branded. And fourth, Seven Network argues that the PwC report in Attachment 11 was submitted by Foxtel to the Commission in relation to Foxtel's digital exemption application in 2002, and was before the Tribunal previously; Foxtel has merely re-filed

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<sup>99</sup> Seven Network submission, 14 February 2006, p. 22.

<sup>100</sup> Attachment 11: PwC: *Report on Gross Purchase Cost of Cable Set Top Units* dated 19 January 2001.

the same material upon which the Tribunal has expressed concerns as to Foxtel's marketing costs.

Seven Network concludes that, due to the aforementioned issues, all the non-branded marketing costs that Foxtel includes in the IBAC should be excluded from the IBAC.

In relation to the second point – the inclusion of Foxtel-specific marketing costs in the ongoing costs to be allocated to access seekers – Seven Network objects to the way Foxtel defines brand-marketing costs in the Undertaking. Seven Network contends that Foxtel defines branded marketing as including only Foxtel marketing in relation to a specific channel in Foxtel's basic package; it excludes marketing by Foxtel in relation to multiple Foxtel channels or the Foxtel pay-TV service in general. Seven Network claims that to include the costs of marketing by Foxtel in relation to multiple Foxtel channels or the general Foxtel pay-TV service as non-branded marketing and part of future costs to be shared with access seekers would be inappropriate and unreasonable.

Seven Network presents a further argument in relation to an access seeker's advertising costs. Seven Network argues that, should the tie of access to Foxtel's basic package remain, an access seeker should be entitled to recover a portion of its advertising costs against Foxtel's access charges. This is because an access seeker seeks to obtain new subscribers through advertising, and that new subscriber would have to install the Foxtel basic package – or keep the basic package – in order to obtain the access seeker's pay-TV channel(s).

Seven Network suggests that an allocation of access seekers' advertising costs could be based similarly upon a revenue and ratings basis as contained in the Undertaking.

### ***Foxtel's supplementary submission to the October 2005 Undertaking***

Foxtel submitted, initially, that non-branded marketing makes up 68 per cent of all marketing costs. This proportion is based on PwC's audit report on cable STUs at Attachment 11.<sup>101</sup> Foxtel states that PwC appears to have analysed Foxtel's marketing budget for the financial year 2000-01 to identify the brand and non-brand marketing allocations.<sup>102</sup> On the basis of that 2000-01 total marketing budget, PwC identified that 32 per cent of that budget was forecast to be spent on specifically identified brand marketing campaigns; the balance of 68 per cent therefore would be on non-brand marketing. PwC then assumed this same proportion, retrospectively, over the period from Foxtel's launch in 1995 to the 2000-01 period.

Foxtel submits that it is reasonable to apply the percentage projected to be spent by Foxtel on brand marketing in the 2000-01 budget to the entire period covered by the

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<sup>101</sup> Attachment 11: PwC: *Report on Gross Purchase Cost of Cable Set Top Units* dated 19 January 2001.

<sup>102</sup> Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 6.



IBAC calculation, particularly in circumstances where Foxtel's total marketing expenses were broadly similar throughout the period.<sup>103</sup>

Foxtel further submits that 68 per cent is a conservative estimate of the level of non-brand marketing in its early years, because it considers that a larger proportion would have been spent in that period on non-brand marketing as Foxtel tried to educate Australian consumers about pay-TV in general.

In relation to non-branded marketing expenses to be included in the estimation of future access charges, in a further submission by Foxtel,<sup>104</sup> Foxtel proposes to amend its Digital Rate Card RAPM.<sup>105</sup> The RAPM currently describes the methodology in regard to marketing costs as including an assumption that 100 per cent of Foxtel's marketing costs is non-branded for the future ten-year period. Foxtel stated that it will amend this assumption to make the estimation of marketing costs responsive to changes over the future period with regard to the levels of brand and non-brand marketing.

Initially, Foxtel intended to replace the RAPM assumption in regard to marketing costs with the following assumption:

Line 15 will record the percentage of Marketing which is non-brand for each year. This percentage will be determined by FOXTEL and subject to an independent review.

To assist in determining the appropriate percentage, Foxtel consulted PwC for a possible review of the marketing costs included in the first period (T1). Foxtel subsequently concluded that the review is expected to be 'very difficult and time consuming' and no longer proposes to obtain an independent review.<sup>106</sup> It proposed to replace the RAPM assumption in regard to marketing costs with the following assumption:

Line 15 will record the percentage of Marketing which should be included for each year as determined by Foxtel in accordance with Schedule 3 of the DAA.

For the first period T1 covering the period 2003-04, Foxtel proposes to use a figure of 90.29 per cent for non-branded marketing costs. From 1 July 2004, the actual percentage for each financial year will be used.

In its submission, Foxtel reiterates its view that non-brand marketing costs should be included in the cost base.

### ***Foxtel's submission to the revised Undertaking***

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<sup>103</sup> Total actual marketing expenses for four years from 1996-97 to 1999-2000 were in a narrow range of [c-i-c] per year.

<sup>104</sup> Foxtel letter to the ACCC, 9 May 2006.

<sup>105</sup> *ibid.*

<sup>106</sup> Foxtel letter to the ACCC, 28 July 2006.

In relation to the Agreed Upon Procedures conducted by PwC in 2005 to verify the historical IBAC, Foxtel refers to the Commission's view in its Draft Decision, where the Commission stated:<sup>107</sup>

The Commission considers that the process of verifying the IBAC costs undertaken by PwC during 2005, pursuant to Foxtel's engagement, is inferior to an audit in accordance with Australian auditing standards. The Commission notes that, based on Australian auditing standards, an audit provides a high level of assurance on the reliability of information provided. A review engagement enables an auditor to provide a moderate level of assurance, being a lower level of assurance than one provided by an audit, while agreed-upon procedures do not enable the auditor to express assurance.<sup>108</sup> Therefore, the Commission notes that different audit and audit-related services provide different levels of assurance to the receiver of information contained in the auditor's report. Foxtel engaged PwC to conduct agreed-upon procedures to verify IBAC cost schedules. The level of assurance, therefore, provided to the Commission in relation to the reliability of information contained in Foxtel's IBAC cost schedules is less than the assurance that could have been provided by an audit.

Foxtel submits that, while the procedure was not an audit in accordance with Australian accounting standards, the PwC procedures should be sufficient for the purposes of a regulatory matter. Further, Foxtel lends support for the Commission's view that there is no certainty that the benefits of an audit would outweigh the cost.

Foxtel's submission also addresses the concerns raised by the Commission in its Draft Decision regarding the cost base that Foxtel has used in calculating the IBAC and the marketing costs to be included in future periods as part of its pricing methodology.<sup>109</sup>

In respect of historic marketing costs included in the IBAC, Foxtel submits that the percentage figure of 68 per cent to represent non-Foxtel-specific marketing costs should be an acceptable proxy. Foxtel makes the following arguments:

- Foxtel considers that a proportion higher than 68 per cent would have been spent for non-branded marketing in the early years of analogue pay-TV to educate consumers about the service.
- In the early periods of analogue pay-TV operation (1997 to 2001), Foxtel's total marketing costs per year were broadly similar. Therefore, using budget figures for a single year (2000-01) to estimate branded versus non-branded marketing costs for the period 1997 to 2001 is reasonable.

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<sup>107</sup> ACCC, *Assessment of Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service – Draft Decision*, August 2006, p. 57.

<sup>108</sup> Auditing & Assurance Standards Board (Australian Accounting Research Foundation), *AUS 106 Explanatory Framework for Standards on Audit and Audit Related Services*, November 2001.

<sup>109</sup> ACCC, *Assessment of Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service – Draft Decision*, August 2006, p. 57-9.

- Before it provided an undertaking to provide access to its network, Foxtel did not differentiate between branded and non-branded marketing costs as it did not consider that it was conducting a business at the wholesale level.
- Due to the lapse of time and the departure of former Foxtel staff, investigating historical costs would be difficult.
- The Commission has already previously accepted the IBAC amounts that Foxtel submitted in its digital exemption application.
- A sensitivity analysis conducted by Foxtel's consultant indicates that the IBAC amount and the final access price are not sensitive to changes in the percentage of non-Foxtel-specific marketing costs.<sup>110</sup>

In respect of future marketing costs to be included in the pool of shared costs (as operating expense or as corporate overhead), Foxtel has responded to the Commission's concerns by making the following amendments to the Undertaking:

- amendment of the definition of 'Defined Capital Expenditure' to exclude marketing of single channels whether in Foxtel's basic package or in tiers
- also, amendment of clause 3.5 (c) of Schedule 3 of the DAA, in relation to depreciation/amortisation of capex and opex, to exclude marketing of single channels whether in Foxtel's basic package or in tiers
- in the new clause 2.6 of the Undertaking, an independent review of the process undertaken by Foxtel to identify and separate general marketing costs from channel-specific and other specific marketing costs will be conducted after the first twelve months and every three years thereafter.

### ***The Commission's view***

The Commission's accepts that there is merit in Foxtel's proposal to include an IBAC for cable TV and satellite TV. The Commission notes that Foxtel has updated these amounts from \$280 million for cable and \$115 million for satellite (for a total of \$395 million) to \$287.6 million for cable and \$105.6 million for satellite (for a total of \$393.2 million) based on a report by its consultant.<sup>111</sup>

The Commission accepts that an IBAC reflecting the efficient costs of developing the customer base over the analogue period, and from which the digital access provider as well as digital access seekers will benefit, is appropriate. In the absence of this expenditure, Foxtel (or a hypothetical digital STU provider) would need to incur larger

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<sup>110</sup> Refer to attachments to Foxtel supporting submission of 1 December 2006: A statement of Michelle Kvello and MK1 to the statement of Michelle Kvello and CRA International, *Revised Cable and Satellite IBAC Estimates*

<sup>111</sup> CRA International, *Revised Cable and Satellite IBAC Estimates*

costs (in money and time) to generate a customer base of equivalent size and loyalty. From this point of view, the IBAC represents an element of an efficient forward-looking replacement cost approach to determining the asset base of a digital STU provider in the absence of a pre-existing analogue STU network.<sup>112</sup>

Therefore, the Commission does not object to Foxtel's proposal to include IBAC costs (including non-Foxtel-specific sales and marketing costs) in the digital cost base.

The Commission notes that the process for verifying the historic IBAC costs undertaken by PwC during 2005 pursuant to Foxtel's engagement was 'agreed upon procedures' rather than an audit. However, the Commission considers it is not certain that the benefit provided by a full audit of the IBAC costs would outweigh the cost of an audit to verify the IBAC costs. The Commission does not have a reason to believe that Foxtel and PwC together would have an incentive to inflate the IBAC costs to be included in the pricing methodology. Further, the Commission, in relation to the digital exemption decision in 2003, already reduced Foxtel's claimed expenditures for inclusion in the cable-TV IBAC from \$858 million to \$280 million by excluding certain expenditures related to the analogue TV phase.

In relation to marketing costs included in the IBAC, the Commission notes that Foxtel has not been able to provide a more robust measure of Foxtel-specific marketing costs in response to the Commission's concerns outlined in its Draft Decision on the October 2005 Undertaking.<sup>113</sup> While the Commission still has some concerns about a budgeted, single year figure being used for calculating the marketing costs included in the IBAC, it notes Foxtel's submission that it would be very difficult to provide that information. It also notes that additional information provided by Foxtel suggests that the overall impact of marketing costs on the total IBAC amount and the resultant access price is likely to be very small.<sup>114</sup>

In relation to non-Foxtel-specific marketing costs to be included in future access prices, the Commission notes that Schedule 3 of the DAA has been amended to exclude marketing devoted to a single Subscription Television Service on Foxtel's tier from 'non-branded' marketing costs.

Delineating the scope of marketing costs that should be categorised as non-Foxtel-specific marketing costs will necessarily be a matter of judgement. In this regard, the Commission notes Foxtel's submission that it does not conduct a wholesale business and thus does not engage in any wholesale marketing of the Digital Set Top Unit Service to potential access seekers.

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<sup>112</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 52.

<sup>113</sup> Foxtel supporting submission of 1 December 2006 at page 8.

<sup>114</sup> Refer to attachments to Foxtel supporting submission of 1 December 2006: A statement of Michelle Kvello and MK1 to the statement of Michelle Kvello.

While the primary purpose of Foxtel's marketing expenditures will be to promote its retail subscription TV service, the effect of these activities is also the proliferation of STUs in customer homes. Under the terms of the Undertaking, such activity has the effect of maintaining and/or increasing the addressable market for access seekers. Therefore, the Commission considers that it is appropriate for access seekers that derive a benefit from the marketing activities of Foxtel to bear some degree of these costs.

Foxtel's revised approach means that marketing directed to a specific Foxtel channel in the Foxtel tier (which may compete with an access seeker's channel) will be excluded from the marketing costs used to calculate the access charge. While the costs of marketing packages of tiers (eg. the sports tier and the movie tiers) will be included as non-Foxtel-specific marketing costs, the Commission notes Foxtel's arguments that these tiers are likely to function as a significant driver of customer acquisition and retention. In this regard, the Commission notes Foxtel's submission that only [c-i-c] of Foxtel's customers acquire only the basic package as part of their subscription.<sup>115</sup>

In light of the amendments and additional supporting information put forth by Foxtel, the Commission is satisfied with the proposed scope and scale of marketing costs used for calculating the IBAC and access prices in future periods as part of Foxtel's pricing methodology.

### **5.2.3 Allocation of shared costs**

#### ***Foxtel's submission***

Foxtel submits that shared costs are costs that were, or will be, incurred by Foxtel but which benefit both Foxtel and access seekers, and should therefore be shared between them.

Annual shared costs will be allocated among Foxtel and access seekers based on subscription revenues and ratings. For Foxtel, its actual revenues will be used as the basis, whilst for the access seeker, its actual revenue or imputed revenue – whichever is higher – will be the basis. Imputed revenue is estimated based on channel ratings. The calculation methodology to apply to this allocation is described in section 7.3 of Schedule 3 to the proposed DAA.<sup>116</sup>

Actual revenue refers to subscription TV revenue, which is subscription revenue obtained for the provision of subscription TV services and related services using the Digital Set Top Unit Service.

On the other hand, the imputed revenue of an access seeker is calculated based on ratings. Rating refers to the audience share obtained by the access seeker's pay-TV

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<sup>115</sup> Refer to Confidential Appendix B of Foxtel's supporting submission.

<sup>116</sup> Foxtel Special Access Undertaking, Appendix 2: Digital Access Agreement, Schedule 3: Access Charges and Pricing Methodology for Digital Set Top Unit Services, 6 October 2005, section 7.3 at p. 71.

service/channel as a percentage of total pay-TV viewing with the use of Foxtel Digital STUs. Foxtel will appoint an independent, experienced organisation to measure ratings. Initially, an access seeker's rating cannot go below 0.25% of the share of total pay-TV ratings.

Imputed revenue refers to imputing a revenue amount to each rating percentage point of the access seeker. This imputed revenue is calculated as follows:

$$\text{Imputed revenue} = \frac{\text{Foxtel total pay-TV revenue}}{\text{Foxtel total ratings}} \times \text{Access seeker's rating}$$

The access seeker's allocated share of annual shared costs will then be based on either its actual revenue or its imputed revenue, whichever is greater.

In its Submission in support of the Undertaking, Foxtel argues that the allocation of shared costs based on revenue and ratings is a fair and appropriate method of allocating common costs, and that revenue and ratings are the best measure of channel success and of the value that users of Digital STUs (both Foxtel and access seekers) derive from that use.

Foxtel contends that this approach reduces the risk of distortion that may arise if allocation of common-cost recovery were to be assessed by reference to revenue alone or ratings alone. If revenues alone were used, an access seeker may be able to disguise (i.e. minimise) its actual revenue in order to avoid a greater allocation to it by Foxtel of Foxtel's shared costs. If ratings alone were used, some access seeker channels may appeal to wide audiences (gaining high ratings but low subscription revenue) or to small audiences with inelastic demand (obtaining low ratings but high subscription revenue).

Foxtel notes that the Commission and the Tribunal accepted its allocation methodology for shared costs in the context of the digital exemption application in 2002/03.

### ***Views of interested parties in response to the October 2005 Undertaking***

Seven Network submits that the cost allocation method based on imputed revenue and minimum ratings is not reasonable. Seven Network expresses its view as follows:

The problem with imputed revenue is:

(a) FOXTEL receives high revenue from the compulsory package, which access seekers do not. This inflates access seekers imputed revenue.

(b) The use of imputed revenue is one-sided as only access seekers' revenue share is the subject of a formula for the greater of the imputed revenue and actual revenue. In particular, FOXTEL's share of costs is not allocated on the basis of the higher of its actual revenue and imputed revenue for channels not in the basic package.

This permits FOXTEL to add additional tier channels to compete with an access seeker's channels but at a significantly lower cost base.<sup>117</sup>

Further, Seven Network submits that the use of a minimum ratings figure for access seekers presents some problems:

- The minimum rating of 0.25% is the average rating on full digitisation with 400 channels, that is, 1/400 equals 0.25%. This implies that an access seeker's channel is likely to have a rating less than the average of 0.25% and should have a lower imputed revenue at minimum.
- The channels in Foxtel's basic package are likely to have ratings in excess of the average ratings because all viewers must receive those channels.
- The minimum ratings figure applies only to the access seeker and not to Foxtel for the purpose of allocating shared costs, with the result that Foxtel has a lower cost base if it wished to provide a competing tier channel.
- For near video-on-demand, access seekers will have significantly higher relative STU access charges compared to Foxtel. This is because near video-on-demand channels always have lower than average ratings, but a minimum ratings figure is applied to access seekers and not Foxtel.<sup>118</sup>

#### ***Foxtel's supplementary submission to the October 2005 Undertaking***

Foxtel addresses the three primary complaints of Seven Network, which are that:

- the revenue or ratings methodology for allocating costs is unfair because only the access seeker's revenue, and not Foxtel's revenue, is subject to an 'imputation';
- the imputed revenue method is unfair because Foxtel receives higher revenue from the basic package compared to an access seeker, and this inflates an access seeker's imputed revenue; and
- the use of a minimum ratings figure per channel is unfair because if and when 400 channels are offered, the minimum rating will equal the average rating.

On the first point, Foxtel argues that Foxtel bears all the costs that are not allocated to access seekers. Accordingly, it is Foxtel's average revenue per rating point that is the relevant base for allocating costs, by imputing a minimum revenue per rating point to access seekers. According to Foxtel, this allocation basis ensures that resources are not devoted to channels which consumers ascribe a low value to. This allocation basis also has the effect that, because access seekers are not required to bear any of the downside risk associated with Foxtel's investment, when the access seekers use that investment

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<sup>117</sup> Seven Network submission, 14 February 2006, section 8.2 at p. 34.

<sup>118</sup> *ibid.*, p 34-5.

they should do so in a manner that does not require Foxtel to bear additional downside risk.

On the last two points by Seven Network, Foxtel argues that:

- there is no evidence to suggest that Foxtel's revenue per rating point for its basic package is higher than for premium packages; and
- the minimum rating figure is the minimum measure of ratings currently offered by television ratings agencies in Australia; if and when a greater number of channels is offered, Foxtel assumes that the rating agencies will use a lower minimum measure.

### ***The Commission's view***

The Commission accepts Foxtel's proposed methodology of allocating shared costs based on an access seeker's actual revenue or imputed revenue (whichever is higher).

The Commission, in its digital exemption decision in 2003, noted that revenue-based measures reflect the end-user's willingness or capacity to pay. An allocation of shared costs based on this willingness or capacity to pay spreads the cost burden in an efficient manner, as those with a greater willingness/capacity bear a greater proportion of common costs.<sup>119</sup> The Commission noted that the approach of using revenue and ratings was put forward by Foxtel as consistent with Ramsey-Boiteux principles, with the assumption that revenue and ratings are good measures of elasticity in the retail markets. The Commission did note that a Ramsey-Boiteux pricing approach is usually difficult to implement because of informational constraints.

The Tribunal, in its review of the Commission decision, stated that it was:

generally satisfied with the pricing methodology (including cost allocation) adopted by Foxtel, as modified by the Commission.... We also accept in principle the method of imputing revenue, but consider that the deemed minimum rating of 0.25% should be reviewed if more finely granulated ratings data become available.<sup>120</sup>

The Commission notes that, in this Undertaking, Foxtel's use of revenue and ratings in allocating shared costs continues to promote Foxtel's use of a Ramsey-Boiteux pricing approach. However, the Commission has not always accepted or favoured the use of this approach in its other regulatory decisions.

The Ramsey-Boiteux pricing rule is concerned with determining the most efficient way for a multi-product firm to recover its common costs of production, given that it engages in linear or one-part pricing. At its simplest, the Ramsey-Boiteux pricing rule

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<sup>119</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 59

<sup>120</sup> *Re Seven Network Limited (No 4) (2004)* 187 FLR 373 at [326].



suggests that the most efficient way to recover common costs is to price the service which has a relatively lower own-price elasticity of demand proportionately higher above its marginal cost than the service that has a relatively lower own-price elasticity of demand. Based on the Ramsey-Boiteux literature, it can be shown that, in principle, structuring prices in this way when seeking to recover common costs will result in a lower efficiency cost overall than if a uniform proportionate price increase was levied across the firm's services.

The optimality of the Ramsey-Boiteux pricing rule is predicated on a number of assumptions and conditions. If these assumptions and conditions do not hold, it becomes less clear as to whether the pricing rule is necessarily the most efficient method for recovering common costs. These assumptions and conditions include the following:

- the necessity for monopoly power – the traditional Ramsey-Boiteux pricing analysis assumes one monopoly producer, and in competitive markets Ramsey pricing may not hold
- all services to be included – all of the firm's relevant services that give rise to common costs must be included in the framework
- knowledge of elasticity estimates – the relevant own-price and cross-price elasticities of demand for each of the firm's services that give rise to common costs must be known or could be estimated with sufficient accuracy
- single-part pricing – it is assumed that the entire burden of common-cost recovery falls on single-part linear prices rather than multi-part or non-linear prices.<sup>121</sup>

The Commission recognises that, in principle, the efficiency properties of Ramsey-Boiteux pricing for the recovery of common costs are convincing and have been well recognised in the literature. However, when, in the Commission's view, the assumptions and conditions for the appropriate application of Ramsey-Boiteux pricing do not hold, or when the informational requirements are difficult and costly, the Commission is constrained from applying the principle in its regulatory decisions. In this event, the Commission prefers the use of alternative methods for common-cost allocation.

In particular, the Commission's preferred alternative method is the equi-proportionate mark-up ('EPMU') method of allocating common costs. EPMU involves measuring the directly attributable costs of each service within a group of services, and allocating the common costs based on each service's proportion of the total directly attributable costs.

In its decision in regard to the assessment of the undertaking by Optus with respect to the supply of domestic mobile terminating access services, the Commission considered

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<sup>121</sup> For a fuller discussion of the Commission's view on and application of Ramsey-Boiteux principles, see ACCC, *Optus' undertaking with respect to the supply of its Domestic GSM Terminating Access (DGTA) Service-Final Decision*, February 2006, chapter 6, p. 66-88.

that Ramsey-Boiteux pricing for the recovery of common costs was not appropriate. The main reason for this decision was that, in the Commission's view, the proposed Ramsey-Boiteux framework did not fully satisfy the necessary conditions required for Ramsey-Boiteux pricing to generate a socially optimal structure of prices. Instead, the Commission favoured the use of EPMU.<sup>122</sup>

However, in the matter of Foxtel's proposed Undertaking currently before the Commission, the Commission considers that the application of the EPMU approach to allocate common costs presents practical problems.

In its digital exemption application in 2002, Foxtel submitted that it would undertake, on the basis of the exemption, to make a large investment to upgrade to a full digital service. Further, in its s 87B undertaking, Foxtel undertook to construct a digital system which from day one can support multiple access seekers.<sup>123</sup>

As explained previously, Foxtel will categorise its annual costs in constructing the digital system into three categories:

- specific cost – incurred by Foxtel as a result only of activity by a particular access seeker for the provision of access to that access seeker
- attributable cost – incurred by Foxtel as a result of the provision of access to all third parties or access seekers as a group
- shared cost – incurred by Foxtel as a result of activity by both Foxtel and third parties

Given Foxtel's commitment to build the digital system ready for third-party access, Foxtel's incremental costs that can be attributed to an individual access seeker ('specific cost') or to access seekers as a group ('attributable cost') are expected to be minimal. It is expected that most of the network expenditure would have been put in place to make the network ready for access, in accordance with Foxtel's s 87B undertaking. Any further required network or satellite enhancements will be categorised as attributable costs but these costs are expected to be minimal, according to Foxtel.

These factors suggest that Foxtel's incremental costs (i.e. 'specific cost' or 'attributable cost') are likely to be minimal, irregular, or non-existent, depending on whether any

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<sup>122</sup> See ACCC, *Optus' undertaking with respect to the supply of its Domestic GSM Terminating Access (DGTA) Service—Final Decision*, February 2006, chapter 6; *Assessment of Vodafone's mobile terminating access service (MTAS) Undertaking—Final Decision*, March 2006, Appendices A2.3 and 3. Vodafone proposed the use of the EPMU method for common cost allocation, and argued that this results in its proposed access prices being more conservative than those that would result if Ramsey-Boiteux pricing were to be applied. However, the Commission disagreed with this conclusion.

<sup>123</sup> *Undertaking to the Australian Competition and Consumer Commission by Foxtel Management Pty Ltd (for and behalf of the Foxtel Partnership) and Foxtel Cable Television Pty Limited*, 21 November 2002.

third party requests for access or, if so, what that party requires in gaining effective access.

The EPMU approach involves measuring the directly attributable costs of each service within the group of services and allocating common costs based on each service's proportion of the total directly attributable costs. This approach will not provide a practical application in the matter of Foxtel's pricing methodology under this Undertaking. This is because of the likelihood that 'the total directly attributable costs' required by the EPMU approach will be minimal, irregular, or non-existent. If the EPMU approach were adopted this would provide an unsound basis for allocating common costs in Foxtel's case.

Foxtel's proposed methodology of allocating shared costs based on revenue and ratings provides a viable alternative to the EPMU approach normally preferred by the Commission in its regulatory decisions. Foxtel's method of allocating shared costs would be supported by the following measures:

- subscription TV revenues for each of Foxtel's and access seekers' channels will be objectively verified by independent auditors; and
- the ratings for each of Foxtel's and access seekers' channels will be determined by an independent TV rating organisation.

In relation to the use of ratings and imputed revenue, the Commission considers it acceptable because:

- it minimises the potential for distortions if access seekers disguised or minimised their actual revenues, and
- ratings and revenues should be reasonably aligned in general, that is, a higher audience share for a channel is likely due to a higher number of pay-TV subscribers paying subscription fees and who are loyal to the channel.

The Tribunal, in the appeal of Foxtel's digital exemption order, also held that it was satisfied with the method of cost allocation by Foxtel.<sup>124</sup>

#### **5.2.4 Weighted average cost of capital**

The WACC is a commonly used measure for determining an appropriate return on asset base and has been consistently used by regulators in Australia. The WACC for a firm is the weighted average of returns on its equity and debt financing.

The Commission has historically adopted a WACC which is a weighted average of the nominal post-tax cost of equity and the nominal pre-tax cost of debt. This WACC does not include the impact of business income tax. The Commission includes the tax liabilities of the firm in the firm's cash flow model and adjusts the cash flow amount to account for the utilisation of imputation credits.

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<sup>124</sup> *Re Seven Network Limited (No 4) (2004) 187 FLR 373 at [326].*

The WACC formula is:

$$WACC = R_e (E/V) + R_d (D/V)$$

where:

$R_e$	=	cost of equity
$R_d$	=	cost of debt
$E$	=	market value of equity
$D$	=	market value of debt
$V$	=	market value of equity plus debt

The cost of equity capital is the expected return required to compensate investors for bearing the risk associated with investing in a firm's equity. The cost of equity is a forward-looking concept and measures the perceived opportunity cost of the investor purchasing equity in the firm, taking account of the risks involved. It determines the return expected by investors on their equity investment in the firm.

The Commission uses the CAPM to estimate the cost of equity capital. As illustrated in the following formula, CAPM yields the required expected return on equity given the return on the market portfolio, the market's own volatility, and the systematic risk of holding equity in the particular firm:

$$R_e = r_f + \beta_e(r_m - r_f)$$

where:

$R_f$	=	expected risk-free rate of return over the period
$(r_m - r_f)$	=	expected market risk premium ('MRP'), defined as the expected premium of return on the market as a whole ( $r_m$ ) over the risk-free rate of return ( $r_f$ ) for the same period
$\beta_e$	=	equity beta, a measure of investors' perceived systematic risk of the individual company's equity relative to the market.

Under the CAPM framework used by the Commission, there are three different beta measures – equity beta, asset beta and debt beta. As mentioned above, the equity beta is a measure of the sensitivity of the return of a particular stock relative to the return on the market portfolio. The asset beta is the beta of the firm without debt financing. It represents the sensitivity of the operating cash flows generated by the firm's assets. If a firm is financed entirely by equity (that is, without debt), then the asset beta is equal to the equity beta. The debt beta measures the systematic risk of debt.

The historic equity beta for publicly listed firms can be obtained from financial information databases. To estimate the equity beta of a regulated firm, a common practice is to take the equity beta of a comparable firm and adjust it for differences in capital structure. That is, the comparable firm's equity beta is adjusted through de-levering to estimate the asset beta of the comparable firm. The asset beta is then re-levered with a benchmark gearing level (i.e. total debt/total capital) to obtain a

comparable benchmark equity beta for the regulated firm. While there are a number of levering formulae, the Commission has consistently adopted the Monkhouse formula:

$$\beta_e = \beta_a + (\beta_a - \beta_d) \times \left\{ 1 - \left[ \frac{R_d}{1 + R_d} \right] (1 - \gamma) T_e \right\} \times D/E$$

where:

$\beta_e$	=	equity beta
$\beta_a$	=	asset beta
$\beta_d$	=	debt beta
$R_d$	=	cost of debt
$\gamma$	=	gamma, or dividend imputation factor
$T_e$	=	the effective tax rate
$D$	=	market value of debt
$E$	=	market value of equity

Although the asset beta and debt beta are used in the Monkhouse formula, it is the equity beta that is used in the CAPM and is important in setting the appropriate regulatory WACC.

In relation to the cost of debt ( $R_d$ ), the risk-free rate is used and added to a benchmark debt margin for the regulated firm to determine the cost of the firm's corporate debt:

$$R_d = R_f + r_d$$

where:

$R_d$	=	cost of debt
$R_f$	=	risk-free rate
$r_d$	=	debt margin

### ***Foxtel's submission***

In its Undertaking, Foxtel estimates its return on capital on the basis of a WACC and CAPM framework.

Foxtel will calculate its WACC as a post-tax nominal return on capital, and this will be re-calculated from time to time but at least every three years. Foxtel's proposed WACC for the first period of the Undertaking is 13.975 per cent, based on certain assumptions.<sup>125</sup>

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<sup>125</sup> Foxtel's proposed parameter values are outlined in section 3.4, Schedule 3 of the Digital Access Agreement. In this Schedule 3, Foxtel indicates its use of a gamma ( $\gamma$ ) value of 0.5, resulting in a WACC of 13.99%. However, this is not consistent with its submission in support of the undertaking, where Foxtel states it 'continues to rely on the expert reports of (Gray) in support of its

Foxtel's proposed WACC of 13.975 per cent for this Undertaking is in line with the WACC of 13.99 per cent contained in the Commission's final decision in relation to Foxtel's digital exemption application in 2002.<sup>126</sup> The components of the Foxtel WACC as currently proposed by Foxtel in this Undertaking, and as set out in the Commission's digital exemption decision are set out in the following table.

The Commission notes that changes in the WACC – whether an increase or decrease – can occur due to a change in market conditions. For example, government and corporate bond rates move according to economic cycles and conditions. The Commission believes that, when appropriate, the WACC parameters should be amended to reflect updated information or evidence.

As evident in the following table, the Commission has updated certain WACC parameters to take into account current market conditions. These updated parameters are the risk-free rate, the debt margin, and the nominal cost of debt. As a result, the Commission has updated its WACC estimate for Foxtel from 13.99 per cent to 14.0 per cent.

A discussion of each WACC parameter is set out in the following sections.

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submission that the appropriate gamma is 0' (see Foxtel submission, page 12). Using a  $\gamma=0$  value, effectively, Foxtel's proposed WACC is 13.975%.

<sup>126</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 58.

Parameter	Symbol	ACCC – 2003 decision on digital exemption application	Foxtel –Digital Set Top Unit Service SAU	ACCC – Digital Set Top Unit Service SAU
Debt	D	20%	20%	20%
Equity	E	80%	80%	80%
Risk-free Rate	$R_f$	5.5%	5.5%	5.8%
Market Risk Premium	$(R_m - R_f)$	6%	6%	6%
Asset Beta	$\beta_a$	1.4	1.4	1.4
Equity Beta	$\beta_e$	1.66	1.66	1.66
Post-tax cost of equity	$R_e$	15.49%	15.49%	15.79%
Debt Beta	$\beta_d$	0.33	0.33	0.33
Debt Margin	$r_d$	2.5%	2.5%	1.05%
Nominal cost of debt	$R_d$	8.0%	8.0%	6.85%
Franking credit utilisation (gamma) *	$\Gamma$	0.5	0	0.5
Pre-tax nominal WACC		n.a.	n.a.	n.a.
Post-tax nominal WACC		13.99%	13.975%	14.0%

\* In its digital exemption application, Foxtel did not make a representation as to the appropriate gamma for its STU business and adopted the Commission's preferred gamma of 0.5 for this purpose.

In the currently proposed special access undertaking, Foxtel indicates its use of a gamma ( $\gamma$ ) value of 0.5, resulting in a WACC of 13.99% (see section 3.4, Schedule 3 of the Digital Access Agreement). However, this is not consistent with its submission in support of the undertaking, where Foxtel states it 'continues to rely on the expert reports of (Gray) in support of its submission that the appropriate gamma is 0' (see Foxtel submission, page 12). Using a  $\gamma=0$  value, Foxtel's proposed WACC effectively is 13.975%, which is the result indicated in the table above.

In Foxtel's Undertaking, the only difference in the parameters used to calculate the proposed WACC in this Undertaking and the previously approved WACC in the Commission's decision on digital exemption is the value of the dividend imputation factor (gamma) that Foxtel proposes to use this time. Foxtel proposes to revise the gamma value from 0.5 to zero. The result of this revision would be to slightly reduce the WACC of Foxtel from 13.99 per cent to 13.975 per cent. Foxtel submits that, except for the gamma parameter, all the other WACC parameters remain appropriate and that it relies on the Commission's previous decision in the 2003 digital exemption application.

The parties' views on the appropriate value of gamma is discussed more fully in a subsequent part of this chapter.

### ***Views of interested parties in response to the October 2005 Undertaking***

The Commission did not receive any submission from interested parties in relation to Foxtel's use of the CAPM and Weighted Average Cost of Capital framework.

### **Dividend imputation factor (gamma)**

#### ***Foxtel's submission***

Foxtel submits that a dividend imputation factor or gamma value of zero should be used to derive access prices in accordance with the Undertaking.

In support of its view, Foxtel attaches a consultant's report made by Professor Stephen Gray on the effect of franking credits on Foxtel's cost of capital.<sup>127</sup> Professor Gray concludes from his study that:

- dividend imputation franking credits do not affect the cost of capital of Australian listed companies;
- the above conclusion that applies generally to Australian companies similarly applies to Foxtel, with additional specific considerations in relation to Foxtel's particular circumstances; and
- an 'overwhelming majority practice' in the Australian market regarding the effect of franking credits on the corporate cost of capital is to set the value of gamma to zero.

In its digital exemption application in 2002, Foxtel did not make a representation to the Commission as to the appropriate gamma value for the pay-TV business. However, the Commission determined in its final decision on the digital exemption application that it

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<sup>127</sup> Attachment 14: *The Effect of Franking Credits on Foxtel's Cost of Capital – A Submission on the Access Undertaking of Foxtel Management Pty Ltd*, 4 October 2005



preferred a gamma value of 0.50 for the purposes of that application.<sup>128</sup> Accordingly, Foxtel adopted the Commission's view.

For this Undertaking, Foxtel submits that the appropriate gamma value is zero, and if the Undertaking is accepted, Foxtel states that its DAA, Regulatory Accounting Procedure Manual and Pricing Model will reflect this gamma value (and its consequent effect on Foxtel's cost of capital).

Foxtel notes that adopting a gamma value of zero would result in a small adjustment in its WACC from 13.99 per cent to 13.975 per cent. Further, it notes that a gamma value of zero would have an impact on the tax allowance in its Digital Access Pricing Model and result in a higher maximum allowable revenue and a higher access price.<sup>129</sup> Foxtel illustrates this expected result (that is, higher access prices if gamma is zero) by the following example:

Suppose the asset base is \$100 and the regulated WACC is 10%. In this case, the regulator will let the regulated business charge prices such that a profit of \$10 is achieved. If the corporate tax rate is 30%, regulated prices will have to be such that the pre-tax profit is \$14.30 (in which case tax of \$4.30 is paid and after-tax profit is \$10, as required).

If the gamma value is set to 0.5, it is equivalent to assuming that half of the corporate tax will be rebated against personal tax obligations. So the corporate tax rate is, in effect, not 30% but 15%. That is, shareholders get half of the corporate tax back via the personal tax system. In this case, a firm only needs a pre-tax profit of \$11.80 to produce an after-tax profit of \$10.

Accordingly, prices would need to be lower if gamma is assumed to be 0.5 rather than zero.<sup>130</sup>

The Commission understands this to mean that, offsetting the lower after-tax WACC is a higher effective rate for corporate income tax, because the absence of dividend imputation credits will result in Foxtel facing greater cash outflows for corporate tax. This small reduction in Foxtel's proposed after-tax WACC may therefore likely result in a slightly higher access charge for the Digital Set Top Unit Service as the firm needs to recover slightly higher tax expenses. That is, with all other factors being equal, a gamma of zero would allow Foxtel a higher regulated revenue than if a higher gamma value (such as 0.5) were used.

### ***Views of interested parties in response to the October 2005 Undertaking***

Seven Network disagrees with Foxtel's view on the appropriate value of the dividend imputation factor to be used in calculating Foxtel's WACC. Seven Network argues that 'ascribing a zero value (to gamma) is unreasonable', while conceding that there is substantial disagreement in economic literature on the true value of franking credits.

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<sup>128</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 58.

<sup>129</sup> Foxtel submission, 6 October 2005, p. 49.

<sup>130</sup> Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 7.

Seven Network refutes the conclusions made by Professor Stephen Gray on behalf of Foxtel and submits that Gray's report:

- ignores the value attributed to franking credits by stock brokers (who are in the field of valuing shares);
- relies on irrelevant factors such as the inability of foreign investors to utilise the franking credits; and
- misinterprets comments by Professor Robert Officer (who made a report attached to Seven Network's submission in relation to franking credits) in previous work.

As a result of these 'errors', Seven Network argues that Professor Gray's – and Foxtel's – conclusions on the appropriate dividend imputation factor and the consequent estimated cost of capital for Foxtel are not reasonable.<sup>131</sup> Seven Network contends that Foxtel uses an 'inflated cost of capital' in estimating the relevant return on investment and therefore increases the price of access above a reasonable level, and above Foxtel's cost of providing the access service.

Seven Network instead supports the conclusions of Officer, who concludes in his report that:

- investors value franking credits, and consider these in their cost of capital estimates to reduce the return they require for investing in a company or project
- evidence supporting the above conclusion includes:
  - equity analysts' inclusion of franking credits in their valuations of companies
  - companies' consideration of franking credits in their capital-management process
  - redemption by domestic shareholders of franking credits worth more than \$A200 billion since 1987
- franking credits act to reduce the effective company tax rate, and this alters the after-tax cost of capital.

Seven Network therefore believes that franking credits have value and that they affect a company's cost of capital.

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<sup>131</sup> Seven Network submission, 14 February 2006, p 21–22.

### ***Foxtel's supplementary submission to the October 2005 Undertaking***

Foxtel submitted a second report by Professor Gray in response to Professor Officer's conclusions on the effect of franking credits on Foxtel's cost of capital. Gray summarises his views as follows:

- the proper interpretation of the empirical evidence on franking credits is that gamma should be set to zero, and this result is the only result consistent with foreign investment in Australia earning a fair return
- if regulated prices are based on a gamma value above zero, shareholders will receive a lower-than-fair expected return
- share buybacks, which are a mechanism to channel franking credits to shareholders who value them, are unlikely in Foxtel's case as it does not have surplus capital
- the question of whether franking credits affect the cost of capital is different from whether shareholders value franking credits or not
- Officer's criticism of potential problems in modelling, such as multicollinearity or model mis-specification error, is misplaced.

Gray concludes that it is not possible for Foxtel to distribute franking credits sufficient to justify setting a gamma value at 0.5. He asserts that the range of possible values for gamma would have a lower bound of zero, and a possible upper bound of 0.35 suggested by Hathaway-Officer.

### **Other WACC parameters**

#### **Equity beta**

Foxtel submits in this Undertaking to use the same value for equity beta used by the Commission in its 2003 final decision, which is a value of 1.66.

Foxtel attached a report by Gray to its submission in support of the Undertaking.<sup>132</sup> Based on his consideration of his available evidence, Gray expressed the view that a reasonable estimate of Foxtel's present equity beta is a range of 1.5 to 1.8. However, Foxtel did not adopt the recommendations of Gray in relation to updated estimates for Foxtel's equity beta – such as the upper end of the range, or an equity beta of 1.8 – and Foxtel maintained a proposed value of 1.66.

The Commission did not receive any submission from other interested parties with regard to Foxtel's proposed value of 1.66 for equity beta to estimate its WACC.

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<sup>132</sup> Refer to Attachment 15, Stephen Gray, *A Beta Estimate for Foxtel – A Submission on the Access Undertaking of Foxtel Management*, 4 October 2005

## Asset beta

Foxtel submits in this Undertaking to use the same value for asset beta used by the Commission in its 2003 final decision, which is a value of 1.4.

The Commission did not receive any submission from other interested parties with regard to Foxtel's proposed value of 1.4 for asset beta to estimate its WACC.

## Risk-free rate

As discussed in the preceding sections, the risk-free rate is a component of both the cost of debt and the CAPM, where:

Cost of debt ( $R_d$ ) = risk-free rate ( $R_f$ ) + debt margin ( $r_d$ )

and

Cost of equity ( $R_e$ ) = risk-free rate ( $R_f$ ) + [equity beta ( $\beta_e$ ) x market risk premium].

In practice, the yield to maturity on Commonwealth government bonds is used as a proxy for the risk-free rate as the risk of default on government bonds is considered negligible. Although there is an inflation risk involved with holding government debt, this does not negate the utility of government debt as a substitute for the risk-free rate.

In determining the risk-free rate, the Commission obtains the government bond yield corresponding to the relevant term to maturity and published by the Reserve Bank of Australia, averages the government bond yields for a period (between 5 and 40 days), and applies the averaged bond yield as the proxy for the risk-free rate.

In determining the risk-free rate to apply to the WACC calculation, it is theoretically correct to use the latest single-day rate, as this is assumed to reflect investors' consideration of the latest market information. However, using a single-day rate ignores daily volatility in bond yields; therefore, the Commission prefers averaging to smooth out the daily volatility.

In relation to the term to maturity of the risk-free rate, the Commission prefers to adopt a ten-year Commonwealth government bond rate as the risk-free rate.<sup>133</sup>

In the matter of Foxtel's digital exemption application in 2002, the Commission adopted a value of 5.5 per cent for the risk-free rate, on the basis of Commonwealth bond rates prevailing at that time.

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<sup>133</sup> In a December 2003 decision, the Australian Competition Tribunal reviewed the Commission's tariff determination for transportation services on GasNet's Victoria natural gas transmission network. Although the Commission used a 5-year rate, the Tribunal accepted GasNet's approach to calculating the risk-free rate on the basis of a 10-year government bond rate. (See Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6 (23 December 2003). Given the Tribunal's decision, the Commission has adopted a 10-year bond rate as the risk-free rate.

To account for current market conditions in regard to this Undertaking, the Commission has used current government bond rates at the time of this Final Decision. At the time Foxtel submitted its first Undertaking in October 2005, average bond rates were at the 5.2 per cent level.<sup>134</sup> At the present time of the Commission's Final Decision (February 2007), single-day and average ten-year bond rates are as follows:<sup>135</sup>

single-day (19 February 2007)	5.770 per cent
10-day average	5.805 per cent
40-day average	5.855 per cent

Therefore, the Commission considers that adopting a risk-free rate of 5.8 per cent for the purposes of this Undertaking is appropriate.

### **Market risk premium**

In the CAPM framework, the MRP is used to estimate the cost of equity:

Cost of equity ( $R_e$ ) = risk-free rate ( $R_f$ ) + [equity beta ( $\beta_e$ ) x market risk premium].

The MRP represents the additional return investors expect to earn for investing in a well-diversified portfolio of risky assets, as compared to investing in a risk-free asset. Because the MRP is an expected return premium, it is not observable. Estimates such as the historical MRP, or the difference between the realised return of the share market and the risk-free rate, are commonly used to provide an indicator of the forward-looking MRP.

Although there has been a substantial amount of research on the MRP, there is debate as to the appropriate value for the MRP in Australia. Based on a long-term view using historic measures and on the available evidence on the MRP, the Commission considers that a reasonable value for the MRP in Australia is around 6 per cent.

The Commission has consistently adopted this MRP value in its regulatory decisions. Other regulators in Australia have also used or provided support to this estimate for the market risk premium.

### **Leverage (capital structure)**

In 2003, the Commission recommended the use of an assumed capital structure for calculating the WACC of Foxtel to be 20 per cent debt and 80 per cent equity.

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<sup>134</sup> 40-day average (estimated based on data from the Reserve Bank of Australia website [www.rba.gov.au](http://www.rba.gov.au) > Statistics > Commonwealth Government Securities – Bonds – Indicative Mid-rates of Selected Commonwealth Government Securities > Historical 2005 to 2007, accessed on 20 February 2007).

<sup>135</sup> *ibid.*

Foxtel initially proposed an assumed all-equity capital structure, but subsequently revised this to take into consideration its intention to use debt financing for the digitisation of its cable TV network. Foxtel therefore submitted that its debt ratio was likely to be closer to 20 per cent. The Commission accepted this assumption in its draft and final decisions in 2003.

The Commission is aware that Foxtel proceeded with its debt financing in January/February 2004, with Foxtel reported to have arranged for a syndicated loan for the amount of \$A550 million underwritten by ABN AMRO and Commonwealth Bank of Australia and lead-arranged by ANZ.<sup>136</sup>

The Commission is not aware of Foxtel's actual capital structure as a result of the loan, nor as it currently stands, because of the lack of publicly available information on Foxtel's balance sheet (Foxtel is not an exchange-listed firm at present).

However, the Commission has taken into consideration information provided by Professor Gray. Gray (2005) summarised in his study the debt-to-total capital ratios (leverage) of a sample of Australian broadcast and cable-TV companies. The available data showed the following:<sup>137</sup>

Company	Leverage (%) – March 2005
PBL	18
Austereo	20
Austar	26
Southern Cross Broadcasting	26
Prime Television	27
Seven Network	32
Ten Network	34
<i>mean</i>	26

The Commission considers that applying a 20% debt–80% equity assumed capital structure in estimating Foxtel's WACC continues to be appropriate.

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<sup>136</sup> insto (The Australian Financial Markets Newsletter), week ending 6 February 2004, p. 17.

<sup>137</sup> Attachment 15: Gray, Stephen, *A Beta Estimate for Foxtel—A Submission on the Access Undertaking of Foxtel's Management*, 4 October 2005, p. 19.

## Cost of debt and debt margin

The cost of debt is typically the debt margin over the risk-free rate as shown by the formula:

$$\text{Cost of debt } (R_d) = \text{risk-free rate } (R_f) + \text{debt margin } (r_d)$$

The debt margin varies depending on the firm's gearing, its credit rating and the term of the debt.

The Commission determines the debt margin by reference to estimates of corporate bond yields available in financial information databases such as Bloomberg. The process by which the Commission obtains the debt margin is similar to that for the risk-free rate. To maintain consistency between the two cost of debt components, the benchmark term of the relevant corporate bond rate should match the term of the risk-free rate being used. Specifically, the cost of debt is calculated by:

- obtaining the debt margin corresponding to the determined benchmark credit rating and term to maturity, by taking the estimated corporate bond yield and subtracting the Commonwealth government bond yield
- averaging the debt margins for the same length of time period as for the risk-free rate, and
- adding the averaged debt margin to the averaged risk-free rate.

There is a limited number of long-term corporate bonds in the Australian debt market. Therefore, the Commission uses ten-year corporate and government bonds for estimating a debt margin, subject to practical application of available data.

An appropriate debt margin for Foxtel would reflect its benchmark investment grade rating and may include an allowance for the costs of debt issuance. The Commission, in its 2003 digital exemption decision, adopted a debt margin of 2.50 per cent for Foxtel.

Information currently available to the Commission indicates that Foxtel's syndicated loan in early 2004 has an 'indicative margin of 140-170 basis points over BBSY'.<sup>138</sup> If these were indeed the finalised rates for the loan, and assuming the loan is a long-term floating-rate loan, on the basis of bank bill swap reference rates and ten-year Commonwealth bond rates current at the time of this Commission final decision,<sup>139</sup> Foxtel's debt margin would be in a range of 2.1 per cent to 2.4 per cent over the risk-

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<sup>138</sup> into (The Australian Financial Markets Newsletter), week ending 6 February 2004, p. 17. BBSY is the main indicator of bank bill rates and is a proxy for the rate at which the major banks can borrow money from each other.

<sup>139</sup> Data available from The Australian Financial Review, Money & Bond Markets section, 15 February 2007, p. 39. The Commission referred to Bank Bill Swap Reference Rate: Average Bid (source: ANZ) for 180 days, which is the longest term for quoted rates.

free rate. Because the Commission does not have full and definite information on the final terms and conditions of the Foxtel loan, this estimate of the actual debt margin for Foxtel only serves as a reference for the Commission.

Further, the Commission's preferred approach is not to adopt a firm's actual debt margin but to use a benchmark debt margin. This is because a firm's actual cost of debt may not reflect efficient financing whilst a benchmark cost of debt may provide the firm with incentive to minimise inefficient financing.

The cost of debt is primarily dependent on the credit rating of the debt issuer. As a general rule, debt assigned with a lower credit rating has greater default risk and attracts a higher premium.

The Commission has not obtained information on the current credit rating of Foxtel, particularly as Foxtel is not a publicly listed firm. A possible consideration for a benchmark is the group of parent companies of Foxtel (all publicly listed companies) and their corresponding credit ratings:

Parent (per cent ownership of Foxtel)	Standard and Poor's credit rating <sup>140</sup>
Telstra (50%)	A (February 2006)
Publishing & Broadcasting Ltd (25%)	A- (July 1999)
News Corp (25%)	BBB (Sept 2005)

The Commission recognises that parent ownership is only one factor that may affect a credit rating. The rating method used by credit rating agencies also considers the financial and business risk characteristics of the subject firm, including its operations, markets, and cash flows.

The Commission considers that Foxtel debt may be viewed at the lower level of investment grade bonds, and part-owner News Corp's credit rating of BBB may be a reasonable benchmark.<sup>141</sup> Using this benchmark rating, the Commission believes a benchmark debt margin of 1.05 per cent is appropriate for the Foxtel WACC for this Undertaking.<sup>142</sup>

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<sup>140</sup> [www.standardandpoors.com](http://www.standardandpoors.com)

<sup>141</sup> It was also reported that the lead underwriters for Foxtel's loan facility advised that covenants for the deal included a contingent equity plan with commitments made by News Corp and Telstra to back up strategic elements of Foxtel's business plans. (source: *insto* (The Australian Financial Markets Newsletter), week ending 6 February 2004, p. 17.) This suggests that financial backing by part-owners News Corp and Telstra would have favourably influenced the credit rating assigned to Foxtel's debt.

<sup>142</sup> Based on the difference between the average yields of BBB-rated Australian bonds (source: Bloomberg) and ten-year government bonds. Averages are based on 40 daily published rates prior to (and including) 9 August 2006.



Foxtel's cost of debt can therefore be estimated by summing the risk-free rate of 5.8 per cent and the debt margin of 1.05 per cent, for an estimated nominal cost of debt of about 6.85 per cent.

### **Debt beta**

The debt beta represents the systematic risk of debt. For the purposes of determining an appropriate equity beta and given the uncertainty associated with the estimation of equity betas, the Commission considers that the debt beta is not material as long as the same value is used in the de-levering and re-levering process.

The Commission adopted a debt beta of 0.33 for Foxtel in its 2003 decision. For consistency, the Commission believes this is still appropriate in assessing Foxtel's WACC in this Undertaking.

### **Tax rate**

In its Undertaking, Foxtel has assumed that the appropriate tax rate to be used in estimating its post-tax nominal WACC is the statutory tax rate of 30 per cent.

In its regulatory decisions, the Commission has favoured the use of effective tax rates rather than statutory tax rates in estimating post-tax WACC. Given the necessary information, the Commission prefers the inclusion of the regulated firm's tax liabilities in the firm's cash flow model (usually covering the regulatory period), and the adjustment of the cash flow amount to account for the utilisation of imputation credits by the firm's equity owners. The actual tax liabilities can then be recouped by the firm through its access prices or allowed revenue. The Commission's approach to tax is in line with the common practice of other Australian regulators.

However, in practice, the effective tax rate can be difficult to estimate without the necessary information – in particular the firm's financial model of expected cash flows will be necessary for such an exercise. With regard to the Foxtel Undertaking, such information is not available.

While the Commission notes that Foxtel's effective tax rate is likely to be lower than the statutory tax rate, the Commission has used a tax rate of 30 per cent for the purpose of estimating a WACC due to the paucity of information necessary to derive a robust measure of Foxtel's effective tax rate at this time. Moreover, sensitivity analysis undertaken by the Commission indicates that the tax rate used in WACC estimation has an insignificant effect in the resulting WACC value.

Going forward, it is expected that Foxtel will calculate its actual tax liabilities based on actual tax rates for the purpose of determining its access prices. As part of its Undertaking, Foxtel also states that it will calculate the value of WACC from time to time but at least every three years. This implies that the re-estimated WACC would take into account the effective tax rate which should already be known at the time. Therefore, the Commission considers that in the future, the risk of overcompensating Foxtel for its tax expenses will be reduced as it is expected that actual expenses will be used.

### *Foxtel's submission to the revised Undertaking*

Foxtel reiterates that it continues to rely on the report of Professor Gray in support of its previous submission that the appropriate value for gamma is zero.

#### **5.2.5 The Commission's view**

The Commission's view is that it would be difficult to justify a departure from the gamma value used in the Commission's final decision in 2003 on Foxtel's digital exemption application.

That value of gamma is consistent with the value adopted by the Commission in its other decisions in relation to the cost of capital of other regulated industries and companies in Australia. Further, it is consistent with the views and decisions of other Australian regulators.

Therefore, the Commission considers that a value of 0.5 is the appropriate value of gamma to be used in estimating Foxtel's WACC in relation to this Undertaking.

As a consequence of the use of a gamma value of 0.5 for regulatory consistency, and with adjustments to some WACC parameters in the Commission's 2003 digital exemption decision take account of current market conditions, the resulting WACC for Foxtel is calculated to be 14.0 per cent. The Commission considers that this WACC for Foxtel is appropriate.

The Commission notes that Foxtel is proposing a slightly lower WACC of 13.975 per cent in relation to this Undertaking. This is the formulaic result of the use of a gamma value of zero, as proposed by Foxtel, and of out-of-date values for the risk-free rate and debt margin. Assuming a gamma value of zero and updated values for the risk-free rate and debt margin (as indicated below), Foxtel's proposed WACC becomes 13.989 per cent.

While the Commission does not accept the use of a gamma value of zero in Foxtel's proposed WACC, the Commission considers that the difference of 0.01 per cent between the WACC proposed by the Commission and that proposed by Foxtel is not material in its overall assessment of the price terms and reasonableness against s.152AH of the Act.

The Commission recognises that financial market conditions have changed since its 2003 digital exemption decision, and in particular, interest rates and government bond yields have fluctuated daily. To take account of current market conditions, the Commission has updated the figures for the risk-free rate, the debt margin and the consequent cost of debt in estimating the WACC for Foxtel. The updated figures are the following:

- risk-free rate ( $R_f$ ) – from 5.5 per cent to 5.8 per cent
- debt margin ( $r_d$ ) – from 2.5 per cent to 1.05 per cent

- nominal cost of debt ( $R_d$ ) – from 8.0 per cent to 6.85 per cent

The recent changes in interest rates (of bonds with ten-year maturity) contribute to a slightly higher cost of capital for Foxtel under current market conditions compared with that at 2003. On the other hand, increases in subscription TV penetration rates may have lowered Foxtel's business/operating risks and may have pushed the equity beta slightly downward, theoretically leading to a decrease in the cost of capital. However, the Commission considers that the estimation of WACC parameters such as equity and asset betas is imprecise, and the values for these parameters should remain unchanged. It has also considered the information in Professor Gray's report<sup>143</sup> and is of the view that the equity and asset betas are still in the range of acceptable values.

### **5.3 Summary of the Commission's assessment of the price terms and conditions**

Having regard to the matters specified in s.152AH(1) of the Act, the Commission has assessed the price terms and conditions contained in Foxtel's proposed Undertaking. It has also given consideration to the views expressed by Foxtel and interested third parties in their respective submissions.

The proposed pricing methodology is a cost-based methodology that enables Foxtel as the access provider to recover its costs and earn a normal return on its investment in the pay-TV facility. The Commission considers that this protects the legitimate business interests of Foxtel and its investment in the digital cable and satellite TV network used to supply the Digital Set Top Unit Service. Further, the Commission considers that this methodology takes proper account of the direct costs Foxtel incurs in providing access to its Digital Set Top Unit Service.

The Commission takes the view that, overall, the price terms and conditions are reasonable, having regard to the requirements of s.152AH of the Act.

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<sup>143</sup> Attachment 15: Gray, Stephen, *A Beta Estimate for Foxtel—A Submission on the Access Undertaking of Foxtel's Management*, 4 October 2005.

## **6. Assessment of the non-price terms and conditions of the Undertaking**

This chapter sets out the Commission's detailed analysis of the non-price terms and conditions, including the Commission's consideration of the various submissions made by Foxtel and interested parties, having regard to the matters set out in s. 152AH of the Act.

The chapter also includes an overview of the non-price terms and conditions contained in the Undertaking.

### **6.1 Overview of the non-price terms and conditions**

At clause 2.2 of the Undertaking, Foxtel undertakes to the Commission to supply the Digital Set Top Unit Service on the terms and conditions set out in the DAA.

The non-price terms and conditions contained in the Undertaking are summarised in Chapter 4 of this report. The non-price terms in the Undertaking are substantially the same as those proposed in the October 2005 Undertaking, however Foxtel has incorporated a number of amendments designed to address the concerns of the Commission expressed in its Draft Decision to reject the October 2005 Undertaking

The non-price terms and conditions of access contained in the DAA are also in large part the same as those that were contained in Foxtel's s.87B undertaking as part of its application for an anticipatory exemption order accepted by the Commission, but subsequently rejected by the Tribunal. However, the Commission notes that the proposed DAA as part of the Undertaking has been amended with respect to the following non-price issues:

- the inclusion of Modem Services;
- the inclusion of access to EPG services;
- the use of satellite capacity; and
- the term of the DAA.

These issues are discussed in turn below.

#### **6.1.1 Modem Services**

Clause 6 of the DAA includes provisions for the supply of Modem services, as defined in Part D of schedule 1. Foxtel notes that it has included terms and conditions governing access to Modem services in the DAA in response to the Tribunal's

comments regarding the exclusion of interactivity in Foxtel's previous exemption application.<sup>144</sup>

The changes to Foxtel's proposed pricing methodology arising from the inclusion of Modem services is outlined in Chapter 5.

### **6.1.2 EPG services**

Foxtel's DAA provides access to EPG Services in respect of access seekers' channels pursuant to the terms and conditions set out in Clauses 5 and 10 of the DAA.

### **6.1.3 Satellite capacity**

In Foxtel's DAA as part of Foxtel's s.87B undertaking access seekers could only obtain satellite capacity from the same satellite network Foxtel was using or a satellite that used the same transmission configuration and same satellite orbital location that Foxtel used (essentially, the C1 satellite). In contrast, the Undertaking allows access seekers to arrange for satellite carriage on another satellite slot. However, Foxtel states that there would be additional costs involved in modifying the Foxtel satellite equipment or installing new satellite equipment in order for the Foxtel STU to receive the access seeker's signal. This cost would be borne by the access seeker.

### **6.1.4 Term of the DAA**

Clause 1.2 of DAA allows for terms of between 5 and 8 years – this differs from the 5 year term provided in the DAA as part of Foxtel's s.87B undertaking. Access seekers also have a right to terminate the DAA on one month's notice,<sup>145</sup> while Foxtel does not have a reciprocal right to terminate.

## **6.2 Assessment of the non-price terms and conditions**

In this section, the Commission's assessment of the non-price terms and conditions is discussed. Although all the non-price terms and conditions were examined, the discussion below focuses on those terms and conditions of most significance to the Commission. The discussion also includes consideration of the various submissions made by Foxtel and interested parties in relation to the reasonableness of specific non-price terms and conditions. The Commission has analysed the non-price terms and conditions having regard to each of the matters listed in s.152AH(1).

No submissions on the reasonableness of the non-price terms in the Undertaking were received in response to the Commission's Discussion Paper. However, the Commission has relied upon all the submissions previously put forward by Foxtel and interested parties in the assessment of the October 2005 Undertaking.

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<sup>144</sup> Foxtel submission, 6 October 2005, p.20

<sup>145</sup> Refer to clause 24.4(d) in the DAA.

### **6.2.1 The core competition concerns**

In assessing the type of access offered under the non-price terms and conditions of the Undertaking, it is instructive to consider the underlying rationale for the Commission's regulation of the Pay TV industry to date.

In declaring the predecessor 'Analogue Pay TV service' in 1999, the Commission considered that declaration would be in the long term interests of end-users as it would promote competition in the market for retail pay television services.

In particular, the Commission considered that declaration would facilitate the suppliers of niche services (eg. ethnic programming) gaining entry in the market for retail pay television services, and that this would likely lead to lower prices for these services as well as a broader range of choice for consumers. In this regard, the Commission considered that the barriers to entry in this market, including the lack of availability of premium programming and the cost and limitations of alternative means of carrying the services, to be significant.

In relation to Foxtel, the Commission was concerned that as a result of its control of significant amounts of premium programming, combined with the fact that customers generally only buy one basic subscription television package and accompanying STU, Foxtel controlled the distribution channel to the primary customer base for subscription television services in Australia. Providers of niche programming would find it hard to distribute their product to customers.

Accordingly, the Commission subsequently accepted an ordinary access undertaking from Foxtel for the distribution of niche programming channels to its customer base via its analogue STUs.

The Commission does not consider that situation has changed with the transition to digital. If anything, there may be additional constraints including access to new features and functionality such as the digital EPG and interactivity, as identified by the Tribunal in *Seven Network Limited (No 4)* [2004] A Comp T 11 (23 December 2004).

For content providers such as niche channel providers, a key obstacle to competitive entry will be access to the potential subscriber base for subscription television in Australia. Such content providers will not be interested in providing a full suite of channels and a full retail Pay TV service. Rather they may aim to provide a tier to an existing full package provider; therefore they will want the ability to distribute their content to subscribers. Importantly, the underlying costs of providing a stand alone channel with own supply of STU, CA/SI services and related billing/management systems may make it difficult to mount a viable business model for a niche channel provider, given the limited revenues that may be realised through the supply of a single channel – this may hold under either a self supply or third party access scenario. Therefore, the ability to gain access to stand alone supply elements such as STU and CA/SI services is unlikely to have any significant effect on promoting competitive entry of content providers such as niche channel providers.

For the competing full package providers who have access to a compelling suite of channels and carriage, and wish to provide a full retail Pay TV service, there would appear to be no impediments to deployment of STUs and related CA/SI functionality for provision of subscription television services to end-users. This is evidenced by the fact that a number of competing subscription television service providers in Australia such as Optus, TransACT, and SelecTV currently supply their own STU and CA/SI systems in order to serve their own subscribers. This would suggest STUs and related CA/SI are contestable inputs, and not bottleneck elements in the supply of subscription television services. The Commission notes that other factors such as access to carriage and/or access to compelling content may be impediments to effective competition between full package providers, however these matters are not directly relevant to the assessment of this Undertaking for the Digital Set Top Unit Service. A firm with sufficient access to premium content and carriage to provide a full retail Pay TV service will be able to buy STUs and CA/SI services on the open market.<sup>146</sup>

However, as stated, the Commission considers that there is an important role for regulatory mechanisms that enable channel providers to access distribution to Foxtel's digital subscriber base given the current market conditions outline above.

The Commission considers that an access undertaking under Part XIC must at the very least provide an effective form of distribution for channel provider access seekers wanting to distribute their channels (including interactive channels) to Foxtel's digital subscriber base. In *Sydney International Airport* [2000] ACompT1, the Tribunal pointed out that a key issue is the minimum bundle of assets required to provide the relevant services.<sup>147</sup> In this matter, effective access to distribution to Foxtel's subscriber base will include access to the minimum bundle of assets required to facilitate distribution of programming to that subscriber base, including modems and inclusion in the EPG.

### **6.2.2 Tying of basic package to access**

Under clause 4.1 of the DAA, an access seeker's subscriber must purchase Foxtel's basic package in order to use Foxtel's Digital Set Top Unit Service. That is, access is only provided by Foxtel to those STUs that are supplied by Foxtel to its own subscribers.

In addition, clause 11.1 of the DAA provides that Foxtel is not obliged to continue providing the Digital Set Top Unit Service where a person ceases to be a Foxtel subscriber, even if that person wishes to continue receiving the access seeker's services.<sup>148</sup>

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<sup>146</sup> Further, if the situation changes in future, the Undertaking no longer attempts to prevent future declaration of such stand-alone services.

<sup>147</sup> *Sydney International Airport* [2000] ACompT1 at [192].

<sup>148</sup> As outlined in Chapter 4, Foxtel does not regard clauses 4.1(c) and (f) of the DAA (the tying clauses) as a limitation on the Undertaking for the purpose of ss.152CBA(5) and 152AL(7) of the Act. Accordingly, the Commission has assessed the reasonableness of these provisions as terms and

### *Foxtel's submissions to the October 2005 Undertaking*

Foxtel submits that the restrictions regarding the provision of the Digital Set Top Unit Service to Foxtel homes only is reasonable. In support of this position, Foxtel's Submission considers the reasonableness of the tying of access to the basic package in comparison to two alternative scenarios for the provision of STUs to access seekers:

1. the supply of full service Foxtel STUs (including CA/SI services) to non-Foxtel homes; and
2. unbundling CA and SI services and providing these services to access seekers using their own STUs.

Foxtel submission also attaches reports concerning economic and technical facets of these scenarios<sup>149</sup>:

- Attachment 4: Henry Ergas, Charles River & Associates: *Reasonableness of Limiting the Supply of FOXTEL's CA Service*. (CRA report);
- Attachment 5: Peter Smart/Mr Ron Higgins, FOXTEL, *Engineering Report*; and
- Attachment 6: Philip Williams – *Frontier Economics: Report on Market Definition and Promotion of Competition* (Frontier report).

In relation to the issue of the tie of access to the Foxtel basic package, Foxtel submits that it would not be reasonable to compel Foxtel to provide full service STUs to non-Foxtel homes.

Foxtel argues that maintaining its current STU ownership model, by which it owns STUs and supplies these to subscribers, is important for a number of reasons, including:

- to subsidise the cost of the STU and reduce the upfront cost to the subscriber in order to encourage the uptake of subscriptions;

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conditions of supply under the Undertaking. If the tying provisions were treated as a limitation on the service for the purpose of ss.152CBA(5) and 152AL(7) of the Act, the tying provisions would clearly be reasonable – they would no longer prevent future declaration of untied services if appropriate and necessary. The only relevant concern to the Commission's assessment under s.152AH would be the extent that acceptance of the Undertaking could potentially lead to multiple access regime – access to those end-user premises covered by Foxtel SAU and access to non-Foxtel end-user premises that could be the subject of future declaration. The Commission considers that arbitrations could take this into account and that in this scenario, the tying provisions would be reasonable.

<sup>149</sup> In addition, on 23 June 2006 Foxtel provided a report by CRA entitled *Response to October 2002 Report by Stephen King* on the welfare effects of the tying of access to STUs to the Foxtel basic package.



- to encourage customers to subscribe to Foxtel's digital subscription television services by removing any perceived risk that the subscriber may be investing in technology that may become outdated or cheaper in the future;
- to enable Foxtel to upgrade its technology by software downloads to the STU on a regular basis at no cost to the subscriber;
- to enable Foxtel to monitor the specifications of the STUs and the quality of their installation to ensure consistent and quality reception; and
- to enable Foxtel to redeploy the STUs on churn rather than leave unused STUs in lapsed subscribers' homes.<sup>150</sup>

Foxtel contends that the technical and operational difficulties, substantial costs to Foxtel, potential dynamic efficiency losses, and a risk of under-recovery of costs means that the risks and difficulties associated with Foxtel providing a full STU service to non-Foxtel homes outweigh any potential benefit that may be derived.<sup>151</sup>

In addition, Foxtel submits that the Commission does not have the statutory power to compel Foxtel to supply STUs to non-Foxtel homes. In this regard, Foxtel contends STUs are not "carriage services" nor "services that facilitate the supply of carriage services" under s.152AL(2) of the Act, thus can not be declared in their own right. Foxtel states access to STUs is captured under s.152AR(8) of the Act as conditional access customer equipment. If an access provider supplies a "declared" service by means of STUs it must supply to an access seeker any service necessary to enable the service provider to supply carriage services or content services using the equipment. Thus, Foxtel argues that the obligation to supply access only arises in relation to the STUs used by the access provider and does not require it to supply STUs that are not in use by it.<sup>152</sup>

### ***Seven Network submission to the October 2005 Undertaking***

Seven Network asserts that the tying condition under the Undertaking is not reasonable within the meaning of section 152CBD(2)(b) of the Act. Seven Network contends that this limitation serves to consolidate Foxtel's upstream market power by maintaining its monopoly over basic pay TV packages, and that this is contrary to the intention of Part XIC and not in the LTIE. In particular, Seven Network argues that the tie does not promote competition, or encourage the efficient use of, and investment in, infrastructure.

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<sup>150</sup> Foxtel submission, 6 October, p.33-34

<sup>151</sup> *ibid.*, p.36-37

<sup>152</sup> *ibid.*, p. 41.

Seven Network states that the tying of access to the Foxtel basic package leads to allocative inefficiencies.<sup>153</sup> In this regard, Seven Network contends that end users that are prepared to pay a price in excess of the economic cost of the access seeker's content, but not willing to pay for Foxtel's basic package, will not purchase channels. This creates a deadweight loss. Conversely, there may be some customers that will acquire both the Foxtel basic package and the access seeker's content, although they would not have acquired the Foxtel basic package if given the option.

In addition, Seven Network contends that the tie creates dynamic inefficiencies and deters innovation as it limits the form of retail pay TV service offerings available to consumers to basic package and premium services. Seven Network states that this form of offering is a construct of Foxtel and may not suit alternative providers. By tying access to the provision of Foxtel's basic package, Seven Network argues that the Undertaking effectively reinforces the requirement for end-users to obtain the basic package and therefore removes the potential for competition based on different forms of service offerings.<sup>154</sup>

Seven Network argues that the tying of access to the basic package immunises Foxtel from competition in respect of retail Pay TV services. In this regard, it argues that:

- tying limits the contestable market by limiting competition between access seekers' channels and Foxtel's tier offerings;
- tying increases barriers to entry as the tie raises rivals costs and therefore the price of access to an access seeker's channels by an amount determined by Foxtel (i.e. the cost of the basic package). Furthermore, access seekers' channels are on the higher part of a consumer's demand curve, where consumer demand is more elastic; and
- tying enables Foxtel to eliminate competition for tiered channels through replicating an access seekers' tier channel with a channel in its basic package. Seven Network asserts that the possibility of such a strategic response by Foxtel is likely to reduce the incentives for new entrants to acquire and develop new content. According to Seven Network this factor means that Foxtel is able to leverage its market power in provision of the basic package into the provision of premium service or tiered channels.<sup>155</sup>

Seven Network also asserts that the tying of access to the Foxtel basic package overcompensates Foxtel for its investment and creates a free rider problem.<sup>156</sup> In this regard, Seven Network contends that Foxtel obtains the benefits of any advertising undertaken by access seekers to promote their channels. The need to acquire the Foxtel

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<sup>153</sup> Seven Network submission, 14 February 2006, p.12-13

<sup>154</sup> *ibid.*, p.11.

<sup>155</sup> *ibid.*, p.14-15.

<sup>156</sup> *ibid.*, p.12.

basic package in order to receive an access seeker channels means that access seekers' efforts in procuring new customers will function to provide new customers for Foxtel or assist in retaining existing customers. In this regard, Seven Network asserts that Foxtel does not incur any costs in respect of these customers and instead receives at least the fee for the basic package from each of them.

Furthermore, Seven Network argues that Foxtel's objections concerning the impact upon its business of supplying STU services are contrary to its assurances that it would build its digital pay TV platform in a manner which facilitated access stipulated in Foxtel's s. 87B undertaking.<sup>157</sup>

### ***Ten Network submission to the October 2005 Undertaking***

Ten Network submits that the proposed tying of access to Foxtel's basic package is not reasonable and not in the LTIE as the arrangements do not promote competition in any relevant market.<sup>158</sup>

Ten Network states that the Tribunal's concerns regarding the tying of access to the Foxtel basic package remains relevant in respect of the current undertaking. It asserts that tying restricts the development of competition in digital subscription television services for a number of reasons. In this respect it notes that:

- Tying increases barriers to entry for competing subscription television services as competition is limited to the sub-set of customers who are interested in acquiring premium content in addition to the Foxtel basic package;
- Tying restricts competition with respect of the provision of basic package offerings as access seekers are effectively unable to offer their services as a substitute for the Foxtel offering. This means Foxtel has limited incentive to innovate and develop new offerings; and
- Foxtel has the ability to foreclose competition by manipulating the content of the basic package to replicate the tier offerings of access seekers.<sup>159</sup>

### ***The Commission's view***

Foxtel's tying provisions in its Undertaking, given effect under clauses 4.1 and 11.1 of the DAA, mean that access seekers will only be able to provide their services to existing Foxtel end-users. As noted above, the Commission considers that access to Foxtel's digital subscriber base is an important factor in niche channel providers gaining entry in the market for retail pay television services. Increased competition at

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<sup>157</sup> *ibid.*, p.19.

<sup>158</sup> Ten Network submission, 21 February 2006, p.3.

<sup>159</sup> *ibid.*, p.4.

the tier level has the potential to lead to lower prices for these services as well as a broader range of choice for consumers.

While the Undertaking may promote competition at the tier level, the form of access offered under the Undertaking would not alter the ability of access seekers to compete with Foxtel's basic package service. This is because access seekers' channels will function only as a complement to Foxtel's basic package, rather than a substitute. The Commission has previously noted:

...since an access seeker's channel(s) can only be a tier on Foxtel's basic package, it is more likely such channels will be a complement to Foxtel's basic package. That is, if the price of the basic package increased (decreased), then, all else equal, it would be expected that a decrease (increase) in demand for an access seeker's tier package. By contrast, access seeker tiers are relatively more likely to be a substitute for Foxtel's tier packages.<sup>160</sup>

Therefore, the Undertaking will be neutral in terms of promoting competitive entry by full package providers.

However, for competing full package providers who have access to a compelling suite of channels and carriage, there would appear to be no impediments to deployment of STUs and related CA/SI functionality for provision of subscription television services to end-users. This is evidenced by the fact that a number of competing subscription television service providers in Australia such as Optus, TransACT, and SelecTV currently supply their own STU and CA/SI systems in order to serve their own subscribers.

The Commission considers that STUs (i.e. the hardware), in of themselves, do not constitute a bottleneck element in the supply of subscription services. While there may be some economies of scale involved in provision, the Commission notes that the functional life of Foxtel's STUs, for example, are 5-7 years, while average subscription terms are 2 years. Therefore STUs can be readily re-deployed and the costs of the STUs are not necessarily sunk.<sup>161</sup> The provision of CA/SI systems may potentially constitute a barrier to entry in the respect that CA/SI services involves economies of scale and some sunk costs. However, the Commission notes that the extent to which CA/SI systems are a barrier to entry may be mitigated by the availability of third party CA/SI hosting and bundled satellite carriage offerings.

Therefore it is not apparent that full package providers pursuing self supply options with respect to STUs and related services would necessarily deter competitive entry or lead to inefficient outcomes. This would suggest STUs and related CA/SI are contestable inputs, and not bottleneck elements in the supply of subscription television services.

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<sup>160</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited, Final report*, December 2003,p.50.

<sup>161</sup> However, competition issues may arise under the STU ownership model where provision of STUs is bundled with the supply of exclusive content.

The Commission notes that other factors such as access to carriage and/or access to compelling content may be impediments to effective competition between full package providers, however these matters are not directly relevant to the assessment of this Undertaking for the Digital Set Top Unit Service.

The Commission notes Seven Network's arguments that the tying condition may deter competitive entry and serve to distort allocative efficiency and potential dynamic efficiency gains. However, the scale of these potential efficiency effects is difficult to predict and quantify. In addition, it is not clear that the level of competitive entry and efficiency outcomes in any alternative scenario to the current STU ownership model of self-provision by full package retail Pay TV providers would lead to improved outcomes.

The Tribunal noted the following implication about similar tying provisions in *Seven Network Limited (No 4) [2004] ACompT*:

The combination of the digital access agreement and the terms of the undertaking therefore means that an access seeker can only compete by way of offering 'tiers' on Foxtel's Basic Package where approximately the first \$600 of annual household expenditure on subscription television is dedicated to Foxtel.<sup>162</sup>

...we consider that the tie of the Basic Package to access to FOXTEL's services as contained in the digital access agreement is a significant deterrent to entry. This is exacerbated by what we regard as an unnecessary prevention of an access seeker using FOXTEL's infrastructure and services, other than its STUs, to deliver subscription television services. In our view, potential access seekers are likely to be deterred from commencing supplying subscription television services in competition with FOXTEL for so long as access is tied in this manner.<sup>163</sup>

The Commission recognises that under the form of third party access offered under the tying provisions, Foxtel could potentially manipulate the pricing and/or composition of its basic package for the purpose of foreclosing competition at the tier level. It would have scope, for example, to increase the price of its basic package which would effectively increase the costs of entry for an access seeker.

The Commission agrees that Foxtel's ability to manipulate the pricing and composition of its basic package is a potential barrier to entry.

However, Foxtel's ability to manipulate the price and/or composition of its basic package exists regardless of the form of the Undertaking and would not be assisted by providing access to contestable inputs such as stand-alone STUs. If Foxtel were to strategically exercise market power by increasing the price of its basic package and squeezing out tier providers, those content providers would only be assisted by being given access to stand-alone STUs and related CA/SI services if their content was sufficiently compelling for customers to pay for it alone (including the efficient price of supply of these stand-alone items, freely available on the open market). In that case,

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<sup>162</sup> *Seven Network Limited (No 4) [2004] ACompT* 11 (23 December 2004) [286].

<sup>163</sup> *Seven Network Limited (No 4) [2004] ACompT* 11 (23 December 2004) [301].

they could provide their channels by acquiring STUs and related CA/SI services on the open market, as other Pay TV companies do. If their content is only compelling enough to survive as a tier, then a squeeze of this nature will drive them out regardless. Therefore, acceptance of the Undertaking would have no effect on the ability of Foxtel to increase the price of the basic package, nor would it affect the ability of competitors to respond to such conduct.

An Undertaking of this nature provides a mechanism for access seekers to provide their content to Foxtel's digital subscriber base (in competition with Foxtel's tier channels). The rights of access under the Undertaking may also reduce Foxtel's ability to exercise market power as an acquirer of pay TV content, by giving content providers negotiating to sell their content to Foxtel an alternative option.

Constraints on Foxtel's ability to squeeze content providers by manipulating the basic package must come from other sources.

In this regard, it is not apparent that Foxtel would have an incentive to engage in this type of strategic behaviour as any increase to the pricing of its basic package would also adversely impact demand for its own retail services. From 2002 to 2005, there were legal restrictions on Foxtel's ability to increase the price of its basic package beyond the Consumer Price Index. The Commission notes that although those restrictions expired in 2005, in May 2006 Foxtel altered the packaging and pricing of its digital subscription television service to reduce the price of the basic package from \$50.95 per month to \$36.95 per month. The Commission understands that this change was intended to increase penetration of its retail subscription television services.

While the Tribunal noted concern about the tying provisions, it also expressed concerns about an alternative scenario in which Foxtel was required to supply STUs to homes not actually receiving its retail pay TV services:

...we are uncomfortable with the proposition that FOXTEL should be required to provide equipment at the behest of an access seeker, whilst receiving no immediate benefit itself (other than access fees), even if, as submitted by Seven Network, it was possible to ensure there was appropriate compensation. This notion also appears to depart from standard situations in which access is required.<sup>164</sup>

In considering the potential impacts of the tying clauses on competition and efficiency, the Commission believes that, on balance, the form of access offered under the Undertaking would be in the LTIE.

Taking into account the various matters under s.152AH, including the legitimate business interests of Foxtel and interests of access seekers, the Commission concurs with the Tribunal's view that Foxtel should not be required to supply STUs to homes to non-Foxtel homes. Accordingly, the Commission is satisfied with the tying provisions given effect under clauses 4.1 and 11.1 of the DAA.

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<sup>164</sup> *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) at [295].

### **6.2.3 Bundling provisions**

Clause 4.1(c)(ii) of the DAA provides that Foxtel is only obliged to supply the Digital Set Top Unit Service to the access seeker 'as a total package and not as one or more component parts' (eg. STU, CA and SI Services, EPG Services and Modem Services).

Clause 2.7 of the Undertaking provides that the Undertaking is only in relation to the supply of the Digital Set Top Unit Service and is not an undertaking in relation to the supply of each component service.

This latter point contrasts with the October 2005 Undertaking where Foxtel considered the undertaking to be in respect of each and all of the component services forming the Digital Set Top Unit Service as defined. One implication of this approach was that, if the Commission was to accept the October 2005 Undertaking, each and all of the component services would be deemed to be declared services pursuant to subsection 152AL(7). If the Commission was to subsequently declare any of the unbundled component services (such as CA/SI services) and an access dispute was notified under s.152CM in respect of that component service, the October 2005 Undertaking would restrict the terms of any arbitration determination made by the Commission (s.152CQ(5)).

In particular, Foxtel considered that a determination could not oblige Foxtel to supply the component service in the absence of the other services that constitute the Digital Set Top Unit Service. The effect of these factors was that acceptance of the October 2005 Undertaking would foreclose the possibility of the Commission making an arbitral determination that mandates access to Foxtel's unbundled component services.

#### ***The Commission's View***

The Undertaking would appear to provide access to the 'minimum bundle of assets' that a niche channel provider requires in order to provide its subscription television services to end-users, including modems and inclusion in the EPG. This is likely to promote competitive entry in the provision of subscription television channels to end-users and facilitate the efficient use of existing STU infrastructure.

In assessing the bundling provisions in the Undertaking, the Commission notes that Foxtel's amendment to the service description and which is reflected in clause 2.7 of the Undertaking means that acceptance of the Undertaking would not foreclose the option for the Commission to make a declaration and arbitral determination in relation to component services that make up the Digital Set Top Unit Service, such as CA/SI services.

In sum, the Commission's view is that it is satisfied as to the reasonableness of clause 4.1(c)(ii) of the DAA as assessed against the matters under s.152AH of the Act.

#### 6.2.4 Interactive services

Clause 6 of the DAA includes provisions for the supply of Modem services, as defined in Part D of schedule 1. Access to Modem Services is intended to facilitate the provision of interactive services by access seekers.

##### *Seven Network submission to the October 2005 Undertaking process*

Seven Network submits that Foxtel's proposed terms and conditions of access to Modem Services are not consistent with the SAOs, and are not reasonable in that they are not in the LTIE. In particular, Seven Network submits that there are three problems with the terms and conditions on which Foxtel is proposing to supply Modem Services.

First, Foxtel is not obliged under the DAA to supply carriage services for the modem "return path". Seven Network argues that if, for example, Foxtel inserted cable modems into its STUs, this would enable Foxtel to use the cable forward path as the return path. Seven Network contends that this would enable Foxtel to supply itself a superior return path than access seekers can obtain using Telstra's PSTN network. A cable return path is said to be superior in the sense that a cable is faster than a PSTN line and there is no need to dial the line each time the end-user wants to send a response.<sup>165</sup>

Second, Seven Network asserts that Foxtel is not obliged under the DAA to amend, develop or upgrade its infrastructure to provide for interoperability with the access seeker's service, and an access seeker is not allowed to undertake the necessary upgrades itself, or to provide its own upgraded infrastructure. Seven Network submits that this particular aspect of the DAA is not consistent with the SAOs under section 152AR(5) of the Act.<sup>166</sup>

Third, Foxtel is not obliged under the DAA to provide access seekers with access to a "constant feed" forward path for content. Seven Network asserts that this is problematic in that Foxtel could supply such a service to itself. In this context, if access seekers could not obtain access to Foxtel's constant feed forward path, Foxtel would be in a position to supply a higher quality of interactive content than access seekers.<sup>167</sup>

Seven Network also asserts that if an access seeker is unable to obtain access to Foxtel's constant feed forward path and cable return path through commercial negotiation, the access seeker would have to seek declaration of these services if it wished to supply an interactive service of comparable quality to Foxtel's service. Seven Network asserts that this is problematic in the case where the SAU is accepted for two reasons. First, it may be difficult for an access seeker to obtain declaration of this part of the pay television service where Foxtel has given a SAU in respect of the rest of the service. Second, if the cable return path and constant feed forward path were declared,

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<sup>165</sup> Seven Network submission, 14 February 2006, p.32.

<sup>166</sup> *ibid.*, p.33.

<sup>167</sup> *ibid.*, p.33.



there would be multiple access regimes, which in the Tribunal's view, is inefficient and not in the LTIE.<sup>168</sup>

***Ten Network submission to the October 2005 Undertaking process***

Ten Network acknowledges that Foxtel has expanded its definition of the Digital Set Top Service to include access to modems which facilitates interactive services. However, it notes that there a number of important limitations placed on the delivery of Modem Services, including:

- Foxtel is under no obligation to provide an access seeker with a return path service.
- Not all Digital STUs with a Modem supplied by Foxtel will have a "return path connection" and Foxtel has no obligation to install such a connection in these STUs.
- Foxtel is not obliged to install a Modem, or to amend, develop or upgrade its STUs or Modem specifications to provide interoperability with an access seeker's modem content.<sup>169</sup>

Ten also asserts that there are a number of problems with Foxtel's attempt to include "interactive services" in the DAA terms and conditions under the heading of "Modem Services":

- By excluding return path services from the definition of Modem Services, there is scope for "multiple parallel access regimes" to occur in circumstances if the return path service is subject to an application for declaration in the future. Ten submits this is not in the LTIE in that it does not encourage the economically efficient use of infrastructure.
- By not properly defining point-to-point interactivity and point-to-multipoint interactivity which do not use Modem Services or a return path, there is ambiguity as to whether these types of services are captured by the DAA.
- Foxtel has no obligation to amend, develop or upgrade its digital STU specifications or Modem Specifications to provide interoperability with or meet the requirements of, the Access Seeker Modem Content. Ten submits that Foxtel should at least be obliged under the DAA to provide "acceptance testing services" to access seekers on fair and reasonable terms.<sup>170</sup>

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<sup>168</sup> *ibid.*, p.32.

<sup>169</sup> Ten Network Submission, 21 February 2006, p.4.

<sup>170</sup> *ibid.*

### ***Two Way TV submission to the October 2005 Undertaking***

Two Way TV's submission makes the following arguments regarding interactivity in support of its view that the Commission should reject the Undertaking:

- Foxtel owns and operates the major interactive television platform in Australia and is the only realistic potential supplier for those entities wishing to provide true interactive television services.<sup>171</sup>
- The Undertaking does not allow existing channel providers to add interactive features to existing channels, and it does not allow access seekers to supply stand-alone interactive services. Accordingly, a declaration will be required in order for access seekers to supply new interactive services that either stand alone, or are bundled with existing channels, as distinct from only supplying interactive services that are bundled with new channels. If the Commission accepts the Undertaking, it will be more difficult to obtain a declaration, and even if a declaration is obtained, there will be multiple access regimes applicable to interactive services.<sup>172</sup>
- Foxtel has omitted key documents – the Operational Procedures Manual and Modem Services Protocol – necessary to assess the reasonableness of the Undertaking. These documents could be structured in such a way as to undermine any access that the Undertaking would otherwise provide.<sup>173</sup>

### ***Foxtel Supplementary Submission to the October 2005 Undertaking***

Foxtel's supplementary submission addresses a number of issues concerning interactivity raised by submitters.

Foxtel states it does not provide itself or other persons with carriage or related services in relation to a return path connection, but rather acquires these services from third parties. This is the case for both PSTN and cable return path connections, and in the case of cable return path, Foxtel states that it currently does not offer this to its subscribers. Accordingly, Foxtel contends that it is not an access provider in respect of such services for the purposes of s.152AR of the Act, and therefore these services have been excluded from the DAA.

Foxtel states that, to the extent that a modem is installed in a Foxtel STU to enable a return path connection, whether a PSTN or cable modem, the DAA provides that Foxtel will grant access to this installed modem. However, it states that requiring Foxtel to

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<sup>171</sup> Two Way TV Australia Limited, *Submission to Australian Competition & Consumer Commission, Foxtel Special Access Undertaking*, 17 February 2006, p.5-7.

<sup>172</sup> *ibid.*, p.9-10.

<sup>173</sup> *ibid.*, p.12.

upgrade the modem connections in its STUs or install these where they are not installed is beyond the scope of Foxtel's obligations under Part XIC of the Act.<sup>174</sup>

Foxtel's Attachment 8: Supplementary Technical Report of FOXTEL Engineering further addresses the issue of the Return path raised by submitters:

Return path connectivity is provided by the modem in the STU. FOXTEL and access seekers can use the same modem (and therefore receive the same quality service). Connectivity into the PSTN is provided by the subscriber's own telephone connection (which again will be used by both FOXTEL and the access seeker). Connectivity from the PSTN to the access seeker's connection point is determined by the phone number provided by the access seeker (the point of presence). The sophistication of the end-processing applied to incoming calls from the PSTN to the access seeker is entirely under the access seeker's control.<sup>175</sup>

The Supplementary Technical Report also addresses the issues raised by the Seven Network submission regarding access to a constant feed forward path:

While the subscriber is tuned to the channel providing the return-path interactive application, there is a constant feed being decoded by the STU, irrespective of whether it is a FOXTEL or access seeker application. When the subscriber is tuned to a different channel, the constant feed of return-path interactive application data is still being supplied in the whole transport stream, but it is not used by the STU because it is not decoding the relevant channel data. This applies equally to FOXTEL and access seeker applications.

...The feed forward for return-path interactive services is provided by the access seeker as part of their content delivery and is in the form of a data carousel. The detail of the interface and protocols are available from FOXTEL. This is a standard product and would usually be available from several equipment vendors. The data carousel system is tailored to implement the specific requirements of the content provider/access seeker. The data from the carousel is carried in a constant forward stream to the subscriber's STU, but is only viewable when the subscriber is tuned to and decoding the access seeker's channel. (This same process applies equally to FOXTEL and access seeker return-path interactive applications.)<sup>176</sup>

Foxtel contends that Two Way TV's criticism that the Undertaking does not allow a third party to provide interactive features which enhance channels already broadcast as part of the Foxtel service is invalid. Foxtel argues that whether a channel on the Foxtel service can add return-path interactivity to its channel, or channels, depends on negotiations between Foxtel and the channel provider, which are in turn dependent on a number of factors including the availability of sufficient transmission capacity and whether Foxtel considers the interactive application will add to the overall appeal of the channel and the Foxtel service. In this regard, Foxtel asserts that the access regime under the Act does not, and is not intended to, impact on the wholesale arrangements between Foxtel and its channel providers.<sup>177</sup>

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<sup>174</sup> Foxtel supplementary submission, 29 March 2006, p.26.

<sup>175</sup> Smart and Higgins, *Supplementary report prepared for Special Access undertaking Application by FOXTEL*, 29 March 2006 p.3.

<sup>176</sup> *ibid.*, p.4.

<sup>177</sup> Foxtel supplementary submission, 29 March 2006, p.28-29.

In addition, Foxtel contends that there are technical difficulties in allowing an access seeker to provide an interactive overlap onto an existing channel. These issues are outlined in the Technical Report at Attachment 8 to its supplementary Submission. In essence, the Technical report states that if an access seeker was able to provide an interactive application in connection with an existing channel, without being broadcast with that channel, it would result in Foxtel having to give up a part of its own cable or satellite capacity.

The Supplementary Technical Report states:

In order to accommodate an access seeker in the manner sought by TWTV, FOXTEL would have to either re-sell a part of its own capacity to the access seeker (which it is prevented from doing by its contracts with Optus and Telstra) or it would have to return some of its capacity to Optus and Telstra and somehow require Optus or Telstra to agree to supply the returned capacity to the access seeker. It may also mean that some services FOXTEL currently supplies to its subscribers could no longer be supplied or that FOXTEL is constrained in efficiently using that capacity for its own service.<sup>178</sup>

In response to drafting issues relating to interactivity raised by the Ten Network and Two Way TV's submissions, Foxtel provides the following responses:

- Foxtel does not believe that the definition of 'Related Services' in the DAA needs to be amended to include an express reference to "interactive services". In this regard, it asserts that the definition is already widely drafted, to the benefit of access seekers. To the extent that "interactive services" are related to the digital subscription television services being provided by an access seeker and have the sole purpose of enhancing television programs, then they are covered by the existing provisions.
- Foxtel submits that the DAA adequately reflects that Foxtel is undertaking to provide Modem Services. The definition of Digital Set Top Unit Services as described in Schedule 1 clearly sets out Modem Services as part of such services.
- Foxtel does not agree that the DAA needs to be amended to include references to Access Seeker Modem Content. It states that the primary purpose of the DAA is to enable access seekers to provide digital subscription television services and related services to subscribers.<sup>179</sup>

In relation to acceptance testing, Foxtel states that it has agreed to undertake technical testing in relation to an access seeker's broadcast signal. Foxtel anticipates that, as part of the Modem Services Protocol, it will also conduct necessary testing at rates set out in the rate card and, as a practical matter, at the same time as testing of the access seeker's broadcast signal.<sup>180</sup>

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<sup>178</sup> Smart and Higgins, *Supplementary report prepared for Special Access undertaking Application by FOXTEL*, 29 March 2006, p.8.

<sup>179</sup> Foxtel supplementary submission, 29 March 2006, p.27-28.

<sup>180</sup> *ibid.*, p. 28.

In response to Seven Network's assertion that the SAU is not consistent with s.152AR(5) of the Act because it does not provide for access seekers to interconnect their own modem, Foxtel states the DAA does not prohibit the interconnection of an access seeker's modem. This is merely an issue that is not addressed in the DAA, however Foxtel notes that under clause 2.1 of the Undertaking it has committed to comply with the obligations in 152AR of the Act. If the contingency identified by Seven materialises, it will be addressed under the Undertaking and in accordance with the requirements of s.152AR<sup>181</sup>

### ***The Commission's view***

The Commission considers that the ability for access seekers to obtain an equivalent quality and functionality of Modem Services is a critical factor in enabling access seekers to compete with Foxtel in the provision of interactive content as part of channel offerings. In this regard, the Commission notes the Tribunal's views in *Seven Network Limited (No 4) [2004] ACompT 11*:

It is our opinion that interactive services are likely to be an integral element of subscription television services within the short-to-medium term. An inability to provide interactivity will result in a much inferior product offering compared to the suite of services able to be offered by Foxtel. We note the position of the Commission (par [77]), that, "[I]f it occurs that access to interactive services is important in its own right, or as a supporting service to subscription television, then this is a matter the Commission will need to consider in the future." In our view, however, and for the reasons already given, interactivity is imminent and will be a feature we expect providers of digital subscription television services will consider intrinsic to the development and promotion of an attractive and competitive product.

Foxtel has stated that, as at 23 March 2006, there were 17 channels out of the 77 channels that comprise the Foxtel Digital service that included interactive content that used a constant feed forward path, and 14 channels that included interactive content that used a return path.

Specifically, the Commission considers that the ability to provide interactive services will be an important basis upon which digital subscription television providers compete with each other. The Commission believes that access seekers have an interest in being able to provide interactivity with their own channels provided over the Digital Set Top Unit Service to their own customers. Therefore, it is important that the Undertaking now provides for Modem services.

The Commission notes that Foxtel's Supplementary submission and 'Attachment 8: Supplementary Technical Report of FOXTEL Engineering' responds to the issues raised by interested parties regarding the scope and nature of access to Modem Services available under the DAA. In particular, the Commission notes Foxtel's response that the return path connectivity provided by the modem in STUs means that Foxtel and access seekers will receive the same quality of service. Similarly, Foxtel's response clarifies that the processes for the provision of constant feed forward path for interactive applications will apply equally to Foxtel and access seekers. In addition,

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<sup>181</sup> *ibid.*, p.29.

Foxtel submits that the DAA does not prohibit the interconnection of an access seeker's modem, and that, pursuant to the Undertaking, Foxtel will comply with the obligations in s.152AR of the Act in relation to such matters. The Commission is also satisfied with Foxtel's response that the definition of Digital Set Top Unit Services contained in the DAA adequately indicates that Foxtel is undertaking to provide Modem Services.

With regard to the exclusion of return path carriage services under the DAA, Foxtel states that it does not provide itself, or any other persons, carriage or related services in relation to a return path connection. Rather it acquires these services from third party providers such as Telstra in the case of point of presence services for the PSTN. Given this factor, it is not apparent that competition and efficiency would be enhanced in the case where Foxtel, as opposed to third party CSPs, were to supply return path carriage services to access seekers.

In relation to Two Way TV's concern that the Undertaking does not allow channel providers to add interactive features to existing channels, the Commission notes that Clause 2.7 of the Undertaking has been amended to provide that the Undertaking is only in relation to the supply of the Digital Set Top Unit Service and is not an undertaking in relation to the supply of each component service. Therefore acceptance of Foxtel's current Undertaking would not restrict the Commission's ability to declare and make arbitral determinations in respect of access to unbundled Modem services for existing channel providers.<sup>182</sup> The Commission considers that if there is a compelling case for declaration of an unbundled Modem services for existing channel providers, this would not be materially impacted by the existence of an operative undertaking for the bundled Digital Set Top Unit Service.

In addition, the Commission believes that Foxtel has a legitimate business interest in deciding what content it provides to its own customers. In deciding whether the terms and conditions of access are reasonable under s.152AH, the legitimate business interest of Foxtel is a factor to be weighed up (s.152AH(1)(b)). In this case, the Commission takes the view that it is a significant factor to be weighed up where the proposal is that access seekers to a service (the Digital Set Top Unit Service) be allowed to intervene in the product that Foxtel provides to its own customers over that service.

In considering the matters under s.152 AH, the Commission finds that, on balance, the Undertaking provides for an effective form of access to Modem services. Therefore, the Commission is satisfied with the interactivity provisions contained in the Undertaking.

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<sup>182</sup> This was an issue in the Commission assessment of the October 2005 Undertaking. See discussion in Draft Decision p. 112-118.

### **6.2.5 EPG services**

As part of the Undertaking, Foxtel will provide EPG Services in respect of access seekers' channels pursuant to the terms and conditions set out in the Clauses 5 and 10 of the DAA.

The Commission notes that Foxtel has deleted Clause 5.2 (e) in the DAA. This will allow all subscribers to view the Access Seeker's channels listing on Foxtel's EPG.

#### ***Ten Network submission to the October 2005 Undertaking***

The Ten Network identifies a number of areas of concern relating to the terms of access to EPG services under the proposed DAA. In particular, it contends that:

- The current definition of EPG services must be expanded to cover new functionality that is directly linked to EPG services such as "series link" and "real-time" functionality.
- The EPG services being offered by Foxtel under the proposed DAA do not allow access seekers to reserve channel numbers or guarantee contiguous numbering. Foxtel has the ability to reserve channel numbers to itself, whilst access seekers cannot reserve channel numbers.
- An access seeker's channel listing will only be visible to subscribers to the access seeker's channel. In contrast, all of Foxtel channel listings are visible to all Foxtel digital subscribers, even if they don't subscribe to particular channels or tiered packages.<sup>183</sup>

#### ***Two Way TV submission to the October 2005 Undertaking***

Two Way TV also asserts that all access seeker channels should be visible in the EPG to all viewers, even if a viewer is not a subscriber to those channels. It argues that only providing EPG channel listings to subscribers once they subscribe to that particular channel is not useful in making subscribers aware of the access seeker's channel. Two Way TV also asserts that it would require greater effort and cost on the part of Foxtel if access seeker channels were only visible in the EPG to subscribers to those channels.

Two Way TV notes that the dominant pay TV operator in the UK is required to provide access to its platform, including its EPG, on fair, reasonable and non-discriminatory terms. Two Way TV submits that similar provisions should apply in relation to Foxtel, in the Australian context to facilitate an "open access" platform.

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<sup>183</sup> Ten Network submission, 21 February 2006, p.6.

Two Way TV also asserts that access seekers should also be able to display and advertise that “red button” interactive features are available as a means to assist viewers to identify and use interactive services.<sup>184</sup>

### ***Foxtel Supplementary Submission to the October 2005 Undertaking***

In response to the issues raised in the Ten Network and Two Way TV submissions regarding EPG services, Foxtel’s supplementary submission makes the following points:

- Foxtel argues that the definition of EPG services do not need not be expanded as the supply of series link and real time functionality is already contemplated by the DAA – Clause 5.1(d)(iv) requires an access seeker to provide to Foxtel series link and real time data, if it wishes to offer series link and real time functionality to subscribers.
- Foxtel asserts that it is reasonable that access seekers are not awarded identical rights to Foxtel in respect of reserving and displaying channel numbers on the EPG. It contends that EPG remains a Foxtel-branded service, and Foxtel bears the bulk of the costs of supplying it to users. Foxtel states that only active channels will be listed on the EPG, thus, even if Foxtel reserves numerous channel numbers in between an active channel number and a channel allocated to an access seeker, the access seeker's channel would be listed directly after the last active channel.
- Foxtel asserts that only allowing access seeker’s listings to be visible to viewers that subscribe to the access seeker's channels is reasonable given Foxtel bears the bulk of the cost of supplying the EPG, and Foxtel's level of investment in the EPG. It states that EPG should not be used as a marketing tool for access seekers when there are numerous other avenues for an access seeker to do this.
- Foxtel states that it currently offers an "Active" button feature on its EPG identifying all channels that have interactive features. Access to this button will be available to all access seekers, in the same manner in which it is to available to all Foxtel channels.<sup>185</sup>

### ***The Commission’s view***

An important benchmark in assessing whether competition will be promoted is whether the proposed terms of access in the Undertaking facilitate non-discriminatory access between downstream suppliers of a service. An effective form of access in accordance with this principle should lead to the promotion of competition and facilitate an efficient use of infrastructure.

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<sup>184</sup> Two Way TV submission, 17 February 2006, p.13-14.

<sup>185</sup> Foxtel supplementary submission, 29 March 2006, p.30-31.



The Commission notes that under the DAA, Foxtel has the ability to reserve channel numbers to itself, whilst access seekers cannot reserve channel numbers. While access seekers will not have identical rights to Foxtel in respect of reserving and displaying channel numbers on the EPG, Foxtel states that only active channels will be listed on the EPG. Foxtel provides that even if it reserves a number of channels between an active channel number and the channel allocated to an access seeker, an access seeker's channel will be listed directly after the last active channel. Given this factor, the Commission believes that the inability to reserve channels will not materially disadvantage access seekers in terms of being able to publicise channel offerings and compete.

Overall the Commission is satisfied with the EPG provisions under the DAA, including the amendments that allow all subscribers to view access seeker's channels listing on Foxtel's EPG.

### **6.2.6 Other non-price issues**

Two Way TV also raised a number of other concerns relating to non-price clauses under the DAA as part of the October 2005 Undertaking assessment process.

#### ***Bank guarantee***

Two Way TV notes that Foxtel requires access seekers to provide a bank guarantee, in an amount "reasonably" determined by Foxtel, as a condition precedent to the DAA taking effect (clause 2.1 of the DAA). The amount is deemed reasonable if "it is sufficient to enable the performance of the access seeker's obligations" under the DAA. Two Way TV contends that since the Agreement will have a term of between five and eight years (at the option of the access seeker), the amount of this guarantee could be quite large. Two Way TV asserts that it should not be necessary to provide a bank guarantee for an amount larger than one month's access charges, given that access seekers can terminate the DAA on one month's notice at any time under clause 24.4(d).<sup>186</sup>

Foxtel, in its Supplementary Submission, contends that the provisions are reasonable and are a typical request in commercial relationships of this nature. Foxtel asserts that the extent of the bank guarantee is limited by the obligation that the amount of the bank guarantee must be determined by Foxtel, acting reasonably. It notes that the exact amount of a bank guarantee will depend on the nature of each access seeker (their size, financial viability etc), and the number and type of services that each access seeker will require from Foxtel for the duration of the term of the DAA. Foxtel also states that the ability to terminate by giving one month's notice would only be a relevant benchmark to determining the amount of a bank guarantee if Foxtel itself had this capacity.<sup>187</sup>

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<sup>186</sup> Two Way TV submission, 17 February 2006, p.14 - 15.

<sup>187</sup> Foxtel supplementary submission, 29 March 2006, p.31-32.

### *The Commission's view*

The Commission considers it reasonable for an access provider to be able to require security from an access seeker in order to protect its legitimate business interests. It is important, however, that the amount of security and any creditworthiness review be determined on an objective basis. The Commission has previously noted that a standard of reasonableness in determining issues relating to creditworthiness and security may be an appropriate criterion.<sup>188</sup> In this regard, the Commission's view is that Foxtel determining the amount of the bank guarantee for access seekers, *acting reasonably*, is appropriate. If the access seeker considers that Foxtel has not acted reasonably in relation to these matters, then it may submit the matter to the dispute resolution procedures under the DAA.

### ***Changes to the DAA***

Two Way TV argues that Foxtel can change the terms and conditions of the DAA at any time and for any reason, even where this imposes additional costs or otherwise has a material adverse effect on an access seeker. Two Way TV argues that this is not reasonable, and is not consistent with the terms of Foxtel's own Undertaking.

Foxtel claims the right to change the terms and condition of the DAA at any time and for any reason (see clause 4.4, especially clause 4.4(b)). Foxtel also claims the right to change any aspect of its equipment, and the supporting documents which govern how access is actually provided under the DAA, at any time and for any reason (clause 11.2, and especially clause 11.2(d)). Two Way TV contends that clauses 4.4 and 11.2 of the DAA are not consistent with clause 2.5 of the Undertaking – the latter purports to impose some restriction on Foxtel's conduct, whereas no such restriction actually exists under the DAA. Further, Two Way TV asserts that the provisions of clause 2.5 of the Undertaking are so broad and vague that access seekers have little protection.

Two Way TV contends that clauses 4.4 and 11.2 of the DAA should be amended to provide that Foxtel can only amend the DAA, or any related documents, for the reasons set out in clause 2.5 of the Undertaking. Those reasons should themselves be clarified. Further, the DAA should make it clear that Foxtel cannot make amendments if they will have an adverse effect on access seekers.<sup>189</sup>

In its Supplementary Submission, Foxtel states that while it does have the right to change certain terms and conditions of the DAA, these are limited to the situations set out in clauses 4.4 and 11.2 only (clause 30.2 of the DAA). In addition, it may not alter the provisions of Schedule 3 that relate to access charges and pricing methodology. Further, Foxtel has agreed with the Commission that it will not vary the DAA other than in accordance with clause 2.5 of the Undertaking. This includes a requirement

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<sup>188</sup> ACCC, *Final Determination—Model Non-Price Terms and Conditions*, October, 2003.

<sup>189</sup> Two Way TV submission, 17 February 2006, p.15-16.

that the Digital Set-Top Unit Services supplied to an access seeker remain supplied to the equivalent quality as Foxtel supplies to itself.

In its new Undertaking Foxtel has made the following amendments in relation to these provisions:

- Clause 4.4(b) of the DAA has been amended to extend the required notice periods before a Change can be enacted (from 1 month to 2 months and from 3 months to 6 months in sub-clauses (b)(ii) and (iii) respectively).
- Clause 11.2(b) of the DAA has been amended to provide that reasonable prior notice of a Modification is not less than 1 month's notice.

In its Submission in support of its new Undertaking, Foxtel also clarifies that:

Clause 4.4(b) relates to changes to the Digital Set Top Unit Service and clause 11.2 relates to changes to the Interface Specifications, Operational Procedures, Modem Protocol and/or Channel Kit. The subject matter of these changes is different to that of section 2.5 of the SAU, which relates to changes to the DAA itself.<sup>190</sup>

*The Commission's view*

The Commission considers that an access provider must have the right to make reasonable decisions about modifications and upgrades to its network. However, it is important that access seekers have appropriate rights and notice in relation to proposed changes to a facility or service that affects their business interests.

In the Draft Decision, the Commission stated that the provisions in clause 2.5 of the Undertaking reasonably counterbalance the rights of access seekers and Foxtel in terms of modifications and upgrades to Foxtel's network. However, the Commission noted it had some concerns about the effects of clauses 4.4(b) and 11.2(e) in the DAA on operation of clause 2.5 of the Undertaking. Additionally, the Commission noted some concerns about the adequacy of the notice periods contained in clauses 4.4(b) and 11.2 of the DAA.

In relation to these concerns, Foxtel has extended the notice periods under clauses 4.4(b) and 11.2 of the DAA. Foxtel has also clarified that the provisions under clauses 4.4(b) and 11.2(e) in the DAA and clause 2.5 of the Undertaking relate to separate matters.

The Commission is satisfied with these amendments and considers that the provisions now give due regard to the legitimate business interests of Foxtel and the interests of access seekers. In addition, the Commission notes Foxtel commitment under clause 2.5 that will ensure the Digital Set-Top Unit Service supplied to an access seeker remains supplied to the equivalent quality as Foxtel supplies to itself.

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<sup>190</sup> Foxtel Submission, 1 December 2006, p.19.

On balance, the Commission's view is that these terms are in the LTIE, and in the interest of access seekers.

### *Charges for faults and repairs*

Two Way TV notes that Schedule 2 clause 6 of the DAA provides that Foxtel will charge access seekers for the costs of faults and repairs, unless the fault is a "Foxtel Fault". Schedule 10 defines this as a fault caused directly by Foxtel's negligence or breach of the DAA. In contrast, an "Access Seeker Fault" is defined as any fault in the Access Seeker's equipment or services, even if the Access Seeker has not been negligent or in breach of the DAA.

Two Way TV asserts that this is commercially unreasonable, since it will allow Foxtel to charge access seekers for fixing faults in Foxtel's own equipment, where those faults have not been caused by the Access Seeker. In this regard, it states that the definition of a "Foxtel Fault" should be changed so that it is consistent with the definition of Access Seeker Fault.<sup>191</sup>

In response, Foxtel contends that these provisions are reasonable as:

- Foxtel is constantly monitoring its pay TV platform and connected equipment, remedying faults. This will limit the need for an access seeker to contact Foxtel about a fault.
- Only where an access seeker notifies Foxtel of a fault with Foxtel's equipment, and Foxtel is not the cause of the fault due to its negligence or breach, will the access seeker be charged (based on the reasonable costs and expenses in investigating a fault). Foxtel asserts that in most cases such notified faults will be caused by an access seeker's equipment or service.
- Access seekers must be fully responsible for their equipment and services and must maintain these to the required technical and operational standards. Unless Foxtel is in breach of its obligations under the DAA, it is reasonable that access seekers take such full responsibility for their equipment and their services.

Foxtel, as part of its current Undertaking has amended the DAA in Schedule 2, clause 6, to provide that where a Fault is notified by the access seeker and it is not caused nor contributed to by Foxtel or the access seeker, then the costs in paragraph (b) will be shared equally between Foxtel and the access seeker.

### *The Commission's view*

Foxtel's amendment to Schedule 2, clause 6 of the DAA functions to reach a better balance between the rights of the access provider and access seeker. Therefore, the Commission is now satisfied with these provisions.

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<sup>191</sup> Two Way TV submission, 17 February 2006 p16.

### *Ownership of enhancements*

Two Way TV notes that while access seekers must pay the costs of any enhancements to the Foxtel system that are required to enable the access seeker to provide services, these enhancements become the property of Foxtel (clause 9.3(b)(iv) of the DAA). Two Way TV contends that Foxtel will obtain a benefit from the provision of access (in the form of an enhancement to its network) which is not based on Foxtel's cost of providing access. In addition, Foxtel may impose additional monthly charges "in relation to the operation and maintenance of the Enhancements" (clause 9.4). It states that it is not clear whether these payments form part of the Access Charges.<sup>192</sup>

In response, Foxtel asserts that any enhancements made will be solely to accommodate, and be for the benefit of, access seekers. These enhancements will merely enable Foxtel to provide services under the DAA, with no additional benefits to Foxtel. Foxtel states that most enhancements will be shared among access seekers and that it will pro-rata the costs of any shared enhancements to a maximum of 20 per cent of the actual costs.

Foxtel states that given the enhancements are shared, it is not clear that they could be removed and "returned" to access seekers. Even if they could be returned, the cost of doing so would be significant. Foxtel contends that it would not be worth the effort nor would it provide any benefit to access seekers to remove enhancements at the termination of the DAA and provide these to access seekers.<sup>193</sup>

### *The Commission's view*

The Commission's view is that it is satisfied with these provisions. In this regard, the Commission notes Foxtel's assertion that any enhancements made will be solely for the benefit of access seekers. Moreover, it is the Commission's understanding that the scope and scale of required enhancements and extensions should not be significant given that Foxtel has previously undertaken to design that part of the network used to provide digital subscription television services to access seekers in a manner that accommodates multiple access seekers without the need for significant additional network enhancements.<sup>194</sup>

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<sup>192</sup> *ibid*, p16.

<sup>193</sup> Foxtel supplementary submission, 29 March 2006, p.33.

<sup>194</sup> Clause 4.9, *Undertaking to the Australian Competition and Consumer Commission by Foxtel Management Pty Ltd (for and behalf of the Foxtel Partnership) and Foxtel Cable Television Pty Limited*, 21 November 2002.

### *Warranties, indemnities and assignment rights*

Two Way TV asserts that the warranties, indemnities and assignment rights provisions are one-sided in favour of Foxtel, and are not reasonable. It notes that:

- Under clause 22.1(a), the access seeker indemnifies Foxtel for consequential loss and legal fees on a full indemnity basis, while Foxtel provides no indemnities at all, and specifically excludes liability for consequential loss, even when caused by the negligence or unlawful or wilful misconduct of Foxtel.
- Under clause 23.2, Foxtel places a limit on its liability, whereas there is no such protection for the access seeker.
- Under clause 29.1, the access seeker may not assign its rights or obligations under the DAA whereas Foxtel may assign or purport to novate any or all of its rights and obligations (clause 29.2), even where the assignee is not capable of performing Foxtel's obligations.<sup>195</sup>

Foxtel contends that the warranties, indemnities and assignment rights in the DAA are commercial and reasonable, given the arrangements that Foxtel has in place with other third parties in relation to its platform and the technical and operational risks to Foxtel of an access seeker's presence on its pay TV platform.

In relation to the assignment provisions, Foxtel contends that it must have the flexibility to reorganise its business and affairs, especially given the term of the DAA. As owner of the Foxtel platform, Foxtel is responsible for numerous subscribers including those of other access seekers. Given that, Foxtel must be able to verify and approve those access seekers who have access to its system. It is likely that potential damage or loss in relation to Foxtel would be greater than an access seeker on Foxtel's pay TV platform and that Foxtel should have the ability to reduce those potential losses or damage. Moreover, Foxtel states that access seekers will only be liable to the extent that they have caused or contributed to the damage or loss.<sup>196</sup>

As part of its current Undertaking Foxtel has amended clause 23.3 of the DAA to make exclusions of liability apply to both parties rather than just the access seeker.

### *The Commission's view*

The Commission considers that, as a general rule, liability provisions should apply to both parties and should place risk with the party which has the ability to control the risk. The Commission recognises that the actions of both access seekers and Foxtel have the potential to inflict damages on the other party, and it is not clear that one party has a materially greater capacity to control risk. In this regard, the Commission's view is that the amendment to clause 23.3 of the DAA functions to reach a better balance

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<sup>195</sup> Two Way TV submission, 17 February 2006, p.17.

<sup>196</sup> Foxtel supplementary submission, 29 March 2006, p.33.

between the legitimate business interests of Foxtel and access seekers. Therefore, the Commission is now satisfied with these provisions.

#### *Excluded services*

Two Way TV also asserts that accepting the Undertaking will mean that access seekers who want to offer interactive services will incur significant costs in setting up and running their own pay TV business. In this regard, Two Way TV states that Foxtel should provide access seekers with the following services, at a cost:

- Marketing and advertising, including listing in the Foxtel magazine and EPG.
- Call centres to handle customer enquiries.
- Subscriber management system.
- Billing of customers.
- Use of Foxtel's POP network - the "point of presence" network.
- The back-end infrastructure used to process interactive applications and supply services to viewers.<sup>197</sup>

#### *The Commission's view*

The Commission's view is that the fact that the Undertaking does not cover these services is not likely to have a significant impact upon the extent to which the terms and conditions are reasonable (the issue of access to the Foxtel EPG is discussed above). The Commission considers that it is unlikely that these services would constitute bottleneck elements in the supply of interactive services. Therefore it is not apparent that access seekers pursuing self supply options or supply through other third party providers with respect to these services would necessarily deter competitive entry or lead to inefficient outcomes.

### **6.3 Summary of the Commission's assessment of the non-price terms and conditions**

The Commission considers that the non-price terms and conditions in the Undertaking would provide a potentially effective form of access for content provider access seekers wanting to provide services to Foxtel's existing subscribers in competition with Foxtel's tier channels i.e. niche channel providers. The Commission considers that there is value in niche channel providers having a mechanism for gaining distribution on Foxtel's digital platform given Foxtel's market power in the acquisition of subscription television content and the scale of its existing subscriber base.

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<sup>197</sup> Two Way TV submission, 17 February 2006, p.11.

The Undertaking would provide access to the 'minimum bundle of assets' that a niche channel provider requires in order to provide its subscription television services to end-users. That is, the Undertaking provides access to Foxtel's subscribers (the key obstacle for content providers), including access to modems and inclusion in the EPG.

In sum, the Commission is satisfied that the non-price terms and conditions in the Undertaking are in the LTIE and give due regard to the interests of Foxtel as the access provider and the interests of access seekers.



## **7. Is the Commission satisfied that the terms and conditions specified in the Undertaking are reasonable?**

### **7.1 Introduction**

The Commission must not accept the Undertaking unless it is satisfied that the terms and conditions are reasonable. This chapter contains the Commission's assessment of whether it is satisfied that the terms and conditions specified in the Undertaking are reasonable.

### **7.2 The Commission's approach to assessing whether the terms and conditions of the Undertaking are reasonable**

In Chapters 5 and 6, the Commission set out its views on a number of the specific terms and conditions. As a matter of practicality, the Commission considers that such an analysis is a necessary component of the assessment of the overall Undertaking. The Commission also notes that most interested parties framed their comments in relation to the Undertaking in terms of the impact of particular clauses of the Undertaking.

In relation to the present Undertaking, the Commission has then, in this chapter, assessed whether it is satisfied that the terms and conditions, as a whole, are reasonable taking into account not only the effect of individual terms/conditions, but also the way in which the terms and conditions interact with each other and the effect that the terms and conditions would have or are likely to have on relevant interests and matters.

Section 152AH of the Act specifies that in determining whether particular terms and conditions are reasonable, the Commission must have regard to at least the matters set out in that section.

Specifically, in undertaking its overall assessment of the reasonableness of the terms and conditions of the Undertaking, the Commission has taken into account the following matters:

- whether the terms and conditions promote the LTIE;
- the legitimate business interests of the service provider and its investment in the facilities used to supply the service;
- the interests of persons who have rights to use the service;
- the direct costs of providing access to the service;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and

- the economically efficient operation of a carriage service, a telecommunications network or a facility.

To assist (as opposed to ‘determine’) this assessment, the Commission will use, where appropriate, the ‘with and without’ test in relation to particular criteria.

The Commission believes that it is appropriate to use the ‘future with and without’ test expressed in the *Sydney Airports* case.<sup>198</sup> The Commission notes that in the *Seven Network Ltd* case,<sup>199</sup> the Tribunal was of the view that the ‘with and without’ approach provides helpful guidance in applying the LTIE test. Similarly, the Commission considers it an appropriate analytical tool in having regard to a number of the reasonableness criteria set out in s.152AH(1) of the Act (which includes the LTIE test).

Essentially, the test enables the Commission to benchmark the Undertaking against other potential outcomes in the absence of the Undertaking, in relation to specific criteria. This is particularly important because the Commission must assess the Undertaking in terms of its reasonableness over the life of the Undertaking and not just in the near future. The Undertaking, if accepted, would operate for a term of approximately eight years from commencement (and a DAA executed in accordance with the Undertaking could potentially operate for a period of between 5 and 8 years after that). Accordingly, the Commission must take a short and longer term view as to the possible effects of the Undertaking through a consideration of likely events with and without the Undertaking.

Having said that, the Commission notes that the ‘with and without’ test lends itself to some, but not all, of the relevant criteria in s.152AH(1) of the Act. Accordingly, in using the ‘with and without’ test, the Commission will only use the test in having regard to those criteria where it facilitates (as opposed to ‘determines’) the Commission’s analysis toward the Commission ultimately determining the overall reasonableness of the Undertaking terms and conditions.

## **7.3 Consideration of each of the matters relevant to reasonableness**

### **7.3.1 Whether the terms and conditions promote the LTIE**

In determining whether the Undertaking promotes the LTIE of either carriage services or services supplied by means of carriage services (‘listed services’), s.152AB of the Act requires the Commission to have regard to the extent to which the Undertaking is likely to result in the achievement of the following objectives:

- the objective of promoting competition in markets for listed services;

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<sup>198</sup> *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

<sup>199</sup> *Seven Network Ltd* [2004] ACompT 11.

- for carriage services involving communications between end-users, the objective of achieving any-to-any connectivity; and
- the objective of encouraging the economically efficient use of, and economically efficient investment in
  - the infrastructure by which listed services are supplied; and
  - any other infrastructure by which listed services are, or are likely to become, capable of being supplied.<sup>200</sup>

Furthermore, the Act provides that the above list is intended to limit the matters to which the Commission may have regard in determining whether the Undertaking promotes the LTIE.<sup>201</sup>

The Commission has made its assessment of whether the Undertaking promotes the LTIE by having regard to these three objectives. The Commission's view in relation to each of the three objectives is set out below:

***The objective of promoting competition in markets for listed services***

As required by s.152AB(4), in determining the extent to which a particular thing is likely to result in the achievement of the objective of promoting competition in markets for listed services, the Commission has regard to the extent to which that thing will remove obstacles to end-users of listed services gaining access to listed services.

*Relevant market(s)*

Foxtel and Seven Network provided views as to the relevant market(s) the Commission should consider in the Commission's assessment of whether the Undertaking promotes the LTIE.

Foxtel, relying on the statements made by it in the C7 litigation contained in Attachment 19 to its submission of 6 October 2005, submits that the relevant market is a television entertainment market. In support of this position, Foxtel also refers to the report in Attachment 6 to its Submission, *Philip Williams – Frontier Economics: Report on Market Definition and Promotion of Competition* (Frontier report). The Frontier report finds that Foxtel competes in a market which includes subscription television operators, free-to-air broadcasters and, to a lesser extent, DVDs and videos. The assumptions upon which Frontier bases its conclusions are said to be derived from statements in Attachment 19. Nevertheless, Foxtel submits that regardless of whether the market is defined as a broad market for television entertainment or a narrow market for subscription television, the Undertaking is likely to promote competition by removing barriers to entry.<sup>202</sup>

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<sup>200</sup> Section 152AB(2) of the Act.

<sup>201</sup> Section 152AB(3) of the Act.

<sup>202</sup> Foxtel submission, 6 October 2005, p.59-60.

Seven Network submits that the Commission should not, and for present purposes does not need to, define the relevant market as the issue of relevant market definition is currently the subject of Federal Court proceedings. It states that, if required, the Commission should adopt the working definition, used by the Tribunal in *Re Seven Network Limited & Anor (No 2)* (2004) 187 FLR 373 – the market for the provision of subscription television services.<sup>203</sup>

The Commission considers that it is not necessary to form a view regarding the definition of relevant market(s) in assessing the reasonableness of the Undertaking. The Commission considers that the definition of markets is a tool that may be used in order to assist in competition analysis. The Commission's assessment of whether Foxtel's Undertaking is reasonable will include amongst other things, whether accepting the Undertaking is in the LTIE and a consideration of other matters set out in the Act. For this purpose, the Commission has considered the likely effect in various markets of accepting the Undertaking. However, the Commission does not consider it necessary, for this purpose, to set out any view as to the exact boundaries of the relevant market(s).

#### *With and Without Analysis*

In assessing this matter, the Commission considered it useful to undertake with and without analysis.

#### **Application of With/Without analysis**

In applying 'future with and without' analysis to assist the assessment of the Undertaking, the Commission will compare the following two situations:

- outcomes the Commission believes are likely to otherwise occur – having regard to the procedures and protections for access seekers that arise under Part XIC of the Act ; and
- options available under the Undertaking.

Each of these alternatives is described in greater detail below.

The Commission notes, however, that ultimately its task is to assess the reasonableness of the terms and conditions specified in the Undertaking. Section 152BV(2)(d) of the Act requires that in order for the Commission to accept the Undertaking, it must be satisfied as to the reasonableness of the terms and conditions specified in the Undertaking. This requires the Commission to give weight to each of the matters set out in s. 152AH(1) of the Act as fundamental elements in making its determination. In this regard, the Commission emphasises that the 'with and without' analysis is *not* a substitute for a consideration of the reasonableness of the specified terms and conditions.

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<sup>203</sup> Seven Network submission, 14 February 2006, p.3.

### *Outcomes without the Undertaking*

In the future without the Undertaking, access seekers would have three main avenues by which to gain access to Foxtel digital STU infrastructure.

First, access seekers could gain access to Foxtel's Digital Set Top Unit Service through commercial negotiation.

Second, access seekers could gain access to Foxtel's Digital Set Top Unit Service under the terms of the s.87B undertaking until 31 December 2015.

Third, it may be that access seekers could obtain declaration of the service by the Commission and then obtain access on terms and conditions determined by an arbitral determination in accordance with s. 152AY(2)(b)(iii). In this case, access seekers would have the ability to refer to arbitration an access dispute over the price and non-price terms and conditions of access to the declared service.

In terms of considering the likely outcomes in the future without the Undertaking, the Commission notes that the assessment of a SAU is similar to an AEO under s.152ATA (in contrast to an ordinary access undertaking under s.152BS). In particular, there are no existing declarations, pricing principles, or relevant model terms and conditions in relation to the Digital Set Top Unit Services to rely upon in considering what protections under Part XIC of the Act the future without the Undertaking would likely provide.

In this context, the Commission recognises that there is considerable uncertainty regarding the likelihood of the outcomes in the absence of accepting the Undertaking. In particular, the probability of declaration, the scope of services included in any such declaration, and the terms and conditions that may be decided in any ensuing arbitral determination are difficult to predict. In this respect, Foxtel submits that it is highly debatable whether the digital subscription television service would be declared even in the absence of the Undertaking.<sup>204</sup>

### *Options with the Undertaking*

In the future with the Undertaking, access seekers would have three main avenues by which to gain access to Foxtel digital STU infrastructure.

First, access seekers could gain access to Foxtel's Digital Set Top Unit Service through commercial negotiation. This is the same as under the 'without' scenario.

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<sup>204</sup> Foxtel submission, 6 October 2005, p.56-57. Foxtel refers to the a report by John Paul of ACPG Pty Ltd, Identification of Media Distribution Mechanisms and Models in Australia, at Attachment 16 that finds that there are a number of ways of delivering audio/visual content and that these alternatives are either currently competitive or are likely to be so, to some extent, with subscription television services in the near future.

Second, access seekers could gain access to Foxtel's Digital Set Top Unit Service under the terms of the s.87B undertaking until 31 December 2015. This is the same as under the 'without' scenario.

Third, access seekers can gain access to Foxtel's Digital Set Top Unit Service under the terms of the Undertaking for a duration of 8 years from the commencement date.<sup>205</sup>

The non-price terms and conditions specified in the Undertaking have been described in Chapter 4 of this report. As discussed above, the DAA as part of the Undertaking differs from the DAA provided by Foxtel as part of its s.87B undertaking in the respect that it provides:

- access to 'Modem Services' to supply Access Seeker Modem Content;
- access to the Foxtel EPG;
- a longer term;
- termination on one month's notice at the access seeker's election; and
- the ability for access seekers to use in satellite capacity from non-Foxtel satellite network in conjunction with the Undertaking.

The price terms and conditions specified in the Undertaking have also been described in Chapter 4 of this report. Foxtel proposes a methodology for estimating charges to access seekers using the Digital Set Top Unit Service based on the report by NECG in Attachment 7 to its Undertaking.<sup>206</sup> Broadly speaking, this is the same methodology as contained in its previous DAA as part of its s.87B undertaking.<sup>207</sup> However, in this Undertaking, Foxtel has revised the service description of the Digital Set Top Unit Service to include two additional services –EPG Services and Modem Services. This inclusion impacts on Foxtel's cost base that forms part of its pricing methodology and is discussed in Attachment 1 to Foxtel's submission of 6 October 2005.<sup>208</sup>

If the Commission accepted the Undertaking, it could still declare a digital set top unit service and related services under s.152AL(8) of the Act and arbitrate the terms and

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<sup>205</sup> See Foxtel submission, 22 November 2005. It has not been argued that there is any potential inconsistency between Foxtel's obligations under s 87B and Part XIC. In the case of the Undertaking, Foxtel submits that the access seeker could elect whether to enter into the DAA attached to either the s 87B undertaking or the Undertaking.

<sup>206</sup> Attachment 7: NECG, Part A: *STU Access Charging*, 4 June 2002; Part B: *Access Pricing Model for Digital Cable and Satellite STUs: Description of cost-based pricing methodology*, 30 August 2002.

<sup>207</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003

<sup>208</sup> Attachment 1: CRA International, *Adjusted access pricing model for digital STUs*, October 2005.

conditions of access. However, pursuant to s.152CQ(5) of the Act, the Commission could not make an arbitration determination that is inconsistent with the Undertaking.

In this scenario then, access seekers would have certainty of access to a declared service that allowed them to distribute their own content (including interactive content) to Foxtel's digital subscriber base, and have their content listed in the EPG, on specified terms and conditions that embrace the SAOs.

Potential access seekers would lose their uncertain ability to seek declaration and have access on arbitrated terms and conditions that embrace the SAOs.

In assessing a SAU, the Commission does not consider that it is necessary to undertake a proxy declaration inquiry and decide whether the service would be declared and, if so, whether 'better' terms and conditions might or might not apply in a hypothetical arbitration involving a hypothetical access seeker. As stated in Chapter 3, the Commission is only required to determine whether the proposed terms and conditions of supply in the SAU are reasonable, not whether they are the best possible terms and conditions or whether they could be improved. This approach is supported by the Tribunal which noted in its decision in respect of *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006), that:

In this analysis we are limiting ourselves to asking whether Telstra's charge term and its cost allocation method is reasonable having regard to the statutory matters. We are not concerned to enquire whether any other price term or cost allocation method is more reasonable.<sup>209</sup>

As long as the Commission is satisfied that the proposed terms and conditions of supply embrace the SAOs and are reasonable, then the regulatory certainty of access afforded to access seekers by the SAU is an improvement on the uncertainty as to declared access they face without the SAU.

### ***Conclusions in relation to the objective of promoting competition***

The Commission has discussed its view of individual terms and conditions in Chapters 5 and 6. For reasons described there, and looking at the terms and conditions of access as a whole, on balance the Commission considers that the Undertaking would provide a potentially effective form of access for content provider access seekers wanting to provide services to Foxtel's existing subscribers in competition with Foxtel's tier channels i.e. niche channel providers.

In particular, accepting the Undertaking would provide access to the 'minimum bundle of assets' that a niche channel provider (who intends to provide tier channels to Foxtel's subscriber base) requires in order to provide its subscription television services to end-users. That is, the Undertaking provides access to Foxtel's subscribers, as well as access to modem services and inclusion in the EPG.

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<sup>209</sup> *Telstra's Line Sharing Service [2006]* ACompT 4 (2 June 2006) at [150]. Also, *Optus Mobile MTAS decision [2006]* ACompT 8 at [93]

The Commission considers that there is value in niche channel providers having a mechanism for gaining distribution to Foxtel's subscriber base on Foxtel's digital platform, given Foxtel's market power in the acquisition of subscription television content and the scale of its existing subscriber base. In this respect, the Commission notes that the Undertaking would provide an improved terms and conditions of access compared with Foxtel's current operative s.87 undertaking, including provision of access to Modem Services and EPG services.

The Commission notes that the 'tying' provisions contained in the Undertaking would promote competition only at the tier level and would not promote competition in terms of facilitating the entry of full package providers that may provide subscription television services in competition with Foxtel's basic package. However, as outlined in section 6.2.1, the Commission considers that STUs and related services of themselves do not constitute a bottleneck element in the supply of subscription services and therefore the Commission concurs with the Tribunal's view that Foxtel should not be required to supply STUs to non-Foxtel homes. Acceptance of the Undertaking will not adversely affect the competitive entry of full package providers who have a full package of subscription television content to sell.

In sum, the Commission believes that accepting the Undertaking would promote competition.

***The objective of achieving any-to-any connectivity***

The Commission has had regard to the issue of any-to-any connectivity but believes that this issue is not relevant to the assessment of the Undertaking because end users (i.e. pay TV subscribers) do not use subscription television services to communicate with each other.

***The objective of encouraging the economically efficient use of, and economically efficient investment in the infrastructure by which listed services are supplied or any other infrastructure by which listed services are, or are likely to become, capable of being supplied***

*Existing investment*

As required by s.152AB(6) and s.152AB(7A), in determining the extent to which a particular thing is likely to result in the achievement of the objective set out in s. 152AB(2)(e), the Commission has had regard to the following matters:

- whether it is, or likely to become, technically feasible for the services to be supplied and charged for, having regard to:
  - the technology that is in use, available, or likely to become available; and
  - whether the costs that would be involved in supplying, and charging for, the services are reasonable or likely to become reasonable; and



- the effects, or likely effects, that supplying, and charging for, the services would have on the operation or performance of telecommunications networks;
- the legitimate commercial interests of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope; and
- the incentives for investment in the infrastructure referred to in s. 152AB(2)(e)(i) and (ii), (including having regard to the risks involved in making the investment).

The Commission notes that a carrier or CSP may give to the Commission a SAU in relation to the provision of a service that has not yet been declared and also may not yet be in existence (i.e. not yet supplied by the provider to itself or others). Where a service is not yet in existence, there may exist some doubt as to whether the carrier/CSP will undertake the investment if the SAU is not accepted.

In the present circumstances, the Commission notes that Foxtel has already (and to a significant extent) invested in, and commenced supply of, digital STUs, CA services, SI services, EPG services and Modem Services.

This factor arguably diminishes the extent to which acceptance of the Undertaking would 'encourage investment' in the provision of Digital Set Top Unit Service by Foxtel or provide 'certainty to investors' at the time of making such investment.

The fact that there has already been significant investment undertaken, and that a service is already being provided, creates a situation that is to some extent similar to the assessment by the Commission of an ordinary access undertaking except that an ordinary access undertaking is of course not available in respect of a service which has not been declared.

The Commission nevertheless recognises that even in relation to the present circumstances, there may be significant benefits flowing from acceptance of the Undertaking, including:

- Providing Foxtel with certainty in relation to the future use of Digital Set Top Unit Service such that it can continue its investment in these services; and
- Providing access seekers with certainty as to the basis upon which they will be able to access the Digital Set Top Unit Service, which may allow those access seekers to invest in other services.

The Commission notes the opportunity offered by the Undertaking for competitors to make use of Foxtel existing infrastructure, including STUs and CA/SI technology, to provide digital subscription television services to Foxtel's existing subscribers without the need to duplicate STU infrastructure. In this respect, the Undertaking is likely to promote productive and allocative efficiency outcomes. Thus, the Undertaking is likely to further the objective of encouraging the economically efficient use of infrastructure.

The Commission also notes that Foxtel's TSLRIC-based proposed methodology would result in access prices based on costs, and that Foxtel would be allowed to recover the costs (operating, capital, and some common costs) incurred in providing the service, plus a normal return on capital. Therefore, the Commission considers that the pricing methodology will lead to efficient access prices and encourage economically efficient investment in infrastructure.

The Commission notes that the tying provisions in the Undertaking may potentially distort efficiency outcomes. However, for the reasons outlined in section 6.2.1, the Commission considers that Foxtel should not be required to provide STUs in non-Foxtel homes.

On balance, the Commission considers that the Undertaking is likely to lead to an efficient use of infrastructure, and efficient investment in infrastructure.

### ***Conclusion in relation to whether the Undertaking promotes the LTIE***

The Commission considers that, on balance, acceptance of the Undertaking is likely to be in the LTIE.

### **7.3.2 The legitimate business interests of the service provider and its investment in the facilities used to supply the service**

As set out above, Foxtel has already made a significant investment in the facilities used to supply the service. A decision by the Commission to accept the Undertaking is unlikely to 'encourage investment' to the extent that it may in circumstances where the access provider had not undertaken the same level of investment.

However, the Commission recognises that Foxtel has made an investment and that it seeks to earn at least a normal commercial return on that investment. The Commission does not consider that Foxtel should be disadvantaged in the assessment of this criterion by the fact that it has chosen to make an investment prior to the Undertaking being assessed by the Commission. Equally, the Commission does not consider that Foxtel should gain any advantage from the fact that it has chosen to make an investment prior to the Commission's assessment of the Undertaking.

As set out above, the Commission is of the view that the concept of legitimate business interests should be interpreted in a manner consistent with the phrase 'legitimate commercial interests' used elsewhere in Part XIC of the Act. Accordingly, it would cover the carrier/ CSP's interest in earning a normal commercial return on its investment.

Having considered Foxtel's proposed methodology in relation to the price of the Digital Set Top Unit Service, the Commission believes that this pricing methodology is likely to result in Foxtel earning an adequate return on its investment in the facilities necessary to supply the Digital Set Top Unit Service. The Commission has also had regard to the legitimate business interest of Foxtel in assessing the non-price terms and conditions in the Undertaking including those clauses relating to tying and bundling, and the access to EPG and Modem services.

### **7.3.3 The interests of persons who have rights to use the declared service**

In assessing the Undertaking, the Commission is considering a service which is not yet declared. The Commission is of the view that under s.152AH, it may consider the interests both of persons who currently have rights to use the service that is the subject of the Undertaking and the interests of persons who may wish to use the service in question in the event that that service is declared. The Commission has taken all of these interests into account.

The Commission considers that the terms and conditions in the Undertaking would provide a potentially effective form of access for an access seeker wanting to provide services to Foxtel's existing subscribers in competition with Foxtel's tier channels. The Commission has considered the Undertaking as a whole, and is satisfied that the price and non-price terms and conditions of access contained in the Undertaking pay due regard to the interests of access seekers.

### **7.3.4 The direct costs of providing access to the service**

The Commission has given detailed consideration to whether the pricing structure proposed by Foxtel in relation to the Digital Set Top Unit Service is likely to reflect the direct costs of providing this service (including the direct costs of providing access to the service).

As already indicated in this report, the concept of the 'direct costs' of providing access to a declared service encompasses those that are necessarily incurred (or caused) by the provision of access. At a minimum, the phrase 'direct costs' is interpreted to mean that an access price should cover the direct incremental costs incurred in providing access. It does not, however, extend to receiving compensation for loss of any 'monopoly profits' that occur as a result of increased competition. This is also set out in the Commission's Access Pricing Principles which note that an access price should not be inflated to recover any profits the access provider (or any other party) may lose in a dependent market as a result of the provision of access.

With respect to this particular assessment, the Commission notes Foxtel's proposed pricing methodology involves aggregating cost pools, with costs categorised as either attributable to an access seeker, specific to an access seeker, or to be shared across all users of the Digital Set Top Unit Service (including Foxtel). The Commission considers the attributable costs and specific costs to be the 'direct' costs of providing access to the Digital Set Top Unit Service.

The Commission further considers that an interpretation of 'direct costs' in this context should include consideration of the recovery of common (or shared) costs. In this particular matter, the Commission takes the view that the recovery of shared costs based on the proposed 'revenue or ratings basis' is reasonable, as this method allocates shared costs based on the benefit gained by the access seeker.

### **7.3.5 The operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility**

The Commission does not consider that accepting the Undertaking would raise concerns under this criterion. Nor would rejecting the Undertaking. Therefore in a strict sense, this criterion has been largely neutral in the Commission's considerations of the Undertaking.

Nevertheless, the Commission has given consideration to this criterion indirectly in relation to a number of issues, including assessment of the tying provisions and interactivity provisions under the Undertaking.

### **7.3.6 The economically efficient operation of a carriage service, a telecommunications network or a facility**

The Commission has given careful consideration to whether accepting the Undertaking would affect the efficient use of carriage services or telecommunications infrastructure, or economically efficient investment in telecommunications infrastructure. The Commission considers that a large part of its considerations set out above under the LTIE criterion in respect of the consideration set out in s.152AB(2)(e) of the Act are also relevant to its consideration of this criterion.

## **7.4 Conclusion on whether the terms and conditions of the Undertaking are reasonable**

The Commission has reached the view that accepting the Undertaking would promote the LTIE. This forms a key component of its assessment of whether the terms and conditions of the Undertaking are reasonable.

In addition, the Commission is satisfied that the terms and conditions in the Undertaking give due regard to the interests of Foxtel as the access provider and are beneficial to the interests of access seekers.

The Commission's final view is that, on balance, it is satisfied that the terms and conditions specified in the Undertaking are reasonable.

## **8. Consistency with the standard access obligations (SAOs)**

Under s.152CBD(2)(a), the Commission must not accept the Undertaking unless it is satisfied that the terms and conditions specified in the Undertaking would be consistent with the SAOs, to the extent that those obligations would apply to Foxtel if the service were treated as an active declared service.

The SAOs are set out in s.152AR and are referred to in chapter 3 above. Part of the purpose of this provision is to ensure that an access undertaking at least meets the basic level of access obligations that would apply to the provider of the declared service, but for the undertaking.

### **8.1 Approach to assessing consistency with the SAOs**

Section 152CBD(2)(a) provides that the Commission must not accept an undertaking unless:

the Commission is satisfied that the terms and conditions referred to in paragraph 152CBA(3)(b) would be consistent with the obligations referred to in paragraph 152CBA(3)(a).

Section 152CBA(3) provides that the undertaking must state that, in the event that the person supplies the service (whether to itself or to other persons), the person:

- (a) agrees to be bound by the obligations referred to in section 152AR, to the extent that those obligations would apply to the person in relation to the service if the service were treated as an active declared service; and
- (b) undertakes to comply with the terms and conditions specified in the undertaking specified in the undertaking in relation to the obligations referred to in paragraph (a).

Clause 2.1 of the Undertaking provides that:

FOXTEL agrees to be bound by the obligations referred to in section 152AR of the Act to the extent that those obligations would apply to FOXTEL in relation to the Digital Set Top Unit Service if the Digital Set Top Unit Service were treated as an active declared service.

This, however, leaves the question of whether the terms and conditions would be consistent with the SAOs. In this regard, the Act does not specify any particular approach for assessing whether the terms and conditions in an undertaking are consistent with SAOs applicable to the access provider. The Commission finds it useful to adopt the following approach:

- identify those SAOs that would be applicable to a particular access provider; and

- assess whether the proposed undertaking would be consistent with the applicable SAOs. This assessment may involve consideration of whether the terms and conditions raise any inconsistencies with the applicable SAOs.

The issue of consistency with the SAOs is especially relevant with respect to the non-price terms and conditions specified in the undertaking. The price terms and conditions are considered to be consistent with the SAOs (i.e. it is consistent with the SAOs to specify a price at which access will be provided). The issue in relation to price terms and conditions is whether they are reasonable. The Commission notes that ‘consistency’ does not appear to demand complete correspondence with the thing in question, but rather a level of conformity.

## 8.2 The Applicable SAOs

This raises the issue of determining which of the SAOs set out in s.152AR would be applicable to Foxtel if the Digital Set Top Unit Service was declared.

The Explanatory Memorandum to the Trade Practices Amendment (Telecommunications) Bill 1996 notes that:

The applicable standard access obligations are those obligations set out in proposed s.152AR that are applicable to the carrier or provider making the access undertaking. A standard access obligation may not be applicable because of an exemption ... or because the carrier or carriage service provider does not supply the declared service concerned.<sup>210</sup>

The Digital Set Top Unit Service is not subject to an exemption in relation to any of the SAOs. The Commission considers that if the Digital Set Top Unit Service was declared, it would trigger the obligations set out in subsections 152AR(3), (5), (6), (7) and (8).

## 8.3 Consistency with the applicable SAOs

The obligations in subsections 152AR(3), (5), (6), (7) and (8) are addressed by Foxtel in its submission of 5 October 2005 (section 8.1) and its submission of 1 December 2006 (section 6). The following sections focus on the three issues raised by Seven Network: the consistency of the tying and bundling clauses with s.152AR(3)(a);<sup>211</sup> technical and operational quality of the service; and interconnection.

### Section 152AR(3)(a): Bundling clause

Section 152AR(3)(a) provides that an access provider must, if requested to do so by a service provider, ‘supply an active declared service to the service provider in order that the service provider can provide carriage services and/or content services’.

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<sup>210</sup> Trade Practices Amendment (Telecommunications) Bill (Cth) 1998 Explanatory Memorandum at page 57.

<sup>211</sup> Seven Network’s submission of 14 February 2006 also refers to s. 152AR(8) (page 9) but in the context of its construction of the obligation in s.152AR(3)(a). See also Seven Network’s submission of 18 January 2007 and Foxtel’s submission of 29 March 2006, p 16).

## **The services the subject of the Undertaking**

Foxtel, in its submission dated 6 October 2005, submits that:

‘there is nothing in s152AR which requires FOXTEL to offer ‘unbundled’ services to access seekers. FOXTEL is obliged to supply the ‘active declared service’ under s152AR(3)(a), being the Digital Set Top Unit Service. This service is a composite, bundled service.’

The Digital Set Top Unit Service is described in Chapter 4 above. Foxtel acknowledges in its Undertaking at clause 2.7 that the Undertaking is only in relation to the supply of the Digital Set Top Unit Service and is not an undertaking in relation to the supply of each component service. This approach is confirmed by Foxtel in its supporting submission of 1 December 2006 in which Foxtel states that it will

“... acknowledge in the Undertaking that the Undertaking is an undertaking only in relation to the DSTUS and not in relation to any possible parts of the DSTUS.”<sup>212</sup>

Clause 4.1(c)(ii) of the DAA provides that,

Foxtel is only obliged to supply and continue to supply the Digital Set Top Unit Service to the Access Seeker

as a total package and not as one or more component parts.

Foxtel submits that,

“as the condition does not relate to any component service, the ACCC would not need to be satisfied that each component service is consistent with the SAOs”.<sup>213</sup>

### **Interpretation of s.152CBD(2)(a)**

In the Commission’s view, if the Undertaking were accepted, ss.152AR(3)(a) would require Foxtel to supply the service the subject of the undertaking to an access seeker where requested to do so by that access seeker.

Subsection 152AY(2) provides that:

(2) The carrier or carriage service provider must comply with the obligations:

(a) on such terms and conditions as are agreed between the following parties ...; or

(b) ...on such terms and conditions relating to that matter as are set out in the undertaking ...

The Commission does not consider that the effect of this section is that any term or condition, so long as it is set out in a SAU, will be consistent with the obligations in

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<sup>212</sup> Foxtel submission 1 Dec 06 at page 25

<sup>213</sup> Foxtel submission 1 Dec 06 at page 25

s.152AR. This would, in the Commission's view, leave no scope for the operation of ss.152CBD(2)(a).

Instead, the Commission considers that it is required by ss.152CBD(2)(a) to assess whether the terms and conditions set out in a SAU are consistent with the applicable obligations in s.152AR.

The Commission believes that a number of terms and conditions in any SAU are likely to intrude upon, or to limit, at least to some extent, the obligation to supply that would otherwise be established by that SAU.

Therefore the Commission's task is to assess the extent to which the terms and conditions limit Foxtel's obligation to supply in order to determine whether those terms and conditions are so limiting as to be not consistent with the obligation set out in ss.152AR(3)(a). This is a question of degree.

### **Is the bundling clause consistent with subsection 152AR(3)(a)?**

Once the Commission accepts a SAU and the undertaking comes into operation, the service the subject of the SAU is deemed to be a declared service.<sup>214</sup>

By operation of ss.152CBD(2) and 152CBA(3), the terms and conditions of the Undertaking must be consistent with the obligations in s.152AR, and in this particular instance, ss.152AR(3)(a) – the obligation to provide the service to an access seeker upon demand.

The Commission notes that under clause 2.7 of the Undertaking, the Undertaking is only in relation to the supply of the bundled Digital Set Top Unit Service and not in relation to the supply of any of the component services. This is reflected in Schedule 1, Parts A, B, C and D of the DAA and throughout the DAA where the applicable service is referred to in the singular rather than plural indicating that there is only one Digital Set Top Unit Service and not individual component services that are supplied pursuant to the Undertaking.

The Commission further notes that under clause 4.1(c)(ii) of the DAA, Foxtel is only obliged to supply the Digital Set Top Unit Service as a bundled package of services under that agreement.

In the present case, an access seeker would not be entitled to request access to any one of the component services alone. An access seeker could only acquire the Digital Set Top Unit Service as a whole.

The obligation under ss.152AR(3)(a) is to supply the declared service to the access seeker on demand. The deemed declared service in the context of the Undertaking and bundling clauses is the bundled Digital Set Top Unit Service only as this is the service the subject of the Undertaking. The Undertaking would oblige Foxtel to supply only

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<sup>214</sup> Subsection 152AL(7)



the bundled service. In this circumstances, the Commission's view is that the terms and conditions relevant to the supply of the Digital Set Top Unit Service would be consistent with the SAO under ss.152AR(3)(a) to supply the declared service on demand.

### **The Tying clauses**

Clause 4.1 of Foxtel's DAA provides inter alia, that:

(c) Foxtel is only obliged to supply and continue to supply the DSTUS to the Access Seeker:

(i) ... where the Digital Set Top Unit to which the Digital Set Top Unit Service is to be supplied is actually in use by a Subscriber for reception of FOXTEL's digital subscription Television Services;

(f) FOXTEL has no obligation to supply the Digital Set Top Unit Service to a location where the Digital Set Top Unit to which the Digital Set Top Unit Service is to be supplied is not in use by a Subscriber for reception of FOXTEL's digital Subscription Television Services

The practical effect of the tying clauses is that Foxtel would not be obliged to supply the Digital Set Top Unit Service to non-Foxtel subscriber homes.

The issue for consideration in relation to the tying clauses is whether the clauses are consistent with the obligation to supply the active declared service on demand pursuant to ss.152AR(3)(a).

Both Foxtel and the Seven Network provided submissions on the consistency of the tying clauses with the SAO under ss.152AR(3)(a).<sup>215</sup>

In addition, both parties rely on all previous submissions and materials put to the Commission in respect of Foxtel's October 2005 Undertaking in respect of the tying (and bundling) issues.<sup>216</sup>

### **Foxtel submission**

Foxtel in its initial submission on the 2005 Undertaking (29 March 2006) argues that the 'active declared services' the subject of the Undertaking must be geographically limited by reference to locations where the end-user is a Foxtel subscriber:

FOXTEL submits that it is clear from the terms of ss 152AL and 152AR that the listed carriage services and facilitating services that it supplies as a carriage service provider are locationally confined to FOXTEL subscriber homes. To contend that FOXTEL's services can be defined

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<sup>215</sup> Foxtel submission of 1 December 2006 at page 26; Foxtel supplementary submission of 12 February 2007; Seven Network submission of 18 January 2007

<sup>216</sup> Freehills letter to ACCC of 18 January 2007 at page 1; Foxtel submission of 1 December 2006 at page 3

without reference to any locational limitation is to ignore the requirements of Part XIC and the provisions of the *Telecommunications Act 1997*.<sup>217</sup>

In Foxtel's view, the tying clauses are consistent with the obligation to supply the declared service. Foxtel submits that the so-called 'tying clause' is simply a bona fide term of supply of the 'active declared service' and is consistent with the SAOs.

Foxtel argues that the relevant SAO is the supply the active declared service under ss.152AR(3)(a) and that under the Undertaking, the active declared service, by virtue of subsection 152AL(7), is the Digital Set Top Unit Service to Foxtel and non Foxtel subscribers.

Foxtel's position is stated as follows,

"The Commission has indicated that if this so-called 'tying clause' was to be regarded as a 'limitation' on the undertaking (pursuant to s152CBA(5)) and therefore defined what was deemed to be declared under s152AL(7), it would accept that the tying clause was consistent with the SAOs. However, the Commission correctly goes on to say that it understands that FOXTEL does not intend that the Undertaking is to be limited in this way; rather, the Undertaking is given in respect of services not only in relation to end users who are FOXTEL subscribers, but also in relation to end users who are not FOXTEL subscribers."<sup>218</sup>

Foxtel asserts that the tying clauses are bona fide terms of supply and not a limitation within the meaning of ss.152CBA(5). As such, the deemed declared service is not limited to Foxtel subscribers but rather, is the broader service to all potential subscribers. The Undertaking provides for the supply of the Digital Set Top Unit Service and is therefore consistent with the obligation to supply the declared service. As such, there is no inconsistency as Foxtel is supplying the Digital Set Top Unit Service and it is proper that it can impose terms of supply over and above the ss.152AR(3)(a) obligation, provided the term is not inconsistent with the obligation. The terms of supply are then assessed against the reasonable criteria.<sup>219</sup>

### **Seven Network submission**

Seven Network's initial submission in respect of the October 2005 Undertaking is that:

Once Foxtel is supplying an active declared service by supplying its Digital Set Top Unit Service, Foxtel is under the obligations imposed by section 152AR. ...

Section 152AR does not, at any stage, contemplate the ability of the access provider to refuse to provide access or to cease to provide access simply because the end user ceases to obtain a service from the access provider. ...

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<sup>217</sup> Foxtel submission of 29 March 2006 at page 14.

<sup>218</sup> Foxtel submission of 1 December 2006, page 26.

<sup>219</sup> Foxtel submission of 1 December 2006, page 26.

Accordingly, Foxtel is under an obligation to supply the service, irrespective of whether the end user is a Foxtel subscriber or not.<sup>220</sup>

On this view, the effect of ss.152AR(3)(a) is that if an access seeker requests the service in respect of a particular end user, Foxtel is required to provide that service irrespective of whether or not the end user is a Foxtel subscriber and irrespective of whether providing such a service requires Foxtel to install a STU at the end-user's address. If this construction is correct, the Undertaking would not be consistent with the SAOs.

The Seven Network has made a further submission that the Undertaking is not consistent with the SAOs. The key reasons for this view are stated as follows:

- Foxtel imposes in clause 4.1(c)(i)(A) of the DAA a limitation upon the Undertaking such that they will only be obliged to provide the Digital Set Top Unit Service to those sites where the subscriber is acquiring Foxtel pay TV content.
- Foxtel asserts, and the Commission agrees, that this is not a limitation upon the scope of the Undertaking. It takes the Undertaking to cover the STU Service in all locations, including locations in which it could potentially be provided.
- Despite taking the Undertaking to extend to all locations, the effect of the provision in the DAA is to limit the obligation of Foxtel to supply only some of the potential locations.
- That is inconsistent with the first SAO (to grant access to the active declared service).

Seven Network concludes that if the Commission determines that it is satisfied that the Undertaking is consistent with the SAOs, the Commission will make an error of law by misinterpreting the requirement in ss.152CBD(2)(a) of Part XIC.<sup>221</sup>

Seven Network's argument is premised on the view that the tying clauses are a limitation on the service. Seven Network notes that a SAU may be subject to 'such limitations as are specified in the undertaking' (152CBA(5)) and that if a SAU is subject to limitations, the service is a deemed declared service only to the extent to which it falls within the scope of the limitations (152AL(7)). The SAU itself discloses whether there are limitations within the meaning of 152CBA(5).

The tying clause that is contained in the DAA restricts the access that Foxtel is obliged to grant to the Digital Set Top Unit Service.

"That follows because, of the two forms of active declared service that Foxtel could give an undertaking in relation to (namely the STU Service in locations receiving Foxtel content and the

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<sup>220</sup> Seven Network submission of 14 February 2006, p.9.

<sup>221</sup> Seven Network submission of 18 January 2007 at page 1

STU Service in locations not receiving Foxtel content), the Undertaking grants access only to the first form of active declared service. Accordingly, the service that the Undertaking covers, on its face, is plainly limited to the STU Service that is supplied only in locations receiving Foxtel content.”<sup>222</sup>

On the basis that the tying clauses are a limitation upon the service within the meaning of subsection 152CBA(5), the deemed declared service is the Digital Set Top Unit Service only to Foxtel subscriber locations.

### **Commission’s preliminary view**

In the Commission’s Discussion Paper on the Undertaking released for public consultation in December 2006, the Commission expressed the preliminary view that it considered that the terms of the Undertaking did provide for the supply of the declared service but that a term of the Undertaking is that Foxtel is only prepared to supply the service to Foxtel subscribers homes. Therefore the tying clauses are consistent with the obligation under ss.152AR(3)(a). Whether or not those particular terms of supply are appropriate in the Undertaking is a matter that should be assessed against that the reasonableness criteria rather than being an issue of consistency with the SAOs.

In responding to this preliminary view, the Seven Network submits that the Commission has read the Undertaking in the light of Foxtel’s submission, which states that the Undertaking is not limited by the tying clause. Seven Network argues that,

“there is no power in subsection 152CBA(5) to define limitations by reference to material extrinsic to the Undertaking. Therefore, if the Commission continues to read the Undertaking in this manner and ultimately accepts that the Undertaking is not subject to such a limitation, the Commission has misinterpreted subsection 152CBA(5).”

Seven Network further submits that if the Commission maintains that the tying clause is not a limitation within the meaning of s.152CBA(5), the SAOs require Foxtel, upon request, to give access seekers access to the active declared service covered by the Undertaking (i.e. the Digital Set Top Unit Service in any location).

If the Commission was to accept that the Undertaking meets the obligation to supply the active declared service in the face of such limitation, the Commission would fall into legal error. If the clause is not regarded as a limitation, it must necessarily follow that the Undertaking cannot be consistent with the obligation to supply the declared service.<sup>223</sup>

### **Foxtel supplementary submission**

Foxtel, in a supplementary submission to the Commission of 12 February 2007, submits that:

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<sup>222</sup> Seven Network submission of 18 January 2007 at page 4

<sup>223</sup> Seven Network submission of 18 January 2007 at pages 4 and 5

“Section 152CBA draws a clear distinction between terms and conditions of supply of the relevant service (referred to in subsection 152CBA(3)(b) and “limitations” to which the undertaking is subject (s152CBA(5)). If an undertaking is subject to limitations, the service supplied is a declared service only to the extent to which the service falls within the scope of the limitations (subsection 152AL(7)). It is apparent that limitations concern the nature or description of the service to be supplied; and not the terms and conditions of supply such as term, price, technological requirements, location of supply and the like. If the contrary were the case, (and all terms and conditions of supply were regarded as “limitations”), a service that was the subject of an undertaking given under s152CBA would be declared by reference to, and to the extent of, the terms and conditions of supply. This would have the result that the identical service could be declared in so far as it was supplied on different terms and conditions. This would be an absurd outcome.

The Commission is therefore correct in its (*preliminary*) view that clause 4.1(c)(i)(A) of the Digital Access Agreement is a term or condition of supply rather than a “limitation” within the meaning of s152CBA(5), and that the Undertaking given by FOXTEL is consistent with the SAOs.

For completeness, we note that FOXTEL also maintains the view that as it does not supply the Digital Set Top Unit Service in non-FOXTEL homes, such a service is not an active declared service within the meaning of s152AR.”<sup>224</sup>

### **Commission view - Is the tying clause consistent with s.152AR(3)(a)?**

The primary question that the Commission must address in the current context is whether the tying clause is consistent with the applicable SAOs. The relevant SAO in this regard is s.152AR(3)(a) – the obligation to supply the active declared service on demand.

The tying clause as set out in clause 4.1 of Foxtel’s DAA has the practical effect of not obliging Foxtel to supply the Digital Set Top Unit Service to homes where the Digital Set Top Unit Service is not in use by a Foxtel subscriber.

Once the Commission accepts a SAU and the undertaking comes into operation, the service the subject of the undertaking is deemed to be a declared service.<sup>225</sup> The question of whether the tying clause is consistent with the obligation to supply the active declared service will depend, to some extent, on what is considered to be the declared service.

As noted above, if the Undertaking is subject to limitations, the service supplied by Foxtel is a declared service only to the extent to which the service falls within the scope of the limitations. Therefore in considering what the deemed declared service is, it is pertinent to determine whether or not the Undertaking is subject to any limitations.

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<sup>224</sup> Foxtel supplementary submission of 12 February 2007 at pages 3 and 4.

<sup>225</sup> Subsection 152AL(7)

The relevant provisions raise a number of complex issues which conceivably raise questions as to the proper scope of the obligation and the interpretation of key terms. These are considered below.

In response to Foxtel's initial argument, the Commission does not consider that the 'active declared service' must be geographically limited as there is nothing in Part XIC of the Act which would prevent Foxtel, or the Commission, from defining the services to which the Undertaking relates more broadly in order that the declared service (following acceptance of the Undertaking) would encompass end-users who are Foxtel subscribers and end-users who are not Foxtel subscribers.

In the Commission's view, this conclusion follows from a consideration of s.152CP(2)(e) which explicitly provides that, in making an arbitral determination in respect of a declared service, the Commission may:

require a party to extend or enhance the capability of a facility by means of which the declared service is supplied

Furthermore, Foxtel (29 March 2006) submits that:

FOXTEL is not a supplier of listed carriage services, and there can be no "active declared service", in respect of locations (or points) where it has not entered into commercial arrangements with a subscriber and has not installed cabling and an STU at the subscriber's premises.<sup>226</sup>

In the Commission's view, the word 'active' relates not to whether the declared service is actually being provided in a particular location, but instead to whether the declared service is being supplied at all (i.e. to any location). The Commission believes that this interpretation is consistent with s.152AR(2).

In the Commission's view, the first step in determining whether something is consistent with a particular requirement will depend on what exactly that particular requirement is. In this case, the requirement is to supply the active declared service on demand.

Seven Network submits that if the Commission maintains that the tying clause is not a limitation within the meaning of s.152CBA(5), the SAOs require Foxtel, upon request, to give access seekers access to the active declared service covered by the Undertaking (i.e. the Digital Set Top Unit Service in any location). It is unclear whether Seven Network is suggesting that the obligation extends to all areas regardless of whether they are currently serviced by Foxtel or whether the obligation is confined to all potential subscribers within the current capabilities of the network. In the Commission's view this raises a potential issue about what constitutes "supplying the active declared service".

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<sup>226</sup> Foxtel Submission, 29 March 2006, p.16.

The next point to consider is the concept of a limitation.

The Commission agrees with the Seven Network that it is the SAU itself that discloses whether there are limitations within the meaning of s.152CBA(5). Further, extrinsic material should not itself define the term, but the Commission does not accept that it cannot look to extrinsic material to assist it in understanding terms of an undertaking. The Commission would generally seek to avoid interpreting an undertaking in a manner inconsistent with the intention of the submitting party, unless that interpretation was clearly unsustainable based on the document itself.

Opposing arguments have been put as to whether the tying clause is in fact a limitation on the Undertaking or not. Foxtel argue for instance, that limitations concern the nature or description of the service to be supplied; and not the terms and conditions of supply such as term, price, technological requirements, location of supply and the like. If the contrary were the case, (and all terms and conditions of supply were regarded as “limitations”), a service would be declared by reference to the terms and conditions of supply.

The Seven Network, on the other hand, views the issue in terms of the clause placing a restriction of access that allows Foxtel to not always grant access to the active declared service.

The supplementary Explanatory Memorandum to the Telecommunications Competition Bill 2002 provides no insight into what is to be regarded as a limitation on a SAU within the meaning of the term in s.152AL(7) and s.152CBA(5).

The Commission notes that Foxtel and the Seven Network view the operation of the Undertaking, and in particular, the tying clauses, differently. In Foxtel’s submission, the tying clause does not limit the deemed declared service to the use of Digital Set Top Unit Service in the premises of Foxtel subscribers. Rather, the deemed declared service is the use of Digital Set Top Unit Service in any location, subject to the condition that the person is currently receiving the Foxtel service.

***Foxtel’s construction – the tying clauses do not limit the scope of the service***

On Foxtel’s construction, the Commission considers that the Undertaking is, arguably, consistent with the SAOs. On Foxtel’s construction, the tying clauses are not limitations on the scope of the service, but rather conditions that must be satisfied before access is provided. Whether such a condition is consistent with the SAOs can be assessed by asking whether the clauses amount to what is, in effect, a complete refusal to supply the active declared service. A complete refusal to supply the service would, in the Commission’s view amount to a de facto exemption from the obligation to supply access to a service. Arguably, such a proposal should be the subject of an exemption application rather than a SAU. An undertaking which, in effect, states that a supplier is not obliged under any circumstances to give access to the active deemed declared service would not be consistent with the SAOs.

The Commission notes that there does not appear to be any ‘bright line’ between what is effectively a refusal to supply access and a mere term and condition that impinges

upon supply. Almost any condition in an access undertaking could be re-formulated as a refusal to supply access. For example, a term which states that a carrier will supply access at price 'X' could also be characterised as a term which states that the carrier will refuse to supply access at any price other than 'X'. Since this relieves the carrier of the obligation to supply in certain circumstances, it might be argued that it is inconsistent with the SAOs. However, the Undertaking still provides for access to the service, subject to the condition that the price is met. This means it would be consistent with the SAOs. Whether the supply is reasonable, would of course be dealt with as a separate question.

By analogy, the relevant condition in Foxtel's Undertaking is that Foxtel is only obliged to supply the service if a digital STU is located in the premises of a current Foxtel subscriber. There is no refusal to provide the service, but the obligation to supply will only arise on the condition as stipulated. The Undertaking still provides for access to the service, provided that condition (among others) is satisfied.

This situation might be contrasted with a hypothetical scenario based on a geographic limitation, eg. an undertaking that provided for access to any digital STU, provided the unit was not located in the State of Victoria. This would be inconsistent with the SAOs since it would amount to saying that there are no circumstances in which access would be provided in certain geographic areas. In effect, this might be seen as an anticipatory exemption in respect of the State of Victoria.<sup>227</sup>

However, this does not appear to be the effect of the tying clauses. The Undertaking sets down conditions that must be satisfied before access must be provided, one of which is a requirement that the unit be located in the premises of a Foxtel subscriber. However, there is no restriction in the Undertaking that appears analogous to the geographic limitation described above. There are no areas in which access will be denied in any circumstances. Rather, there are a set of conditions that must be satisfied before access will be provided.

#### ***Alternative construction – the tying clauses limit the scope of the service***

The alternative construction is that one takes the view that the tying clauses are limitations on the Undertaking on the basis of Seven Network's argument that they are limitations on the scope of the declared service. On this interpretation, the Undertaking would be an undertaking in relation to the supply of the service only to Foxtel subscribers. It would follow that the deemed declared service would be the service only to Foxtel subscribers and not all potential subscribers.

This then raises the issue of whether the Undertaking is consistent with the obligation to supply the active declared service (that being the Foxtel subscriber only service). The obligation is to provide access to the active declared service. In the context of the

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<sup>227</sup> In this example, access to the service is restricted by reference to geography. This is done solely for the purposes of illustration. It is conceivable that an undertaking could impose other types of restrictions or limitations on access (eg. by reference to the identity of the access seeker).



Undertaking and based on the view that the tying clauses are limitations, there would clearly be alignment between the deemed declared service and the supply obligation in the Undertaking. However, this is not how Foxtel considers the Undertaking to operate.

These are difficult questions and one on which there is limited guidance. The immediate task of the Commission is that it be satisfied that the tying clauses are consistent with the applicable SAO. Both Foxtel and Seven Network have advanced reasonable arguments as to the consistency of the tying clauses. On either scenario, the Commission believes the tying clauses can be said to be consistent with the SAOs.

The Commission's conclusion is that the tying clauses are consistent with the obligation to supply the declared service.

### **Section 152AR(3)(a): Conclusion**

The Commission has had regard to all of the terms and conditions specified in the Undertaking, including the bundling clause and the tying clause.

Its overall assessment in respect of the obligation set out in s.152AR(3)(a) is that the Commission is satisfied that the terms and conditions in the Undertaking are consistent with this obligation.

### **Section 152AR(3)(b): Technical and operational quality**

Section 152AR(3)(b) provides that an access provider must, if requested to do so by a service provider, 'take all reasonable steps to ensure that the technical and operational quality of the active declared service supplied to the service provider is equivalent to that which the access provider provides to itself'.

Clause 4.2(a) of the DAA sets out services that are not included in the Digital Set Top Unit Service including 'access to or use of flash memory but only to the extent that flash memory is used or intended to be used for operational purposes'. In relation to this exclusion, Foxtel states<sup>228</sup>:

FOXTEL submits that the STUs are, and will remain, the property of FOXTEL (or its nominees) and that FOXTEL will also use these STUs to provide services to FOXTEL subscribers, as well as access seekers. Therefore, the access seeker is granted the right to access the STUs for specific purposes only. Further, this access is also limited to the extent necessary to receive the Digital Set Top Unit Services.

The provisions of clause 4.2(a)(v) do not prevent the access seeker from receiving the Digital Set Top Unit Services for the purposes of providing digital Subscription Television Services and related services to its subscribers.

Flash memory is electronic memory that forms part of a Digital Set Top Unit, the contents of which do not alter after the Digital Set Top Unit is de-powered. FOXTEL utilises the flash memory to store proprietary data for the proper functioning of the STU.

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<sup>228</sup> Foxtel submission, 6 October 2005, p 54.

Excluding these services from the services FOXTEL will provide to access seekers is not inconsistent with the SAOs.

Seven Network submits that the Undertaking is inconsistent with the SAOs due to the exclusion of key elements from the Undertaking.<sup>229</sup> In particular, Seven Network states:

[A]ccess seekers do not have access to flash memory in the STU. Seven understands that Foxtel is able to store on demand videos on the flash memory, which when requested by a subscriber, may be accessed immediately without waiting for the usual broadcast slot. This, when combined with no access to the constant feed forward path, means that Foxtel can offer a better enhanced service, because Foxtel is able to constantly update its content and store its content on the STU whereas access seekers cannot. Foxtel subscribers will be able to view Foxtel content at the time of their choosing, whereas subscribers to access seeker content will not be able to do this as easily.

The Commission considers that the exclusion of flash memory from the Digital Set Top Unit Service represents a limitation on the service as described by the Undertaking. Accordingly, the SAOs do not apply to this service. The Commission has considered the effect of clause 4.2(a)(vi) in its assessment of whether the Undertaking is reasonable.

On balance, the Commission believes that the terms and conditions of the Undertaking are consistent with s.152AR(3)(b).

#### **Section 152AR(5): Interconnection**

Section 152AR(5) of the Act relevantly provides that if an access provider owns or controls one or more facilities; the access provider must, if requested to do so by a service provider:

- permit interconnection of those facilities with the facilities of the service provider to allow the service provider to supply carriage services and/or content services;
- take all reasonable steps to ensure that the technical and operational quality and timing of the interconnection is equivalent to that which the access provider provides to itself; and
- take all reasonable steps to ensure that the service provider receives, in relation to the interconnection, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself.

Seven Network submitted in relation to this issue:

The second problem with the DAA is that given Foxtel is not obliged to upgrade or amend its STU or modem to meet the requirements of an access seeker's modem content, the DAA does

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<sup>229</sup> Seven Network submission, 14 February 2006, p 34.

not appear to allow access seekers to use their own STU with an upgraded modem, while still receiving Foxtel's modem services (or STU services for that matter).

...

If Foxtel refuses to permit interconnection of its equipment (i.e. the playout centre and CA equipment) with the access seeker's equipment (by releasing specifications so that the access seekers can make their equipment compatible) for the purpose of allowing the access seeker to provide an interactive content service, then Foxtel fails to comply with section 152AR(5)

#### Foxtel responded:

In section 7.5(c) of the Seven Submission, Seven submits that access seekers may want to use a better modem than the one installed in Foxtel's STUs. Seven asserts that the SAU is not consistent with s. 152AR(5) because it does not provide for access seekers to interconnect with their own modem.

The DAA does not prohibit the interconnection of an access seeker's modem; it is simply not addressed in the DAA. It is not possible in the DAA to address every conceivable contingency or requirement of access seekers. It is questionable whether the contingency identified by Seven will in fact eventuate.

In any event, in the SAU Foxtel undertakes to comply with the obligations in s. 152AR (see clause 2.1 of the SAU). Accordingly, it is incorrect to assert that the SAU or any part of the DAA is inconsistent with the SAOs. If the contingency identified by Seven materialises, it will be addressed under the SAU and in accordance with the requirements of s. 152AR.

The Commission agrees with Foxtel in relation to this issue. The scenario described by Seven Network is not explicitly covered by the Undertaking. In particular, the Commission notes that the scenario is not explicitly covered by clause 6.1(c)(iv)(C) of the DAA, which provides:

Foxtel has no obligation:

...

to amend, develop or upgrade its Digital Set Top Unit specifications or Modem specifications to provide interoperability with, or meet the requirements of, the Access Seeker Modem Content.

If a service provider were to install improved modems in the STUs of its subscribers, clause 6.1(c)(iv)(C) does not address whether Foxtel would be required to upgrade the STU to accommodate the improved modem because modems are distinct from modem content.

The Commission agrees with Foxtel that, to be consistent with the SAOs, the DAA need not provide for every conceivable eventuality that might arise in future and notes that if an access provider and an access seeker are unable to reach agreement in relation to compliance with the SAOs, s.152AY(b)(ii) provides for arbitration.

The Commission also agrees that, because of the more general provisions in the Undertaking and DAA that provide for adherence of those documents to the SAOs,

Foxtel would be bound to release the specifications of its STUs to the service provider if this eventuality were to occur.

The Commission also notes that the access provider must, pursuant to s.152AR(5)(d):

(5) Take all reasonable steps to ensure that:

(d) the technical and operational quality and timing of the interconnection is equivalent to that which the access provider provides to itself.

The Commission considers that 'all reasonable steps' would certainly extend to releasing STU specifications to the service provider in order to ensure compatibility with any improved modem. However, it would not include requiring Foxtel to upgrade its STU to maintain interoperability. Accordingly, the Commission takes the view that clause 6.1(c)(iv)(C) is not inconsistent with Foxtel's obligations under s.152AR(5).

On balance, the Commission believes that the terms and conditions of the Undertaking are consistent with Foxtel's obligations under s.152AR(5).

### **Sections 152AR(6) and (7): Billing information**

The Commission considers that the provisions under clause 15 of DAA are consistent with the obligations under ss.152AR(6) and (7) to provide billing information.

The Commission received no submissions on this issue from interested parties.

### **Section 152AR(8): CA customer equipment**

The Commission considers that the terms and conditions in the Undertaking are consistent with the obligation under s152AR(8) to supply 'any service necessary to enable the service provider to supply carriage services and/or content services by means of the active declared service using the conditional-access customer equipment'.

As outlined above, the Undertaking provides access to the 'minimum bundle of assets' that a niche channel provider would require in order to provide its subscription television services to Foxtel's subscriber base, including modems and inclusion in the EPG.

The Commission received no submissions on this issue from interested parties.

## **8.4 Conclusion**

The Commission's final view is that it is satisfied that the terms and conditions specified in the Undertaking are consistent with the applicable SAOs to the extent that those obligations would apply to Foxtel if the relevant service was treated as a declared service.

## **9. Final Decision on the Foxtel Undertaking**

Following from the analysis provided in the preceding chapters:

- the Commission's final view is that it is satisfied that the terms and conditions specified in the Undertaking are consistent with the applicable SAOs to the extent that those obligations would apply to Foxtel if the relevant service(s) were treated as declared service(s) as is required by s.152CBD(2)(a); and
- the Commission's final view is that it is satisfied that the terms and conditions specified in the Undertaking are reasonable as required by s.152CBD(2)(b).

Pursuant to s.152CBD(2), the Commission must not accept a SAU unless it is satisfied of both of the matters that are set out in s.152CBD(2)(a) and s.152CBD(2)(b). In the present case, the Commission is satisfied of both these matters. As a result, the Commission's Final Decision is to accept the Undertaking.

## **10. Documents examined by the Commission in reaching its Final Decision**

### **10.1 Legislative supplementary materials**

*Trade Practices Amendment (Telecommunications) Bill 1996*, Explanatory Memorandum

*Trade Practices Amendment (Telecommunications) Bill 1998*, Explanatory Memorandum

*Telecommunications (Competition) Bill 2002*, Explanatory Memorandum

*Telecommunications Competition Bill 2002*, Supplementary Explanatory Memorandum.

*Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, Explanatory Memorandum,

### **10.2 Special Access Undertakings**

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Foxtel Management Pty Limited for and on behalf of the Foxtel Partnership and Foxtel Cable Television Pty Ltd (Foxtel), *Special Access Undertaking to the Australian Competition & Consumer Commission*, 1 December 2006.

### **10.3 Submissions by or on behalf of Foxtel**

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1. CRA International, *Adjusted access pricing model for digital STUs*, October 2005.
2. Bill McDonald, *Independent expert report for submission to the Australian Competition and Consumer Commission*, 30 September 2005 (Part confidential).
3. Peter Campbell, *Confidential statement of Peter Campbell regarding the terms of Foxtel's digital content agreements*, 29 September 2005 (Confidential).
4. CRA International, *Reasonableness of limiting the supply of Foxtel's CA service*, October 2005 (Part confidential).
5. Peter Smart and Ron Higgins, *Report prepared for special access undertaking by Foxtel*, 4 October 2005.

6. Frontier Economics, *Foxtel's Special Access Undertaking: a report for Allens Arthur Robinson in connection with Foxtel's proposed Special Access Undertaking to the Australian Competition and Consumer Commission*, 5 October 2005.
7. NECG, *FOXTEL Explanatory Material in relation to STU Pricing, Part A: STU Access Pricing*, 4 June 2002; and *Part B: Access Pricing Model for Digital Cable and Satellite STUs: Description of cost based pricing methodology*, 30 August 2002
8. Price Waterhouse Coopers, *Agreed upon procedures report on cable IBAC cost schedules*, 13 July 2005 (Confidential).
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11. Price Waterhouse Coopers, *Report on cost schedules prepared for ACCC*, 19 January 2005 (Confidential).
12. Price Waterhouse Coopers, *Independent review report on Foxtel's digital rate card regulatory accounting procedures manual*, 13 July 2005 (Confidential).
13. Price Waterhouse Coopers, *Independent audit report on Foxtel's digital access pricing model dated 13 May 2005, version 6, for the T1 period*, 13 July 2005 (Confidential).
14. Strategic Finance Group, Stephen Gray, *The effect of franking credits on Foxtel's cost of capital: a submission on the access undertaking of Foxtel Management Pty Ltd*, 4 October 2005.
15. Strategic Finance Group, Stephen Gray, *A beta estimate for Foxtel: a submission on the access undertaking of Foxtel's management*, 4 October 2005 (Part confidential).
16. Market Ridge, *Consultancy report to the Australian Competition and Consumer Commission: subscriber management and CA systems*, 19 December 2001 (Confidential).
17. VPG Consulting, *Response to consultancy report to the Australian Competition and Consumer Commission regarding subscriber management and CA systems*, 18 January 2002 (Confidential).
18. ACPG, *Identification of media distribution mechanisms and models in Australia*, 27 September 2005.

19. Foxtel, *Folder of statements in relation to market definition*, 6 October 2005 (Confidential).

Foxtel, *Supplementary submission to Australian Competition & Consumer Commission: Foxtel Special Access Undertaking*, 29 March 2006 Attaching:

1. Table showing the percentage of time spent viewing subscription television in subscription television homes nationally between 6am and midnight in the 2002, 2003, 2004, 2005 and 2006.
2. Graph showing the percentage of time spent viewing subscription television in subscription television homes nationally between 6am and midnight in the 2002, 2003, 2004, 2005 and 2006.
3. Further submission in relation to sections 2.2(c) and 6.4(b) (confidential).
4. Subscriber acquisition costs (confidential).
5. Examples Mr Houston uses to support standardisation
6. CRA International, *Response on reasonableness of FOXTEL's CA/SI bundling*, 27 March 2006.
7. Strategic Finance Group, *Response to Officer (2006) "FOXTEL's special access undertaking: Issues with imputation"*, 28 March 2006
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CRA International, *Response to October 2002 Report by Stephen King*, 23 June 2006.

FOXTEL Management Pty Ltd, *Submission to Australian Competition & Consumer Commission, Foxtel Special Access Undertaking, supplementary confidential statement of Peter William Campbell dated 26 June 2006* (Confidential).

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- B. A statement of Michelle Kvello(confidential);



C. MK1 to the statement of Michelle Kvello (confidential); and

D. Confidentiality undertaking.

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#### **10.4 Submissions by other interested parties**

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Seven Network Limited, *Submission by Seven Network Limited in relation to Foxtel's special access undertaking in relation to Digital Set Top Unit Service*, 14 February 2006. Attaching:

1. NERA Economic Consulting, Greg Houston Report: *FOXTEL's Special Access Undertaking in relation to the Digital Set Top Unit Service*, 14 February 2006. (Part confidential)
2. Capital Research, Robert Officer Report: *Foxtel's Special Access Undertaking Issues with Imputation*, February 2006. (Part confidential)

Two Way TV Australia Limited, *Submission to Australian Competition and Consumer Commission: Foxtel Special Access Undertaking*, 17 February 2006.

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Seven Network Limited, *Submission on whether Foxtel's revised undertaking is consistent with the SAOs*, 18 January 2007.

## **10.5 Reports commissioned by the Commission**

Convergent Consulting, *The technical feasibility of Foxtel providing access seekers to its Digital Set Top Unit Service with the capability to equip existing channel offerings with genuinely interactive features, Final report, 24 July 2006*

## **10.6 Correspondence from Foxtel, its legal representatives and its consultants**

Allens Arthur Robinson, letter to Michael Cosgrave, *Foxtel Management Pty Ltd – Special Access Undertaking*, 22 November 2005.

Allens Arthur Robinson, letter to Michael Cosgrave, *Foxtel Special Access Undertaking – Submission by Seven Network* 21 March 2006.

Allens Arthur Robinson, letter to Michael Cosgrave, *Foxtel Digital Set Top Unit Special Access Undertaking: request for further information*, 11 April 2006. Attaching annexures:

1. Appendix 3 to the Special Access Undertaking.
2. Draft Modem Services Protocol.
3. FOXTEL Analogue STU Access Pricing.
4. Cable IBAC using depreciation method and asset life of 20 years.
5. Cable IBAC using depreciation method and asset life of 12 years.
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Allens Arthur Robinson, letter to Michael Cosgrave, *Foxtel Digital Set Top Unit Special Access Undertaking: request for further information*, 24 April 2006. Allens Arthur Robinson, Jacqueline Downes, letter to Michael Cosgrave, *Foxtel Digital Set Top Unit Special Access Undertaking*, 9 May 2006.

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Telephone discussions between ACCC, Allens Arthur Robinson and Foxtel, 15 June 2006.

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*Assessment of Vodafone’s mobile terminating access service (MTAS) Undertaking—Final Decision*, March 2006,

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