



**Australian
Competition &
Consumer
Commission**

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

Draft Decision

August 2006

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Abbreviations

Act	<i>Trade Practices Act 1974 (Cth)</i>
Capex	capital expenditure
CA	conditional access
CAPM	capital asset pricing model
CRA	Charles River Associates
CSP	carriage service provider
Commission	Australian Competition and Consumer Commission
DAA	digital access agreement
DSTUS	digital set top unit service
EPG	electronic programming guide
Foxtel	Foxtel Management Pty Ltd and Foxtel Cable Television Pty Ltd
IBAC	installed base acquisition costs
LTIE	long term interests of end users
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
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
WACC	weighted average cost of capital

Executive Summary

1.1 Background

FOXTEL Management Pty Ltd and FOXTEL Cable Television Pty Ltd (together Foptel) lodged its special access undertaking ('Undertaking') pursuant to s.152CBA in Division 5 Part XIC of the *Trade Practices Act 1974* ('Act') with the Australian Competition and Consumer Commission ('Commission') on 6 October 2005. The Undertaking relates to what Foptel describes as the Digital Set Top Unit Service. Digital STUs are generally used by subscription television service providers for the reception, decryption and display of content (including interactive content) at the end-user premises.

The Commission has previously considered the issue of third party access to Foptel's digital set top units ('STUs') in some detail in the context of accepting s.87B undertakings arising in relation to the content-sharing arrangement entered into between Foptel and Optus in 2002, and Foptel'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 Foptel's 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 Foptel.

Even without the exemption order, the s.87B undertakings submitted by Foptel 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 Foptel and Telstra Digital Access Agreements. Foptel commenced supplying a digital pay TV service on 14 March 2004.

Foptel's s.87B undertaking, as varied on 18 December 2003 as part of the exemption application process, currently provides access seekers with access to Foptel's digital STUs for the supply of a digital subscription television service on the terms and conditions in its Digital Access Agreement.

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 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.¹

¹ 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

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.

1.3 The Commission's assessment

On 10 November 2005, the Commission published the Undertaking on its internet web page at 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.

In response, the Commission received submissions from three interested parties. A list of the submissions, as well as other documents that the Commission has examined in the course of making its Draft Decision is provided in Chapter 10.

After considering the submissions received and the documents described in Chapter 10, the Commission has made a Draft Decision to reject the Undertaking.

The Commission's draft view is that the terms and conditions in the Undertaking are reasonable.

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.

However, the Commission's view is that it is not satisfied that the terms and conditions of access are consistent with the standard access obligations.

The Act states that the Commission may not accept a special access undertaking unless it is satisfied of both these things. Therefore, the Commission's draft view is that it is required to reject the Undertaking.

This document sets out that Draft Decision, and the reasons for the Draft Decision.

Draft Decision

In terms of the access to the Digital Set Top Unit Service itself, the Commission considers that the Undertaking would provide a potentially effective form of access for access seekers wanting to provide services to Foxtel's existing subscribers as additional tiers to the Foxtel Basic Package service. The Commission considers that there is value in content providers such as niche channel providers having a mechanism for gaining distribution on Foxtel's digital platform (such as the existing s.87B undertaking), given Foxtel's market power in the acquisition of subscription television content and the scale of its existing subscriber base.

Had the Undertaking been limited to the Digital Set Top Unit Service itself, the Commission would have been likely to form the view that it should accept it.

The key difficulty with Foxtel's proposed Undertaking lies in its intent that the services covered by the Undertaking should be not only the bundled Digital Set Top Unit Service, but also the various unbundled components of that service; *and* the inclusion of a term and condition that prevents an access seeker from obtaining those latter services other than as part of the bundled Digital Set Top Unit Service.

The effect of the Foxtel Undertaking as it stands is that, if an access seeker were to subsequently seek and obtain declaration of the unbundled service, the access seeker would not in fact be able to obtain unbundled access. In this regard, the Commission could not make an arbitral determination that is inconsistent with the terms and conditions for services covered by the Undertaking, including the term and condition for the component elements that only allows an access seeker to obtain them as a bundle.

As noted above, 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. If the Undertaking were accepted, s.152AR(3)(a) would in essence require Foxtel to supply any or each of these services to an access seeker where requested to do so by that access seeker. The Commission considers that the effect of the bundling clause is to allow Foxtel, under the Undertaking, to constructively refuse to supply individual component services to access seekers. On this basis, the Commission can not be satisfied that the bundling clauses of the Undertaking are consistent with the obligation imposed by s.152AR(3)(a) to supply the services on request.

The Commission notes that it does not consider that Foxtel is in any way obliged to include unbundled services on a stand-alone basis in the Undertaking. However, the Commission notes that a SAU is a mechanism to offer access services on agreed terms and conditions that embrace the SAOs. It is not a mechanism that can be used to

foreclose access to other services. The proper mechanism for doing this under the Act is to accompany a SAU with an application for an exemption from the SAOs. In this case, the Commission does recognise that the Tribunal has already refused Foxtel a previous application for an exemption.

Reasonableness of terms and conditions in the Undertaking

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

The Commission has long been concerned that Foxtel has significant market power in the acquisition of content from content providers, such as niche channel providers.

On balance, the Commission considers that the price and non-price terms and conditions in the Undertaking would provide niche channel providers with an alternative outlet to end customers, ie. direct to existing subscribers as a tier to Foxtel's existing service (subject to some lesser concerns about the terms of the Digital Access Agreement and pricing calculations).

The Commission does note that the 'tying' and 'bundling' provisions contained in the Undertaking mean that acceptance of the Undertaking would promote competition only at the tier level. That is, the restricted form of access provided by the Undertaking 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.

In particular, the tying provisions mean that the Undertaking provides for access to the Digital Set Top Unit Service only in existing Foxtel subscriber homes – thus access seekers can only supply their channel as a tier to the Foxtel basic package. Foxtel is not obliged to continue providing access to 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. Thus, the 'tying' condition effectively limits the arena of competition between Foxtel and access seekers to the tier level with access seekers' channels more likely to function as a complement to the Foxtel Basic Package.

The Tribunal, in its review of the Commission's previous decision to grant Foxtel an anticipatory individual exemption, expressed concern about the tie of access to the Basic Package under Foxtel's terms and conditions contained in its s.87B undertaking. It, however, stated that Foxtel should not be required to provide STUs in non-Foxtel homes. Instead, the Tribunal noted the possibility of Foxtel 'unbundling' the provision of Conditional Access ('CA') and Service Information ('SI') services² 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. The Tribunal's views were *obiter dicta* and it noted that it did not have any evidence before it on this matter.

² The provision of CA/SI services essentially entails the use of information systems. CA systems comprise encryption which specifies how the content can be accessed, while SI systems specify how the content is arranged within the broadcast transport streams.

The Undertaking includes a ‘bundling’ clause that 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’. In addition, Foxtel’s stated intention is that the Undertaking is in respect of each and all of the services forming the Digital Set Top Unit Service as defined (i.e. it is intended to ‘cover the field’). If the Commission were to accept the Undertaking, each and all of the component services would be deemed to be declared services. However, if an access dispute was notified under s.152CM in respect of a component service (such as CA/SI services), Foxtel argues that the Undertaking would restrict the terms of any arbitration determination made by the Commission (s.152CQ(5)). In particular, Foxtel considers 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. In addition, the ‘tying’ provisions would ensure that these component services could only be supplied to homes currently in receipt of Foxtel’s Basic Package.

The above factors mean that acceptance of the Undertaking would effectively foreclose the possibility of the Commission making an arbitral determination that mandates access to unbundled components of Foxtel’s Digital Set Top Unit Service, such as CA/SI services in Foxtel and non-Foxtel homes, if such services were to be declared.

In this regard, the Commission’s assessment of the reasonableness of the Undertaking involves a weighing up of the *definite* (albeit restricted) access offered in the Undertaking against the benefits in maintaining the *possibility* of broader access that may be possible via access to unbundled CA/ SI services.

Accepting the Undertaking would appear to 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 in competition with Foxtel’s tiered offerings. That is, the Undertaking provides access to Foxtel’s subscribers (the key obstacle for content providers), as well as Foxtel’s STU, CA/SI, modem services and EPG services (non-bottleneck inputs).

Rejecting the Undertaking would leave open the possibility that access seekers could acquire access to unbundled set top units and CA and SI services via a declaration/arbitration process. Access to unbundled set top units and CA and SI services may potentially be a relevant input for full retail pay television providers that supply subscription television services that are competitive with Foxtel’s Basic package. Based on the evidence provided by interested parties, however, set top units and CA/SI services appear to be contestable inputs. Overall, the Commission considers that other factors, such as access to premium content and access to carriage, are more critical impediments to effective competition between full package providers. A firm with sufficient access to premium content and carriage to provide a full retail Pay TV service will be able to buy set top units and CA and SI services on the open market. The Commission notes that unbundled access to Foxtel’s CA/SI services may provide a potentially lower cost option for subscription television service providers compared with self-supply options in certain circumstances, but this does not make them a bottleneck input, *per se*.

The Commission notes that the Tribunal was mindful to facilitate the promotion of competition at more than the level of niche channel provider. In this regard, having

multiple competing full package providers would potentially improve the bargaining position of niche channel suppliers in gaining distribution on a full package provider's platform in the longer term. However, it appears that the proposed remedy of unbundling CA/SI may be seen as an indirect and possibly ineffectual means to achieve this end, given that these services are contestable inputs and do not appear to constitute a significant barrier to entry for full package providers.

The Commission notes that a number full package providers in Australia, eg. Optus, Austar, TransACT and SelecTV have deployed their own CA/SI systems in order to provide subscription television services to end-users. Moreover, the Commission understands that a variety of CA/SI systems and hosting solutions can be readily purchased from third party suppliers.

In addition, the Commission notes that it has not been asked to declare the unbundled CA/SI services nor commenced a declaration inquiry in respect of them itself.

Thus, having had the advantage of evidence on the issue from interested parties, the Commission would not be inclined to place great weight on the value of the option of access to unbundled CA/SI services.

On balance, the Commission considers that accepting the Undertaking that provides for access for content providers to Foxtel's STU infrastructure and subscribers is likely to outweigh the value of access to unbundled CA/SI services for the benefit of full retail Pay TV firms given that they can buy those services on the open market.

The Commission has some minor concerns about non-price provisions in the Undertaking in relation to indemnities and liabilities, and the access provider's ability to change the terms of the Digital Access Agreement ('DAA'). Similarly, while the Commission takes the view that, overall, the price terms and conditions in the Undertaking promote the long-term interests of end-users, it would prefer to have more information about the cost base that Foxtel has used in calculating the Installed Base Acquisition Cost ('IBAC') as part of its pricing methodology.

Notwithstanding these concerns, the Commission's draft view is that, on balance, it is satisfied that the terms and conditions specified in the Undertaking are reasonable.

Consistency with the standard access obligations

The Commission's draft view is that it is not 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).

The relevant service(s) incorporate not only the bundled Digital Set Top Unit Service, but also each of the constituent component services set out in Appendix 1 of the DAA.

Section 152AR(3)(a) contains an obligation that, if requested to do so, access providers must supply an active declared service.

The DAA contains a number of terms and conditions including a bundling clause and a tying clause. The bundling clause provides that Foxtel is only obliged to supply the

services as a total package and not as one or more component parts. The tying clause provides that Foxtel has no obligation to supply the services to locations where there is not a current Foxtel subscription.

In the Commission's draft view, the bundling clause enables Foxtel to constructively refuse to supply the component services. This is because, as a result of the bundling clause, Foxtel is not obliged to supply any of the component services unless the access seeker agrees to acquire not only the component service in question, but also all of the other component services making up the bundled Digital Set Top Unit service.

On this basis, the Commission is not satisfied that the terms and conditions specified in the Undertaking are consistent with the obligation set out in s.152AR(3)(a).

1.4 Conclusion

The Commission's draft view is that it is not 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).

The Commission's draft view is that it is satisfied that the terms and conditions specified in the Undertaking (incorporating the amendments identified by Foxtel on 29 March 2006 and 29 May 2006) are reasonable as required by s.152CBD(2)(b).

As a result, the Commission's Draft Decision is to reject the Undertaking (being the version given to the Commission by Foxtel on 6 October 2005, or incorporating the amendments identified by Foxtel on 29 March 2006 and 29 May 2006).

The Commission notes the possibility of Foxtel's s.87B undertaking expiring in 2007 without a special access undertaking to replace it. It remains open to content providers to commercially negotiate access or to seek declaration of the service if necessary.

1.5 Making submissions

The Commission invites people to make submissions in relation to this Draft Decision. The closing date for submissions is cob 25 September 2006. Any submissions or enquiries in relation to this Draft Decision should be directed to:

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Where submissions contain confidential information, this should be clearly indicated.

Non-confidential and confidential versions of submissions should be provided to the Commission at the time of making submissions.

1.6 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 Draft Decision on the Undertaking; and
- **Chapter 10** lists the documents given to the Commission in connection with the Undertaking, and other documents considered by the Commission in reaching its Draft Decision.

2. Background

2.1 What are Digital Set Top Units?

A Digital Set Top Unit ('STU') is a component of the network architecture and systems used for the provision of subscription television services to end-users.³

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.⁴

³ 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.

⁴ Refer to FOXTEL MANAGEMENT PTY LIMITED, Foxtel Engineering, Peter Smart and Ron Higgins, *Report prepared for special access undertaking by FOXTEL*, 6 October 2005, p.7.

2.2 Commission's previous consideration of access to digital set top units and related services

2.2.1 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.⁵

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.⁶

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 2003.⁷

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')

⁵ 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.

⁶ 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.

⁷ 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.

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 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, compared with 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.

2.2.2 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.

2.2.3 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'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 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. Legislation relevant to assessing access undertakings

This chapter sets out:

- A consideration of special access undertakings 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 Act⁸:

- Anticipatory exemption orders (‘AEOs’); and
- Special Access Undertakings (‘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.⁹

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

⁸ *Telecommunications (Competition) Act 2002 (Cth)*

⁹ *Telecommunications (Competition) Bill 2002 (Cth) Explanatory Memorandum*, p. 16.

provide access should the service be declared. In particular, where “risky investments” are subject to potential declaration, the investment may be rendered uneconomic as a result of this uncertainty.¹⁰

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.¹¹

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.¹²

¹⁰ *ibid.*, p. 81.

¹¹ *ibid.*, p. 72.

¹² 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 carriage service provider, 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.¹³ 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 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.¹⁴ In summary, if requested by a service provider, an access provider is required to:

- supply an active declared service to the service provider in order that the service provider can provide carriage and/or content services;

¹³ 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.

¹⁴ Refer to ss.152AS and 152AT of the Act.

- 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 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. 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 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.¹⁵

This does not, by implication, limit the matters to which regard may be had.¹⁶

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.¹⁷

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.¹⁸

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.¹⁹

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 is then considered in Chapter 7.

¹⁵ Section 152AH(1) of the Act.

¹⁶ Section 152AH(2) of the Act.

¹⁷ 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.

¹⁸ *Telstra’s Line Sharing Service [2006] ACompT 4 (2 June 2006)* at [150].

¹⁹ *Telstra’s Line Sharing Service [2006] ACompT 4 (2 June 2006)* at [69].

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.

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

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.²⁰ 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.²¹

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
 - 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.²²

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.

²⁰ Australian Competition and Consumer Commission, *Telecommunications services — Declaration Provisions: A Guide to the Declaration Provisions of Part XIC of the Trade Practices Act*, July 1999.

²¹ *ibid.*, pp. 32-33.

²² Section 152AB(2) of the Act.

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.²³ 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.²⁴

However, the Commission notes that Foxtel appears to advocate a different interpretation in its Supplementary submission.²⁵

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.

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.

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

²³ 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.

²⁴ *Sydney International Airport [2000] ACT 1*, para. 106.

²⁵ Foxtel, *Supplementary Submission to the Australian Competition and Consumer Commission, FOXTEL Special Access Undertaking in support of the Undertaking*, 29 March 2006, p. 11.

- *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 its decision on access to subscription television services, noted in relation to the terms that make up the LTIE that:

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 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 than would otherwise be the case

Long-term: the long-term will be the period over which the full effects of the ... decision 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.²⁶

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.²⁷ 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.²⁸

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

²⁶ Application by C7 Pty Limited & Seven Network Limited re: Foxtel and Telstra reasons for decision f 23 December 2004 at paragraph 120

²⁷ 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.’

²⁸ Explanatory Memorandum for the *Trade Practices Amendment (Telecommunications) Bill 1996*, p. 44.

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.²⁹

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 special access undertakings 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.

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

²⁹ *Telstra's Line Sharing Service [2006] ACompT 4* (2 June 2006) at [89].

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.³⁰

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 defined to mean:

... costs an access provider will incur in producing a service assuming the access provider produced no other services.³¹

³⁰ Explanatory Memorandum for the Trade Practices Amendment (Telecommunications) Bill 1996, p.44

³¹ 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.³²

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.

³² 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.

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

3.2.4 Public process

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

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.

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, 10 November 2005.

Foxtel's supplementary submission dated 29 March 2006 and letter to the Commission dated 29 May 2006, each of which proposed an amendment to the Undertaking were placed on the Commission's website on 18 April 2006 and 5 June 2006 respectively.

The Discussion Paper, amongst other things, sought interested parties' views on the Undertaking and the supporting submissions. In response, the Commission has received submissions from 3 interested parties. A list of the submissions received is at Chapter 10 to this report. The Commission has considered these submissions in reaching its Draft 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.³³

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:

(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.

³³ 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’.

3.3.3 Calculating the decision-making period for the Undertaking

Information request under section 152CBB of the Act

The Commission received the Undertaking from Foxtel on 6 October 2005.

Since that date, the Commission has made the following requests for further information under s.152CBB of the Act:

- on 23 March 2006, the Commission requested further information and clarification on a number of price and non-price conditions contained in the Undertaking. Foxtel provided a response to this information request on 11 April 2006; and
- on 13 April 2006, the Commission requested clarification on the intended effect of clause 4.1(c)(ii) of the DAA in the Undertaking in terms of restricting the terms of any arbitral determination in respect of component services that comprise the Digital Set Top Unit service if the Commission declared such a service under s.152AL of the Act. Foxtel provided a response to this information request on 24 April 2006;
- on 31 May 2006, the Commission sought further information from Foxtel in relation to the technical difficulties claimed by Foxtel regarding the provision of modem services to Foxtel's existing channel providers. Foxtel provided a response to this information request on 27 June 2006.

In the Commission's view, the Undertaking 'clock' was stopped during the periods outlined above.

Public consultation process

On 10 November 2005, the Commission released a Discussion Paper and called for submissions on the Undertaking. In this Discussion Paper, the closing date for submissions was to be no later than six 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.

Additionally, it was stipulated that if, prior to the expiry of this period, the Commission made a request, under s.152CBB, for further information about the Undertaking, the 6 weeks would be 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.

The above conditions were satisfied on 3 January 2006. The Commission therefore set a closing date for submissions of 14 February 2006. A note to this effect was placed on the Commission's website.

In the Commission's view, the Undertaking 'clock' was stopped during the period outlined above.

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 draft view. The Commission has assessed this sensitive information having regard to its policy on the treatment of information,³⁴ 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.

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 primarily relied upon the supporting submissions provided by Foxtel, and the further submissions provided by Foxtel in response to the Commission's requests for further information under s.152CBB of the Act.

The Commission has also relied upon the submissions provided by interested parties in response to the Discussion Paper.

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.

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

3.3.6 Amendments to the undertaking

Following its initial lodgement of the Undertaking on 6 October 2005, Foxtel proposed two amendments to the Undertaking (together the '**Proposed Amendments**') in:

³⁴ ACCC, *Collection and Use of Information*, 2000.

- Foxtel's letter to the Commission dated 29 May 2006 and correction of 23 June 2006; and
- Foxtel's supplementary submission provided to the Commission on 29 March 2006.

Section 152CBD(1A) of the Act provides that a person may modify an undertaking in certain circumstances. These circumstances are left to be defined in the Procedural Rules, which are not yet in existence.

In the Commission's view, some doubt exists as to whether the Proposed Amendments referred to above dated 29 March 2006, 29 May 2006 and 23 June 2006 have the effect of modifying the undertaking.

The Commission has assessed both the Undertaking as originally submitted on 6 October 2005 and the Undertaking incorporating the Proposed Amendments. In particular, the Commission views on the reasonableness of the Undertaking are on the basis that the Undertaking does incorporate the Proposed Amendments.

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 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; and
- undertakes to supply the Digital Set Top Unit Service on the terms and conditions specified in the Digital Access Agreement.

The Undertaking includes two appendices: Appendix 1 defines Foxtel's Digital Set Top Unit Service. Appendix 2 sets out the Digital Access Agreement (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
- condition precedents 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 carriage service provider 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 undertaking may be without limitation or may be subject to such limitations as are specified in the undertaking (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 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.

This service description differs from Foxtel's current s. 87B undertaking in that it includes EPG Services (electronic program guide) and Modem Services.

Two further aspects of the service description should be noted. In doing so, it is necessary to consider the operation of s.152AL(7) of the Act.

Section 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 upon two other matters being satisfied (ie. the undertaking is in operation and the person supplies the service). With regard to the service that will become declared, s. 152AL(7) goes on to state 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.'

The first aspect concerns clause 4.1(c)(ii) of the DAA which states that Foxtel is only obliged to supply the Digital Set Top Unit Services as a total package and not as one or more component parts. In Foxtel's view, the Undertaking is in respect of 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.³⁵

In its letter of 24 April 2006, Foxtel states:

³⁵ Foxtel submission (24 April 2006) in response to a request for further information issued by the ACCC on 13 April 2006.

FOXTEL intends for the SAU to constitute an undertaking pursuant to s 152CBA in respect of each and all of the services forming part of the DSTUS as defined. Accordingly, in any arbitration under Division 8 of Part XIC of the Act concerning the terms and conditions on which FOXTEL is to comply with the standard access obligations in respect of any of the services within the DSTUS, FOXTEL submits that s 152CQ(5) will apply.

The second aspect concerns clauses 4.1(c)(i), 4.1(f), 11.1(d) and 11.1(e) of the DAA. Clause 4.1(c)(i) provides that Foxtel is only obliged to supply Digital Set Top Unit Services 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 the reception of Foxtel's digital subscription television services.

The Commission understands Foxtel to contend that the Undertaking is 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. As such, the Commission understands that Foxtel does not regard any of clauses 4.1(c)(i), 4.1(f), 11.1(d) and 11.1(e) as a limitation to the scope of the declared service for the purpose of ss.152CBA(5) and 152AL(7).³⁶

In the Commission's view, this position is implicit in the reasoning of Foxtel's submission of 24 April 2006.

In reaching this view, the Commission notes that the submissions made by Foxtel in relation to the application of the standard access obligations arguably suggests a contrary view. In particular, Foxtel states in its supplementary submission:

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.³⁷

However, the Commission's view is that this comment relates specifically to a line of argument that Foxtel is pursuing in relation to the consistency of the Undertaking with the applicable standard access obligations. Furthermore, this comment was made prior to Foxtel's letter of 24 April. The Commission has taken the 24 April letter to represent Foxtel's view on the specific matters which it addressed and as taking precedence over earlier statements in relation to similar subject matter. For example, the Commission has also taken the view that the statements in the letter of 24 April take precedence over the following statement in Foxtel's submission of 5 October 2006:

Foxtel 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.³⁸

As is set out above, Foxtel contends:

³⁶ 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.

³⁷ Foxtel supplementary submission of 29 March 2006, p 14.

³⁸ Foxtel Submission of 5 October 2005, pp. 50-51.

in any arbitration under Division 8 of Part XIC of the Act concerning the terms and conditions on which FOXTEL is to comply with the standard access obligations in respect of any of the services within the DSTUS, FOXTEL submits that s 152CQ(5) will apply.

The Commission therefore understands Foxtel to contend that following acceptance of the Undertaking, the declared service would be a service in respect of both end-users who are Foxtel subscribers and end-users who are not Foxtel subscribers and, further, that s.152CQ(5) would apply to an arbitration in respect of end-users in either of these categories.

The Commission considers that there is some doubt as to whether the definition of the Digital Set Top Unit Service set out in Appendix 1 to the Undertaking, operates as Foxtel intended. However, the Commission has assessed the Undertaking on the basis of Foxtel's construction of the service description.

4.3 Digital Access Agreement (DAA)

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

4.3.1 Non-price terms and conditions of access

Bundled 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'. A similar clause is included in Foxtel's s.87B undertaking.

As noted above, Foxtel considers that the Undertaking is in respect of each and all of the services forming the Digital Set Top Unit Service as defined. On this basis, if the Commission were to accept the Undertaking, each and all of the component services would be deemed to be declared services. However, if an access dispute was notified under s.152CM in respect of a component service (such as CA Services and Service Information Services), the Undertaking would restrict the terms of any arbitration determination made by the Commission (s.152CQ(5)). In particular, Foxtel considers 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.

Restriction on 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 Digital Set Top Unit Services to the Access Seeker where the Digital Set Top 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) and (ii)) (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 Services to a location where the Digital Set Top Unit 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 Set Top Unit from a Subscriber Premises.

Similar clauses are included in Foxtel's s.87B undertaking.

As noted above, the Commission has assumed for the purpose of this assessment that Foxtel does not regard clauses 4.1(c) and (f) of the DAA as a limitation to the scope of the declared service for the purpose of ss.152CBA(5) and 152AL(7) of the Act. On this basis, 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. In particular, Foxtel considers that a determination could not oblige Foxtel to extend the facility to non-Foxtel homes.³⁹

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 set top unit 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. As noted in Chapter 4 above, Foxtel, in a letter dated 23 June 2006 identified changes to clause 5.2(e) of the DAA.

³⁹ 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.

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;
- the ability of Foxtel to allocate an access seeker's listings in the EPG according to genre, at Foxtel's discretion;⁴⁰ and
- Foxtel only supplying EPG services to an access seeker in respect of that access seeker's subscribers.

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 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
- the ability of the Digital Set Top Unit to activate the modem to dial a number using the PSTN.⁴¹

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 Set Top Unit via the return path.

⁴⁰ The procedures for allocation of EPG listings are outlined in Schedule 9 of the DAA.

⁴¹ Foxtel submission, 6 October 2005, p.21.

Foxtel states that the inclusion of terms and conditions governing access to Modem Services in the DAA is in response to the Tribunal's comments regarding the exclusion of interactivity in Foxtel's previous exemption application.⁴²

The changes to Foxtel's proposed pricing methodology arising from the inclusion of Modem Services is outlined in Chapter 5.

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.⁴³ 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)
- Privacy (clause 17)
- Defamation (clause 20.3)
- Indemnities and liability (clauses 22 and 23)
- Intellectual property (clause 18)

⁴² Foxtel submission, 6 October 2005, p.20.

⁴³ DAA clause 24.4(d).

- 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 s.87B undertaking.

4.4 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 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.⁴⁴ Foxtel submits that the methodology proposed in that exemption application continues to be relevant to this 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 its submission of 6 October 2005.⁴⁵

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;

⁴⁴ 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.

⁴⁵ Attachment 1: CRA International, *Adjusted access pricing model for digital STUs*, October 2005.

- 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 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 annual 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 annual 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.⁴⁶

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.

⁴⁶ Definitions of terms are set out in Schedule 10 of the DAA.

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.⁴⁷ 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. The cost base includes an amount of \$280 million for Cable IBAC and \$115 million for Satellite IBAC.

In response to the Tribunal's concerns regarding the verification or audit of IBAC, Foxtel engaged PricewaterhouseCoopers to perform Agreed Upon Procedures in relation to the components of the IBAC Input Costs schedules.⁴⁸

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.

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 cent⁴⁹ 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;

⁴⁷ Foxtel's proposed parameter values are outlined in section 3.4 of Schedule 3.

⁴⁸ 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];

⁴⁹ This percentage figure appears to be based on the historical cost proportion of Foxtel's corporate overhead costs to its operating expenses.

- 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 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 Services.

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

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.

The 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.

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 Digital Access Agreement describes the methodology by which Foxtel will calculate annual access charges it would charge access seekers.

In its Submission in support of the Undertaking, Foxtel proposes 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] AComptT 11, 23 December 2004.

Foxtel refers to two papers by NECG that are parts of Attachment 7 to its Submission 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 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 that forms part of its pricing methodology and is discussed in Attachment 1 to Foxtel’s Submission.⁵⁰

A brief summary of Foxtel’s pricing methodology to determine access charges is provided as follows:

Foxtel will use a “building block” methodology to establish cost bases or “cost pools”. These four cost pools are for capital expenditure (capex), installed base acquisition cost (IBAC), operating expense (opex) and corporate overhead. Each of these cost pools will be annualised or spread over yearly periods.⁵¹

The costs for each yearly period will be summed up to arrive at total annual costs for each period. The total annual cost in each year is the sum of the annual capital expenditure cost, the annual IBAC cost, the annual operating expense, and the annual overhead cost. The total annual costs for each year will be allocated among all users of the service (access seekers and Foxtel) and classified as either specific costs, attributable costs, or shared costs.

Specific costs are actual costs incurred by Foxtel as a result only of activity by a particular access seeker for the provision of access to that access seeker. Attributable costs are costs incurred by Foxtel as a result of the provision of access to all 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 are costs incurred by Foxtel that, according to Foxtel, benefit both Foxtel and access seekers and should be shared between them. (Annual shared costs will be allocated based on the access seeker’s actual revenue or imputed revenue, whichever is greater.)

⁵⁰ Attachment 1: *CRA International, Adjusted access pricing model for digital STUs*, October 2005.

⁵¹ 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. The IBAC pool consists of Foxtel’s costs of acquiring the installed analogue customer base which is migrated to the digital platform. 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). See 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. 70.

Finally, the costs will be translated into 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 annual access charge payable by the access seeker.

5.2 Discussion and assessment of price terms and conditions

The following sections contain the Commission's discussion and analysis with respect to its consideration of the price terms and conditions set out in the Undertaking. The Commission has conducted its consideration of the price terms and conditions while having regard to the relevant legislative criteria in s.152AH(1) of the Act.

The discussion also includes consideration of the submissions made by Foxtel and interested parties in relation to particular price terms and conditions.

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
- the method of allocating shared costs, and
- the appropriate weighted average cost of capital 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 7.⁵² Foxtel proposed the same methodology when it applied for its digital exemption application in 2002.⁵³ 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.

⁵² 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.

⁵³ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003

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 STU 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, is 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 Foxtel's retail pricing is not altered unnecessarily, which may otherwise distort demand for pay-TV services.⁵⁴

The methodology is described in detail in Schedule 3 of the proposed Digital Access Agreement.⁵⁵ It is also described in much greater detail in PwC's independent review report on Foxtel's Regulatory Accounting Procedures Manual (RAPM) in Attachment 12.⁵⁶

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.⁵⁷ 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 ended 30 June 2004.

⁵⁴ Foxtel submission, 6 October 2005, p. 46.

⁵⁵ 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.

⁵⁶ Attachment 12: PricewaterhouseCoopers, *Independent Review Report on Foxtel's Digital Rate Card Regulatory Accounting Procedures Manual*, 13 July 2005. (part confidential)

⁵⁷ 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)

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 (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

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.⁵⁸

Views of interested parties

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’.⁵⁹ 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.

⁵⁸ CRA International, *Adjusted access pricing model for digital STUs, October 2005*, pp. 18, 21.

⁵⁹ Ten Network, *Submission by Ten Network Holdings Limited to the Australian Competition and Consumer Commission*, 21 February 2006, p. 7.

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.⁶⁰ 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 Digital Access Agreement.⁶¹ 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.

Foxtel's supplementary submission

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 Digital Access Agreement and is very transparent.⁶²

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.⁶³

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.

⁶⁰ Seven Network submission, section 8.2 at p. 34.

⁶¹ 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.

⁶² Foxtel, supplementary submission, 29 March 2006, p. 25.

⁶³ 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.

As the Commission discussed in its Access Pricing Principles,⁶⁴ TSLRIC is the incremental or additional cost the firm incurs in the long term in providing the 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 the 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 2002. In that decision, the Commission considered that a TSLRIC-type approach as proposed by Foxtel for the pricing of the STU Service is justified.⁶⁵

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'.⁶⁶ The Tribunal was 'generally satisfied with the pricing methodology (including cost allocation) adopted by Foxtel, as modified by the Commission'.⁶⁷

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 long-term interests of end-users. 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

⁶⁴ Australian Competition and Consumer Commission, *Access Pricing Principles: Telecommunications – a guide*, July 1997.

⁶⁵ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003.

⁶⁶ *Re Seven Network Limited (No 4) (2004)* 187 FLR 373 at [136].

⁶⁷ *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.⁶⁸

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,⁶⁹ 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;
- 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, or are still to be incurred. It is likely that these recently incurred costs closely approximate the replacement costs of modern equivalent assets. This satisfies a significant requirement of the TSLRIC methodology, which is the use of forward-looking, efficient costs.

⁶⁸ ACCC, *Access Pricing Principles – Telecommunications, July 1997*. pp. 28-30.

⁶⁹ 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).

- 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.
- At the time of Foxtel's digital exemption application in 2002, the digital pay TV service was not well developed in Australia (it was in fact non-existent) and local market demand for the service was uncertain. One condition of appropriately using TSLRIC was therefore not satisfied. Further, the Commission had an additional consideration of encouraging new investment in pay TV services. The Commission understands that in 2003 pay TV penetration in Australia was only 22 per cent, compared with 85 per cent in the U.S. and over 40 per cent in the U.K. and New Zealand. The Commission had an implied view that the uncertainty in recovering costs would have discouraged new investment in digital pay TV services if the Commission rejected Foxtel's pricing methodology.⁷⁰
- 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 Astar) 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...

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 over-spend 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) is 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. These two factors imply that the majority of shared costs is likely to be shouldered by Foxtel and would not be allocated to access seekers.

⁷⁰ Although the Tribunal adopted a different view from the Commission, ie. that the granting of Foxtel's digital exemption was not necessary to promote digitisation.

Foxtel therefore has the incentive to minimise costs and to find the least cost way of supplying digital subscription television services.

- An outcome of the Commission's decision on Foxtel's digital exemption application in 2002 was the acceptance of Foxtel's s. 87B undertaking, and that undertaking remains operative until 31 December 2007. 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.

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. Whether the Commission finds this Undertaking reasonable in its entirety, and therefore acceptable, is discussed in Chapter 7.

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 and ratings basis). If the shared costs of EPG and modem services are allocated on a basis different from the revenue and ratings basis, there are likely to be difficulties (such as measurement problems or lack of economic justification) with regard to the alternative variables (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 differently the costs of provision of EPG and modem services if these services are provided as part of the component services included in 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.⁷¹ 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

⁷¹ Foxtel, Appendix 2 Digital Access Agreement, section 4.2.

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.⁷²

Whether the exclusion of certain services from the Digital Set Top Unit Service is reasonable is a separate question, and is a matter discussed in Chapter 6 of this report in the Commission's assessment of non-price terms and conditions.

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.

Given Foxtel's commitment to build the digital system ready for third-party access, in accordance with its s. 87B undertaking, 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. That is, the Commission understands that most of the network expenditure and enhancement are expected to be built into the network to make it ready for third party access, in accordance with the s.87B undertaking. This expenditure is likely to be categorised as a shared cost, and not specific to or attributable to any particular access seeker or group of access seekers.

[c-i-c]

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.

In relation to the annual Rate Card for access seekers, Foxtel stated in its submission in support of the Undertaking that:

Foxtel has undertaken to the Commission that after the first 12 months and then not less than every 3 years, Foxtel will arrange for its rate card calculations to be audited by an independent auditor and will make a copy of the independent audit available to the Commission. This should provide confidence to the Commission and access seekers that Foxtel is calculating its rate card in accordance with the pricing methodology.⁷³

However, in its review of Foxtel's Undertaking, including the relevant attachments to the Undertaking, the Commission has not found a statement by Foxtel that gives effect to the abovementioned commitment. The Commission is concerned that, without an explicit provision in Foxtel's Undertaking, there is no assurance that the verification by an independent auditor of Foxtel's calculation of annual access charges will occur.

⁷² Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 8.

⁷³ Foxtel submission, 6 October 2005, paragraph 7.2, p. 47.

5.2.2 Installed base acquisition costs

Foxtel's submission

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.

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.⁷⁴

NECG justifies the recovery of these unrecovered costs by arguing that:⁷⁵

- 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.

⁷⁴ NECG, *Foxtel explanatory material in relation to STU pricing, Part A: STU Access Pricing*, 4 June 2002, p. 5.

⁷⁵ *ibid.*, pp. 5-9.

The IBAC amounts that Foxtel submits for this Undertaking consist of an amount of \$280 million for cable TV and \$115 million for satellite TV,⁷⁶ or a sum of \$395 million.

Foxtel submits the same IBAC amounts in this Undertaking as those amounts included in its digital access exemption application and accepted by the Commission in 2003.

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.⁷⁷

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 submits for this Undertaking.⁷⁸ 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 \$280 million cable-TV IBAC mainly comprises [c-i-c]. The \$115 million 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 weighted average cost of capital. The IBAC net present value will then be distributed over the 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.⁷⁹

⁷⁶ Foxtel submission, 6 October 2005, pp. 46-7.

⁷⁷ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, pp. 52-3.

⁷⁸ Foxtel reply to ACCC request for further information, 11 April 2006, pp. 4-6.

⁷⁹ 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, pp 69-70.

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'.⁸⁰ Foxtel engaged Pricewaterhouse Coopers (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:⁸¹

- Cable IBAC cost schedules – Agreed Upon Procedures
- Gross capital purchase cost of cable set top units – Audit
 - Other costs related to cable set top units – Agreed Upon Procedures
- Satellite IBAC cost schedules – Agreed Upon Procedures
- Gross capital purchase cost of satellite set top units – 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'.⁸²

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.⁸³ 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.

Views of interested parties

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:

⁸⁰ *Re Seven Network Limited (No 4) (2004)* 187 FLR 373 at [326].

⁸¹ 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.

⁸² Foxtel submission, 6 October 2005, p. 47.

⁸³ Foxtel submission, 6 October 2005, p. 47.

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.⁸⁴

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 11⁸⁵ 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 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

⁸⁴ Seven Network submission, p. 22.

⁸⁵ Attachment 11: PwC: *Report on Gross Purchase Cost of Cable Set Top Units* dated 19 January 2001.

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

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 11.⁸⁶ 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.⁸⁷ 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 IBAC calculation, particularly in circumstances where Foxtel's total marketing expenses were broadly similar throughout the period.⁸⁸

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,⁸⁹ Foxtel proposes to amend its Digital

⁸⁶ Attachment 11: PwC: *Report on Gross Purchase Cost of Cable Set Top Units* dated 19 January 2001.

⁸⁷ Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 6.

⁸⁸ Total actual marketing expenses for four years from 1996-97 to 1999-2000 were in a narrow range of \$[c-i-c] million per year.

⁸⁹ Foxtel letter to the ACCC, 9 May 2006.

Rate Card Regulatory Accounting Procedures Manual (RAPM).⁹⁰ 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.⁹¹ 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.

The Commission's view

The Commission's accepts that there is merit in Foxtel's proposal to include in the IBAC the amounts of \$280 million for cable TV and \$115 million for satellite TV. As it stated previously in its digital exemption decision in 2003, 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 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.⁹²

⁹⁰ *ibid.*

⁹¹ Foxtel letter to the ACCC, 28 July 2006.

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

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.⁹³ 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.

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 expenditures related to the analogue TV phase.

Therefore, subject to the Commission's concerns below, 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.

In relation to sales and marketing costs included in the IBAC and in future periods, the Commission remains unconvinced that Foxtel has excluded,

- has excluded Foxtel-specific marketing costs in the IBAC, and
- will exclude Foxtel-specific marketing costs in future periods.

The bases for the Commission's concerns are as follows:

- Under the Digital Access Agreement, Defined Capital Expenditure includes all expenditure on 'marketing other than Retention Marketing and marketing solely devoted to a single Subscription Television Service in the basic package of FOXTEL or its nominated Associate'.⁹⁴ With this definition, it appears that Foxtel's marketing expenses in relation to marketing more than one Foxtel channel, or Foxtel's pay-TV business in general, will be classified as non-specific marketing and will be part of shared costs to be allocated to access seekers.

⁹³ Auditing & Assurance Standards Board (Australian Accounting Research Foundation), AUS 106 Explanatory Framework for Standards on Audit and Audit Related Services, November 2001.

⁹⁴ Refer to section 8, pp. 73-4 of the DAA.

- Under the Digital Access Agreement, Defined Operational Expenditure includes all expenditure on ‘Retention Marketing’, being marketing intended to retain existing customers.⁹⁵ With this definition, Foxtel’s marketing expenses incurred to retain current Foxtel subscribers appear to be part of shared costs to be allocated to access seekers.
- As Foxtel initially proposed, the claimed proportion of non-specific marketing expenses being 68 per cent of total marketing costs is based only on a single year, 2000-01, but is assumed over the entire period from 1995 to the end of the ten-year forecast period covering digital services. Further, this proportion was based not on actual costs in 2000-01 but on budgeted costs only, on the basis of planned marketing programs for that year. The use of the 68 per cent figure therefore lacks a firm basis.
- Foxtel subsequently stated that it would amend its Regulatory Accounting Procedure Manual (RAPM) for its Digital Access Pricing Model to remove the assumption that 100 per cent of marketing is non-specific for the full ten-year period. Instead, it will record the percentage of marketing which is non-specific for each year, and this percentage will be determined by Foxtel and subject to an independent review.⁹⁶ Foxtel subsequently determined that the percentage to be used for the first period 2003-04 is 90.29 per cent, and from 2004-05 the actual percentage for each financial year will be used. Further, the RAPM will be amended to state that the percentage of marketing to be included for each year will be determined by Foxtel in accordance with the DAA.

With these final amendments to the RAPM, the Commission remains concerned that the determination of the appropriate percentage for non-Foxtel-specific marketing is dependent on Foxtel, is not subject to independent review, and is likely to remain non-transparent in future periods. Further, the percentage figure for non-specific marketing for the first period 2003-04 is increased from 62 per cent to 90.29 per cent, a proportion that appears to be unreasonably high for non-Foxtel -specific brand marketing activity.

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

⁹⁵ Refer to section 8, p. 74 of the DAA.

⁹⁶ Foxtel letter to ACCC, 9 May 2006.

calculation methodology to apply to this allocation is described in section 7.3 of Schedule 3 to the proposed DAA.⁹⁷

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 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

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:

⁹⁷ 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.

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.⁹⁸

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.⁹⁹

Foxtel's supplementary submission

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.

⁹⁸ Seven Network submission, section 8.2 at p. 34.

⁹⁹ *ibid.*, pp 34-5.

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 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).

As held by the Commission in its digital exemption decision in 2002, it was of the view 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.¹⁰⁰ The Commission noted that the approach of using revenue and ratings was put forward 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 Ramsey-Boiteux pricing approaches are 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.

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 Ramsey-Boiteux pricing. 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

¹⁰⁰ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 59

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 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 which 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.¹⁰¹

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

¹⁰¹ 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, pp. 66-88.

the supply of domestic mobile terminating access services, the Commission considered 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.¹⁰²

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.

That the EPMU approach is problematic, in the Commission's view, in this particular case of the Foxtel Undertaking is elaborated as follows.

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.¹⁰³

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 will be put in place to make the network ready for access, in accordance with Foxtel's s 87B undertaking. This expenditure is likely to be categorised as a shared cost, and not specific to or attributable to any particular access seeker or group of access seekers.

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

¹⁰² 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.

¹⁰³ Foxtel s 87B undertaking; Allens Arthur Robinson on behalf of Foxtel, 29 October 2003.

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

If the EPMU approach involves measuring the directly attributable costs of each service within the group of services and allocating the common costs based on each service's proportion of the total directly attributable costs, then this approach of allocating common costs ('shared cost') based on 'each service's proportion of the total directly attributable costs' 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. Therefore, there will be an unsound basis for allocating common costs in Foxtel's case, if the EPMU were adopted.

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. The imperfect use of Ramsey-Boiteux pricing in this case is mitigated by the following factors:

- subscription TV revenues for each of Foxtel's and access seekers' channels can 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.¹⁰⁴

5.2.4 Weighted average cost of capital

The weighted average cost of capital (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

¹⁰⁴ *Re Seven Network Limited (No 4) (2004) 187 FLR 373 at [326].*

liabilities of the firm in the firm's cash flow model and adjusts the amount to account for the utilisation of imputation credits.

The WACC formula is:

$$\text{WACC} = R_e (E/V) + R_d (D/V)$$

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. As such, it determines the return expected by investors on their equity investment in the firm.

The Commission uses the Capital Asset Pricing Model (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 of the market as a whole (r_m) over the risk-free rate of return (r_f) for the same period
β_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:

β_e	=	equity beta
β_a	=	asset beta
β_d	=	debt beta
R_d	=	cost of debt
γ	=	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.¹⁰⁵

¹⁰⁵ Foxtel's proposed parameter values are outlined in section 3.4, Schedule 3 of the Digital Access Agreement.

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 2002.¹⁰⁶ 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.

¹⁰⁶ 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 STU Service special access undertaking	ACCC – Digital STU Service special access undertaking
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	β_a	1.4	1.4	1.4
Equity Beta	β_e	1.66	1.66	1.66
Post-tax cost of equity	R_e	15.49%	15.49%	15.8%
Debt Beta	β_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%	6.9%
Franking credit utilisation (gamma) *	γ	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 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

The Commission did not receive any submission from interested parties in relation to Foxtel's use of the Capital Asset Pricing Model 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.¹⁰⁷ 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 preferred a gamma value of 0.50 for the purposes of that application.¹⁰⁸ 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).

¹⁰⁷ 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

¹⁰⁸ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003, p. 58.

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.¹⁰⁹ 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.¹¹⁰

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 STU 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

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.

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.

¹⁰⁹ Foxtel submission, 6 October 2005, p. 49.

¹¹⁰ Foxtel, letter to ACCC in reply to request for further information, 11 April 2006, p. 7.

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.¹¹¹ 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.

Foxtel’s supplementary submission

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

¹¹¹ Seven Network submission, pp 21–22.

- 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.¹¹² 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 weighted average cost of capital.

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 weighted average cost of capital.

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 (β_e) x market risk premium].

¹¹² Refer to Attachment 15, Stephen Gray, *A Beta Estimate for Foxtel – A Submission on the Access Undertaking of Foxtel Management*, 4 October 2005

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.¹¹³

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.

To account for current market conditions in regard to this Undertaking, the Commission has used current government bond rates at the time of this draft decision. At the time Foxtel submitted its Undertaking in October 2005, average bond rates were at the 5.2 per cent level.¹¹⁴ At the present time of the Commission's Draft Decision (August 2006), single-day and average ten-year bond rates are as follows:¹¹⁵

single-day (9 August 2006)	5.780 per cent
10-day average	5.818 per cent
40-day average	5.812 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.

¹¹³ 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.

¹¹⁴ 40-day average (estimated based on data from the Reserve Bank of Australia, 'Indicative Mid-rates of Selected Commonwealth Government Securities', available at www.rba.gov.au).

¹¹⁵ *ibid.*

Market risk premium

In the CAPM framework, the market risk premium (MRP) is used to estimate the cost of equity:

Cost of equity (R_e) = risk-free rate (R_f) + [equity beta (β_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 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.

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.¹¹⁶

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

¹¹⁶ insto (The Australian Financial Markets Newsletter), week ending 6 February 2004, p. 17.

(leverage) of a sample of Australian broadcast and cable-TV companies. The available data showed the following:¹¹⁷

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.

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

¹¹⁷ Attachment 15: Gray, Stephen, *A Beta Estimate for Foxtel—A Submission on the Access Undertaking of Foxtel’s Management*, 4 October 2005, p. 19.

- 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 had an 'indicative margin of 140-170 basis points over BBSY'.¹¹⁸ 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 draft decision,¹¹⁹ Foxtel's debt margin would be in a range of 1.96 per cent to 2.26 per cent over the ten-year Commonwealth bond 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:

¹¹⁸ 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.

¹¹⁹ Data available from The Australian Financial Review, Money & Bond Markets section, 9 August 2006, p. 46. The Commission referred to Bank Bill Swap Reference Rate: Average Bid (Source: ANZ) for 180 days (the longest term for quoted rates).

Parent (per cent ownership of Foxtel)	Standard and Poor's credit rating ¹²⁰
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.¹²¹ 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.¹²²

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 6.9 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.

¹²⁰ www.standardandpoors.com

¹²¹ 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.

¹²² 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.

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 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 charge. 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 charge. 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 in the future the risk of overcompensating Foxtel for its tax expenses will be reduced as it is expected actual expenses will be used.

5.2.5 The Commission's views on Foxtel's proposed WACC

The Commission's view is that it would be difficult to justify a departure from the appropriate value of gamma 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 or companies in Australia. Further, it is consistent with the views or 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 weighted average cost of capital 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 to consider 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. However, this is the formulaic result of the use of a gamma value of zero, as proposed by Foxtel. Because the Commission is of the view that a gamma value of zero is inappropriate, it does not accept the resulting WACC even if this WACC were slightly lower.

Whilst the Commission recognises it is rejecting a proposed WACC that is slightly lower, it also recognises that a slightly lower WACC may result in a slightly higher access price for the Foxtel service. As discussed in an earlier part of this chapter, this is due to the effect of dividend imputation on corporate tax cash flows and the allowable revenue for Foxtel.

In any event, the Commission believes that the practical difference between the WACC value proposed by the Commission and that proposed by Foxtel is not significant. The difference of 0.025 per cent applied to the estimated total asset base related to the digital upgrade of Foxtel's network is not a material amount, based on the Commission's estimates.

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 6.9 per cent

The recent rise in interest rates contributes to a slightly higher cost of capital for Foxtel under current market conditions than in 2003, while increases in subscription TV penetration rates may have lowered Foxtel's business/operating risks and may have pushed the equity beta slightly downward, leading to a slight 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 are left unchanged. It has also considered the information in Professor Gray's report¹²³ 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

¹²³ Attachment 15: Gray, Stephen, *A Beta Estimate for Foxtel—A Submission on the Access Undertaking of Foxtel's Management*, 4 October 2005.

parties in their respective submissions and in relation to the Undertaking's price terms and conditions.

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 STU Service.

However, in assessing the IBAC component used to calculate access charges, the Commission notes that it remains unconvinced that Foxtel has excluded, or will exclude, Foxtel-specific marketing costs in the IBAC and in future periods. The Commission therefore remains concerned about the lack of verification of non-Foxtel-specific marketing costs included in the IBAC and to be included in future costs.

Notwithstanding the above concern, the Commission takes the draft view that, overall, the price terms and conditions promote the long-term interests of end-users, but would prefer to have more robust and verifiable information about non-Foxtel-specific marketing costs included in the IBAC and in future periods.

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. In section 3.3.6, the Commission identified that doubt exists as to whether the Undertaking incorporates two Proposed Amendments. This chapter proceeds on the basis that the Undertaking does incorporate the Proposed Amendments.

The non-price terms and conditions of access contained in the DAA are 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.¹²⁴

¹²⁴ Foxtel submission, 6 October 2005, p.20

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 has amended the DAA to provide 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 previous DAA, 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 now 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 previous DAA. Access seekers also have a right to terminate the DAA on one month's notice,¹²⁵ 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 and concern 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).

6.2.1 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 STU. 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 STU services where a person ceases to be a Foxtel subscriber, even if that person wishes to continue receiving the access seeker's services.

¹²⁵ Refer to clause 24.4(d) in the DAA.

Foxtel's submissions

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's arguments in relation to the second scenario are outlined in section 6.2.2 below.

Foxtel submission also attaches reports concerning economic and technical facets of these scenarios¹²⁶:

- Attachment 4: Henry Ergas, Charles River & Associates: *Reasonableness of Limiting the Supply of FOXTEL's Conditional Access 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;
- 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

¹²⁶ 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 enable Foxtel to redeploy the STUs on churn rather than leave unused STUs in lapsed subscribers' homes.¹²⁷

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.¹²⁸

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.¹²⁹

Seven Network submission

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.

Seven Network states that the tying of access to the Foxtel basic package leads to allocative inefficiencies.¹³⁰ 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

¹²⁷ Foxtel submission, 6 October, pp.33-34

¹²⁸ *ibid.*, pp.36-37

¹²⁹ *Ibid.*, p. 41.

¹³⁰ Seven Network submission, pp.12-13

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.¹³¹

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 the premium service or tiered channel.¹³²

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.¹³³ 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 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.¹³⁴

¹³¹ *ibid.*, p.11.

¹³² *ibid.*, pp.14-15.

¹³³ *ibid.*, p.12.

¹³⁴ *ibid.*, p.19.

Ten Network submission

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.¹³⁵

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.¹³⁶

The Commission's view

Foxtel's tying of its basic package to access to its STUs, given effect under clauses 4.1 and 11.1 of the DAA, means that while the Undertaking may promote competition in terms of facilitating the entry of access seekers at the tier level, it does not promote competition in the provision of basic package services. Indeed, the tying condition may serve to consolidate Foxtel's market power in the provision of digital subscription television services more generally – in order to gain access to access seekers tiered offerings, consumers will need to purchase the Foxtel basic package. This means that 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.¹³⁷

Thus, while the Undertaking may function to promote competition at the tier level, the tying limits the ability of access seekers' services to provide a competitive discipline on

¹³⁵ Ten Network submission , p.3.

¹³⁶ *ibid.*, p.4.

¹³⁷ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited, Final report*, December 2003,p.50.

Foxtel in terms of improving the price, quality and product dimensions of its basic package service.

As Seven Network notes, the tying condition may limit competition in the provision of digital subscription television services by increasing barriers to entry. In this respect, the tie effectively serves to raise access seeker's costs and thus the price of obtaining an access seeker's channels by the cost of the basic package.¹³⁸ This will mean that access seekers' channels are on the higher part of a consumer's demand curve, where demand is more elastic. In this regard, 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.¹³⁹

The tie may also limit competitive entry by tier channels as Foxtel may be able to manipulate the composition of its Basic Package for the purpose of foreclosing competition at the tier level. This may, for example, occur through Foxtel replicating an access seekers' tier channel with a channel in its basic package.¹⁴⁰ The Commission agrees with the Tribunal's observation that the use of this type of strategic response for anti-competitive purposes may be difficult to identify and enforce under Part IV and Part XIB of the Act.

The Commission considers that these factors may function to reduce the certainty and effectiveness of access for potential access seekers.

Turning to the efficiency implications of these provisions, the Commission notes that the tying condition may serve to distort allocative efficiency. As outlined by Seven Network and NERA, tying of access to the Foxtel basic package will lead to allocative inefficiencies and reduced demand through its impact on the consumption choices of three subsets of consumers:

¹³⁸ The Commission notes that Attachment 3 to Foxtel Supplementary submission outlines that in May 2006 Foxtel altered the packaging and pricing of its Basic Package digital subscription television service. The price of the Basic Package was reduced from \$50.95 per month to \$36.95 per month. The number of channels offered in the Basic Package was also reduced as follows:

- Fox Sports 1, Fox Sports 2 and Fox Footy were moved to a sports tier called "My Sport".
- UKTV, W and The LifeStyle Channel were moved into a general entertainment tier called "My Escape".

¹³⁹ *Seven Network Limited (No 4) [2004] ACompT* 11 (23 December 2004) [286].

¹⁴⁰ Foxtel's arguments in respect of why it would not be rational for it to pursue such a strategy are premised on it moving an existing channel from its premium tiers to the basic tier – see Foxtel Submission pp.43-44. However, Foxtel's Submission does not address the scenario where a new channel that replicates an access seekers channel is added to the basic tier.

- customers who view Foxtel and alternative providers as substitutes may only purchase Foxtel, despite the fact they may benefit from being able to purchase the alternative channels alone;
- customers who value alternative channels relatively highly may purchase Foxtel to gain access to the alternative channels, even though they would not buy Foxtel alone; and
- customers who value alternative channels at more than the cost of provision (including STU costs) may not purchase any services because of the need also to purchase Foxtel.

However, the Commission notes that the scale of these potential effects is difficult to predict and quantify.

Furthermore, the Commission notes that the tying condition effectively insulates Foxtel's basic package from competition, and therefore may limit dynamic efficiency gains in terms of the type of content and type of service offerings available to consumers.

The Tribunal expressed concern about similar tying provisions in *Seven Network Limited (No 4) [2004] ACompT 11*:

...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.¹⁴¹

However the Tribunal continued:

...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.¹⁴²

Accordingly, while the Commission notes the above impacts of the tying clauses on competition and efficiency, it also notes the Tribunal's concerns about an alternative scenario in which Foxtel was required to supply STUs to homes not actually receiving its retail pay TV services.

More generally, 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,

¹⁴¹ *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [301].

¹⁴² *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [295].

while average subscription terms are 2 years. Therefore STUs can be readily re-deployed and the costs of the STUs are not necessarily sunk.¹⁴³ As such it is not apparent that access seekers pursuing self supply options with respect to STUs would necessarily deter competitive entry or lead to inefficient outcomes. 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.

6.2.2 Provision of unbundled CA/SI services

In *Seven Network Limited (No 4) [2004] ACompT 11*, the Tribunal noted the possibility of Foxtel 'unbundling' the provision of CA and SI services as a potential option for access seekers using their own STU to supply pay TV services without having to fully duplicate Foxtel's infrastructure.

...the ability of an access seeker to provide subscription television services using its own STUs but without having completely to duplicate FOXTEL's delivery infrastructure would appear to be a potentially attractive and valuable option. Accordingly, we do not wish to foreclose any scope which may exist for Conditional Access ('CA') and Service Information ('SI') services to be supplied separately from STUs. On such a view, the tying of the Basic Package does not appear necessary or appropriate.¹⁴⁴

Clause 4.1(c)(ii) of the DAA provides that Foxtel will supply the Digital Set Top Unit Service only as a total package, and not as one or more component parts (eg STU, Conditional Access and Service Information Services, EPG Services and Modem Services).

Foxtel and interested parties provided submissions on the reasonableness of Foxtel 'unbundling' the provision of CA and SI services to access seekers. These submissions are discussed below.

Foxtel submissions

Foxtel contends that it is not reasonable for Foxtel to supply unbundled CA/SI services to access seekers using their own STUs.

Foxtel states that there are a number of technical and operational issues that would be involved if Foxtel were to provide access to unbundled CA/ SI services. These are outlined in detail in Attachment 5 to its Submission and include the following:

- an access seeker's STU would need to be compatible with the Foxtel STU at all times in order to decode Foxtel signals;
- access seeker and Foxtel STUs would need to be managed uniformly and would need to be tested and upgraded at the same time;

¹⁴³ However, competition issues may arise under the STU ownership model where provision of STUs is bundled with the supply of exclusive content.

¹⁴⁴ *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [302].

- management of different versions/variants of compatible STUs would become expensive, complex and time-consuming;
- increased bandwidth would be needed for management and support; and
- any conflicts may lead to one or both platforms stalling in their development and impacting on all users (and subscribers).¹⁴⁵

In addition to these technical and operational issues, Foxtel asserts that providing CA and SI services to access seekers in non-Foxtel homes would require several significant modifications to its systems, including:

- redesigning the Active Customer Smartcard Database;
- changing Foxtel's STU tracing and field installation/maintenance databases;
- the establishment by Foxtel of smartcard purchase management; and
- changes to Foxtel's testing facilities.

Foxtel contends that the costs of these modifications would have to be borne by access seekers. In addition to the costs of modifying Foxtel's system, Foxtel notes that access seekers would have to compensate Foxtel for the incremental cost of supplying access as well as some contribution to the cost of developing the CA/SI service (and the STUs). Foxtel asserts this cost is likely to be closer to the stand-alone cost of access seekers supplying the service themselves, and thus it may be more efficient for access seekers to supply the service themselves. In this regard, it states that access seekers have the ability to purchase bundled carriage, CA and SI services on satellite from providers such as Globecast.¹⁴⁶

Foxtel also states that there are not likely to be any efficiency gains from the use of identical STUs by access seekers compared with the Foxtel STU in circumstances where access seekers use Foxtel CA and SI systems to provide services. Foxtel notes the need for access seekers to purchase an STU to the same technical specification of Foxtel's STU may increase costs for access seekers who do not need the same level of functionality as Foxtel. It also asserts that there would not be any efficiency gains from an access seeker's STU being used for both the provision of access seeker and Foxtel services as an access seeker has no obligation to give Foxtel access to its STU, nor can Foxtel be forced to use the access seeker's STU.

Moreover, Foxtel contends that that it cannot be forced to supply CA/SI services to non-Foxtel homes. It asserts that CA and SI services on their own could not be declared under Part XIC as they are not listed carriage services nor services that facilitate the supply of listed carriage services. Foxtel asserts that the supply of CA and SI services are only caught under s.152AR(8) of the Act as services which are 'necessary' for the supply of content services using the particular STUs used by the access provider.

¹⁴⁵ Foxtel submission, pp.38.

¹⁴⁶ *ibid.*,p.40.

Therefore, if the access seeker is not using the Foxtel STUs then it has no right to be provided with these ancillary services.¹⁴⁷

CRA report

In support of its contention that forcing Foxtel to supply unbundled CA and SI services to access seekers is not reasonable, Foxtel provides an economic report from Charles Rivers Associates (CRA) in Attachment 4.

The CRA report discusses the reasonableness of Foxtel limiting the supply of Digital Set Top Unit Services to Foxtel homes, as per the conditions in the Undertaking, in comparison with the scenario where Foxtel unbundles its CA/SI such that access seekers can use these services with their own STUs in non-Foxtel homes.

Broadly speaking, CRA argues that it is unlikely that unbundling CA/SI is more reasonable than the arrangements in the Undertaking under the statutory criteria because the costs of unbundling are not clearly offset by greater efficiencies, or improved competition that might be in the LTIE.

CRA contends that supply-side and demand-side barriers to entry will not be reduced by CA/SI unbundling relative to the arrangements under the Undertaking.

In terms of supply-side barriers to entry, CRA asserts that while economies of scale and sunk costs may be present in the provision of CA/SI systems, this in and of itself does not indicate that these services constitute a significant barrier to entry. In this regard, CRA states that various levels of CA/SI systems are available at a cost that is relatively small in the context of the other deployment costs access seeker face in entering the pay TV market. In addition, CRA argues that access seekers using Foxtel unbundled CA/SI systems would bear the attributable costs of third party access. It states that these costs could be material and thus may eliminate cost savings from entry via the use of unbundled CA/SI systems compared with own supply.¹⁴⁸

In relation to demand-side barriers to entry, CRA contends that customers do not mind ‘stacking’ multiple technological formats and so would be prepared to stack multiple STUs. CRA argues that even if to need to ‘stack’ equipment were to constitute a significant barrier to entry, it is not clear that CA/SI unbundling would reduce or remove it. In this regard, CRA argues unbundling of CA/SI may actually increase costs for access seekers as Foxtel-compatible STUs have a high level of functionality and thus are a relatively high cost. Furthermore, even if an unbundled CA/SI service was widely taken up, there is no certainty that the commercial arrangements for compatible STUs would result in all providers sharing them.¹⁴⁹

¹⁴⁷ *ibid.*, p.38.

¹⁴⁸ Attachment 4: Henry Ergas, Charles River & Associates: *Reasonableness of Limiting the Supply of Foxtel's Conditional Access Service*, p.30.

¹⁴⁹ *ibid.*, p.32

CRA contends any potential advantages from having Foxtel and access seekers using the same technology for customer conditional access on their basic packages would be offset by other possible negative impacts on competition. In this regard, CRA states that mandating access to Foxtel's CA and SI systems in non-Foxtel homes could distort and adversely affect competition because:

- If CA/SI services were to be unbundled this would reduce the dimensions over which Foxtel can compete with access seekers and reduce the incentives for rivalry in quality and functionality.
- CA/SI unbundling could potentially blunt competition in customer equipment as in order to use Foxtel's CA/SI system an access seeker must arrange for its customers to have an identically specified STU.
- Compatibility would decrease the number of technologies available to consumers.¹⁵⁰

In terms of efficiency effects, CRA asserts that the provision of unbundled CA/SI services to access seekers in non-Foxtel homes compared with the Undertaking may provide productive efficiency gains through the realisation of economies of scale. In particular, if CA/SI services are unbundled:

- an access seeker might avoid the costs of establishing its own CA/SI¹⁵¹; and
- the cost of simulcasting may be avoided if an access seeker offers the same channel in both non-Foxtel homes (using the unbundled CA/SI service) and in Foxtel homes on a tier (using the Undertaking).

However, offsetting these potential gains, CRA argues that unbundling CA/SI services may compromise efficiency in a number of respects.

CRA argues that unbundling CA/SI services may reduce productive efficiencies arising from vertical integration between the CA/SI and the STU (efficiencies of developing the functionality of CA/SI together with the capabilities of the STU) and vertical integration between the CA/SI/STU and the content (economies of simultaneous development of content and functionality).¹⁵² In this context, unbundling is said to lead to the following outcomes:

- Foxtel would lose the ability to optimise its CA/SI in lock-step with its own STU and content requirements;
- non-Foxtel STUs would have to be tested to ensure that they are compatible with Foxtel CA/SI services, and remain so at all times; and

¹⁵⁰ *ibid.*, pp.37-40

¹⁵¹ However, it is not certain that the absolute costs incurred by an access seeker will be lower under the unbundled CA/SI scenario.

¹⁵² Attachment 4: Henry Ergas, Charles River & Associates: *Reasonableness of Limiting the Supply of Foxtel's Conditional Access Service*, p. 53.

- Foxtel and access seekers would need to reach agreements regarding the risks and responsibilities of sharing CA/SI services, and the nature of system changes.¹⁵³

CRA also contends that unbundling CA/SI services may negatively impact dynamic efficiency by increasing the cost and diminishing the pace of improvements in the functionality of digital subscription television. This is because unbundling means that a variety of STU models are likely to be connected to the network, and any improvements in the CA/SI services would need to be negotiated between access seekers and Foxtel and tested on a variety of STUs of different design.

In sum, CRA asserts that there are no clear overall efficiency gains from unbundling CA/SI services. It asserts that potential gains are limited and uncertain and such gains may be offset by associated efficiency losses. However, CRA notes that the outcome in practice will depend on empirical matters including the future choices of access seekers, which are difficult to predict.

CRA also argues that many of the purported technical and efficiency impacts of Foxtel providing access to unbundled CA/SI services would interfere with Foxtel's ability to earn at least a normal commercial return. In this regard it notes that:

- costs would be increased¹⁵⁴, and may not be recovered¹⁵⁵;
- efficiency might be compromised; and
- innovation and continuous improvement would be more difficult, thus dampening Foxtel's incentives and ability to increase returns through innovation.¹⁵⁶

¹⁵³ *ibid.*, p.54

¹⁵⁴ Costs of unbundling CA/SI relate to purchasing hardware and developing systems and processes to manage and coordinate the provision of CA (including smartcards) and SI; increasing the capacity of the CA/SI (for example, additional licence fees); extending IP licensing arrangements, as necessary, if STU specifications are to be sub-licensed; and the implementation of any changes to the CA/SI on behalf of access seekers.

¹⁵⁵ CRA asserts that there would be informational and pricing complexities in setting access charges that were sufficient to compensate Foxtel for these additional costs of unbundling CA/SI – refer to pp. 33-36.

¹⁵⁶ Attachment 4: Henry Ergas, Charles River & Associates: *Reasonableness of Limiting the Supply of Foxtel's Conditional Access Service*, p.56.

NERA

NERA, on behalf of Seven Network, provides a report that assesses whether the terms and conditions of the Undertaking would promote competition and encourage the economically efficient use of and investment in infrastructure relative to CA/SI unbundling. The report also critiques the analysis and claims contained in the CRA report and Frontier Report.

NERA argues that the Commission cannot be satisfied that the Undertaking would provide better opportunities and environment for competition than a counterfactual in which Foxtel's CA/SI services are unbundled. This view is based on the following findings in the NERA report.

- Foxtel currently possesses market power in the supply of digital subscription television services because there is sufficient reason to believe that, if entry were to occur as a result of CA/SI unbundling, Foxtel would reduce its prices and may be forced to alter its fundamental programming subscription choices.¹⁵⁷
- Unbundling CA/SI reduces a significant barrier to entry posed by the current incompatibility between competing STUs and Foxtel's existing STU base. NERA asserts that customers subscribing to a potential alternative subscription television service will most likely want the option of also receiving Foxtel programming at some point in the future, and potentially programming from other providers as well. In this regard, preclusion of this option represents an entry barrier.¹⁵⁸
- The CRA report is said to understate the impact of the Undertaking on switching costs for consumers relative to CA/SI unbundling, since customers will take into account a lack of compatibility when assessing the cost of a competing provider's service.¹⁵⁹
- CA/SI unbundling relative to the terms and conditions pursuant to the Undertaking would lead to allocative efficiency gains and increased competition.¹⁶⁰
- The risk of Foxtel altering its basic package of programming so as to disadvantage competitors and foreclose competition in the market for subscription television services is significantly greater when access is tied to the basic package as per the Undertaking, than in the scenario where CA/SI services are unbundled.¹⁶¹

¹⁵⁷ NERA, *Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service, A report prepared for Freehills on behalf of Seven Network Limited*, 14 February 2006, p.32.

¹⁵⁸ *ibid.*, p. 32

¹⁵⁹ *ibid.*, p.36

¹⁶⁰ *ibid.*, pp.37-38.

¹⁶¹ *ibid.*, pp.39-40

- The CRA report is said to overemphasise the potential detriment to competition from standardisation of CA/SI/STU technologies and understates the potential benefits that creating an industry standard would have on competition for the price, content and quality of subscription television. The benefits from increased competition across these dimensions of supply are said to outweigh the loss of competition on delivery technology and performance.¹⁶²
- The CRA report and Frontier report are said to understate the prospect of new entry. Reducing the barrier to entry posed by incompatibility will provide greater opportunities for new entry by all forms of access seekers, irrespective of the number of channels they wish to offer.¹⁶³

In addition, NERA asserts that the Commission cannot be satisfied that the Undertaking would encourage the economically efficient use of, and investment in, infrastructure within the meaning of s.152AB(2)(e) of the Act, relative to CA/SI unbundling. In this regard, NERA makes the following findings:

- The tie of access to the Foxtel basic package in the Undertaking is likely to reduce retail competition for subscription television services and lead to allocative efficiency losses relative to the counterfactual in which CA/SI services are unbundled.¹⁶⁴
- It is not clear that there would be a significant reduction in the vertical efficiencies as a result of CA/SI unbundling. NERA asserts that, on balance, any decrease would likely be more than off-set by allocative efficiency improvements brought about by greater competition for the price, content and quality of subscription television services.¹⁶⁵
- NERA argues that the CRA report does not establish why Foxtel's dynamic incentives would differ significantly as between the terms of supply under the Undertaking and CA/SI unbundling.¹⁶⁶

Foxtel Supplementary Submission

Foxtel's supplementary submission notes that NERA adopts Option D counterfactual (as outlined the CRA report) as the counterfactual with which to assess the reasonableness of the Undertaking.¹⁶⁷ It asserts that this counterfactual makes a number

¹⁶² *ibid.*, p.44.

¹⁶³ *ibid.*, p. 46

¹⁶⁴ *ibid.*, p.47

¹⁶⁵ *ibid.*, p.53

¹⁶⁶ *ibid.*, pp.53-54

¹⁶⁷ This counterfactual involves Foxtel submitting the Undertaking but with the addition of an unbundled CA/SI service, and the licensing of its STU specifications and the 'security keys' to its STU. Such a service would enable an access seeker to offer subscription television services to non-Foxtel homes, by use of its own STU and carriage, but using Foxtel's CA/SI system.

of assumptions that NERA's analysis does not address. In this regard, Foxtel claims that it is important to acknowledge that:

- Declaration is uncertain.
- It is highly unlikely that there will be a new subscription television entrant in the medium term that is commercially viable on a stand-alone basis. Even if such a new entrant emerged, Foxtel submits that competition and efficiency are better promoted by the Undertaking than the Option D counterfactual.
- Even if the service were declared, the Commission could not require Foxtel to provide unbundled CA/SI services to access seekers. Further, Foxtel submits that if the service were declared, it would not be reasonable or in the LTIE for the Commission to require Foxtel to supply unbundled CA/SI services to access seekers.¹⁶⁸

In terms of the potential for new entry, Foxtel makes the following points:

- The underlying costs involved in the provision of subscription television services mean that niche channels are unlikely to be provided on a stand alone basis. A potential provider of niche programs is likely to want to access Foxtel's customer base, as its programs will function as complements to the Foxtel service. In this case, access is facilitated by the Undertaking and competition and efficiency are not improved by any plausible counterfactual.¹⁶⁹
- If an access seeker is able to offer a service to compete with the Foxtel basic package, it is likely to have similar content, and therefore it is unlikely that a consumer would have any interest in subscribing to both services. In that case, the access seeker would be in a position to acquire its own conditional access system and STUs which best met its needs.¹⁷⁰

In response to NERA's contention that incompatibility between competing STUs is the critical barrier to entry for a person who wishes to provide a subscription television service that is substitutable to the Foxtel service, Foxtel submits the following arguments.

Foxtel contends that its business model, under which consumers do not have to purchase an STU, removes any potential barrier to entry associated with incompatible STUs and is pro-competitive. In contrast, it states that NERA appears to assume that a new entrant would adopt a business model where it would sell STUs. If the new entrant adopted the same business model as Foxtel, then switching between the two providers

¹⁶⁸ Foxtel supplementary submission, p.17

¹⁶⁹ *ibid.*, pp.18-19

¹⁷⁰ Foxtel assumes that it is unlikely that a potential new entrant will be able to supply a service that is considered by consumers to be both a substitute for Foxtel basic service as well as a service that appeals to Foxtel subscribers.

would impose no significant cost at all. Foxtel asserts that NERA's assumption is contrary to current industry practice in Australia and not reasonable.¹⁷¹

Foxtel states that NERA's contention that incompatible STUs constitute a barrier to entry must also assume that reciprocal access would be available and that Foxtel would be willing, or could be compelled to use a foreign STU to provide its service. Foxtel maintains that, for commercial reasons, it is highly unlikely that it would choose to use a foreign STU. Foxtel also states that the Commission does not have powers under Part XIC to compel Foxtel to use a foreign STU.¹⁷²

Foxtel disagrees with NERA's assertion that consumers are averse to stacking and submits that consumers understand that if they change service providers they need new equipment (either leased or bought). Furthermore, Foxtel asserts that stacking of STUs would not be necessary in the assumed counterfactual being considered by NERA. If the counterfactual assumes that a new subscription television provider is able to offer a substitute service to that of Foxtel, it is unlikely that the subscriber will want both services at the same time. If the counterfactual assumes a niche provider, then the service is highly unlikely to be a stand alone service and the provider will wish to supply the service, as a tier channel, to Foxtel's subscriber base. This could be achieved through the gaining of access via the Undertaking without the need for stacking.¹⁷³

Foxtel also responds to various other issues raised by the Seven Network and NERA in relation to the reasonableness of the Undertaking:

- Foxtel asserts that NERA's arguments regarding the benefits from "standardisation" of STUs are purely theoretical and are not reflective of real world experience. An industry standard for a CA/SI system or an STU is said to be not desirable or practical because it limits the development of application, content and STU functionality. Foxtel states that the various overseas examples NERA uses to support standardisation are either taken out of context or are irrelevant and in support provides Attachment 5 to its supplementary submission.¹⁷⁴
- Foxtel disagrees with Seven Network and NERA's contention that Foxtel would have lesser incentive and ability to foreclose competition through manipulation of the basic package in the unbundling counterfactual than in the case of the Undertaking. In this regard, Foxtel denies that it has the incentive to alter the content of its basic package in the way alleged by Seven Network and NERA. Foxtel also refers to the supplementary report of CRA at 'Attachment 6: Response on reasonableness of FOXTEL's CA/SI bundling' that asserts that even if the

¹⁷¹ Foxtel supplementary submission, p.20.

¹⁷² *ibid.*, p.21.

¹⁷³ *ibid.*, p.22.

¹⁷⁴ *ibid.*, p.22-23.

foreclosure concern has some valid basis, unbundling the CA/SI would not materially reduce the risk of such a manipulation strategy succeeding.¹⁷⁵

- Foxtel claims that Seven Network has not provided any evidence in support of its contention that Foxtel's operational or technical requirements are not compromised under the counterfactuals of unbundling CA/SI or providing the full STU service. NERA assumes that CA/SI unbundling is technically feasible, albeit potentially at a cost to Foxtel. However, Foxtel submits that NERA does not take these costs into account at all in its analysis, nor does it weigh up those costs with the likelihood of a promotion of competition as a result of unbundling.¹⁷⁶
- Seven Network's argument that Foxtel's submissions concerning the impact on its business if it were forced to supply unbundled CA/SI or supply the full STU service are contrary to its assurances about access in its s. 87B undertaking. Foxtel states that its s 87B undertaking was clearly provided on the basis that access was to be granted only to STUs in Foxtel homes.¹⁷⁷

CRA Response on reasonableness of Foxtel's CA/SI bundling

CRA provides a report¹⁷⁸ that aims to address the issues raised by the NERA report and consider the reasonableness of Undertaking compared with counterfactual involving CA/SI unbundling.

In relation to the barriers to entry, CRA rejects the notion that STU incompatibility constitutes a barrier to entry that CA/SI unbundling would address. It asserts that reluctance to use an STU that cannot also receive Foxtel is unlikely to have a significant effect on an access seeker's ability to sell its own service. This is especially so if, as per the industry practice in Australia, the STU is supplied on a rental basis, bundled with programming. CRA asserts that the counterfactual is unlikely to deliver benefits such as lower switching costs unless reciprocal STU access is in place, which it considers is unlikely.¹⁷⁹

CRA also notes that at certain points NERA suggests that access to Foxtel's content is the true barrier to entry, rather than compatibility or incompatibility. CRA asserts that if this is the case, then CA/SI unbundling represents an indirect and inefficient means of addressing this concern.¹⁸⁰

¹⁷⁵ *ibid.*, p.23.

¹⁷⁶ *ibid.*, p.23-24.

¹⁷⁷ *ibid.*, p.24.

¹⁷⁸ CRA, *Response on reasonableness of Foxtel's CA/SI unbundling*, Attachment 6 to Foxtel Supplementary submission.

¹⁷⁹ *ibid.*, p.13

¹⁸⁰ *ibid.*, p.14

In relation to NERA's assertion that competition is better promoted under the case of CA/SI unbundling compared with the Undertaking, CRA puts forth the following arguments:

- NERA's analysis of competition and allocative efficiency is based on the assumption that incompatibility between Foxtel and access seeker STUs is a critical entry barrier. However, successful entry does not require that an access seeker's customers buy STUs.¹⁸¹
- NERA considers that competition and allocative efficiency may be harmed under the Undertaking, as compared with the CA/SI unbundling counterfactual, because Foxtel's basic package must be bought if access seeker content is to also be bought. However, NERA does not establish that an access seeker could not make sales to consumers who do not have Foxtel's content. Even, if the access seekers ability to service these customers was improved under the CA/SI unbundling counterfactual, the resultant competitive and allocative efficiency benefits would be marginal and likely be overwhelmed by the high cost of CA/SI unbundling.¹⁸²
- The risk of foreclosure by manipulation of Foxtel's basic package in response to entry, to the extent that it is a valid concern, would not be materially reduced under the counterfactual case of unbundling the CA/SI compared with the Undertaking.¹⁸³
- NERA's arguments concerning competition and efficiency effects of standardisation are based on unjustified assumptions regarding Foxtel's technology being the de facto industry standard and the possible adoption of a retail model in the situation where CA/SI unbundling occurs. Furthermore, CRA asserts that NERA fails to take account of the significant costs of unbundling and the complexities in recovering these costs through access prices.¹⁸⁴

In relation to NERA's assertion that CA/SI unbundling compared with the Undertaking will better encourage the economically efficient use of, and investment in, infrastructure, CRA mounts the following arguments:

- CA/SI unbundling may undermine Foxtel's STU ownership model as a move to an alternative model in which Foxtel's ability to control the STU standard is compromised would have negative effects in the form of interfering with Foxtel's ability to manage its end-to-end system and impeding Foxtel's ability to advance digital innovation.¹⁸⁵

¹⁸¹ *ibid.*, p.11

¹⁸² *ibid.*, p.17

¹⁸³ *ibid.*, pp.19-20

¹⁸⁴ *ibid.*, pp.21-21

¹⁸⁵ *ibid.*, p.24

- CA/SI unbundling may compromise the economies offered by simultaneous development of content and functionality. CRA notes that while cooperation may be feasible when the interests of Foxtel and an access seeker are aligned, divergence in incentives will inevitably lead to disagreements concerning the appropriate CA/SI standard and the financial contributions that each party would be expected to make towards upgrading costs.¹⁸⁶
- Compensating Foxtel for the full costs of CA/SI unbundling through the access price mechanism will be costly. In this regard, CRA argues that any increased costs of network development and opportunity costs related to the retardation of the development of new services and applications by Foxtel will be difficult to quantify and apportion.¹⁸⁷

The Commission's View

The possibility of providing unbundled access to Foxtel's CA/SI services was identified by the Tribunal as a potential means by which to address the competition and efficiency impacts of the tie of access to the Foxtel basic package. While the Tribunal expressed the view that the conditions of access under the tying condition provided a 'significant deterrent to entry', it considered Foxtel should not be required to provide STUs in non-Foxtel homes.¹⁸⁸ In this respect, the prospect of unbundling CA/SI may be viewed as means of promoting competition at the level of basic package offerings in the absence of compelling Foxtel to provide access to STU equipment in non-Foxtel homes.

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'.

As noted above, Foxtel considers that the Undertaking is in respect of each and all of the services forming the Digital Set Top Unit Service as defined. On this basis, if the Commission were to accept the Undertaking, each and all of the component services would be deemed to be declared services. However, if an access dispute was notified under s.152CM in respect of a component service (such as CA/SI services), the Undertaking would restrict the terms of any arbitration determination made by the Commission (s.152CQ(5)). In particular, Foxtel considers 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. Furthermore, the tying clause would have the effect that access seekers would only be able to offer their services to end users who subscribed to at least Foxtel's basic package.

The effect of these factors is that acceptance of the Undertaking would foreclose the possibility of the Commission making an arbitral determination that mandates access to Foxtel's unbundled CA/SI services in Foxtel and non-Foxtel homes.

¹⁸⁶ *ibid.*, p.25

¹⁸⁷ *ibid.*, pp.26-27.

¹⁸⁸ *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [301].

In this context, the Commission's assessment of the reasonableness of the Undertaking, to the extent that it comprises of a with/without analysis, will necessarily involve comparison of the definite provisions for access provided under the terms and conditions of the Undertaking against the counterfactual that includes the possibility of broader access that may encompass requiring Foxtel to provide unbundled CA/SI services to access seekers in an arbitration determination. To assist in its assessment, the Commission has considered the potential competition and efficiency effects of access seekers having access to unbundled CA/SI services.

Competition effects of access to unbundled CA/SI services

The Commission notes that unbundled access to Foxtel's CA and SI systems may lead to increased competition through lowering entry barriers for potential retail pay TV providers. As CRA acknowledges, 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.¹⁸⁹

One obvious advantage in access seekers using Foxtel's CA and SI (as opposed to a third party provider's services) systems is that the ability to simulcast channels would alleviate the need to purchase two separate channels (for cable and satellite) of carriage to offer the same channel of content over two different CA systems in the case where an access seeker offers its services to customers in Foxtel homes using a Foxtel STU and offers its services to customers in non-Foxtel homes by providing its own STU. However, this does not *per se* make it a bottleneck input.

Unbundling CA/SI services may also reduce the barrier to entry associated with the risk that Foxtel may alter its basic package of programming to foreclose competition at the tier level to entry, and thus promote competitive entry.

With respect to demand side barriers to entry, the Commission notes that access to unbundled CA/SI would not appear to ameliorate the need for access seekers to install additional STUs in existing Foxtel subscriber homes if access seekers wanted to provide basic package offerings that are competitive with Foxtel's basic package. That is, to the extent that the need for multiple STUs (i.e. stacking) in subscriber homes creates a deterrent to basic package competition for this subset of consumers, the unbundling of CA/SI would not address this concern.

Similarly, the unbundling of CA/SI would not appear to reduce switching costs for consumers. In this regard, the Commission notes that NERA's arguments regarding incompatibility appear to be premised on the adoption of a retail model where the customer would own a (standardised) STU, and pay TV providers enter into reciprocal access arrangements for STUs. The Commission notes that these assumptions are in contrast to current industry practice in Australia and Foxtel has submitted it is highly unlikely that it would choose to use a foreign STU, and could not be compelled to do so under Part XIC of the Act.

¹⁸⁹ Foxtel identifies three available suppliers in this regard.

The Commission notes CRA's arguments that mandating access to Foxtel's CA and SI systems in non-Foxtel homes could adversely affect competition in relation to the quality and functionality of CA/SI services and STUs. While the Commission considers that there may be some negative effects on incentives to compete in terms of these supply inputs, it is not apparent that such effects would outweigh the potential gains from competition in relation to other dimensions of supply, such as the price, content and quality of subscription services and channels that may result from unbundling CA/SI.

Efficiency effects of access to unbundled CA/SI services

In terms of efficiency outcomes, the Commission notes that the provision of unbundled CA/SI services to access seekers may provide productive efficiency gains through the realisation of economies of scale. In particular, if CA/SI services are unbundled:

- an access seeker might avoid the costs of establishing its own CA/SI; and
- the cost of simulcasting may be avoided if an access seeker offers the same channel in both non-Foxtel homes (using the unbundled CA/SI service) and in Foxtel homes on a tier (using a Foxtel STU).

To the extent that an access seeker's ability to service customers on a stand alone basis may increase through having access to unbundled CA/SI services, this may lead to higher demand and ameliorate the potential inefficiencies that result from the tying condition.

Offsetting these potential gains, Foxtel and CRA argue that unbundling CA/SI services may compromise economic efficiency in a number of respects. CRA argues that unbundling CA/SI services may reduce vertical efficiencies arising from the simultaneous development of content and functionality and the efficiencies of developing the functionality of CA/SI together with the capabilities of the STU. In addition, CRA contends that unbundling CA/SI services may negatively impact dynamic efficiency by increasing the cost and diminishing the pace of improvements in the functionality of digital subscription television services.

While the Commission recognises that such inefficiency could arise, the Commission considers that probability and scale of any such effects is uncertain. Moreover, these effects may be able to be mitigated through implementation of contractual terms and conditions of supply that protect Foxtel's legitimate interest in being able to improve and upgrade its platform.

Summary of the competition and efficiency effects of access to unbundled CA/SI services

Upon the evidence before the Commission, it appears that access to Foxtel's unbundled CA and SI systems may lead to increased competition through lowering entry barriers for potential retail pay TV providers, albeit what appears to be a relatively small barrier. In terms of promoting efficiency, the Commission considers that it is not possible to accurately predict the probability nor scale of the potential efficiency effects outlined above. Therefore, it is not clear the overall effect that unbundling of CA/SI would have on economic efficiency.

Overall considerations

In considering the effects of the the bundling provisions in the Undertaking, it may be useful to differentiate between two different types of subscription television service providers:

1. full package providers (eg. 40 channels, basic and tier) who are competing with Foxtel's at the basic package level
2. content providers such as niche channel providers (single channels of niche content as a tier) who are providing additional services to Foxtel's full service subscribers, and competing with other individual channels at the tier level.

For the 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. This would suggest STUs and related CA/SI are contestable inputs, and not bottleneck elements in the supply of subscription television services, *per se*. 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 the Undertaking. A firm with sufficient access to premium content and carriage to provide a full retail Pay TV service will be able to buy set top units and CA and SI services on the open market.

The Tribunal noted that it was not comfortable with Foxtel being compelled to provide access to STUs in non-Foxtel homes. This view is consistent with the above proposition that STUs, in and of themselves, are not a bottleneck input. Rather, the Tribunal suggested that unbundled access to Foxtel's CA/SI services may promote competition in the provision of subscription television services and noted that it would not want this option foreclosed given the effect of the tying condition. However, the Tribunal did note at the time that it had not received any submissions on this particular matter.

Based on the evidence provided by interested parties, CA/SI services appear to be contestable inputs. The Commission notes that unbundled access to CA/SI may provide a lower cost option for potential subscription television service providers

compared with self-supply options in the case where an access seeker offers its services to customers in Foxtel homes using a Foxtel STU and offers its services to customers in non-Foxtel homes by providing its own STU; however, this does not *per se* make it a bottleneck input..

For content providers such as niche channel providers, the relevant obstacle to entering the downstream supply of subscription television services to end-users may be fundamentally different. Niche channel providers will not be interested in providing a full suite of channels. Rather they may aim to provide a tier to an existing full package provider, therefore will want access to the full package provider's existing subscriber base. 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. Hence, Foxtel has significant market power in negotiations with niche channel providers for the acquisition and distribution of their channels to end-users.

Under this construction, 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 i.e. access to Foxtel's subscribers (the key obstacle), STU, CA/SI, modem services and EPG (non-bottleneck inputs).

The Tribunal noted that the original intent of Foxtel providing its digital STU s.87B undertaking was to address the reduction in the bargaining power of channel suppliers to secure adequate distribution for their content resulting from the implementation of the Foxtel-Optus Content Supply Agreement – this agreement effectively meant that Optus would no longer be a competitor to Foxtel in the acquisition and placement of channels as part of its retail subscription television service. In this regard, the Tribunal stated that it would be reluctant to grant an exemption that effectively endorsed access terms and conditions which entrenched Foxtel's market position.¹⁹⁰

Therefore, it appears that the Tribunal was mindful to facilitate the promotion of competition at the level of niche channel provider. In this regard, having multiple full package providers competing may improve the bargaining position of niche channel suppliers in the longer term. However, it appears that the proposed remedy of unbundling CA/SI services may be seen as an indirect and possibly ineffectual means to achieve this end, given that CA/SI services are contestable inputs and do not appear to constitute a significant barrier to entry for full package providers.

Having had the advantage of evidence on the issue from interested parties, the Commission would not be inclined to place great weight on the value of access to unbundled CA/SI services. In considering the various matters under s.152AH, the Commission considers that, on balance, accepting the Undertaking that provides for access for niche channel to Foxtel's STU infrastructure and subscribers is likely to outweigh the potential benefits in maintaining the option of access to unbundled CA/SI service.

¹⁹⁰ *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [303].

Therefore, the Commission's preliminary view is satisfied with clause 4.1(c)(ii) of the DAA that provides that Foxtel will supply the Digital Set Top Unit Service only as a total package, as assessed against the matters under s.152AH of the Act.

6.2.3 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

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.¹⁹¹

Second, Seven Network asserts that given Foxtel is not obliged under the DAA to amend, develop or upgrade its infrastructure to provide for interoperability with the access seeker's service, 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.¹⁹²

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.¹⁹³

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

¹⁹¹ Seven Network submission, p.32.

¹⁹² *ibid.*, p.33.

¹⁹³ *ibid.*, p.33.

of the pay television service where Foxtel has given a special access undertaking in respect of the rest of the service. Second, if the cable return path and constant feed forward path were declared, there would be multiple access regimes, which in the Tribunal's view, is inefficient and not in the LTIE.¹⁹⁴

Ten Network submission

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 Set Top Units or Modem specifications to provide interoperability with an access seeker's modem content.¹⁹⁵

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.¹⁹⁶

¹⁹⁴ *ibid.*, p.32.

¹⁹⁵ Ten Network, Submission, p.4.

¹⁹⁶ *op cit.*

Two Way TV

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.¹⁹⁷
- 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.¹⁹⁸
- 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.¹⁹⁹

Foxtel Supplementary Submission

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 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.²⁰⁰

¹⁹⁷ Two Way TV Australia Limited, *Submission to Australian Competition & Consumer Commission, Foxtel Special Access Undertaking*, pp.5-7.

¹⁹⁸ *ibid.*, pp.9-10.

¹⁹⁹ Two Way TV submission, p.12.

²⁰⁰ Foxtel supplementary submission, p.26.

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.²⁰¹

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.)²⁰²

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.²⁰³

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 provided was able to provide an interactive application in connection with an existing channel, without being

²⁰¹ Supplementary Technical Report of Foxtel Engineering, p.3.

²⁰² Ibid., p.4.

²⁰³ Foxtel supplementary submission, pp.28-29.

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.²⁰⁴

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.²⁰⁵

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.²⁰⁶

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

²⁰⁴ Supplementary Technical Report of Foxtel Engineering, p.8.

²⁰⁵ Foxtel supplementary submission, pp.27-28.

²⁰⁶ *ibid.*, p. 28.

Seven materialises, it will be addressed under the Undertaking and in accordance with the requirements of s.152AR²⁰⁷

The Commission's view

Interactive Services Generally

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 channels compete with each other and digital subscription television providers compete with each other. The Commission considers that the relevant arenas of competition include:

- competition between rival providers of pay TV packages in respect of the provision of interactive services; and
- competition between individual channels in respect of interactive services.

The Commission believes that the introduction of interactive services could potentially alter the competitive dynamics within these arenas. In the absence of interactivity, channels would mainly compete for:

- visibility of their offerings to the public, leading to increased advertising revenue (such as free-to-air channels who provide their product to Foxtel); and
- in some cases, the negotiated feed price to Foxtel.

However, adding interactive features to these channels opens the possibility of additional revenue streams directly to the channel provider. For example, the provider

²⁰⁷ *ibid.*, p.29.

of a pay TV sports channel could add an interactive betting feature, which could provide significant revenue streams to the channel provider. Consequently:

- providers of these channels are likely to be less interested in subscription revenue flows;
- interactive channel providers will be increasingly concerned not only that their channels are available to the public, either as access seekers to the Digital Set Top Unit Service or by selling directly to Foxtel, but that the channel attracts increasing viewers; and
- that even those firms that sell their feed directly to Foxtel can be regarded as access seekers, since they are asking Foxtel to carry their channel in order to allow them to earn a separate stream of revenue from the interactive services.

In this future scenario, denying existing channel providers the opportunity to use modem services might have the ability to stifle competition, since the advent of interactive TV could not only engender intensified competition, but also a shift in the underlying bases of competition. 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, 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 carriage service providers, were to supply return path carriage services to access seekers.

Adding Interactive Services to Existing Foxtel Channels

The Commission notes Two Way TV's concern that the Undertaking does not allow channel providers to add interactive features to existing channels. As noted in Two Way TV's submission, the restriction on existing channel providers in relation to their interactive applications is made effective through the effect of several clauses of the Undertaking. Appendix 1 defines the Digital Set Top Unit Service as: "services for the reception and decryption of signals for a digital Subscription Television Service and a

Related Service”. “Subscription Television Service” is defined as “a service that delivers television programs”, as either broadcasting or narrowcasting. Additionally, clause 4.1(c)(ii) provides that Foxtel is only obliged to supply the Digital Set Top Unit Service “as a total package and not as one or more component parts”.

Furthermore, clause 6.5(a) of the DAA provides:

Nothing in this Agreement will permit or require any Access Seeker Modem Content to be connected to, viewed by or otherwise used by a Subscriber, if that Subscriber is then connecting to, attempting to connect to, viewing, attempting to view, using or attempting to use any service other than the Access Seeker’s Digital Subscription Television Service. For the avoidance of doubt, Access Seeker Modem Content must not be linked to any channels or programming other than the Access Seeker’s Digital Subscription Television Service.

In essence, Two Way TV proposes a requirement that where Foxtel has or chooses to acquire a channel for the Foxtel service, it must also offer modem services with it to enable that channel to be interactive.

However, the Commission does not understand why Two Way TV proposed that Foxtel should be obliged to acquire any particular channel for its package.

Foxtel, on the other hand, submits that the issue of adding interactivity to existing Foxtel channels is not relevant to the Commission’s assessment. For the reasons given below, the Commission does not accept the argument that the Commission cannot examine the issue.

However, the Commission does agree 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.

Legal and technical arguments by Foxtel that this issue is not relevant to the Commission’s assessment

The Commission notes Foxtel’s view that whether a channel provider can add interactive features is a matter for commercial negotiation between Foxtel and its channel providers. However, the Commission believes that an examination of this relationship is not beyond its purview in the current instance because:

- interactive offerings are likely to change the relationship between Foxtel and third party channel providers to a relationship more closely akin to access provider and access seeker, since the channel provider will wish for Foxtel to carry the channels to the end customers so that the channel provider can earn revenue from interactive features;
- the Commission understands that a number of existing channel suppliers have contracts with Foxtel that are silent on the issue of interactive services; and

- this is effectively an issue of whether existing channel providers can also access some portion of the Digital Set Top Unit Service. To the extent that existing channel providers wish to use modem services to enhance their current offerings, they can be regarded as an access seeker.

While the Commission is mindful of Foxtel having appropriate capacity to protect its legitimate business interests, it is not convinced that the arguments put forth by Foxtel, such that allowing this capability, would lead to the airing of inappropriate content. Foxtel could contract with channel providers to prevent this. This would not contravene the terms of the Undertaking. Likewise, allowing interactive features is unlikely to place Foxtel in breach of its other legislative obligations, such as the *Broadcasting Services Act 1992*. Foxtel could contract with channel providers to ensure programs comply with all relevant laws (such a term is standard in almost any commercial contract). The Commission considers that interactive features in current channels would not raise any issues that are not currently dealt with by Foxtel in relation to:

- the provision of content by current channel providers; or
- the provision of interactive content by existing channel providers; or
- the provision of channels, with or without interactive content, by access seekers in future pursuant to the Undertaking.

In response to Foxtel’s Supplementary Engineering Submission, the Commission engaged Convergent Consulting to report on the concerns raised by Foxtel. On the basis of this report, the Commission considers that it is very unlikely that Foxtel would be required to make enhancements or upgrades to its capabilities in order to allow it to deliver interactive enhancements requested by current channel providers.²⁰⁸ Foxtel is not constrained by the need to insert additional channel capacity into any particular multiple program transport stream (MPTS), since if any particular MPTS is full, it is feasible for Foxtel to rearrange channels within different MPTS. Issues of constraint might only arise in a very small margin of cases, such as where an interactive feature was proposed that allowed a viewer to see many channels simultaneously, and all of these channels were “greedy” for bandwidth, such as sports channels.

In such a situation, Foxtel could legitimately refuse to make the enhancement on technical grounds, or could request payment from the access seeker to recompense Foxtel for the incremental costs of any such enhancement.

However, if, contrary to the Commission’s opinion, Foxtel were required to upgrade or enhance its facilities in order to accommodate an interactive function, Foxtel could identify the costs associated with such an upgrade, and could charge the channel provider for the incremental costs of the upgrade. It is quite likely that Foxtel itself could also use any such upgrade for its own channels, and might therefore derive some

²⁰⁸ Convergent Consulting, *The technical feasibility of Foxtel providing access seekers to its Digital Set Top Unit service (DSTUS) with the capability to equip existing channel offerings with genuinely interactive features*, Final report, 24 July 2006.

benefit from the upgrades itself; this should be reflected in any charge to the channel provider.

In sum, the Commission considers the issue of the restrictions on existing channel providers gaining access to modem services as part of the Undertaking to be relevant to the Commission's assessment. Furthermore, it appears that it is technically feasible for Foxtel to provide interactivity to existing channels, subject to possible enhancements or upgrades as discussed above.

Assessment of the reasonableness of the interactivity provisions

Having stated that the Commission considers that it can assess the issue, the next step is the assessment. Several of the factors to which the Commission is required to have regard when assessing reasonableness under s.152AH are particularly pertinent.

These include:

- whether the terms and conditions promote the long-term interests of end-users;
- the legitimate business interests of Foxtel; and
- the interests of persons who have rights to use the declared service.

In relation to other factors that the Commission is required to have regard to, the Commission considers for the reasons given in the previous section that these are neutral factors, or that the claims of the parties have not been made out.

In assessing effect of the interactivity provisions in the Undertaking, especially the long-term interests of end-users, the Commission considers it useful to consider the future with and without the Undertaking.

The impact of the Interactivity provisions on the long-term interests of end-users: competition between rival providers of subscription television packages

The future with the Undertaking

Access to the Digital Set Top Unit Service may remove certain barriers to the establishment of a rival subscription television service. In the event that a rival subscription television service was set up using the Digital Set Top Unit Service, channel providers that wanted to add interactivity to their channels through the use of modem services would be able to do so under the provisions of the Digital Set Top Unit Service. As such, accepting the undertaking may have the effect of promoting competition in the market for the provision of interactive services to end users.

The future without the Undertaking

In the event that a rival subscription television service was established in the absence of the Undertaking (for example, using access to a separate set top unit), channel providers may be able to add interactive services to their channels through modems in those rival set top units. However, those channel providers would not have a need to access modem services in Foxtel's set top units.

Summary

The inability of existing Foxtel channel providers to add interactivity under the Undertaking has no material effect *per se* on competition between providers of Pay TV packages.

Assessment of the impact of Interactivity provisions on the long-term interests of end-users: competition between individual channels

Future with the Undertaking

The restrictions on existing Foxtel channel providers adding interactivity to existing channels, as outlined above, mean that, if the Commission was to accept the Undertaking, new interactive channel providers would be able to utilise the Digital Set Top Unit Service as access-seekers.

Existing channel providers would have three possible options by which to add return path interactivity to their channels. These include:

- Commercial negotiation with Foxtel to remain a Foxtel service, but with interactivity. As noted above, Foxtel states that negotiations with a channel provider would take in account 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.
- Channel providers could become interactive non-Foxtel channels, i.e. as access-seekers using the Digital Set Top Unit Service under the terms and conditions of the Undertaking, once their existing agreements with Foxtel expire. They would need to acquire carriage from, say, Optus or Telstra.
- Channel providers could continue providing the channel to Foxtel without the interactive feature, and also utilise the Digital Set Top Unit Service, as well as acquiring carriage from, say, Optus or Telstra, to provide a second non-Foxtel form of the channel with interactivity.

The first option outlined above would appear to provide limited scope and certainty for existing channels carried by Foxtel to gain access to modem services in order to add return path interactivity to their channels. In particular, the Commission notes that as a vertically-integrated channel provider, Foxtel would have the ability and perhaps the incentive to deny non-affiliated channels the capacity to add return path interactivity to their channel in the context of commercial negotiations. Foxtel's statement that its decision would involve an assessment of whether it considers the interactive application will add to the overall appeal of the channel and the Foxtel service raises some concern for the Commission. While the Commission recognises that Foxtel should have some control over its relationship with channel providers in order to protect its legitimate business interests, this type of subjective criteria could potentially be used as a means by which to foreclose competition from third party channel providers.

While the second option may provide a more effective means for channel providers to add interactive features to existing channels, the efficacy of this option may depend on

how long it takes existing agreements between channel providers and Foxtel to expire. Given that a number of channels on the Foxtel digital service already offer interactive functionality, the Commission considers that the timeliness of access to return path interactivity for existing channels under this option may be a concern.

The Commission does recognise that there may be an additional barrier to following this path, namely the ability to acquire carriage, given *inter alia* the Tribunal's views about the effectiveness of Telstra's s.87B undertakings relating to carriage on its HFC platform.²⁰⁹ However, if this is a barrier, the appropriate resolution would be to seek declaration of the HFC or another platform. It is not appropriate to impose obligations on Foxtel simply to address a possible bottleneck owned by a third party.

With regard to the third option, the Commission considers that this scenario would clearly lead to an inefficient use of communications infrastructure, because transmission bandwidth would be used to carry essentially the same content twice, once by Foxtel and once using the Digital Set Top Unit Service. In this regard, it may be more efficient for the channel to be carried once, with the interactive feature.

It should be noted that while acceptance of the Undertaking would still in theory leave open the possibility for declaration and arbitral determination in respect of Modem service, pursuant to s.152CQ(5) of the Act, the effect of accepting the Undertaking is to preclude a determination and arbitration for requiring modem services to be provided to existing Foxtel channel providers. The Commission could not make an arbitration determination that is inconsistent with the Undertaking. In this regard, Foxtel has provided a submission asserting that the Undertaking is intended to cover the Digital Set Top Unit Service and all permutations of that service such that the Undertaking for the purposes of s.152CQ(5) would restrict the terms of an arbitration determination. The effect of this is that the Commission could not make a determination inconsistent with that requirement that an access seeker acquire the Digital Set Top Unit Services only as a package of services pursuant to clause 4.1(c)(ii) of the DAA.²¹⁰ In addition, the Commission could not make an arbitration determination that is inconsistent with clause 6.5(a) in the DAA. The effect of this latter clause is that a channel provider could not gain access to modem services while it remains on Foxtel's subscription television service.

Future without the Undertaking

If the Commission was to reject the Undertaking, new interactive channel providers would not be able to access the Digital Set Top Unit Service (with modem services) to offer their interactive channels.

Existing Foxtel channel providers would have two possible options by which to add return path interactivity to their channels. These include:

²⁰⁹ *Seven Network Limited (No 4) [2004] ACompT 11* (23 December 2004) [253].

²¹⁰ Foxtel letter of 24 April 2006.

- Commercial negotiation with Foxtel. As noted above, Foxtel states that negotiations with a channel provider would take into account 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.
- Existing Foxtel channel providers could seek access to modem services via declaration and arbitral determination.

The first option will raise the same issues as outlined in the scenario of the future with the Undertaking.

The second option, however, would offer the possibility for declaration and arbitral determination in respect of access to unbundled Modem services. In this scenario there would be no undertaking in place to restrict the terms of any arbitration determination.

The Commission notes Foxtel's submission that for legal and commercial reasons, existing channel providers would not be able to unilaterally add interactive services to these channels. However, the Commission understands that while a number of Foxtel's existing contracts include terms specifically prohibiting channel providers from enhancing their channels with interactive services, there are also a number of contracts that are silent on this issue. The Commission recognises that Foxtel's legitimate business interest will be served through having flexibility and control over how it supplies channels as part of its subscription television package to end-users. However, the Commission does not accept Foxtel's submission that commercial and legal considerations would operate to exclude these channel providers from being able to enhance their channels with interactive content in the event that modem services were declared. Nevertheless, the Commission does accept, from the perspective of the materiality of its concerns, that the ability of channel providers to add interactive content to their channels may be restricted in circumstances where those channel providers are dealing with Foxtel under contracts that were entered into prior to 13 September 1996 or contracts that explicitly prohibit the addition of interactive content without the consent of Foxtel.

This course of action, if successful, would have the additional benefit for those channel providers who could use it, of overcoming any third party carriage bottleneck by requiring Foxtel to buy carriage and on-sell it. However, as previously stated, this does not seem a proper consideration.

In any event, Foxtel is not required to renew purchase of any channel for its own package. Thus the benefit to existing Foxtel channel providers of being able to access modem services without Foxtel's commercial agreement may be only temporary.

Overall assessment of the long-term interests of end-users

Given the factors outlined above, the Commission's assessment of the interactivity provisions in the Undertaking as they affect existing channel providers involves, in essence, a comparison of benefits of maintaining the possibility for declaration and arbitral determination in respect of access to unbundled Modem services against the certain form of access to the Digital Set Top Unit Service provided for under the Undertaking.

The Commission notes that maintaining the possibility for declaration and arbitral determination in respect of access to unbundled Modem services has the potential to promote timely competition between channels within Foxtel's suite of pay TV channels in respect of the provision of interactive services. However as noted above, this will only be a meaningful option for a subset of channel providers with existing Foxtel channels that have on-going agreements that are silent on the issue of interactive enhancements. It does not provide Digital Set Top Unit Service services for new interactive access-seeker channels. Furthermore the Commission recognises that there is uncertainty as to the terms and conditions that would be decided in any ensuing arbitration; and that the effect even for those channels that could benefit may be only temporary, not long-term.

In contrast, the Commission considers that the Undertaking has greater long-term potential to promote competition between channels in respect of the provision of interactive services, by allowing the entry of new channels and by allowing existing Foxtel channels to use (or threaten to use) the Digital Set Top Unit Service as access seekers. Carriage is, of course, required, but if this does constitute a bottleneck then the appropriate action is to seek a declaration of that bottleneck. Additionally, the Undertaking provides for access to other parts of Foxtel's STU infrastructure that may facilitate the entry of access seeker channels. Increased competition may bring with it resultant efficiency gains in the provision of channels, including interactivity. Furthermore, any increased supply of interactive offerings by channels on rival subscription television services using the Digital Set Top Unit Service may over time alter Foxtel's incentive to allow interactive enhancement for channels carried as part of its suite.

On balance, the Commission considers that accepting the Undertaking may be more likely to promote competition in the market for the provision for interactive services than rejecting the Undertaking.

Overall assessment

The criteria under s.152AH require a weighing-up of several factors.

The Commission finds that the long-term interests of end-users in competition between channel providers are promoted overall by accepting the Undertaking.

The Commission considers 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. The Commission finds that that the Undertaking provides for this.

The Commission considers that Foxtel has a legitimate business interest in controlling the product Foxtel offers to Foxtel's own customers, and therefore in not providing access to interactivity for existing Foxtel channels. The Undertaking is consistent with this. By contrast, even if one were to focus narrowly on the long-term interests of end-users in subsidiary competition between Foxtel channel providers, these interests are at best only weakly promoted, by rejecting the Undertaking.

The Commission considers that the other factors are neutral, or that the parties' claims about them have not been made out.

As such, the Commission is satisfied with the interactivity provisions contained in the Undertaking.

6.2.4 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.

On 29 May 2006, Foxtel sent a letter to the Commission with a proposal for amending the Undertaking by deleting clause 5.2(e) of the DAA .

Ten Network submission

While the Ten Network acknowledges that Foxtel has expanded its definition of the Digital Set Top Unit Services to incorporate EPG Services, it 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.²¹¹

Two Way TV

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.

²¹¹ Ten Network submission, 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.²¹²

Foxtel Supplementary Submission

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.²¹³

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. In this regard, two aspects of the terms and conditions of supply to EPG services under the proposed DAA raise concerns.

²¹² Two Way TV submission, pp.13-14.

²¹³ Foxtel supplementary submission, pp.30-31.

First, Foxtel has the ability to reserve channel numbers to itself, whilst access seekers cannot reserve channel numbers. Second, all of Foxtel channel listings are visible to all Foxtel digital subscribers, even if they do not subscribe to that particular channel. In contrast, an access seeker's channel listing will only be visible to subscribers to the access seeker's channel under the terms of the DAA. The main justification that Foxtel has provided for this differential treatment is that it bears the bulk of the cost of supplying the EPG. The Commission does not believe that this is a reasonable basis for discriminatory treatment given that access seekers will pay an access charge for use of these EPG services. The Commission's assessment of this access charge is separately discussed in Chapter 5.

The Commission's concerns about access seekers not having identical rights to Foxtel in respect of reserving and displaying channel numbers on the EPG are ameliorated somewhat by Foxtel's response 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.

However, the Commission considers that the limitation on an access seeker's channel listing being visible only to subscribers to the access seeker's channel, when all of Foxtel's channel listings are visible to all digital subscribers, is likely to hinder the ability of access seekers to compete. In particular, this condition would appear to limit an access seeker's ability to compete with Foxtel for subscribers to tiered channels. Given the tie of access to the Foxtel basic package, existing digital subscribers may be a particularly important source of demand for access seekers as this subset of consumers will not have to acquire the Foxtel Basic package in order to acquire access seekers' tier channel offerings. In addition, Two Way TV's assertion that Foxtel would in fact incur greater costs in making access seeker channels only visible in the EPG to subscribers to those channels raises further concerns with regard to the issue of the efficiency in the use of infrastructure.

As noted above, on 29 May 2006, Foxtel sent a letter to the Commission requesting an amendment that involves deletion of clause 5.2(e) of the DAA stating that:

'While Foxtel still believes that it should not be *required* to include access seeker listings on the EPG for all homes (as this essentially markets the channels for the access seeker'), it is prepared to allow this in order to provide an additional benefit for access seekers under the DAA.'

The Commission considers that such an amendment would, in principle, address the concerns outlined above.

6.2.5 Other non-price issues

Two Way TV also raises a number of other concerns relating to non-price clauses under the DAA.

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).²¹⁴

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.²¹⁵

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.²¹⁶ In this regard, the Commission’s preliminary 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.

²¹⁴ Two Way TV submission, pp.14 - 15.

²¹⁵ Foxtel supplementary submission, pp.31-32.

²¹⁶ ACCC, *Final Determination—Model Non-Price Terms and Conditions*, October, 2003.

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.²¹⁷

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 that the Digital Set-Top Unit Services supplied to an access seeker remain supplied to the equivalent quality as Foxtel supplies to itself.

Foxtel contends that these provisions are reasonable as:

- they are necessary to enable Foxtel to improve, enhance and adapt its pay TV platform to take advantage of new technologies, market practices etc;
- Foxtel remains committed to providing an equivalent quality of service to access seekers as it provides to itself and;
- access seekers can terminate the DAA if they receive notice of change under clause 4.4(b) or 11.2(b) (see clause 24.3(i) and (j) of the DAA).²¹⁸

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 reasonable rights and notice in relation to proposed changes to a facility or service that affects their business interests.

While the Commission considers that the provisions in clause 2.5 of the Undertaking reasonably counterbalance the rights of access seekers and Foxtel in this regard, it has

²¹⁷ Two Way TV submission, pp.15-16.

²¹⁸ Foxtel supplementary submission, p.32.

concerns about the effect of clauses 4.4(b) and 11.2(e) on the underlying intent and applicability of this clause. Additionally, the notice periods in clauses 4.4(b) and 11.2 raise some concerns.

The Commission considers that clause 4.4(b) may be inconsistent with the provisions in clause 2.5 of the Undertaking. Clause 4.4(b) provides that it may change any provisions in the DAA (excluding Schedule 3) subject to giving access seekers notice, while clause 2.5 of the Undertaking could be interpreted to provide that Foxtel will only amend the DAA in order to address technical problems and changes, and market practices. In addition, the Commission has concerns about the notice periods under 4.4(b)(ii) and 4.4(b)(iii). In particular, to the extent that proposed changes impact access seekers, the minimum notice period of 1 month under 4.4(b)(ii) as it relates to circumstances under clause 4(a)(ii)-(iv) appears insufficient.

Similarly, the Commission considers that the provisions in clause 11.2(e) are not consistent with clause 2.5 of the Undertaking. Furthermore, the notice periods provisions under clause 11.2(b) appear to provide Foxtel with considerable discretion in assessing when it provides access seekers notification of modifications to the Digital Set Top Unit Service.

Clause 4.4(b) of the DAA detracts from the certainty that the Commission may otherwise have in respect of the terms and conditions on which access would be provided to access seekers in the event that the Commission accepted the Undertaking.

On balance, the Commission's preliminary view is that these terms are not in the LTIE, and not 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.²¹⁹

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.

²¹⁹ Two Way TV submission, p16.

- 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 states that it agrees to amend the DAA to provide that in Schedule 2, clause 6, 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.²²⁰

The Commission's view

The Commission notes that clause 6 of schedule 2 may provide an incentive for access seekers to not notify Foxtel of a fault that it is aware of. This could potentially have a detrimental effect upon the extent to which the Digital Set Top Unit Service is operated in a safe and reliable manner.

The Commission's preliminary view is that, subject to Foxtel implementing its proposed amendment to Schedule 2, clause 6 of the DAA as discussed above, it is satisfied with these provisions.

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.²²¹

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.

²²⁰ Foxtel supplementary submission, pp.32-33.

²²¹ Two Way TV submission, p16.

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.²²²

The Commission's view

The Commission's preliminary 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.²²³

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.²²⁴

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

²²² Foxtel supplementary submission, p.33.

²²³ 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.

²²⁴ Two Way TV submission, p.17.

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.²²⁵

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. On this basis, the Commission's preliminary view is that the proposed indemnities and liabilities clauses appeared to be heavily weighted in favour of Foxtel.

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 electronic program guide (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.²²⁶

The Commission's view

The Commission's preliminary 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. As such it is not apparent that access seekers pursuing self supply options or supply through other third

²²⁵ Foxtel supplementary submission, p.33.

²²⁶ Two Way TV submission, p.11.

party providers with respect to these services would necessarily deter competitive entry or lead to inefficient outcomes.

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 that 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 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 took into account the following matters:

- whether the terms and conditions promote the long-term interests of end-users (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*.²²⁷ The Commission notes that in the *Seven Network Ltd case*,²²⁸ the Tribunal was of the view that the ‘future 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 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 ‘future 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.

In section 3.3.6, the Commission identified that doubt exists as to whether the Undertaking incorporates two Proposed Amendments. This chapter proceeds on the basis that the Undertaking does incorporate the Proposed Amendments.

7.3 Consideration of each of the matters relevant to reasonableness

7.3.1 Whether the terms and conditions promote the long-term interests of end-users (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;

²²⁷ *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

²²⁸ *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 either listed services are supplied; and
 - any other infrastructure by which listed services are, or are likely to become, capable of being supplied.²²⁹

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.²³⁰

As such, 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, 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.²³¹

²²⁹ Section 152AB(2) of the Act.

²³⁰ Section 152AB(3) of the Act.

²³¹ Foxtel submission, 6 October 2005, pp.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.²³²

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:

- options available under the Undertaking; and
- 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.

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 'future with and without' analysis is *not* a substitute for a consideration of the reasonableness of the specified terms and conditions.

²³² Seven Network submission, p.3.

Options set out in the Undertaking

The future with the Undertaking may involve Foxtel providing access to its Digital Set Top Unit Service under the terms of either the Undertaking or s.87B undertaking until 31 December 2007, and under the terms of the Undertaking from 1 January 2008 for a duration of 8 years from the commencement date.²³³

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.²³⁴ Broadly speaking, this is the same methodology as contained in its previous DAA as part of its s.87B undertaking.²³⁵ However, 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 that forms part of its pricing methodology and is discussed in Attachment 1 to Foxtel's Submission.²³⁶

Accepting the Undertaking would not preclude access seekers from gaining access to Foxtel's Digital Set Top Unit Service through commercial negotiation.

²³³ 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.

²³⁴ 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.

²³⁵ ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, December 2003

²³⁶ Attachment 1: CRA International, *Adjusted access pricing model for digital STUs*, October 2005.

If the Commission accepted the Undertaking, it could still declare digital set top unit service and related services under s.152AL(8) of the Act and arbitrate the terms and conditions of access. In the case of a declaration inquiry under s.152AL(8), the Commission cannot declare a service unless it is satisfied that the declaration will promote the LTIE. Section 152CR of the Act outlines the matters that the Commission must take into account in making an arbitration determination. These are for the most part the same matters that the Commission must consider in determining reasonableness under s.152AH(1).²³⁷ 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 respect, Foxtel has provided a submission that asserts the Undertaking is intended to cover the Digital Set Top Unit Service and all permutations of that service such that the Undertaking for the purposes of s.152CQ(5) would restrict the terms of an arbitration determination.²³⁸ That is, the Commission could not make a determination that is inconsistent with requirement under clause 4.1(c)(ii) of the DAA that Foxtel will supply the Digital Set Top Unit Service only as a total package, and not as one or more component parts (eg. Set Top Unit Services, Conditional Access Services, EPG Services and Modem Services).

The Commission has also assumed for the purpose of this assessment that Foxtel does not regard clauses 4.1(c)(i) and (f) of the DAA as a limitation to the scope of the declared service for the purpose of ss.152CBA(5) and 152AL(7) of the Act. On this basis, 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 also be precluded by s.152CQ(5) from making an arbitration determination that was inconsistent with the Undertaking. In particular, Foxtel considers that a determination could not oblige Foxtel to extend the facility to non-Foxtel homes.²³⁹

Outcomes in the absence of the Undertaking

In the future without the Undertaking, access seekers would have three main avenues by which to gain access to Foxtel digital set top unit 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 2007.

²³⁷ One additional factor under s.152CR(1)(e) that the Commission must consider is the value to a party of extensions, enhancement of capability, whose cost is borne by someone else.

²³⁸ Foxtel response of 24 April 2006.

²³⁹ 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.

Third, it may be that access seekers could obtain access on terms and conditions determined by an arbitral determination in accordance with s. 152AY(2)(b)(iii) following declaration of the services by the Commission. 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. However, unlike the ‘future with’ scenario described above, there would be no restriction upon the Commission in making an arbitration determination with respect to the component services that comprise the Foxtel Digital Set Top Unit Service.

In terms of considering the likely outcomes in 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 declaration, 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 Undertaking²⁴⁰ and asserts that unbundled CA/SI on their own could not be declared under part XIC.²⁴¹

Notwithstanding this uncertainty, the Commission notes that one important distinction as between the future with and without the Undertaking is that accepting the Undertaking would, in effect, foreclose the possibility of making an arbitration determination requiring different terms with respect to the component services that comprise the Foxtel Digital Set Top Unit Service than those terms in the Undertaking.

Conclusions in relation to the objective of promoting competition

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.

However, the Commission notes that the ‘tying’ and ‘bundling’ 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

²⁴⁰ Foxtel submission, 6 October 2005, pp.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.

²⁴¹ *ibid.*, p. 42.

may provide subscription television services in competition with Foxtel's Basic Package .

The Commission believes that the effect of the Undertaking on competition is best considered by taking into account the tying and bundling provisions together. This is because the 'bundling' provisions would prevent access seekers from having the option to gain access to individual component services of Foxtel Digital Set Top Unit Service such as CA and SI services only. In addition, the 'tying' provisions would ensure that these component services could only be supplied to homes currently in receipt of Foxtel's basic package.

The Commission considers that unbundled access to CA and SI services would be technically feasible, and that the possibility of declared access to unbundled CA and SI services is a possible 'without' scenario against which to compare the Undertaking. In this regard, acceptance of the Undertaking would foreclose the option that the Tribunal noted may provide the basis for effective competition in the absence of mandating 'untying'.

In light of the above factors, the Commission's assessment of the Undertaking involves a weighing up of the *definite* (albeit restricted) access offered in the Undertaking against the benefits in maintaining the *possibility* of broader access that may be possible via access to unbundled CA/ SI services.

Rejecting the Undertaking would leave open the possibility that access seekers could acquire access to unbundled CA and SI services, either through commercial negotiation, or via a declaration/arbitration process. Access to unbundled CA and SI services will potentially be a relevant input for full package providers that supply subscription television services that are competitive with Foxtel's Basic Package. Based on the evidence provided by interested parties, CA/SI services appear to be contestable inputs. The Commission notes that unbundled access to CA/SI services may provide a lower cost option for potential subscription television service providers compared with self-supply options in certain circumstances. However, this does not mean that CA/SI services are bottleneck inputs, *per se*. Overall, the Commission considers that other factors, such as access to premium content and access to carriage, are more critical impediments to effective competition between full package providers. A firm with sufficient access to premium content and carriage to provide a full retail Pay TV service will be able to buy set top units and CA and SI services on the open market.

By contrast, accepting the Undertaking would appear to 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 in competition with Foxtel's tiered offerings. That is the Undertaking provides access to Foxtel's subscribers, as well as Foxtel's STU, CA/SI, modem services and EPG services.

The Commission notes that that the Tribunal was mindful to facilitate the promotion of competition at more than the level of niche channel provider. In this regard, having multiple competing full package providers would potentially improve the bargaining position of niche channel suppliers in gaining distribution on a full package provider's platform in the longer term. However, it appears that the proposed remedy of

unbundling CA/SI may be seen as an indirect and possibly ineffectual means to achieve this end, given that these services are contestable inputs and do not appear to constitute a significant barrier to entry for full package providers.

Having had the advantage of evidence on the issue from interested parties, the Commission would not be inclined to place great weight on the value of the option of access to unbundled CA/SI services. On balance, the Commission is not convinced that access to unbundled CA/SI in order to facilitate competition between full retail Pay TV providers would outweigh the benefits to competition at the tier level that the Undertaking is likely to provide. In particular 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 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 carriage service provider 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 (ie. 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 set top units, conditional access 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 of 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 by providing for a normal commercial return on efficient investments in infrastructure.

The Commission notes that the tying provisions in the Undertaking may distort allocative efficiency and may inhibit dynamic efficiency, by potentially limiting the type of content and type of service made available to consumers. 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. As such, 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.

To a minor degree, the Commission has concerns that the provisions relating to indemnities and liabilities and the access provider's ability to change the terms of the DAA do not reflect a fair balance between the rights of the access seeker and access provider.

However, on balance, the Commission considers that the provisions 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 SAU 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. For example, pursuant to its consideration of whether it is appropriate to unbundle certain component services of the Digital Set Top Unit Service together, the Commission gave consideration to the views of Foxtel and interested parties on the feasibility of providing unbundled CA and SI services. Specifically, the Commission considered whether it would be technically feasible for Foxtel's digital feed to be transmitted into the homes of non-Foxtel subscribers, using Foxtel's CA and SI services, and decoded using the STU (and possibly the Smartcard) of one of Foxtel's competitors. On balance, the Commission has reached the view that there would be some scope for this to occur (in the absence of the Undertaking).

Consequently, this issue has informed the Commission's consideration of the 'without' scenario in relation to the bundling of the various components of the Digital Set Top Unit Service.

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 Undertaking gives due regard to the interests of Foxtel as the access provider and is beneficial to the interests of access seekers.

The Commission has some minor concerns about the provisions in the Undertaking in relation to indemnities and liabilities, the access provider's ability to change the terms of the DAA and the cost base that Foxtel has used in calculating the IBAC as part of its pricing methodology.

Notwithstanding these concerns, the Commission's draft 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 standard access obligations, to the extent that those obligations would apply to Foxtel if the service were treated as an active declared service.

8.1 The applicable 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).

This raises the issue of determining which of the SAOs set out in section 152AR would be applicable to Foxtel if the Digital Set Top Unit Service were declared.

The Explanatory Memorandum to the Trade Practices Amendment (Telecommunications) Bill 1996 explains 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.²⁴²

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 were declared, it would trigger the obligations set out in ss.152AR(3), (5), (6), (7) and (8).

²⁴² Parliament of the Cth of Australia – Trade Practices Amendment (Telecommunications) Bill 1996 Explanatory Memorandum at page 57.

8.2 Consistency with the applicable SAOs

The obligations in ss.152AR(3), (5), (6), (7) and (8) are addressed by Foxtel in its submission of 5 October 2005 (section 8.1). 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),²⁴³ technical and operational quality of the service; and interconnection.

8.2.1 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'.

8.2.2 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.'

However, as is set out in Chapter 4 of this Draft Decision, in Foxtel's view, its Undertaking is in respect of the bundled service (Digital Set Top Unit Service) *and* each of the component services specified in the definition of Digital Set Top Unit Service (such as a CA and SI service). Foxtel treats the bundling clause in its DAA²⁴⁴ as a term and condition on which Foxtel supplies the relevant service(s).²⁴⁵

On this basis, the services that are the subject of the Undertaking (and, if the Undertaking was accepted, would therefore be deemed declared services) are as follows:

- The Digital Set Top Unit Service bundled service;
- The STU Service, as defined in Appendix 1 to the Undertaking;
- The CA Service, as defined in Appendix 1 to the Undertaking;

²⁴³ 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 Foxtel's submission of 29 March 2006, p 16).

²⁴⁴ The tying and bundling clauses in are set out in detail in chapter 4 of this draft decision. In summary, these clauses provide that Foxtel is only obliged to supply the relevant service as a package of services (the bundling clause).

²⁴⁵ For example, Foxtel, in effect, undertakes to supply the CA and SI service on the condition that the access seeker also acquires the STU, Smartcard Authorisation Verification Information, EPG and Modem services.

- The SI Service, as defined in Appendix 1 to the Undertaking;
- The Smartcard Authorisation Verification Information Service, as defined in Appendix 1 to the Undertaking;
- The EPG Service, as defined in Appendix 1 to the Undertaking; and
- The Modem Service, as defined in Appendix 1 to the Undertaking.

8.2.3 Interpretation of s.152CBD(2)(a)

In the Commission's view, if the Undertaking were accepted, s.152AR(3)(a) would in essence require Foxtel to supply any one or more of these services to an access seeker where requested to do so by that access seeker.

Section 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 s.152AR. This would, in the Commission's view, leave no room for the operation of s.152CBD(2)(a).

Instead, the Commission considers that it is required by s.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 accepts 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.

As such, 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 s.152AR(3)(a). This is a question of degree.

8.2.4 Is the bundling clause consistent with s.152AR(3)(a)?

In considering specific terms and conditions, the Commission is of the view that the following non-exhaustive list of factors may be relevant:

- Whether the specific term/condition is a well accepted commercial term of supply; and
- Whether the terms and conditions have the effect that the SAU is consistent with the purpose of Part XIC of the Act as is set out in s.152AB

In the present case, the effect of the bundling clause is that if an access seeker requests access to any one of the component services alone, Foxtel would only be required to provide access if the access seeker also acquired all of the other services that comprise the Digital Set Top Unit Service.

For example, if an access seeker requested access to the CA/SI services alone, Foxtel would not be obliged by the Undertaking to provide access unless the access seeker also acquired all of the other component services. In *Seven Network Limited (No 4) [2004] ACompT 11*, the Tribunal stated:

‘... the ability of an access seeker to provide subscription television services using its own STUs but without having completely to duplicate Foxtel’s delivery infrastructure would appear to be a potentially attractive and valuable option. Accordingly, we would not wish to foreclose any scope which may exist for Conditional Access (“CA”) and Service Information (“SI”) services to be supplied separately from STUs’

The Commission believes that the price of acquiring all of the component services would be significantly higher than the price of acquiring the CA/SI services alone. In large part, the Commission believes that this difference would be attributable to the capex and opex cost pools. This additional cost is, in the Commission’s view, a very significant limitation upon the obligation to supply CA/SI services as it would be likely to increase the price of obtaining these services far above their cost (even allowing for a commercially reasonable mark-up).

As a result, the Commission considers that the effect of the bundling clause is to allow Foxtel, under the Undertaking, to constructively refuse to supply individual component services to access seekers. In the Commission’s view, a term which allows Foxtel to constructively refuse to supply a declared service is unlikely to be consistent with the obligation set out in s152AR(3)(a) to supply declared services.

On the basis of the above, the Commission is not satisfied that the bundling clauses of the Undertaking are consistent with the obligation imposed by s.152AR(3)(a) to supply the services on request.

8.2.5 Section 152AR(3)(a): Tying clauses

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’.

8.2.6 The services the subject of the Undertaking

In its Supplementary Submission of March 2006, Foxtel suggests that the Undertaking is in respect of a service that is geographically limited to locations in which the end user is a Foxtel subscriber:

Under the undertaking, FOXTEL undertakes to provide Digital Set Top Unit Services to an access seeker where the particular STU is being used by a FOXTEL subscriber. ...

FOXTEL submits that the restriction is a proper delimitation of the extent of the Digital Set Top Unit Service supplied by FOXTEL and is consistent with the obligations referred to in paragraph 152CBA(3)(a).²⁴⁶

Assessed on this basis, the Commission considers that the tying clauses are consistent with the obligation imposed by s.152AR(3)(a) on the basis that the service which would be defined (by virtue of s.152AL(7)) of the Act, would be a service that is geographically limited to locations where there exists a Foxtel STU (ie. the end user is a Foxtel subscriber).

On this approach, if an access seeker were to request access to the bundled Digital Set Top Unit Service (that service being geographically confined), Foxtel would be required, by the terms of the Undertaking, to provide access to that service.

However, as is set out in Chapter 4 of this Draft Decision, the Commission has conducted the rest of its assessment on the understanding that service(s) the subject of the Undertaking was not intended to be so confined. Furthermore, the Commission is of the view that the service(s) that are the subject of the Undertaking must remain the same as these are the services that will be deemed declared services by virtue of s.152AL(7) upon the acceptance of the Undertaking.

8.2.7 Is the tying clause consistent with s.152AR(3)(a)?

In the Commission's view, Seven Network approaches the issue of consistency with the SAOs in this latter manner. Specifically, Seven Network submits that the tying clause is not consistent with the SAOs. In particular, Seven Network states:

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. ...

Accordingly, Foxtel is under an obligation to supply the service, irrespective of whether the end user is a Foxtel subscriber or not.²⁴⁷

On this view, the effect of s.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.

An additional argument raised by Foxtel (29 March 2006) is 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:

²⁴⁶ Foxtel supplementary submission, p.13.

²⁴⁷ *ibid.*, p.9.

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 without reference to any locational limitation is to ignore the requirements of Part XIC and the provisions of the *Telecommunications Act 1997*.²⁴⁸

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.²⁴⁹

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 (ie. to any location). The Commission believes that this interpretation is consistent with s.152AR(2).

In the Commission's view, assuming the broader interpretation of the 'service' the subject of the Undertaking, the tying clause has the two primary and related effects, being:

- That Foxtel is only required to provide the service in respect of end users who are Foxtel subscribers; and
- That Foxtel is not required to provide the service if, in order to do so, it would be necessary to extend existing infrastructure (the facility by means of which the service is supplied).

In the Commission's view, the issue of whether or not the tying clause, viewed in isolation, is consistent with the obligation set out in s. 152AR(3)(a) is finely balanced.

²⁴⁸ *ibid.*, p.14.

²⁴⁹ *ibid.*, p.16.

8.2.8 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.

In its overall assessment in respect of the obligation set out in s. 152AR(3)(a), the Commission is not satisfied that the terms and conditions in the Undertaking are consistent with this obligation.

8.2.9 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 states²⁵⁰:

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.

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.²⁵¹ 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.

²⁵⁰ Foxtel submission, 6 October 2005, p 54.

²⁵¹ Seven Network submission, p 34.

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).

8.2.10 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 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 conditional access 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).

8.3 Conclusion

The Commission’s draft view is that it is not 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).

In particular, the Commission is not satisfied that the terms and conditions specified in the Undertaking are consistent with the obligation set out in s.152AR(3)(a).

9. Draft Decision on the Foxtel Undertaking

Following from the analysis provided in the preceding chapters:

- the Commission's draft view is that it is not 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 draft view is that it is satisfied that the terms and conditions specified in the Undertaking (incorporating the Proposed Amendments) 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 not satisfied of the former. As a result, the Commission's Draft Decision is to reject the Undertaking (being the version given to the Commission by Foxtel on 6 October 2005, or incorporating the amendments identified by Foxtel on 29 March 2006 and 29 May 2006).

The Commission also observes that had the Undertaking been limited to the Digital Set Top Unit Service itself, without any attempt to foreclose on stand-alone access to its unbundled component elements, the Commission would have been likely to form the draft view that it should accept it (subject to some minor concerns about terms and conditions and pricing calculations), based on the Commission's view that the terms and conditions specified in the Undertaking are reasonable.

10. Documents relied on by the Commission in reaching its Draft Decision

Legislation

Trade Practices Act 1974 (Cth)

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