



**Australian  
Competition &  
Consumer  
Commission**

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

## **Discussion Paper**

**November 2005**

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# 1. Preface

FOXTEL Management Pty Ltd and FOXTEL Cable Television Pty Ltd ('Foxtel') have lodged a special access undertaking ('the Undertaking') pursuant to section 152CBA in Division 5 Part XIC of the *Trade Practices Act 1974* ('the Act') with the Australian Competition and Consumer Commission ('the Commission') on 6 October 2005. The Undertaking specifies the terms and conditions upon which Foxtel undertakes to supply what it terms as the Digital Set Top Unit Service.

Under Part XIC of the Act, the Commission must accept or reject the Undertaking. The process the Commission will follow to assess the Undertaking will be open and public, allowing parties to express their views and provide relevant information to the Commission.

As well as lodging the Undertaking, Foxtel has provided a submission ('the Submission'), with nineteen attachments, to the Commission in support of the Undertaking. The public versions of the attachments that are currently available are displayed on the Commission's website. The Commission is in the process of finalising, with Foxtel and other parties, the confidentiality of the remaining attachments.

Foxtel has indicated to the Commission that it intends to establish a confidentiality regime for access to information confidential to Foxtel. Interested parties who wish to obtain access to the confidential versions of Foxtel's attachments should contact Jacqueline Downes of Allens Arthur Robinson, tel (02) 9230 4850, in the first instance.

The time limit for interested parties to make submissions on the Undertaking is 6 weeks (extended if an information request is made under s.152CBB) from the date upon which these confidentiality issues are finalised. (The final calendar date will be notified on the Commission's website). Please forward submissions to:

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Interested parties who make written submissions should also provide submissions in electronic format.

The Commission will treat all submissions it receives as public, and will place written submissions on its website, unless an interested party specifically indicates to the Commission that it wishes to claim confidentiality in relation to all or part of a submission.

Parties who wish to claim confidentiality in relation to part of a submission should provide the Commission with both a confidential and public version of their

submission. The public version should clearly indicate which portions are confidential and cannot be viewed by the public.

Any queries in relation to this Discussion Paper should be directed to Arek Gulbenkoglul on 03 9290 1892 or via the contact details provided earlier in this Discussion Paper.

## 2. Background

### 2.1 ACCC's previous considerations of access to digital set top units and related services

#### *2.1.1 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 set top unit and related conditional access services.<sup>1</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>2</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 Digital Access Agreements 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>3</sup>

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

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<sup>1</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>2</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>3</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 section 152AB.

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 Digital Access Agreement and Telstra's Access Agreement would provide for a more effective form of access, with the additional conditions specified in the final exemption decision as compared to the original access terms proposed by the parties in their s.87B undertakings.

While the general form and content of the proposed Digital Access Agreements 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 Digital Access Agreements.

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

Subsequent to the Commission making its final decision to accept Foxtel's and Telstra's applications, the Seven Network lodged an application for review of the Commission's decision with the Australian Competition Tribunal ('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; s.152ATA(6) and stressed the importance of focusing on this criteria, 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 and therefore the Tribunal came to the view that it could not be said that the granting of 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.

### ***2.1.3 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 Digital Access Agreements.

Foxtel commenced supplying a digital pay TV service on 14 March 2004. This factor in combination with the Tribunal's decision to refuse Foxtel 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.

It should be noted that 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 Digital Access Agreement 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>.

## 3. The Legislative Criteria for the Assessment of Undertakings

### 3.1 Legislative criteria

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

Section 152CBD of the Act specifies that the Commission must not accept the special access undertaking unless:

- the Commission is satisfied that the terms and conditions set out in the undertaking are consistent with the standard access obligations ('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.

A service supplied by a person who has given the Commission a special access undertaking and which the Commission has accepted, is a declared service under s.152AL(7) of the Act.<sup>4</sup> However, the Commission may still declare a service under s.152AL(3) even if the service is covered by a special access undertaking.

#### ***3.1.1 Consistency with standard access obligations***

The SAOs are set out in s.152AR of the Act. Subject to class or individual exemptions made by the Commission, a carrier or carriage service provider must comply with the SAOs in regard to declared services it supplies either to itself or to other persons.<sup>5</sup> In particular, s.152AR requires access providers to, among other things:

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<sup>4</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.

<sup>5</sup> Refer to ss.152AS and 152AT of the Act.



- supply an active declared service if requested to do so by a service provider (subject to certain limitations) and to 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;
- 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;
- if an access provider supplies an active declared service by means of conditional-access customer equipment, the access provider must, if requested to do so by a service provider, supply to the service provider any service that is necessary to enable the service provider to supply carriage services and/or content services by means of the active declared service and using the equipment;
- permit the interconnection of the facilities an access provider either owns, controls or is responsible for, with the facilities of a service provider for the purpose of enabling the service provider to be supplied with active declared services; and
- provide billing information (if requested by the service provider) at certain intervals and in a certain manner and form.

The Commission will assess whether the Undertaking is consistent with the SAOs.

### ***3.1.2 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. In determining whether 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 carriage service provider concerned, and the carrier's or carriage service provider'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>6</sup>

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<sup>6</sup> Section 152AH(1) of the Act.

This does not, by implication, limit the matters to which regard may be had.<sup>7</sup>

In considering whether the terms of an access undertaking promote the LTIE, the Commission must consider the achievement of the following objectives:

- promoting competition in markets for telecommunications services;
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users; and,
- the objective of encouraging the economically efficient use of, and 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.<sup>8</sup>

### ***3.1.3 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.

### ***3.1.4 Published the undertaking and invited people to make submissions***

For the purposes of ss.152CBC(6)(a) and 152CBD(2)(d), the Undertaking was published by the Commission on the date this Discussion Paper was released, 10 November 2005. Parties are invited to make submissions to the Commission on the Undertaking. Any such submission must be received by the Commission on or before 6 weeks after the date upon which:

- (a) the confidentiality of Attachments 8-13, 16 and 17 to the Submission is finalised and non-confidential versions of these documents (if any) are placed on the Commission's website; and
- (b) Foxtel has established a process for responding to requests for access to confidential material, and a pro forma confidentiality undertaking is placed on the Commission's website.

If, prior to the expiry of this period, the Commission makes a request, under s.152CBB, for further information about the Undertaking, the 6 weeks is extended by the time taken for the request to be fulfilled; the confidentiality of the information to be finalised; and a non-confidential version of the information (if any) placed on the Commission's website.

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<sup>7</sup> Section 152AH(2) of the Act.

<sup>8</sup> Section 152AB(2) of the Act.

The final calendar date will be notified on the Commission's website. The time limit set by the Commission reflects the need to ensure that parties have reasonable access to the information necessary to form an opinion, and provide informed comment, on the Undertaking. This issue is further discussed in section 4 below.

## **4. The Commission's Process for Assessing the Undertaking**

The process the Commission will follow to assess the Undertaking will be as open and public as practicable allowing parties to express their views on the Undertaking, provide relevant information to assist the Commission and allow comment on preliminary views formed by the Commission and its analysis of the Undertaking.

### **4.1 Time limit for assessment**

The Act imposes a time limit for the Commission's assessment of undertakings. While the Commission would intend to make its decision as soon as is practicable for it to do so, the Commission must in any event make a decision within 6 months. If it does not do so, it is deemed to have accepted the Undertaking. However, the Commission is able to extend its decision-making period for up to 3 months at a time provided it gives a reason for doing so. In addition, if the Commission requests further information in relation to the Undertaking, the time taken for the Commission to receive the information is excluded from the 6 month period. Similarly, the consultation period specified by the Commission is excluded from this timeframe.<sup>9</sup>

### **4.2 Process**

The Commission intends to adopt the following process in assessing Foxtel's Undertaking.

#### **Stage 1: Lodgement of Undertaking**

The application given to the Commission by Foxtel on 6 October 2005 consists of:

- covering letter from Foxtel (6 October 2005);
- Foxtel's Undertaking; and
- Foxtel's Submission.

The Submission includes the following Attachments:

- Attachment 1: Henry Ergas, Charles River & Associates: Adjusted Access Pricing Model for Digital STUs;
- Attachment 2: Bill McDonald, Australian Spectrum Consultants Pty Ltd – Report on Satellite Amendments;
- Attachment 3: Confidential Statement of Peter Campbell regarding the terms of FOXTEL's digital content agreements;
- Attachment 4: Henry Ergas, Charles River & Associates: Reasonableness of Limiting the Supply of FOXTEL's Conditional Access Service;
- Attachment 5: Peter Smart/Mr Ron Higgins, FOXTEL, Engineering Report;

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<sup>9</sup> See s.152CBC (5), (6) & (7).

- Attachment 6: Philip Williams – Frontier Economics: Report on Market Definition and Promotion of Competition;
- Attachment 7: NECG: FOXTEL Explanatory Material in Relation to STU Pricing. Part A: STU Access Pricing dated 4 June 2002; and Part B: Access Pricing Model for Digital Cable and Satellite STUs: Description of Cost Based Pricing Methodology dated 30 August 2002;
- Attachment 8: DN Ridehalgh, PricewaterhouseCoopers: Report on Cable IBAC Cost Schedules dated 13 July 2005;
- Attachment 9: DN Ridehalgh, PricewaterhouseCoopers: Report on Satellite IBAC Cost Schedules dated 13 July 2005;
- Attachment 10: DN Ridehalgh, PricewaterhouseCoopers: Independent Audit Report on the Schedule of Gross Capital Purchase Costs of Satellite Set Top Units (STUs) dated 13 July 2005;
- Attachment 11: Maria Martin, PricewaterhouseCoopers: Report on Gross Purchase Cost of Cable Set Top Units dated 19 January 2001;
- Attachment 12: DN Ridehalgh, PricewaterhouseCoopers: Independent Review Report on FOXTEL's Digital Regulatory Accounting Procedures Manual dated 13 July 2005;
- Attachment 13: DN Ridehalgh, PricewaterhouseCoopers: Independent Audit Report on FOXTEL's Digital Access Pricing Model dated 13 May 2005, version 6, for the T1 period dated 13 July 2005;
- Attachment 14: Stephen Gray, SFG Consulting: The Effect of Franking Credits on FOXTEL's Cost of Capital;
- Attachment 15: Stephen Gray, SFG Consulting: A Beta Estimate for FOXTEL;
- Attachment 16: Mark Ettridge, Market Ridge Pty Ltd: Final Report, Consultancy Report to the Australian Competition and Consumer Commission, Subscriber Management and Conditional Access Systems dated 19 December 2001;
- Attachment 17: Greg Woolstencroft, VPG Consulting: Response to Consultancy Report to the Australian Competition and Consumer Commission Regarding Subscriber Management and Conditional Access Systems dated 18 January 2002;
- Attachment 18: John Paul, ACPG Pty Ltd: Identification of Media Distribution Mechanisms and Models in Australia; and
- Attachment 19: Folder of Statements in relation to market definition.

Foxtel's Submission identified:

- Attachments 1, 5, 7, 14 and 18 – as non-confidential;
- Attachments 3, 8, 9, 10, 11, 12, 13, 16, 17 and 19 – as confidential; and

- Attachments 2, 4, 6 and 15 – as part confidential.

On 13 October 2005, the Commission placed the Undertaking, Submission and Attachments 1, 5, 7, 14 and 18 on its website. On 18 October 2005, Foxtel provided non-confidential versions of Attachments 2, 4, 6 and 15. These were placed on the Commission's website on 20 October 2005.

The Commission is currently in the process of resolving the confidentiality of Attachments 8-13, 16 and 17 with Foxtel and other parties.

In addition, Foxtel is in the process of:

- establishing a procedure (including a confidentiality undertaking) to allow Foxtel to respond promptly to requests by parties for access to the confidential material (Attachments 3 and 19; the confidential parts of Attachments 2, 4, 6 and 15; and Attachments 8-13 and 19 (depending on the outcome of the process previously mentioned); and
- providing information on the intended operation of the existing s.87B undertaking if the Undertaking were to be accepted.

## **Stage 2: Publish the Undertaking and seek submissions**

As stated in section 3.1.4 above, the Undertaking was published by the Commission on the date this Discussion Paper was released. The Discussion Paper aims to inform parties of the matters the Commission must take into consideration in assessing the Undertaking, and the issues which the Commission would particularly like addressed in submissions. This Discussion Paper is available on the Commission's web site at [www.accc.gov.au](http://www.accc.gov.au).

The time limit for submissions specified by the Commission in section 3.1.4 is intended to ensure that interested parties are not disadvantaged by the relevant attachments or information becoming available during the course of the consultation period.

While the Commission will, as required, have regard to all submissions that are made to it on or before the closing date for submissions, the Commission strongly encourages all interested parties to make their submissions as soon as they are in a position to do so. In particular, the Commission requests that should a party intend to make a submission on any matter not addressed in this Discussion Paper, it notify the Commission of its intentions as soon as possible.

The Commission also encourages parties to make their submissions in a way that facilitates the efficient assessment of its various contentions, including the verification of any facts or data upon which those contentions are based. In this regard, parties are encouraged to restrict confidentiality claims to a minimum and to establish appropriate confidentiality regimes for the disclosure of any information that is claimed to be confidential to interested parties or to others to allow their critical assessment. Accordingly, the Commission would recommend that should a party intend to provide confidential material in support of a submission, that it now put in place pro forma documentation (a confidentiality undertaking and procedure for responding to requests) to facilitate the prompt disclosure of that information to appropriate third parties.

Should the Commission not be in a position to efficiently assess a party's contentions, including by receiving the results of independent critical assessments of them, it will be necessarily constrained in the weight to which it will be able to attach to those contentions. This will particularly be the case where conflicting material is before the Commission that has been critically assessed.

### **Stage 3: Publish draft assessment and seek further submissions**

Following its analysis of the Undertaking and the submissions of interested parties, the Commission intends to publish the findings of its initial analysis and its draft decision within a reasonable period after submissions close. The Commission will invite further submissions on its draft decision. Due to the statutory imposed timetable within which the Commission must make its decision, the period within which these responsive submissions will be able to be made is likely to be considerably shorter than the initial consultation period.

The Commission would expect that these submissions would be responsive to the draft decision, and would not expect a party to raise any further issues that were not addressed in the submissions that the party made during Stage 2 as discussed above.

### **Stage 4: Publish final assessment**

Taking into account the submissions, the Commission will form a view on whether to accept or reject the Undertaking, and publish the reasons for its decision.

The date by which this decision must be made will be notified on the Commission's website.

## **4.2 Confidentiality**

In general, the Commission is of a view that all information and submissions it proposes to take into account in assessing the Undertaking should be publicly disclosed. This enables persons with an interest in the Undertaking to comment on matters affecting their interests, and enables the Commission to test the veracity of the information. As noted above, parties are encouraged to restrict confidentiality claims to a minimum and to establish appropriate confidentiality regimes where necessary.

However, the Commission is aware of the need to protect certain of Foxtel's information where disclosure of such information may harm Foxtel's legitimate commercial interests. Therefore, in order to balance the possible harm from disclosure and the harm that interested persons may suffer if they are unable to comment on matters affecting their interests, the Commission considers that a more limited form of disclosure may be appropriate. For example, Foxtel may require that parties who wish to have access to confidential information sign confidentiality undertakings.

In this regard, the Commission believes that such confidentiality undertakings should enable the relevant party to view all information supplied by Foxtel to the Commission in these proceedings. Should Foxtel choose not to supply any confidential information to parties who wish to have access to it, the Commission may decide to give lesser weight to such information if it is not available to parties who have an interest in it, and the veracity of it can not be tested by the Commission to its satisfaction.

## **5. Synopsis of the Undertaking and supporting Submission**

The Undertaking specifies the terms and conditions on which Foxtel undertakes to supply what it terms the Digital Set Top Unit Service to access seekers, and meet its standard access obligations 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.

In addition to the body of the Undertaking, there are two appendices attached:

1. Appendix 1 provides a service description of Foxtel's Digital Set Top Unit Service.
2. Appendix 2 comprises the Foxtel Digital Access Agreement (the 'DAA') which sets out the price and non-price terms and conditions of access to its Digital Set Top Unit Service

Foxtel's application also includes the Submission in support of the Undertaking. The Submission includes 19 attachments containing expert reports and evidence – these are listed in section 4.2.

This following sections of the Discussion Paper outlines the key terms of the Undertaking and appendices.

### **5.1 The Undertaking**

The Undertaking includes sections relating to:

- commencement and duration;
- capacity for access seekers;
- condition precedents for Foxtel entering into a DAA with an access seeker;
- the terms and conditions of access to the Digital Set Top Unit Service (with reference to the DAA); and
- variation of the Undertaking.

With regard to the issue of commencement and duration, the Undertaking would enter into force immediately after it is accepted by the Commission and would continue for a period of 8 years after the date of commencement.

A number of the other matters above are discussed in section 5.3 regarding the terms and conditions of access specified in the DAA.

The Commission seeks the views of interested parties on the reasonableness of these, and the other terms, contained in the body of the Undertaking.



## 5.2 Service Description

Foxtel's Digital Set Top Unit Service as specified in Appendix 1 comprises:

- 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 Conditional Access Customer Equipment and Customer Cabling;
- b) Conditional Access 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 Conditional Access Customer Equipment and Customer Cabling;
  - (ii) Service Information Service which is the processing of information necessary to be received by Conditional Access 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 Conditional Access Customer Equipment which enable a customer to send to the provider of the content a reaction of the customer to that content.

The Commission notes that this service description differs from that previously provided in the context of Foxtel's exemption application with respect to the inclusion of what are termed EPG services and Modem services – these are discussed in section 5.3.1.

The Commission seeks the views of interested parties as to the reasonableness of Foxtel's proposed service description.

## 5.3 Digital Access Agreement (DAA)

As noted above, Foxtel's DAA sets out the price and non-price terms and conditions of access to its Digital Set Top Unit Service.

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

The Undertaking specifies numerous non-price related terms and conditions of access as contained in the DAA, including the following.

#### *Restrictions on provision of STU services to only Foxtel homes*

Clause 4.1 of the DAA contains the following condition regarding the use of Foxtel's Digital Set Top Unit Service by access seekers:

- (c) FOXTEL is only obliged to supply and continue to supply Digital Set Top Unit Services to the Access Seeker:
  - (i) (A) where the Digital Set Top Unit to which the Digital Set Top Unit Services are 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 any of the Digital Set Top Unit Services to a location where the Digital Set Top Unit to which the Digital Set Top Unit Services are to be supplied is not in use by a Subscriber for reception of FOXTEL's digital Subscription Television Services...

These provisions in the DAA, in effect, mean that the Digital Set Top Unit Service is only offered by Foxtel where the particular Digital Set Top Unit is being used by a Foxtel subscriber. Given that Foxtel subscribers must take Foxtel's basic package to gain access to 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.

Additionally, clause 11.1 provides:

The Access Seeker acknowledges and agrees that:

- ...
- (d) nothing in this Agreement limits FOXTEL's rights at Law or under an agreement with its Subscribers 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;
- (e) FOXTEL will have no liability to the Access Seeker if FOXTEL exercises the rights referred to in clause 11.1(d);

This clause means that Foxtel is not obliged to continue providing the Digital Set Top Unit Service to a person who ceases to be a Foxtel subscriber, even if the subscriber still wishes to receive an access seeker's service. If the subscriber wishes to continue to receive the access seeker's service once it ceases purchasing the Foxtel service, the access seeker will need to supply the subscriber with an STU.

In its Submission, Foxtel notes this right is limited by clause 11.5, which provides:

- (a) 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.
- (b) FOXTEL 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 Set Top Unit from a Subscriber Premises.

Foxtel submits that the above restrictions regarding the provision of the Digital Set Top Unit service to Foxtel homes only is reasonable and consistent with the standard

access obligations. In support of this position, Foxtel's Submission considers two alternative scenarios for the provision of STUs to access seekers:

1. the supply of Foxtel STU to non-Foxtel homes
2. unbundling Conditional Access ('CA') and Service Information ('SI') services and providing these services to access seekers using their own STUs in non-FOXTEL homes.<sup>10</sup>

In considering these two approaches, Foxtel argues that there are technical and operational difficulties associated with providing the services, as well as substantial costs to Foxtel, potential dynamic efficiency losses, and a risk of under-recovery of costs. In sum, Foxtel contends that the risks and difficulties outweigh any potential benefit that may be derived from Foxtel providing a full or unbundled service to non-Foxtel homes.

In support of these arguments, the Foxtel Submission attaches two reports:

- Attachment 4: Henry Ergas, Charles River & Associates: Reasonableness of Limiting the Supply of FOXTEL's Conditional Access Service; and
- Attachment 5: Peter Smart/Mr Ron Higgins, FOXTEL, Engineering Report.

The economic report from Charles Rivers Associates (CRA) in Attachment 4 discusses the reasonableness of Foxtel limiting the supply of Digital Set Top Unit Services to Foxtel homes in comparison with the scenarios where Foxtel is compelled to provide a full or unbundled STU service to non-Foxtel homes. CRA finds that neither of these alternative scenarios would be more reasonable than Foxtel's proposed approach as CRA's analysis suggests:

- Entry barriers would not be significantly reduced, if at all;
- Significant costs would be incurred, with no assurance of recovery;
- There would be no clear efficiency gains;
- Foxtel's ability to recover and gain a return on its investment would be compromised; and
- In the case of CA/SI unbundling, competition may be reduced or distorted; and innovation and service upgrading would be made substantially more difficult.

The Engineering Report from Foxtel in Attachment 5 outlines, amongst other things, the technical and operational issues that would arise if Foxtel was compelled to supply the Digital Set Top Unit Service to non-Foxtel homes and unbundled CA and SI services in non-Foxtel homes.

Foxtel contends that requiring the supply of the Digital Set Top Unit Service to non-Foxtel homes would necessitate a number of modifications to Foxtel's operations as represented in Figure 5 of the Engineering Report.

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<sup>10</sup> This form of unbundling was noted by the Tribunal as a potential option for access seekers using their own STU to supply pay TV services without having to fully duplicate Foxtel's delivery infrastructure.

Foxtel states that it would need to separate its subscriber management systems and create a separate access seeker STU provision business division for the purpose of providing ordering, warehousing, inventory, calendar, installation and STU provision services to access seekers for non-Foxtel homes. Foxtel's Active Customer Smartcard Database (ACSD) would also need to be modified to enable it to include smartcard numbers that are not linked to an active Foxtel subscriber.

Foxtel argues that the upfront and ongoing costs it would need to incur to modify the system would be significant, and would need to be borne by access seekers.

Furthermore, Foxtel notes in its Submission that it would also need to obtain sub-licences in respect of all third party intellectual property in the STUs, CA and SI, and that this would most likely need to be done on a case-by-case basis (at the insistence of the IP rights holder).

The Engineering Report also outlines the technical and operational issues that would be involved if Foxtel was required to unbundle CA and SI services and supply those services to access seekers in non-Foxtel homes. Foxtel asserts the key issues include the following:

- an access seeker's STU would need to be compatible with the Foxtel STU at all times otherwise the access seeker's STU would become unstable and eventually fail to decode Foxtel signals;
- access seekers' STUs would need to be managed as if they were Foxtel STUs, and would need to be tested and upgraded at the same time as the Foxtel STUs;
- management of different versions/variants of compatible STUs would become very expensive, complex and time-consuming;
- increased bandwidth would be needed for management and support;
- the need for any upgrades to Access STU software would have to be negotiated with the access seeker. This may cause extended delays or block other essential upgrades; and
- platform upgrades would take longer due to the need to have all versions of STUs to be confirmed as compatible.

Additionally, Foxtel asserts that providing CA and SI services to non-Foxtel subscribers would require several significant modifications to the Foxtel platform:

- the ACSD would need to be redesigned and rewritten as the original specification was for a different operating model;
- Smartcard purchase management would need to be established; and
- changes would be required to Foxtel's testing facilities.

Foxtel contends that this would essentially require establishment of a wholesale division with dedicated personnel who have responsibility for managing provision of services to access seekers. It notes that the costs of this division would also need to be borne by access seekers.

In addition to the above arguments, Foxtel's Submission states that the Commission does not have the statutory power to compel Foxtel to supply Digital Set Top Units or CA and SI services to non-Foxtel homes. It argues that even if the Digital Set Top Unit Service was declared, Foxtel would not be obliged to supply Digital Set Top Unit Services in non-Foxtel subscriber locations.<sup>11</sup>

The Commission seeks the views of interested parties on whether the condition to limit access to the Digital Set Top Unit Service to Foxtel subscriber homes is reasonable and consistent with the SAOs.

The Commission seeks the views of interested parties on supporting materials included in attachment 4 and attachment 5 to the Submission regarding the reasonableness of limiting access to the Digital Set Top Unit Service to Foxtel subscriber homes.

The Commission seeks the views of interested parties on what proportion of potential retail subscription television subscribers Foxtel's current subscriber base represents.

The Commission seeks the views of interested parties on the nature of STU system infrastructure and related services that an access seeker would need in order to provide its digital subscription television service in non-Foxtel subscriber homes, while at the same time providing its service in Foxtel subscriber homes under the proposed terms of the Undertaking.

### *Modem Services*

Clause 6 of the DAA includes provisions for the supply of Modem services. Modem services are specified in Part D of schedule 1:

This service 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 that the Modem services that it will supply to an access seeker comprise:

- access to the modem hardware installed within the Digital Set Top Unit;
- provision of specifications to enable access seekers to develop interactive applications specific to the channel or program being viewed;
- the ability of the Digital Set Top Unit to download interactive applications through the cable or satellite 'forward path' from the access seeker to the subscriber; and

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<sup>11</sup> Foxtel Management Pty Limited, Submission to Australian Competition and Consumer Commission, FOXTEL Special Access Undertaking, pp.41-42.

- the ability of the Digital Set Top Unit to activate the modem to dial a number using the PSTN.<sup>12</sup>

Clause 6.3 specifies that Foxtel's obligation to provide Modem services do 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 Set Top Unit via the return path.

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>13</sup>

The changes to Foxtel's proposed pricing methodology arising from the inclusion of Modem services is outlined in section 5.3.2

#### *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 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;
- the ability of Foxtel to allocate an access seeker's listings in the EPG according to genre, at Foxtel's discretion;<sup>14</sup> and
- Foxtel only supplying EPG services to an access seeker in respect of that access seeker's subscribers.

The changes to Foxtel's proposed pricing methodology arising from the inclusion of EPG services is outlined in section 5.3.2.

#### *Term of the DAA*

Clause 1.2 of the DAA allows for terms of between 5 years and 8 years. Access seekers have the right to terminate the DAA on one month's notice,<sup>15</sup> while Foxtel does not have a reciprocal right to terminate.

Foxtel argues in its Submission that a term of between 5 to 8 years at the access seeker's election is reasonable, and will allow an access seeker to recover its sunk costs, and make a reasonable return on its investment.<sup>16</sup>

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<sup>12</sup> Foxtel, p.21

<sup>13</sup> Foxtel, p.20

<sup>14</sup> The procedures for allocation of EPG listings are outlined in Schedule 9 of the DAA.

<sup>15</sup> Refer to clause 24.4(d) in the DAA.

<sup>16</sup> Foxtel, p.25

Foxtel contends that in order to recover sunk costs and make a reasonable return, access seekers are likely to need to enter supply agreements for broadcasting content to offer to their subscribers. In this regard, Foxtel argues that the average term of content supply agreements in the digital environment is 7 years.<sup>17</sup>

#### *Other Non-Price Terms and Conditions*

The DAA also specifies a number of other non-price terms and conditions. In particular, Foxtel submits that it has amended its DAA to address the issues raised by the Commission in relation to a number of non-price terms and conditions in the context of Foxtel's s.87B undertakings and exemption application processes. These relate to:

- Bank Guarantees (clauses 2 and 3)
- Ownership of Network Enhancements (clause 9.1(b))
- Operational Procedures (clauses 4.5, 4.7(d), 8.1(a) and 12(e))
- 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)
- Defamation (clause 18.3(a)(ii))
- Liability (clause 23)
- Immediate termination by FOXTEL (clause 24.2(f))
- Dispute resolution procedures (clause 27) term, suspension and termination;

The Commission seeks comment on the reasonableness of any of the non-price related terms and conditions contained within the Undertaking.

#### ***5.3.2 Price terms and conditions of access***

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 ('Schedule 3') describes the pricing methodology by which Foxtel will calculate annual access charges payable by access seekers.

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<sup>17</sup>In support of this claim, Foxtel has provided Attachment 3 to its Submission: Confidential Statement of Peter Campbell regarding the terms of FOXTEL's digital content agreements. The reasonableness of the term is also discussed in Attachment 4: Henry Ergas, Charles River & Associates: Reasonableness of Limiting the Supply of FOXTEL's Conditional Access Service, pp.67-69.

In its Submission in support of the Undertaking, Foxtel states that the price for the Digital Set Top Unit Service will be calculated by reference to the costing 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>18</sup> Foxtel submits that the methodology proposed in that exemption application continues to be relevant to this Special Access Undertaking.

In this Undertaking, Foxtel has revised the service description of the Digital Set Top Unit Service to include two additional services – Electronic Program Guide (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 the Submission.<sup>19</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.

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 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 among all users of the service (access seekers and Foxtel) and classified as attributable costs, shared costs or specific costs.
5. Finally, the costs will be translated into access charges. The annual access charge will be the sum of :
  - allocated annual attributable costs;
  - allocated annual shared costs; and
  - allocated annual specific costs.
6. The access charge will be payable for each Subscription Television Service delivered by an access seeker using the Digital Set Top Unit Service.

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<sup>18</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>19</sup> Attachment 1: CRA International, Adjusted access pricing model for digital STUs, October 2005.



7. 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 Set Top Units, Smartcards, Conditional Access System, and Service Information system.<sup>20</sup>

The capex forecasts for each year will be assigned to periods for recovery by annualising these costs over the economic life of the asset.

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 on the first period is 13.99 per cent, based on certain assumptions.<sup>21</sup> The return on capital is estimated on the basis of a Weighted Average Cost of Capital (WACC) and Capital Asset Pricing Model (CAPM) framework.

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

#### *IBAC Pool*

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

Foxtel argues that these are costs associated with the development of Foxtel's subscriber base that were not recovered or will not to be recovered prior to the cessation of the analogue subscription television 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.

The cost base includes an amount of \$280 million for Cable IBAC and \$115 million for Satellite IBAC.

In its Submission in support of the Undertaking, Foxtel contends that the IBAC costs do not include brand marketing costs but only sales and marketing acquisition costs and retention marketing costs. Foxtel notes that the Tribunal accepted the inclusion of the IBAC in the cost base, provided Foxtel-specific marketing costs were excluded.

Foxtel also notes that the Tribunal indicated it wanted more rigorous verification of the cost inputs. In response to the Tribunal's concerns, Foxtel engaged

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<sup>20</sup> Definitions of terms are set out in Schedule 10 of the DAA.

<sup>21</sup> Foxtel's proposed parameter values are outlined in section 3.4 of Schedule 3.

PricewaterhouseCoopers to perform Agreed Upon Procedures in relation to the components of the IBAC Input Costs schedules.<sup>22</sup>

Recovery of IBAC costs will be smoothed over a ten-year period to produce a smoothed annual IBAC cost for both the Cable IBAC and the Satellite IBAC.

#### *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 of annual opex cost.)

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

The Commission seeks the views of interested parties as to the reasonableness of IBAC costs included in Foxtel's pricing methodology.

The Commission seeks the views of interested parties as to the reasonableness of Foxtel's decision to use a post-tax nominal Weighted Average Cost of Capital (WACC) as a basis for its pricing methodology.

The Commission also invites interested parties to comment on Foxtel's WACC estimation, and the reasonableness of its individual WACC parameters, in particular the estimates of betas and gamma.

#### 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

The total annual costs will be divided into three cost categories:

- annual specific costs;

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<sup>22</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];

- annual attributable costs; and
- annual shared costs.

### *Specific Costs*

Specific costs are actual costs (both capital and 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 allocated to the particular access seeker whose activity incurred those costs.

### *Attributable Costs*

Attributable costs are costs incurred by Foxtel as a result of the provision of access to access seekers. Annual attributable costs will be allocated equally across all access seekers independently of the number of channels used, revenue share or Ratings.

### *Shared Costs*

Shared costs are costs that are shared between access seekers and Foxtel. Annual shared costs will be allocated based on both revenues and ratings.

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 costs, and that it is 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 cost recovery were to be assessed by reference to revenue alone or ratings alone. Foxtel notes that the Commission and the Tribunal accepted this allocation methodology in the context of the exemption application.

The Commission seeks the views of interested parties as to the reasonableness of Foxtel's method of allocation of total annual costs.

The Commission further seeks the views of interested parties as to the reasonableness of Foxtel's method of allocation of annual shared costs based on revenues and ratings.

### Access Charges

The access charge will be the sum of allocated annual attributable costs, the allocated annual shared costs and the allocated annual specific costs.

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

Foxtel will calculate and produce an access seeker Rate Card which specifies the access charges payable by access seekers.

The Commission seeks the views of interested parties as to the reasonableness of Foxtel's pricing methodology for calculating access charges payable by access seekers.

## 5.4 Submission in Support of the Undertaking

### 5.4.1 *Foxtel Views on Why the Undertaking Satisfies the Statutory Criteria*

As noted above Foxtel has provided a Submission in support of the Undertaking to the Commission. The Submission outlines the main provisions of the Undertaking as well as detailing the reasons why Foxtel considers the Undertaking satisfies the relevant statutory criteria.<sup>23</sup> In this regard, Foxtel claims that the prices and non-price terms and conditions of the Undertaking are consistent with Foxtel's SAOs under the Act and reasonable. Foxtel asserts that the Undertaking:

- is in the long-term interests of end-users;
- promotes competition by removing barriers to entry, and allowing access by other subscription television operators to Foxtel's infrastructure;
- balances Foxtel's legitimate business interests with the interests of access seekers;
- allows cost recovery by FOXTEL and a reasonable return on capital; and
- provides certainty to access seekers.<sup>24</sup>

The Commission seeks the views of interested parties on any of the arguments presented in the Submission and related attachments in support of Foxtel's claim that the price and non-price terms and conditions in the Undertaking are reasonable and consistent with the SAOs.

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<sup>23</sup> Refer to section 8 of the Submission.

<sup>24</sup> Foxtel p.7