



## **Foxtel's Special Access Undertaking**

A REPORT FOR ALLENS ARTHUR ROBINSON IN CONNECTION WITH  
FOXTEL'S PROPOSED SPECIAL ACCESS UNDERTAKING TO THE  
AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

5 October 2005

**Public Version**



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<b>1</b>	<b><u>Introduction</u></b> .....	<b>2</b>
1.1	<u>What I have been asked to consider</u> .....	3
1.2	<u>Structure of this report</u> .....	4
<b>2</b>	<b><u>Principles of market definition</u></b> .....	<b>6</b>
2.1	<u>Purpose of market definition</u> .....	6
2.2	<u>Defining markets by starting with the activities of the companies in question</u> .....	8
<b>3</b>	<b><u>Application of the principles of market definition</u></b> .....	<b>15</b>
3.1	<u>The starting point: the activities of the firm(s)</u> .....	15
3.2	<u>The market in which The carriage service is produced and supplied</u> 15	
3.3	<u>The market in which the digital TV service is supplied</u> .....	17
3.4	<u>Are the facilitating services provided by Foxtel functionally separate from the digital subscription television service?</u> .....	20
3.5	<u>Competitive constraints upon Foxtel’s activities</u> .....	23
3.6	<u>Do the free-to-air broadcasters constrain the price and product policies of Foxtel ?</u> .....	24
3.7	<u>Conclusion: the market in which Foxtel’s digital television subscription service competes</u> .....	36
<b>4</b>	<b><u>Whether the SAU would promote competition</u></b> .....	<b>38</b>
4.1	<u>Principles of promoting competition</u> .....	38
4.2	<u>Degree of competition in the broadcasting market without the SAU</u> .....	41
4.3	<u>Effect of the SAU on competition in the television broadcasting market</u> .....	50

<u>4.4</u>	<u>Conclusions on the effect of the SAU on competition in the television broadcasting market</u> .....	53
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[Figure 1: Share of total viewers per week by broadcaster](#) .....43

Table 1: Percentage of viewers in OzTAM metropolitan panel 30/5/04 to  
15/01/05 .....44



# 1 Introduction

- 1 This Report has been written by Philip Williams.
- 2 I was a full-time academic economist at the University of Melbourne from 1978 until February 2002 when I resigned my full-time position as Professor of Law and Economics in the Melbourne Business School. I continue to teach at the University on a part-time basis and I am an honorary Professorial Fellow of the University with that status in both the Department of Economics and in the Melbourne Business School.
- 3 Since February 2002 I have been the full-time Executive Chairman of Frontier Economics Pty Ltd. I founded the company in May 1999 with Danny Price; but I worked in the company only one day a week until February 2002. Annexure A to this Report is my current curriculum vitae.
- 4 Frontier's work within the area of telecommunications has been undertaken principally by Dr Graeme Woodbridge (until he left us in October 2002), Anthea Harris and Rebecca Burdon. Frontier's principal clients in the field of telecommunications regulation have been the ACCC, the NZCC, the Office of the Telecommunications Authority of Hong Kong, Vodafone and Foxtel – or their solicitors.
- 5 In the area of television, most of our work has been for Foxtel or for its solicitors, Allens Arthur Robinson. Apart from the current dispute, teams from Frontier have undertaken work relating to the following matters for Foxtel or for its solicitors:
- a. Dispute with TARBS and C7 over access to the Foxtel system (1999 -2000).
  - b. Content Sharing Agreement (2002).
  - c. Local Content Rules (2003).
  - d. Trading of Regulatory Obligations (2004).
  - e. Digital TV Review (2004).
  - f. Valuing the retransmission right (2004).
  - g. C7 litigation (2005).
- 6 I have been retained by Allens Arthur Robinson to answer certain questions in respect of this Application. The questions are reproduced as Annexure B to this Report.
- 7 I have been provided with a copy of the Guidelines for Expert Witnesses in Proceedings in the Federal Court of Australia. I have agreed to be bound by these Guidelines.
- 8 In undertaking the research on which this Report is based, I have been assisted by Mr Tom Chan, an employee of Frontier Economics. Mr Chan joined Frontier Economics in 2002. Prior to that, he worked with Professor Ian Harper as a Research Assistant at the Melbourne Business School. Mr Chan has honours Law and Commerce degrees from the University of Melbourne.



9 I have made all the enquiries which I believe are desirable and appropriate; and no matters of significance which I regard as relevant have, to my knowledge, been withheld from the Commission.

10 I have been provided with a list of factual assumptions which I have been instructed to make as the basis of my Report. This list of factual assumptions is Annexure C of this Report. The material that I have relied upon is listed in the footnotes to this Report.

## 1.1 WHAT I HAVE BEEN ASKED TO CONSIDER

11 I have been asked to consider a special access undertaking (SAU) proposed by Foxtel to the Australian Competition and Consumer Commission (ACCC) under s 152CBA(2) of the *Trade Practices Act 1974* (Cth) (TPA) in connection with the provision of access to Digital Set Top Unit Services supplied by Foxtel.

12 I have been asked to provide my opinion as to:

- a the markets that would be relevant for assessing whether and to what extent the terms and conditions of the SAU are likely to result in the achievement of the objective of promoting competition in the markets for listed services; and
- b whether, and to what extent, the SAU would promote competition in the markets that I have defined.

13 I outline below my understanding of what Digital Set Top Unit Services I have been asked to consider.

### ***The Digital Set Top Unit Service***

14 I have been instructed that the Digital Set Top Unit Service comprises those services defined in Appendix 1 of Foxtel's SAU, which defines the Digital Set Top Unit Service in the following manner:

“The Digital Set Top Unit Service means:

- (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.”

15 I understand that, in order to deliver subscription television services to its subscribers, Foxtel undertakes a number of activities that facilitate the transmission of content to its subscribers. Apart from procuring carriage services via cable network and satellite carriage services, Foxtel undertakes certain activities on its own behalf that ‘facilitate’ the carriage of the digital signals to provide the services to its subscribers.

16 These ‘facilitating services’ include activities described as Digital Set Top Unit Services (DSTUS) and include those services described above. Schedule 1 of the Foxtel Digital Access Agreement (DAA) appended to the SAU provides more detail on what are DSTUS that would be supplied by Foxtel. These include:

- a Set Top Unit Services (the use of Set Top Units and customer cabling);
- b Conditional Access Services, consisting of Conditional Access (CA) Services, Service Information (SI) Services, Smartcard Authorisation Verification Information Services;
- c EPG Services (incorporation of the access seeker’s channel information into the Foxtel EPG);
- d Modem Services (enables ‘interactive’ functions on the Digital Set Top Unit).

### ***Listed services***

17 I have been instructed that the relevant listed services are:

- in the case of carriage services, services by which digital subscription television services are carried by HFC cable or by satellite to subscriber locations;
- in the case of services supplied by means of carriage services, digital subscription television services.

## **1.2 STRUCTURE OF THIS REPORT**

18 This Report is structured as follows:

- Section 2 sets out the principles of market definition

- Section 3 applies these principles to determine the relevant market(s).
- Section 4 considers how acceptance of the SAU might affect competition in the market(s) defined in section 3.

## 2 Principles of market definition

19 I have been asked to define the markets in which the relevant listed services are supplied. In this section, I set out the principles governing the definition of markets in general. Then I apply these principles in the following section to define the relevant markets for the purposes of considering the promotion of competition by the SAU.

### 2.1 PURPOSE OF MARKET DEFINITION

20 Economics views market power and competition as opposites: “market power and competition are but the inverse of each other”.<sup>1</sup> That is, conduct that has the effect of lessening competition has the effect of increasing the market power of members of that market. It does this by lessening the constraint that would otherwise be placed on members of that market by the pressure of competition. This is explained in the famous words of the United States Attorney-General’s National Committee to Study the Antitrust Law in its *Report* of 1955 at p 320:

The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new or potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements ...<sup>2</sup>

21 The best-known economic models of market power and competition involve extreme cases. The model of pure monopoly involves an enterprise that has unfettered market power: it has no direct competitors and its pricing is not constrained by the threat that potential competitors may enter its market. It is able to earn monopoly profits. The other extreme model is that of perfect competition. In this model no enterprise has any market power at all. There are many firms in the market and there are no barriers to entry to the market. So each enterprise in the perfectly-competitive market has no discretion at all as to the price that it charges and it can only earn that level of profit that just compensates its shareholders for the opportunity cost of using their funds.

22 The majority of all enterprises in Australia operate in competitive environments between these two extremes. These enterprises are constrained, to a greater or lesser degree, by the price and product policies of other enterprises. In the cases of firms that produce differentiated (non-identical) products, these firms are producing products that, to a greater or lesser degree, are substitutes for those of the enterprise whose market power is in question.

23 The definition of a market involves the drawing of lines - even though competition is a matter of degree. The changing of a price or the acquisition of an asset by a company in one sector in the economy is likely to have far-reaching repercussions in other businesses and in other sectors of the economy. However, many of these effects are very small in magnitude. The drawing of the boundaries to a market involves drawing lines between those institutions that are likely to have a

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<sup>1</sup> Maureen Brunt, “Market Definition’ Issues in Australian and New Zealand Trade Practices Litigation”, *Australian Business Law Review*, 1990, Vol 18, No 2, 86-128, at 95.

<sup>2</sup> Quoted in Brunt, *op cit*, p 95.

substantial effect on the business (or businesses) whose market power is in question and those other institutions that have a less-immediate effect. This drawing of boundaries has the useful effect of placing some limits on the boundaries to economic analysis: it makes economic analysis tractable.

24 The drawing of market boundaries does more than make the analysis of competition and market power tractable. It is necessary in order to give some precision to the analysis of competition. Economic theory contains certain well-established propositions that link the structure of markets to the behaviour of firms within those markets – and thereby the effectiveness of competition. So if one seeks to explain or predict the behaviour of firms, a natural starting point is the structure of the market(s) within which they operate.<sup>3</sup>

25 Although the elements of market structure that may be relevant to the analysis of any particular problem may vary with that problem, standard elements of market structure are (i) the number and size distribution of firms<sup>4</sup>; (ii) the nature of the relationships among those firms; and (iii) the condition of entry to the market. However, if one is going to count the number of firms in a market or analyse the condition of entry to the market, one must be able to specify the boundaries of the market to which one is referring. So one must define a market in order to be precise about the links between market structure and the behaviour that one is seeking to analyse.

26 The language of French J in the decision of the Full Federal Court in *Singapore Airlines Ltd v Taprobane Tours WA Pty Ltd* (1992) ATPR 41-159 reflects the idea that enterprises compete in the activities that they undertake. The judgment refers to the definition of markets as the drawing of lines around activities:

In competition law it [the concept of ‘market’] has a descriptive and a purposive role. It involves fact finding together with evaluative and purposive selection. In any given application it describes a range of economic activities defined by reference to particular economic functions (e.g. manufacturing, wholesale or retail sales), the class or classes of products, be they goods or services, which are the subject of those activities and the geographic area within which those activities occur. In its statutory setting the market designation imposes on the activities which it encompasses limits set by the law for the protection of competition. It involves a choice of the relevant range of activity by reference to economic and commercial realities and the policy of the statutes. To the extent that it must serve statutory policy, the identification will be evaluative and purposive as well as descriptive.<sup>5</sup>

27 In my opinion this passage is consistent with the notion of ‘market’ that an economist would adopt when talking of the structure of a market as having a key influence on patterns of behaviour. Used in this sense, the word ‘market’ is not referring to a place where trades occur – as would be the case if it were used in phrases such as ‘a fruit and vegetable market’, ‘the National Electricity Market’ or ‘the stock market’. Rather, in the context of the analysis of competition and market power,

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<sup>3</sup> A useful summary is provided by F M Scherer and David Ross, *Industrial Market Structure and Economic Performance*, Houghton Mifflin, 3<sup>rd</sup> edition, 1990, pp 4-7.

<sup>4</sup> The reference to ‘size distribution’ is to the relative sizes of firms within a market. Economic theory suggests that the number of firms (or even the percentage of sales accounted for by the largest 4 firms) is not so important in determining competition as the allocation of sales among all the firms in the market. The measure of this distribution suggested by much economic theory is generally known as the Hirschman-Herfindahl Index. See F M Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3<sup>rd</sup> ed, 1990, Houghton Mifflin, pp 72-73.

<sup>5</sup> *Singapore Airlines v Taprobane*, pp 40,169-70.

economists use the word market to refer to the activities undertaken by a particular set of institutions that affect (in a substantial way) the business strategies that the economist is seeking to analyse. I shall use the word market in this sense.

## 2.2 DEFINING MARKETS BY STARTING WITH THE ACTIVITIES OF THE COMPANIES IN QUESTION

28 The starting point of any definition of markets should be the activities of the firm (or firms) whose market power is at issue. This approach to the problem of market definition is frequently identified with Edward Mason, the founder of the field of economics that is known as industrial organisation:

... the market, and market structure, must be defined with reference to the position of a single seller or buyer. The structure of a seller's market, then, includes all those considerations which he takes into account in determining his business policies and practices. His market includes all buyers and sellers, of whatever product, whose action he considers to influence his volume of sales.<sup>6</sup>

29 The Mason perspective suggests, in the words of Professor Brunt, a 'practical methodology' that should guide the definition of markets in the context of antitrust litigation:

This suggests, as a practical methodology, that one begins with a specification of the conduct claimed to be unlawful, (or for which authorisation is sought). That specification will be assisted by study of the requirements for breach laid down in the relevant provisions of the Act. The next question will be: what productive activities of the enterprise generate this conduct? And, finally, what decision-making unit within the firm (whether it be a company, a division, an establishment – or the whole complex organisation), and what product or set of related products, should be the centre-point of the analysis? It is a matter, in short, of seeking the constraints upon the 'price and production policies of the relevant activity of the firm in question'.<sup>7</sup>

30 I have adopted this practical methodology in the structure of this Report.

31 The breadth of the market boundaries is critical to the analysis of competition and the classification of the competitive constraints on providers. Given this, it is probably prudent, as a number of economists have noted,<sup>8</sup> to define the market sufficiently broadly to ensure that relevant constraints are not eliminated. For example, Fisher et al argue that:

Both choosing too broad and choosing too narrow a market are wrong – if the choice then leads one to forget the facts. In practice, too narrow a market definition is more likely to prove harmful. The definition of the market provides the universe of discourse for the analysis of the problem. Products left outside are likely to be given only cursory treatment, if they are treated at all. Products inside the

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<sup>6</sup> E S Mason, "Price and Production Policies of Large-Scale Enterprise", *American Economic Review*, 1939, Reprinted in E S Mason, *Economic Concentration and the Monopoly Problem*, Harvard University Press, 1957, pp 55-72, at p 65.

<sup>7</sup> Maureen Brunt, "'Market Definition' Issues in Australian and New Zealand Trade Practices Litigation", *Australian Business Law Review*, Vol 18, 1990, 86-128, at 105.

<sup>8</sup> See Brunt, M. (1990), *op cit*, pp.86-128, and Fisher, F.M., J.J. McGowan and J.E. Greenwood (1983), *Folded, Spindled and Mutilated, Economic Analysis and U.S. v IBM*, MIT Press.

market, on the other hand, at least become the subject for further investigation of how they do or do not constrain the power of the alleged monopolist (p.45).<sup>9</sup>

32 It has become standard practice among economists when determining the limits of the market, to examine the following four dimensions: product, functional, geographic, and time. A key focus is on identifying close substitutes for the good or service in question. Each of dimensions is discussed below.

### 2.2.1 Product dimension

33 The first dimension of the market that I wish to discuss is the product dimension. The enterprise(s) whose market power is at issue will produce a product or a group of products; and these products will be the base from which the product dimension of the market is defined. It is now common for economic analysis to analyse pricing and product policy in the context of a multi-product enterprise. However, this was not always the case.

34 Indeed, until the mid 1970s most of the economic theory of the firm was expounded in models that assumed that each enterprise produced only one product. Although some economists had been aware of the important implications for economic theory more than a century before,<sup>10</sup> the developments in the 1970s were far-reaching for economic theory.<sup>11</sup> Economists now realise that, for most enterprises, consideration of revenue, costs and profits must take explicit account of the fact that enterprises produce more than one product.

35 Indeed, in many real-world applications, the very idea of a product is somewhat slippery. In *Re QCMA and Defiance Holdings* (1976) ATPR 40-012, the Tribunal confined the product dimension of the primary market to flour. It may seem that flour is a single product; however, the product dimension of this market embraced bakery flour, packaged flour and 'other flour'.<sup>12</sup>

36 Similarly, a newspaper publisher that publishes a single newspaper each day might be thought to be producing a single (physical) product. However, a well-known paper by the eminent economist, Max Corden, characterised the activities of a newspaper as producing products of two kinds: (i) text to satisfy the demand of readers; and (ii) advertising opportunities for advertisers.<sup>13</sup>

37 Corden pointed out that the costs and revenues of these two 'products' were related. He pointed out that revenue from these two products were related: increased circulation would increase the price per line that advertisers were prepared to pay; but an increase in the proportion of the newspaper devoted to advertising would decrease demand for the newspaper and, as a consequence, its circulation. He also pointed out that a newspaper could increase the quality of its

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<sup>9</sup> Fisher, F.M. et. al (1983) *op cit*.

<sup>10</sup> An important early statement was by J S Mill, *Principles of Political Economy*, Ashley Edition, pp 569-70.

<sup>11</sup> A survey is provided by E E Bailey and A F Friedlaender, "Market structure and multiproduct industries", *Journal of Economic Literature*, Vol 20, 1982, pp 1024-41.

<sup>12</sup> At 17,248.

<sup>13</sup> W M Corden, "The Maximisation of Profit by a Newspaper", *The Review of Economic Studies*, Vol 20 No 3, 1952-53, pp 181-190.

content (and, as a consequence, its circulation) by spending more on content. Although this would entail a cost, it would also facilitate an increase in the price that it could charge per line of advertising. Corden proceeded to take these relationships into account in developing a model as to how a newspaper might seek to maximise its profits.

38 This economic approach to the analysis of the products of newspapers was reflected in the characterisation of the newspaper publishing market that was adopted by the Tribunal in *Re 7-Eleven Stores*. In that decision the Tribunal defined a “market for the publication and distribution of metropolitan daily newspapers offering two interconnected products: news, information and entertainment; and classified and display advertising.”<sup>14</sup>

39 In the case of a multi-product firm, complementarities in demand and/or supply should guide the choice of products that are included in the market. In particular, the product dimension of the market should include those products that are linked by substantial complementarities of demand and/or supply when those complementarities are of the kind that can most-efficiently be captured within a single enterprise.<sup>15</sup>

40 Complementarities in demand may be defined as existing if purchasers are prepared to pay a higher price to purchase the goods from a single firm compared with the sum of the prices they would pay to purchase the same group of products – each from a separate enterprise. An example may be the retail purchases of groceries. Consumers are likely to be prepared to pay a higher price to purchase milk, bread, butter and so on from a single store compared with the sum of the prices they would be prepared to pay to purchase the same group of products from separate stores.

41 Complementarities in supply may be defined as existing if the cost to a single enterprise of producing a group of products is less than the sum of the costs of producing the same group of products – each with a separate enterprise. An example might be the various products produced by banks. The literature on the cost functions of banks reveals that a bank can gain access to significant cost savings by producing a range of products compared with the case of a set of banks – each of which produces only one product.<sup>16</sup> If these cost savings from the production of multiple products within a single enterprise are substantial, the enterprise that produces the full range of products will have a competitive advantage over firms that produce only part of the range.<sup>17</sup>

42 Once one has identified a set of products connected by complementarities in demand or supply produced by the firm(s) whose market power is in question one must then ask: which other

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<sup>14</sup> *Re 7-Eleven Stores Pty Ltd, Australian Association of Convenience Stores Incorporated and Queensland Newsagents Federation* (1994) ATPR 41-357 pp 42,672-3.

<sup>15</sup> See Maureen Brunt, “Market Definition’ Issues in Australian and New Zealand Trade Practices Litigation”, *Australian Business Law Review*, Vol 18, 1990, 86-128, at 106-07 and *Sydney International Airport* (2000) ATPR 41-754 at para 97.

<sup>16</sup> See T Gilligan and M Smirlock, ‘An empirical study of joint production and scale economies in commercial banking’, *Journal of Banking and Finance*, Vol 8, 1984, pp 67-77 and T Gilligan and M Smirlock, ‘Scale and scope economies in the multiproduct banking firm’, *Journal of Monetary Economics*, Vol 13, 1984, pp 393-405.

<sup>17</sup> J C Panzar and R D Willig, ‘Economies of Scope’, *American Economic Review*, Vol 71, 1981, pp 268-72. Professor Brunt’s discussion of this issue is particularly helpful. She points out that complementarities in supply (economies of scope) are closely related to substitution in demand and supply. See Maureen Brunt, “Market Definition’ issues in Australian and New Zealand Trade Practices Litigation”, *Australian Business Law Review*, Vol 18, 1990, pp 86-128, at 105-7.



enterprises, because of the range of products they produce, constrain the market power of the firm(s) whose market power is in question? The range of products of other enterprises may constrain market power because, if the first enterprise(s) tried to charge prices above the competitive level, consumers would switch from its products to those of rival producers.

43 Constraints on market power may arise either because of substitution in demand or substitution in supply. Substitution in demand is determined from the perspective of consumers. Products (or groups of products) are said to be substitutes in demand if an increase in the price of one (the first enterprise(s)) leads to an increase in the demand by consumers for the other – because consumers switch their demands from one to the other in response to the change in (relative) prices.

44 Substitution in supply is determined from the perspective of producers. Products (or groups of products) are said to be substitutes in supply if an increase in the price of one leads producers to switch their production capacity from the production of another product over to the production of the product that is now relatively more profitable.

45 If, as is common, the product dimension of a market must embrace a range of products, patterns of substitution in demand and supply can become quite complicated:

It is the possibilities of such substitution [in demand and supply] which set the limits upon a firm's ability to "give less and charge more". Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to "give less and charge more" would there be, to put the matter colloquially, much of a reaction? And if so, from whom? In the language of economics the question is this: From which products and which activities could we expect a relatively high demand or supply response to price change, i.e. a relatively high cross-elasticity of demand or cross-elasticity of supply?<sup>18</sup>

## 2.2.2 The geographical dimension of the market

46 Enterprises that produce (or could readily switch to producing) products that are substitutes for those produced by the enterprise(s) whose market power is in question are not necessarily in the same market as the first enterprise(s). Those other enterprises should only be classified as being in the same market as the first enterprise(s) if they are operating in the same geographical and functional space as the first enterprise(s).

47 Determining the geographical dimension of a market should proceed in a way that is analogous to that of defining the product dimension of the market. That is, one should first identify the geographical boundaries to the relevant activities of the enterprise(s) whose market power is at issue and then seek to determine whether it is economic for customers to switch their purchases to producers in other geographic regions in response to the first firm's attempt to charge monopoly prices.

48 Complementarities in demand and supply are relevant in assessing the geographical dimension of a market for the same reason they are relevant in determining its product dimension. If substantial cost savings can be obtained from operating in multiple geographical areas (compared with the sum of the costs of separate enterprises operating each in a separate area) or if there are substantial

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<sup>18</sup> *Re QDMA*, at 17,247.

complementarities in demand from straddling multiple areas, enterprises will tend to pursue strategies that straddle multiple areas. If these complementarities of demand or supply characterise the operations of the first firm, the market should embrace at least the area over which these complementarities are present.

49 It is sometimes the case that these complementarities are not so great as to compel all firms to embrace similar geographical areas: some enterprises may attempt to gain access to the benefits of the complementarities from geographical spread, whereas others may attempt to gain benefits from specialising in serving a local community. An example may be the way in which national car-hire companies compete with car-hire companies that operate in only one city or town.<sup>19</sup>

50 In that case, the guiding principle of market definition should be its purpose: markets are defined to identify those enterprises that constrain the price and product policy of the enterprise(s) whose market power is at issue. Accordingly, the strategy of the first enterprise(s) should guide the geographical boundaries to the market. In particular, the geographic dimension of the market should be coincident with the geographical scope of the strategy of the enterprise(s) whose market power is at issue. If its (or their) strategy for product range, pricing and promotion is national in scope, one must consider a national market in order to analyse this strategy.

51 Once the geographical boundaries to its strategy have been established, one can then ask who is located in an area that is sufficiently proximate to that of the first enterprise(s) to constrain its price or product policy? Suppose that the national car-hire companies have a nation-wide promotion and product strategy. If the market power of a national car-hire enterprise is at issue, one should define a national car-hire market; but if the market power of a Sydney car-hire firm is at issue, one should define a Sydney market – and include enterprises operating in any areas that are sufficiently proximate to Sydney as to be in a position effectively to constrain the price and product policies of the Sydney-based company.

### 2.2.3 The functional dimension of a market

52 The third principal dimension of a market is its functional dimension. This refers to its stage or stages in the process of production. Any economic activity can be subdivided into a series of stages. The most celebrated instance of this subdivision of economic activity into stages is the example of the pin-maker with which Adam Smith begins Book I of the *Wealth of Nations*:

To take an example, therefore, from a very trifling manufacture; but one in which the division of labour has been very often taken notice of, the trade of the pin-maker; a workman not educated to this business (which the division of labour has rendered a distinct trade), nor acquainted with the use of the machinery employed in it (to the invention of which the same division of labour has probably given occasion), could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty. But in the way in which this business is now carried on, not only the whole work is a peculiar trade, but it is divided into a number of branches, of which the greater part are likewise peculiar trades. One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner,

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<sup>19</sup> See *TPC v Ansett Transport Industries (Operations) Pty Ltd & Ors* (1978) ATPR 40-071. p 17,710.

divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in other the same man will sometimes perform two or three of them.<sup>20</sup>

53 If one were to define markets to analyse the market power of Adam Smith's pin manufacturer, one would first have to establish whether each of the eighteen distinct operations was to be considered a separate market, whether they were to be treated as one integrated activity or whether they were to be allocated among a number of functions. One could not proceed to investigate substitution possibilities until this functional allocation had been made. Substitution possibilities could only be investigated after it had been decided whether one was investigating rivals for the integrated activity of pin-making or, for example, whether one was investigating rivals for the activity of drawing wire.

54 In the case of Adam Smith's pin manufacturing, there is likely to be little disagreement among economists as to the functional boundaries to the market. Sets of transactions form the functional boundaries to markets. Adam Smith suggests that the process of converting wire, paper and labour into a packet of pins is rarely, if ever, divided among multiple enterprises. The various stages in the production process are undertaken within a single enterprise without intervening transactions. This suggests that all the productive activities that are undertaken within Adam Smith's factory should be classified within the one pin-making market.

55 The position is more complicated if some enterprises are vertically integrated across all activities but others are not. The issue arose (famously) in the *Queensland Wire* litigation;<sup>21</sup> and it has arisen in many subsequent cases that involve questions of an enterprise that is not vertically integrated attempting to compete against a vertically-integrated enterprise.

56 In this case, two principles are useful guides. The first is that if there are substantial complementarities in supply in undertaking the two functions within a single enterprise, one should define the market to embrace both functions. The reason for this is similar to that which I gave when dealing with complementarities in supply under the heading of the product dimension of the market: if there are substantial cost savings to be got by straddling both functions, one would expect that the only enterprises that will survive in the long run will be those that straddle both functions. That is, the only competition will be between enterprises that straddle both functions – this is the functional dimension of the field of rivalry.

57 However, the matter may not be so clear-cut. Some enterprises may be attempting to gain competitive advantage through vertical integration and others may be attempting to gain competitive advantage by specialising in one particular function. In that case, if the enterprise(s) whose market power is in question seek to gain economic efficiencies via vertical integration,<sup>22</sup> then

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<sup>20</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1<sup>st</sup> ed 1776, Glasgow Edition, Oxford University Press, 1976, pp 14-15.

<sup>21</sup> An excellent discussion is provided by Professor Brunt in Maureen Brunt, "'Market Definition' Issues in Australian and New Zealand Trade Practices Litigation", reprinted in her *Economic Essays on Australian and New Zealand Competition Law*, pages 226-30.

<sup>22</sup> An economic efficiency is a source of wealth for the whole community. It may be contrasted with a benefit to the enterprise that arises because it increases the ability of the enterprise to bargain for a larger share of a given amount of wealth. The latter is an increase in its market power.

there is a strong presumption in favour of defining the functional boundaries of the market so as to include the range of activities undertaken by that enterprise.<sup>23</sup>

58 This is similar to the principle that I adopted with respect to the geographical dimension of the activities of the enterprise(s) whose market power is at issue. It can be adopted for any of the three principal dimensions of the activities of an enterprise. If enterprises pursue different strategies with respect to their range of products, their geography or their range of functions, one should bear in mind the purpose of market definition. It is to identify the principal competitive constraints on the enterprise(s) whose market power is in question. This suggests that, if there is any doubt, the relevant dimension of the market should be coincident with the activities of the first enterprise(s) – and include any activities which constrain that range of activities.

#### 2.2.4 Time dimension

59 Markets should be defined so as to allow a sufficiently long time period to observe substitution possibilities at work. Economists recognise that competition (and substitution) are not static but dynamic processes. For example, Brunt argues that:

Competition is a process rather than a situation. Dynamic processes of substitution are at work (p.96).<sup>24</sup>

60 Adopting a long run dynamic view of competition is particularly important in telecommunications and broadcasting where rapid technological advancements are occurring which can quickly alter the competitive constraints faced by providers. Markets are changing as technologies develop and new opportunities present themselves.

61 Economists acknowledge that competitive processes take time. Short-term positions of market power arise in many markets from time to time. Some of these serve a useful purpose in encouraging competitive activity – such as new entry to a market or a sub-market.

62 Even if short-lived positions of market power have negative social consequences, antitrust policy is an ineffective policy instrument to deal with such problems. Antitrust policy is only effective in preventing the structure of markets from altering in such a way as to create or enhance positions of market power. For this reason, most economists would agree with the proposition that, if barriers to entry to a market are low the market should not give rise to antitrust concerns. This is not because short-lived problems of market power cannot arise in such markets. Rather, it is that competition works in rough and ready ways and takes time.

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<sup>23</sup> In my respectful opinion, excellent examples of this approach are provided by the Tribunal (Lockhart J) in *Re Queensland Independent Wholesalers Limited* (1995) ATPR 41-438 pages 40,949-40,952 and by the Tribunal (Goldberg J) in *Sydney International Airport* (2000) ATPR 41-754, paras 90-99.

<sup>24</sup> Brunt, M. (1990) *op cit.*

### 3 Application of the principles of market definition

63 In this section I draw on the principles set out in the previous section to determine what I consider to be the relevant markets for the purposes of considering the promotion of competition in the context of the SAU.

#### 3.1 THE STARTING POINT: THE ACTIVITIES OF THE FIRM(S)

64 As I noted in section 2.2 above, I propose to adopt the ‘practical methodology’ suggested by Professor Brunt in defining the markets relevant to assessing the issues of competition and market power that are raised by the SAU. Professor Brunt’s practical methodology suggests that one should begin with a specification of the conduct that provokes the legal question. In this case, the conduct is the offering of the SAU.

65 In the case of the SAU, the natural starting point is the three services that are relevant to the SAU:

- a the carriage services comprising the use of cable or satellite to transmit data;
- b the facilitating services provided by Foxtel; and
- c the digital subscription television services that are supplied by means of (a) and (b).

66 The production of each of these services may be considered as successive activities in a production process – similar to the successive stages in Adam Smith’s stylised process of making pins in the Eighteenth Century. One possibility would be to consider each of these services to be produced and supplied in a separate market. Such an approach would raise the obvious questions as to whether it is appropriate to classify services (a) and (b) in separate markets, and whether it is appropriate to classify (b) as being located in a market that is functionally differentiated from (c). These questions must be considered before one can enquire as to the substitutes in demand and supply that might cause other suppliers to be classified in the same market as the services in question.

67 The exposition in the remainder of this section will follow the reasoning of the preceding paragraph. I shall first enquire whether each of these services should be considered as being produced and sold in a separate (functionally differentiated) market and, once I have explained my reasoning on that point, I shall then consider the substitutes in demand and supply that might constrain the price and product strategies of the provider of the relevant service and should, for that reason, be included in the market in which that service is produced and traded.

#### 3.2 THE MARKET IN WHICH THE CARRIAGE SERVICE IS PRODUCED AND SUPPLIED

68 Foxtel’s proposed SAU is an undertaking to provide DSTUS subject to the access seeker arranging for the carriage of its digital subscription services via digital cable or digital satellite. Foxtel is not proposing to provide carriage services to access seekers under the SAU. This is indicated by clauses 2.3 and 2.4 of the SAU.

69 Clause 2.3 of the SAU states:

FOXTEL undertakes to make available at least the following amount of capacity for the supply of the Digital Set Top Unit Service to access seekers:

- (a) 15% of the total capacity of FOXTEL to supply the Digital Set Top Unit Service during the Simulcast Period; or
- (b) 35% of the total capacity of FOXTEL to supply the Digital Set Top Unit Service after the Simulcast Period,

based on the quantity of digital cable or digital satellite capacity that addresses the relevant STU. It is the responsibility of the access seeker to obtain an equivalent volume of digital cable or satellite capacity as the case may be.

70 Clause 2.4 of the SAU states, among other things:

FOXTEL has no obligation to enter into a Digital Access Agreement with an access seeker unless:

- (a) the access seeker has arranged for the carriage of its digital Subscription Television Services to the Network Termination Point and has provided to FOXTEL, if requested, such proof as FOXTEL may require; and
- (b) the access seeker has provided to FOXTEL:
  - (i) an executed confidentiality agreement in the form of Appendix 3;
  - (ii) a bank guarantee as required pursuant to the Digital Access Agreement; and
  - (iii) a deposit of \$50,000, in cleared funds which amount will be applied towards the access seeker's fees once it commences acquiring the Digital Service under the Digital Access Agreement or, if the access seeker does not commence acquiring the Digital Service and asks FOXTEL to terminate negotiations, will be refundable to the access seeker with interest after FOXTEL deducts any reasonable costs incurred by FOXTEL.

71 The relationship between Foxtel (as the television broadcaster) and Telstra (as the provider of carriage services) is similar to that of many downstream producers and their (upstream) suppliers of inputs. A manufacturer of socks sells the socks to a clothing retailer. The sock manufacturer competes with other sock manufacturers in the sock manufacturing market. The retailer competes with other clothing retailers in the business of the retailing of clothing. Customers of the retailer purchase socks as part of the bundle of services (including location, service, display, cleanliness etc) that the retailer provides. But the retailer competes with other retailers by offering retailing services of a kind that it hopes customers will value and at a cost that allows its business to be viable.

72 In the same way, Telstra produces carriage services and it competes with other producers of carriage services. It supplies these services to Foxtel which uses them as an input in its business of producing and selling a subscription television service. The activities of Telstra as a provider of carriage services and the activities of Foxtel as a provider of television broadcasting services are co-ordinated by means of contract. These contracts mark the (functional) boundary of a market.

73 I shall not investigate the precise boundaries to the market in which the carriage service is produced and traded. I have adopted this course for two reasons. In the first place, access to the carriage service is not affected by the SAU; and, secondly, competition in this market (however it is defined) will not be promoted by acceptance of the SAU.

74 I shall now consider whether service (b) - the facilitating services provided by Foxtel – and service (c) - the digital subscription television services that are supplied by means of (a) and (b) – are produced and supplied in functionally distinct markets. When I have presented my conclusions on that issue, I shall be able to examine substitutes for the relevant services – in both demand and supply.

### 3.3 THE MARKET IN WHICH THE DIGITAL TV SERVICE IS SUPPLIED

75 The activities of Foxtel might be characterised as the production, marketing and distribution of the Foxtel Service.<sup>25</sup> Although, as will be explained below, the introduction of a digital service has enhanced certain characteristics of the Foxtel service and certain extra channels, the nature of Foxtel's activities are substantially the same whether the service is provided in analogue or digital form.<sup>26</sup> I will refer to both the analogue and digital subscription television services as the 'Foxtel service'. Foxtel delivers its retail pay television service by way of cable and satellite.<sup>27</sup>

76 The primary facts that I have been asked to assume suggest that the various channels comprising the Foxtel service are linked together by substantial complementarities in both demand and supply of the kind that can most-efficiently be captured within a single enterprise.<sup>28</sup> As I noted in section 2.2.1 above, the boundaries of a market should not be drawn so as to allocate into separate markets products that are linked together by complementarities of these kinds. The presence of these complementarities suggests that the product dimension of the market should embrace at least the range of channels that Foxtel includes within the Foxtel service.

77 The first reason for my inference of complementarities is that Foxtel sells its programs and channels in the form of packages. The Foxtel Analogue Service comprises a basic package of 25 video channels (plus the programming guide channel on cable) and, on the satellite service, 12 audio channels. In addition, subscribers to the basic package can subscribe to additional channels and suites of channels, as well as a service called Main Event that offers pay-per-view events.<sup>29</sup> Foxtel Digital is structured in a similar manner,<sup>30</sup> and also has extra channels, enhanced features such as a

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<sup>25</sup> The Foxtel Service comprises a package of subscription television services known as 'channels'. Assumption 1.1.

<sup>26</sup> Assumptions 1.6 and 1.7.

<sup>27</sup> Assumptions 1.3 and 1.6.

<sup>28</sup> The reasons for this are explained below.

<sup>29</sup> Assumption 1.5.

<sup>30</sup> Assumption 1.6.

near-video-on-demand service, games service, and interactive services (some of which use the modem).<sup>31</sup>

78 My second reason for inferring complementarities in demand and supply is that the Foxtel service is promoted as a package. The basis of Foxtel's sales strategy is to show potential subscribers that Foxtel offers subscribers more of the television content that they love to watch, when they want to watch it. It highlights the depth and breadth of content available on Foxtel. This involves challenging a potential subscriber's satisfaction with his or her current television options.<sup>32</sup>

79 My final reason for inferring complementarities in demand and supply is the way Foxtel assesses the profitability of its operations.<sup>33</sup> Economic theory suggests that, where products are complements in demand or supply, one cannot assess the profitability of an individual product in isolation from its effect on the profits of other products.

80 The activity of Foxtel in both producing channels and in producing programming for channels raises the question of the functional dimension to the activities of Foxtel. In particular, to what extent can Foxtel's activities in producing programming and producing channels be considered independently from its activity in producing, marketing and distributing the Foxtel service?

81 I have formed the opinion that the activities of Foxtel in producing programming and producing channels cannot be considered independently from its activity in producing, marketing and distributing the Foxtel service. I have come to this conclusion for two reasons. In the first place, Foxtel has chosen to produce some of its own programming and channels because it believes it is profitable to do so.<sup>34</sup> The likely source of this increase in profits is from an increase in economic efficiency. Secondly, the primary facts that I have been instructed to assume suggest that Foxtel is increasingly competing with the free-to-air networks by controlling the programming that it makes available by the Foxtel service.<sup>35</sup> Key aspects of this control over programming are its production of programming and its production of channels available on the Foxtel service.

82 Foxtel has four groups of purchasers whose willingness to pay for its products may be affected by its producing channels and programming in-house. Its four principal groups of purchasers are:

- a. subscribers who pay installation fees and monthly subscription fees as well as pay-per-view and *Foxtel Box Office* charges;
- b. advertisers who place advertising on its constituent channels;
- c. other pay television operators who purchase licences to the Foxtel Platform; and

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<sup>31</sup> Assumption 1.7.

<sup>32</sup> Assumptions 9.6, 9.7 and 9.9.

<sup>33</sup> This is discussed further in section 4.2.3 below.

<sup>34</sup> Assumptions 5.5 and 5.6.

<sup>35</sup> Assumption 5.5.



- d. other pay television operators who purchase licences to channels that are produced by Foxtel.<sup>36</sup>

83 The willingness to pay for the Foxtel service (or for a channel produced by Foxtel) is the sum of the willingness to pay of each of these four principal sources of revenue. If Foxtel can undertake an initiative that generates an increase in willingness to pay greater than the increase in costs, that initiative will generate value and enhance the efficiency with which society allocates its resources.

84 I have been instructed that it is expensive for Foxtel to produce its own channels. Nevertheless, Foxtel sometimes judges that the extra expenditure that is required is worth it in order to exercise increased control, editorially, creatively or operationally over the channel so that it can better react to changing market demands.<sup>37</sup>

85 In a similar manner, Foxtel sometimes judges that it is worth the extra expenditure that is required to produce its own channel when Foxtel is unable to readily source a channel to meet a known audience demand and where it wants a channel to have a uniquely Australian personality. “In producing its own channels, Foxtel can control the branding of the channels, the interstitials, the look and feel of the program and the channel and creative element. It would also initiate programs that would attract publicity.”<sup>38</sup>

86 These assumptions suggest that Foxtel’s activity in producing its own programming and channels is a means of generating a competitive advantage by undertaking activities that increase the gap between the cost of the activity and the willingness to pay for the products of that activity. Furthermore, these assumptions suggest that this efficiency is of the kind that can only be produced by Foxtel’s undertaking of this range of activity. This is the basis of my opinion that the functional dimension of the market in which Foxtel competes should embrace the production, marketing and distribution of the Foxtel service – including its activities in producing its own channels and programming.

87 I am instructed that the Foxtel service is distributed by both cable and satellite.<sup>39</sup> Although there are some slight differences between the cable and satellite services available by analogue,<sup>40</sup> the services are identical in their digital form.<sup>41</sup> For my purposes, I shall assume that there is no substantial difference between the services that are distributed by cable and those that are distributed by satellite. The SAU clearly contemplates the provision of the DSTUS in either case.

88 I am instructed that the Foxtel service is not distributed by Foxtel throughout Australia. It is distributed via the Telstra Cable in Sydney, Melbourne, Brisbane, the Gold Coast, Adelaide and

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<sup>36</sup> Assumption 1.12.

<sup>37</sup> Assumption 4.2(f).

<sup>38</sup> Assumption 4.2(h).

<sup>39</sup> Assumption 1.3.

<sup>40</sup> Foxtel does not transmit all the FTA channels by satellite. Assumptions 1.8 and 1.9.

<sup>41</sup> Assumption 1.9.

Perth.<sup>42</sup> The Foxtel service is available via satellite to homes in Sydney, Melbourne, Brisbane, Adelaide, Perth, Canberra, Geelong, Newcastle, the NSW central coast, and prior to December 2003, some of regional WA, and since December 2003, all of WA.<sup>43</sup>

89 Because the Foxtel service does not vary substantially depending on the location of the subscriber, there are substantial complementarities in supply in providing the service to various locations. Indeed, the costs of the production and marketing of the service are common to almost all subscribers regardless of their location. For this reason, I would characterise the geographical boundary to the market in which Foxtel produces, markets and distributes the Foxtel service as Australia wide.

90 I am instructed that Foxtel does not currently service Austar's regional and rural areas, except for the Gold Coast<sup>44</sup> so I do not, by my definition of the geographical boundaries to the above market, wish to give any impression to the contrary. Nevertheless, because of the substantial supply complementarities, one must consider Foxtel's production, marketing and distribution of the Foxtel service as one coherent group of activities throughout Australia; that is, it is appropriate to characterise this market as Australia wide.

91 This section of my Report has attempted to characterise the productive activities of Foxtel as a first step in the process of defining a market in which competition might be promoted. I have characterised these activities as the production, marketing and distribution of the Foxtel service (including the production of the in-house Foxtel programs and channels) throughout Australia.

### **3.4 ARE THE FACILITATING SERVICES PROVIDED BY FOXTEL FUNCTIONALLY SEPARATE FROM THE DIGITAL SUBSCRIPTION TELEVISION SERVICE?**

92 In the preceding section I characterised the activities of Foxtel as comprising the production, marketing and distribution of the Foxtel Service. In this section, I shall address the question as to whether Foxtel's activities in supplying the DSTUS can be regarded as functionally separate from the rest of its activities.

93 To deliver subscription television and other services to its subscribers, Foxtel undertakes a number of activities that facilitate the transmission of content to its subscribers. Apart from procuring carriage services from Telstra via its cable network and satellite carriage services, Foxtel undertakes certain activities on its own behalf that 'facilitate' the carriage of the digital signals to provide the services to its subscribers. These 'facilitating services' are described as Digital Set Top Unit Services (DSTUS). The DSTUS (as defined in Schedule 2 of the Foxtel Digital Access Agreement appended to the SAU) consists of:

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<sup>42</sup> Assumption 1.4

<sup>43</sup> Assumption 1.4.

<sup>44</sup> Assumption 13.1.

- a Set Top Unit Services (the use of Set Top Units and customer cabling to provide the interface between the Network Termination Point and the subscriber's television or VCR);
- b Conditional Access Services, consisting of Conditional Access (CA) Services, Service Information (SI) Services, Smartcard Authorisation Verification Information Services;
- c EPG Services (incorporation of the access seeker's channel information into the Foxtel Electronic Program Guide);
- d Modem Services (which enable use of the modem in the Digital Set Top Unit).

94 It is convenient to consider each of these services separately and to ask whether each or all of these services should be considered functionally separate from the activity of providing the Foxtel Service.

95 I am instructed that Foxtel's commercial business model is based on its owning the STU and providing the STU to its subscribers. That is, Foxtel has created a business model that seeks to gain synergies from integrating the functions of providing the Foxtel Service and providing the STU. Foxtel has adopted this model for the following reasons:

- a to subsidise the cost of the STU so as to reduce the upfront cost to the subscriber in order to encourage subscriptions;
- b 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;
- c to enable Foxtel to upgrade its technology by software downloads to the STU on a regular basis at no cost to the subscriber, and by replacing the physical STU at the end of its service life, making the platform more attractive to subscribers and content providers;
- d to enable Foxtel to monitor the specifications of the STUs and the quality of their installation to ensure consistent and quality reception;
- e given the STUs are single purpose devices, Foxtel can redeploy the STUs on churn rather than leave unused STUs in lapsed subscribers' homes. As churn is a common feature of the subscription television industry, and because the useful life of the STU (approximately 5-7 years) exceeds the average life of a Foxtel subscription, such redeployment is typical. For these reasons, continued ownership of the STU by Foxtel reduces costs and is efficient; and
- f Foxtel operates in a relatively infant and underpenetrated market – consequently it is important for Foxtel to act as a 'market maker' for STUs as it cannot rely on alternative sales channels to stock STUs in the quantity and across the geographic range necessary for Foxtel to reach its growth targets.<sup>45</sup>

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<sup>45</sup> Assumption 1.15.

96 This strategy, and the reasons underpinning it, suggest that Foxtel's activity of producing and selling the Foxtel Service and its activity of supplying STUs should be considered within the same market. Foxtel judges that it is more efficient to co-ordinate these two activities within one enterprise than to co-ordinate them by means of contract across two separate enterprises.

97 The CA system used by Foxtel is obtained by means of licence from a large global provider. However, for security and operational reasons, the CA licence is network-specific (that is, unique to a single network).<sup>46</sup> Furthermore, certain elements of the Foxtel STUs are hard-wired so that they function only with the CA system to which Foxtel has a licence.<sup>47</sup> In addition, only Foxtel STUs use the same security keys as Foxtel uses and therefore can utilise Foxtel's CA and SI.<sup>48</sup>

98 These facts strongly suggest that Foxtel's activities in (i) supplying the Foxtel service; and (ii) supplying STUs and the CA and SI services should be considered within a single market. Nothing is to be gained from the point of view of economic analysis by considering them as taking place in separate markets; and much is to be lost. In particular, by considering these activities as occurring in separate markets, an analyst would be discounting the efficiencies that Foxtel hopes to reap by undertaking these activities within a single enterprise. Although I shall include these services as part of the function of Foxtel in providing the Foxtel Service, it will be seen below that this classification makes little or no difference to the conclusions that I reach.

99 There is a further reason why the activities of Foxtel in producing and supplying the DSTUS should be classified as part of the same function as the other activities that are part of the provision of the Foxtel Service. This is that the activities of Foxtel in providing STUs and licensing a CA system are undertaken solely for the purpose of its subscription television service.<sup>49</sup> This means that the competitive constraints that confront Foxtel in the production and supply of its subscription television service are likely to come from the same source as the competitive constraints that confront Foxtel in the production and supply of its carriage services. In effect, both Foxtel and its competitors are best analysed as integrated production, marketing and distribution organisations - except to the extent that they purchase services from other enterprises.

100 The relation of patterns of competition in an input market to patterns of competition in an output market has arisen in a number of proceedings before the Tribunal. In the Tribunal's *Review of TPC notice: B.H.P./Koppers purchasing agreement* (1981) ATPR 40-203, the Tribunal considered a submission from the applicants that was as follows:

If a basic material A is supplied exclusively to a company producing B from which C is then derived and C competes with product F which is derived in turn from E which comes from D, then A and D are competitive probably within the one market even though A cannot be used to produce E and D cannot be used to produce B ... The economic implications of this are that monopolistic price exploitation at the primary level will be subject to strict limits because of indirect competition against

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<sup>46</sup> Assumption 1.16.

<sup>47</sup> Assumption 1.17. I am instructed that this is true of other subscription television systems worldwide.

<sup>48</sup> Assumption 1.18.

<sup>49</sup> Assumption 1.16.

the rival product stream ... Tertiary market competition is accordingly most important in judging the proper field of competition and the definition of the market.<sup>50</sup>

101 The Tribunal commented on this submission:

We accept Koppers' submission in principle. Indeed it is very much in accordance with the formulations of the "market" concept contained in earlier Tribunal determinations: see especially *Re QCMA and Defiance Holdings* (1976) ATPR 40-012, at p 17,247; *In re Tooth & Co. Ltd., In re Tooheys Ltd.* (1979) ATPR 40-113, at pp. 18,196-18, 197.

102 The same issue arose, in the context of an application for coverage for the purposes of the Gas Code of the Duke Eastern Gas Pipeline. The decision of the National Competition Council was appealed to the Tribunal as *Duke Eastern Gas Pipeline Pty Ltd* (2001) ATPR 41-821. The Duke Eastern Gas Pipeline (EGP) transported gas from the Gippsland Basin to Sydney. The Tribunal found that the Moomba Sydney Pipeline (MSP) also transported gas to Sydney – but from the Moomba field. A key issue before the Tribunal was the extent to which pricing of the services provided by the EGP was constrained by pricing of the MSP. The Tribunal concluded that:

EGP will not have sufficient market power to hinder competition based on the commercial imperatives it faces, the countervailing power of other market participants, the existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect. As EGP does not have market power, the Tribunal cannot be satisfied that coverage would promote competition in either the upstream or downstream markets.<sup>51</sup>

103 In my opinion, the reasoning of the Tribunal in such decisions as *Koppers* and *Duke Eastern Gas Pipeline* should be applied to any consideration of the market in which the DSTUS is supplied because they are consistent with economic principles. That is, one can only consider the competitive constraints faced by Foxtel in its provision of the DSTUS after one has considered the extent to which the services carried by Foxtel via its DSTUS face competition from services carried by other carriage services.

104 For the purposes of defining markets for considering whether the SAU will promote competition, the activity of providing the DSTUS should be considered part of Foxtel's provision of the digital subscription television service – as it is integral to the delivery or distribution of this service. I propose to include the DSTUS as part of the market in which Foxtel supplies its digital subscription television service.

### 3.5 COMPETITIVE CONSTRAINTS UPON FOXTEL'S ACTIVITIES

105 In seeking to define the market in which competition may be promoted as a result of the acceptance of the SAU, I have first defined the range of activities undertaken by Foxtel. I have defined these activities as the production, marketing and distribution of the Foxtel service throughout Australia. In this sub-section of my Report I shall seek to identify the constraints upon these activities. Once the constraints upon these activities have been identified, the process of

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<sup>50</sup> Quoted by the Tribunal at p 42,825.

<sup>51</sup> *Duke Eastern Gas Pipeline Pty Ltd* (2001) ATPR 41-821 at 43,070.

defining the market in which Foxtel produces and supplies its carriage service and its subscription television service will have been completed.

### 3.6 DO THE FREE-TO-AIR BROADCASTERS CONSTRAIN THE PRICE AND PRODUCT POLICIES OF FOXTEL ?

106 I am instructed that Foxtel has existed for a decade.<sup>52</sup> In that time its relationships with other television companies (both free-to-air and pay TV) have been marked by a mix of co-operation and competition.<sup>53</sup> In particular, the mix of competition and co-operation with the pay TV operators on the one hand and the FTA networks on the other hand has changed markedly during that time. I shall explain in this section the reasons for my opinion that, throughout the decade of its existence, Foxtel (and the other pay TV broadcasters) have been under strong competitive pressure from the FTA networks. However, the relationships among the pay TV broadcasters have changed from relationships characterised primarily by competitive rivalry to relationships characterised more by co-operation. At the current time, the principal competition facing the pay TV broadcasters is from the FTA networks.

107 In the decade since Foxtel began operations the identity and product range of the pay TV operators have changed markedly. Australis, which first listed on the Australian Stock Exchange in 1993,<sup>54</sup> went into receivership on 18 May 1998<sup>55</sup>; and TARBS, which began operations in 1999,<sup>56</sup> went into receivership in July 2004.<sup>57</sup>

108 From 1 December 2002, the pay television providers (apart from Foxtel) were Optus, Austar, Neighborhood Cable, TransACT and Telstra Pay TV.<sup>58</sup> Each of these had entered into an agreement with Foxtel by which they had access to substantial Foxtel content. The relevant agreements are as follows. The Foxtel/Optus CSA was to last for 8 years from 1 November 2002.<sup>59</sup> On 7 April 2005, Foxtel and Optus announced that Optus has a right to extend the agreement by another three years to 31 December 2013.<sup>60</sup> The various arrangements between Foxtel and Austar provide for each to sublicense the other with key channels.<sup>61</sup> Neighbourhood Cable,<sup>62</sup> TransACT,<sup>63</sup> and Telstra Pay TV<sup>64</sup> each has the right to retail the Foxtel service.

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<sup>52</sup> Assumption 1.2.

<sup>53</sup> This is the theme of a well-known text book: Barry J Nalebuff and Adam M Brandenburger, *Co-opetition*, Harper Collins, 1997.

<sup>54</sup> Assumption 2.1.

<sup>55</sup> Assumption 2.2.

<sup>56</sup> Assumption 2.3.

<sup>57</sup> Assumption 2.4.

<sup>58</sup> Assumption 1.14 and 13.1

<sup>59</sup> Assumption 14.2(a).

<sup>60</sup> Assumption 14.3(h).

<sup>61</sup> Assumptions 1.12(d), 13.2, 13.3, 13.5, 13.6, 13.9 and 13.10.

109 During the decade of its existence, the relationship between Foxtel and the FTA networks has changed greatly. I am instructed that the total number of Foxtel subscribers has grown steadily up to 895,294 at June 2004.<sup>65</sup> At this same time, Optus had 195,149 subscribers and Austar had 406,523 subscribers.<sup>66</sup>

110 The growth in the number of Foxtel subscribers has changed aspects of the competitive relationship between Foxtel and the FTA networks. I am instructed that XYZ produces Australian pay TV channels; and it is jointly owned by Foxtel and Austar.<sup>67</sup> However, XYZ is still at a disadvantage when bidding for certain pre-existing programming compared with the Commercial and National Broadcasters because of the larger number of viewers that those broadcasters can generate and the consequent larger stream of revenue they are able to generate per program.<sup>68</sup> This competitive disadvantage of XYZ is likely to diminish as its number of subscribers increases.

111 Another example of the changing relationship between Foxtel and the FTA networks is a change in the willingness of the FTA networks to share live sports rights. I am instructed that, since 1995, the Australian sporting bodies with the most valuable sports rights have usually sought to sell both pay and FTA rights to broadcast their sport. As subscriber numbers have increased, pay television has become more acceptable to sporting bodies as medium for broadcasting their sport.<sup>69</sup>

112 A third example of the changing relationship between Foxtel and the FTA networks is the change in the attitude of Commercial Broadcasters to carrying advertising for the Foxtel analogue service. I am instructed that this was initially refused. Only since 1997 have the Commercial Broadcasters regularly placed advertising for Foxtel. The Commercial Broadcasters continue to place restrictions on the forms that this advertising may take.<sup>70</sup>

113 I have formed the opinion that the FTA networks do constrain the price and product policies of Foxtel in various ways and, for this reason, should be classified as operating in the same market as Foxtel. The activities of the FTA networks affect the profitability of Foxtel by making its costs higher and its revenues lower than they would otherwise be. The constraints on the profits of Foxtel that are imposed by the FTA networks cause me to classify the FTA networks as operating in the same market as Foxtel. These reasons are spelt out in the remainder of this section.

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<sup>62</sup> Assumption 1.12(d).

<sup>63</sup> Assumption 1.14(c).

<sup>64</sup> Assumption 1.14(a).

<sup>65</sup> Assumption 15.

<sup>66</sup> Assumption 15.

<sup>67</sup> Assumption 7.1.

<sup>68</sup> Assumption 7.5.

<sup>69</sup> Assumption 4.11.

<sup>70</sup> Assumption 9.10.

***Reason One: Competitive bidding by the FTA networks substantially increases the cost to Foxtel of acquiring certain inputs.***

114 Profit is the difference between revenue and costs. Anything that enables this difference to be widened will increase profits; and anything that decreases this difference will decrease profits. To the extent that competition from the FTA networks increase the prices that Foxtel pays for its inputs, they constrain the profits that it is able to earn.

115 With respect to programming, I am instructed that Foxtel's preference is to acquire first run rights to programs because the first run of a program is more popular than a repeat. Nevertheless, in the past Foxtel has generally been unable to acquire first run rights because of past deals or because it has been outbid by the Commercial FTA broadcasters.<sup>71</sup> More recently, Foxtel has been able to acquire first run rights to a number of programs and series; and these have frequently been acquired by outbidding one or more of the Commercial or National broadcasters.<sup>72</sup> The position has been different in relation to movies distributed by the major distributors. In that case, the broadcast rights are generally released to pay television following DVD and video but before the Commercial and National broadcasters.<sup>73</sup> I do not wish to give the impression that Foxtel is constrained by the FTA networks in the prices that it pays for every category of its programming. Rather, I point to certain input prices over which bidding by the FTA networks acts as a constraint on the activities of Foxtel.

***Reason Two: Competition from the FTA networks is the principal reason why Foxtel seeks to produce its own programming.***

116 The second reason for my opinion that the FTA networks should be classified as within the same market as Foxtel for the purpose of assessing the SAU is that competitive bidding by the FTA networks substantially increases the cost to Foxtel of acquiring certain inputs – in particular, rights to sporting content. However, there are other ways in which competition with the FTA networks increases Foxtel's costs and thereby constrains its profits. Chief among these is the effect of competition from the FTA networks on Foxtel's policy to screen original content, where the phrase 'original content' refers to programs that have not previously been shown on FTA TV or on other pay TV platforms in Australia.<sup>74</sup>

117 I am instructed that Foxtel considers that it needs original content to differentiate its service from those provided by the FTA broadcasters and to enable it to control programming release windows. In particular, Foxtel considers that it needs to commission original content in areas that are not well provided for by the FTA broadcasters, namely music, comedy, documentary and children's programming, so as to differentiate itself from the services provided by the FTA broadcasters.<sup>75</sup>

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<sup>71</sup> Assumption 4.4.

<sup>72</sup> Assumption 4.10.

<sup>73</sup> Assumption 4.6.

<sup>74</sup> Assumption 5.1.

<sup>75</sup> Assumptions 5.1 and 5.2.



118 In the past, Foxtel has at times worked in partnership with FTA broadcasters, in order to defray the production costs of new Australian material, especially new Australian drama.<sup>76</sup> However, Foxtel has become increasingly concerned that these arrangements do not assist Foxtel to attract or retain viewers. In December 2003, it implemented a new policy to focus its drama allocation on first-run original programming rather than relying on re-runs of programs previously shown on FTA television.<sup>77</sup>

119 This suggests that, as the growth in its subscription base permits, Foxtel is increasingly trying to differentiate its programming from those of its FTA competitors. That is, Foxtel's programming choices are being affected by the programming choices of the FTA networks.

***Reason Three: Foxtel is constrained by the lobbying of the FTA networks.***

120 Another way in which competition from the FTA networks increases the costs of Foxtel is through their lobbying activity – in particular, their lobbying to secure the introduction and continuation of the anti-siphoning regime. I am instructed that, although Foxtel has been involved in lobbying to change this regime, the FTA broadcasters have opposed these proposed changes.<sup>78</sup> Similarly, the FTA broadcasters have lobbied to reduce restrictions on multi-channeling; and Foxtel has opposed these changes.<sup>79</sup>

***Reason Four: Foxtel competes with the FTA networks in attracting viewers.***

121 My first three reasons why the FTA networks should be classified as operating in the same market as Foxtel related to constraints they imposed on Foxtel's costs and programming choices. My fourth reason is that the FTA networks impose constraints on Foxtel's revenue – in particular, revenue from subscribers.

122 Foxtel derives revenue from sources that are different from those of the FTA networks. As shown in Table 1 below, Foxtel is currently generating around **[confidential]** of its revenue in the form of subscriptions. Apart from revenue share forgone,<sup>80</sup> the other three substantial categories of revenue are (i) installation and service revenue; (ii) advertising revenue; and (iii) channel sub-licence and programming sales.

123 The differing sources of revenue do not indicate that the two categories of broadcaster are in different markets. Although Foxtel is principally reliant on revenue from subscriptions and the FTA networks are principally reliant on revenue from advertising, each of these sources of revenue is critically dependent on gaining viewers.

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<sup>76</sup> Assumption 5.4.

<sup>77</sup> Assumption 5.5.

<sup>78</sup> Assumptions 11.6 and 11.7.

<sup>79</sup> Assumption 11.8.

<sup>80</sup> Revenue share foregone refers to payments from Telstra to Foxtel in consideration of Foxtel agreeing to Telstra stopping the cable roll out early.

124 The alternative sources of revenue available to television broadcasters are similar to Corden's analysis of newspapers.<sup>81</sup> Newspapers compete for readers and for advertisers. In a similar way, Foxtel competes with FTA broadcasters for both viewers and for advertisers. Just as FTA networks constrain the conduct of Foxtel, so we observe newspapers competing against each other when one charges a cover price and the other is distributed free of charge.<sup>82</sup>

125 A standard form of evidence as to whether products are substitutes in demand is to estimate cross-price elasticities of demand. These measure the extent to which consumers (in this case subscribers) switch from one product to another in response to changes in prices. I was provided with data with which I sought to estimate cross-price elasticities of demand – that is, the extent to which consumers switched from pay TV to FTA television in response to changes in the price of pay TV. I asked Associate Professor Joseph Hirschberg to assist me with this analysis. Upon investigation, we discovered that changes in Foxtel's price were generally introduced together with changes in the Foxtel service. This meant that we could not estimate cross-price elasticities in the standard way; and, accordingly, we abandoned the attempt.

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<sup>81</sup> See section 2.2.1 above.

<sup>82</sup> See *ACCC v Rural Press Limited* (2001) ATPR 41-085, in particular paras 5, 9, 38 and 42.

[Confidential]

Table 1 Foxtel's sources of revenue \$000s

*Source: FOXTEL profits and loss accounts*



- 126 Despite the absence of estimates of cross-elasticities of demand, the facts that I have been asked to assume suggest that the FTA networks do constrain the ability of Foxtel to attract subscribers. For example, Foxtel seeks to attract subscribers by comparing its products with those of the FTA networks. I am instructed that the basis of Foxtel's sales strategy was to show potential subscribers that Foxtel offered subscribers more of the television content that they love to watch, when they want to watch it. This involved challenging a potential subscriber's satisfaction with his or her current television options, which in the majority of cases included the channels broadcast by the FTA broadcasters.<sup>85</sup> I am also instructed that Foxtel runs advertisements that draw comparisons with FTA television.<sup>84</sup>
- 127 The conclusion that I draw from these facts is that, although Foxtel's revenue is derived principally from subscriptions and the Commercial networks derive their revenue principally from advertising, the FTA networks compete closely with Foxtel in seeking viewers.
- 128 I am also instructed that the programming schedules on the Foxtel owned and operated channels reflect counter-scheduling by Foxtel in reaction to the programming of the FTA broadcasters.<sup>85</sup> To some extent, Foxtel's ability to counter-schedule programming has been limited by its need to settle its programming schedules six to eight weeks in advance for publication in the monthly Foxtel subscriber magazine, whereas the commercial broadcasters only need to settle their schedules two weeks in advance to meet the "TV Week" deadlines.<sup>86</sup> In certain circumstances, Foxtel will break with its published schedule to counter significant programming on a FTA broadcaster.<sup>87</sup>
- 129 I am instructed that three channels carried by Foxtel – Fox 8, TV1 and arena – most closely reflect the programming profiles of the Commercial broadcasters, particularly in the evening and prime time timeslots and particularly in relation to the programming of general entertainment programs. Programs scheduled on these Foxtel channels were strategically selected to compete with the programs scheduled on the commercial free-to-air networks in order to attract the same or similar viewers.<sup>88</sup>
- 130 I am instructed that, by at least October 1999, Foxtel perceived that digital FTA TV posed a substantial competitive threat to Foxtel, primarily because it raised the prospect of the FTA broadcasters being able to engage in datacasting and multi-channelling. I am instructed that, in broad terms, datacasting is the provision of enhancements to a program signal by broadcasting that

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<sup>83</sup> Assumption 9.6.

<sup>84</sup> Assumption 9.11.

<sup>85</sup> Assumption 6.1.

<sup>86</sup> Assumption 6.2..

<sup>87</sup> Assumption 6.3.

<sup>88</sup> Assumption 6.4.

signal together with information (in the form of data) which consumers could access. Multi-channelling in broad terms is supplying a package of channels to consumers.<sup>89</sup>

131 I am instructed that Foxtel also saw its digital service as an opportunity for Foxtel to expand the range and improve the quality of its services, which would assist it to compete with FTA TV, other pay TV services and also with video and DVD rentals and purchases.<sup>90</sup> Foxtel proceeded to create and launch a digital service that was designed to offer much greater value to subscribers than they could get from the FTA networks.<sup>91</sup> I discuss the implications of this for market definition in section 3.5.1 below.

132 Although the price and ratings data have not enabled me to estimate cross-elasticities of demand in the normal manner, the assumptions that I have referred to suggest that the willingness of viewers to switch between FTA television and the offerings of Foxtel constrain the price and product policies of Foxtel. In particular, substitution in demand between the Foxtel service and the FTA offerings is suggested by the methods by which Foxtel promotes its service, its practice of counter-scheduling and its strategy for the introduction of digital television.<sup>92</sup>

***Reason Five: Foxtel competes with the FTA networks in attracting advertisers.***

133 The FTA networks also constrain the ability of Foxtel to attract advertisers. As in the Corden model of competition between newspapers, competition between Foxtel and the FTA networks for viewers is closely related to the competitive constraint imposed by the FTA networks on Foxtel's ability to attract advertisers.

134 The connection between the number of Foxtel's subscribers and its revenue from advertising is confirmed by a comparison of the data in Table 1 with the data showing the growth revenue from subscriptions. Foxtel's advertising revenue has increased as its penetration rate has grown. I am instructed that Foxtel's budgets for 2002, 2003 and 2004 incorporate increased advertising revenue as a reflection of an increased penetration rate.<sup>93</sup>

135 The facts that I have been instructed to assume suggest that advertising on the FTA networks may attract advertisers with needs that differ somewhat from advertisers that might be attracted to use Foxtel. Multi Channel Network Pty Ltd (MCN) was established in March 1997 to sell advertising on behalf of a number of channels on the Foxtel Analogue Service and the service provided by Austar.<sup>94</sup> I am instructed that, in dealings between agencies and MCN, agencies frequently suggest that the advantage of FTA advertising over pay TV is that FTA networks have state based feeds

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<sup>89</sup> Assumption 8.1.

<sup>90</sup> Assumption 8.1.

<sup>91</sup> Assumptions 8.1 and 8.4.

<sup>92</sup> I have considered whether substitution in supply is relevant to the definition of the market in this case; and I have formed the opinion that it is not.

<sup>93</sup> Assumption 10.21.

<sup>94</sup> Assumption 10.1.

and have a broader reach. In response, MCN seeks to emphasise the benefits of pay TV, including in relation to price, the ability to more specifically target an audience, better ‘cut-through’ (advertisements are more likely to be recalled because there are fewer advertisements) and the opportunity to build an association with a particular sport.<sup>95</sup>

136 Despite this evidence that suggests differentiation of the advertising product, the facts that I have been asked to assume suggest that the price that Foxtel is able to charge for advertising is determined by that charged by the FTA networks for a similar number of expected viewers of a particular demographic.

137 I am instructed that MCN sells spot advertising, which is a standard television commercial usually 30 seconds in duration. It also sells sponsorship advertising, which typically involves the sponsor being acknowledged as the sponsor at the beginning and end of a program by way of billboards as well as spot advertising throughout the program.<sup>96</sup>

138 In formulating the recommended advertising rates for the channels it represents, MCN seeks to estimate the advertising rates being charged by the commercial FTA networks for the same relevant demographic. The method of comparison is by reference to the cost to reach 1,000 viewers, known as the “CPM”.<sup>97</sup> The primary emphasis in setting rates by MCN is to ensure that the rates and thereby the CPM being established are competitive with those being charged by the FTA networks.<sup>98</sup> MCN finds it difficult to sell advertising at a price greater than the CPM charged by a FTA network; and MCN considers that a represented channel would be selling advertising time too cheaply if the price were below that charged by a FTA network.<sup>99</sup>

139 It is commonly observed that one test of substitution is the extent to which prices are correlated across suppliers.<sup>100</sup> In this case, the evidence that the price an advertiser must pay for access to a thousand viewers is broadly similar across different categories of broadcaster supports the inference that purchasers of these two types of advertising regard them as being good substitutes.

140 In this instance, this inference is not complicated by the standard objection that the movements in the prices over time may be correlated because each is driven by, for example, similar movements in the costs. In this case, the identity of the prices across different categories of broadcaster seems to invite the inference that advertising on the two categories of broadcasting are close substitutes.

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<sup>95</sup> Assumption 10.19.

<sup>96</sup> Assumption 10.3.

<sup>97</sup> Assumption 10.5.

<sup>98</sup> Assumption 10.6.

<sup>99</sup> Assumption 10.7.

<sup>100</sup> The seminal paper is George J Stigler and Robert A Sherwin, “The Extent of the Market”, *Journal of Law and Economics*, Vol 28, 1985, pp 555-586.

### 3.6.1 Does Foxtel's introduction of its digital television subscription service affect the definition of the market?

141 Apart from the reasons given in the preceding section, Foxtel's introduction of its digital television service also provides evidence of the type of competition faced by Foxtel. By May 2002, Foxtel had formed the view that it needed to create a new, digital product with better picture and sound, more channels and interactivity in order to address the slowing of subscriber growth.<sup>101</sup>

142 Foxtel saw free-to-air television as its principal competitor; and FTA was due to launch digital service on 1 January 2001. Foxtel saw digital pay television as an opportunity for Foxtel to expand the range and improve the quality of its pay television services, which would assist it to compete with FTA television, other pay television operators and also with video and DVD rentals and purchases.<sup>102</sup>

143 Foxtel believed that the dominant entertainment products competing with the Foxtel Analogue Service were the channels provided for free by the Commercial Broadcasters, but that other competing entertainment products included the channels of the National Broadcasters and video and DVDs (as these also occupied the viewing time of television viewers). Foxtel saw the existence of fee alternatives of the Foxtel Analogue Service from the Commercial and National Broadcasters as representing a major '*roadblock*' to attracting viewers to the Foxtel Analogue Service and was concerned that this product was not achieving the necessary '*cut through*' in terms of exciting consumers and convincing them to subscribe and view.<sup>103</sup>

144 Foxtel introduced its digital product with a desire to design a product that would as much as possible reduce this '*roadblock*' by delivering a television entertainment product that offered significantly better '*value for money*' than the current product to draw viewers to Foxtel.<sup>104</sup>

145 Foxtel also saw as an increasing threat, DVD-based television entertainment.<sup>105</sup> The advent of DVD technology in Australia also saw the release of movies for sale move forward in time ahead of release on FTA television, pay TV and Pay-Per-View.<sup>106</sup>

146 Foxtel then went about creating a new differentiated product that might represent a better value to price proposition to viewers.<sup>107</sup> Foxtel's strategy was reflected in the design of its digital product. Based on its own market research and the experience of UK operator BskyB, Foxtel believed that to achieve the goal of increasing the penetration rate of Foxtel (which involved a combination of

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<sup>101</sup> Assumption 8.2.

<sup>102</sup> Assumption 8.1.

<sup>103</sup> Assumption 8.3.

<sup>104</sup> Assumption 8.3.

<sup>105</sup> Assumptions 8.1, 8.2 and 8.5.

<sup>106</sup> Assumptions, Annexure A.

<sup>107</sup> Assumption 8.6.



increasing subscriber numbers and decreasing churn) Foxtel Digital would have to dramatically increase the value that it offered subscribers compared to the Foxtel Analogue Service and, more importantly, other television entertainment products.<sup>108</sup> This included a combination of features including:

- a Additional channels, to differentiate it from the FTA broadcasters by delivering more programming and choice.<sup>109</sup> Digital technology facilitated this.
- b Enhanced (and interactive) services, also to differentiate it from the FTA broadcasters by offering choice and control over what was displayed on the television. Enhanced elements include for example, 'active' modes for channels; an electronic programming guide; and a games service.<sup>110</sup>
- c Near-video-on-demand ('Foxtel Box Office'), as a response primarily to the increasing popularity of DVDs which had 'eroded' the 'value and attractiveness of the linear movie channels'.<sup>111</sup>

### ***Implications for market definition and competition analysis***

147 In my opinion, Foxtel's introduction of its digital service is a classic example of the dynamic process of competition in the relevant market – where participants in the market jockey for position (or a competitive advantage) by seeking to respond to changing consumer preferences, making investments to develop products and services for which there is perceived to be greater demand and willingness to pay, in the hope of enticing consumers away from their competitors, at least in the short-run.

148 In my view, this evidence suggests two things:

- a that Foxtel operates in a highly dynamic market where it is constrained in its behaviour by other subscription broadcasters, FTA broadcasters and other forms of television entertainment (such as DVDs); and
- b that Foxtel's investment in developing its digital service was an effort to obtain a (temporary) competitive advantage over the FTA broadcasters.

149 Foxtel moved to obtain a (temporary) competitive advantage over its FTA competitors by offering a product that was intended to be more valuable to television viewers who had not been moving to take up subscriptions to Foxtel at the rate that had been hoped for. Foxtel was compelled by its competitors to re-evaluate its 'price-value equation' and to differentiate this product from

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<sup>108</sup> Assumption 8.3.

<sup>109</sup> Assumption 1.6.

<sup>110</sup> Assumption 1.5.

<sup>111</sup> Assumption 1.5 It was intended that this service would draw viewing time away from videos and DVDs and to Foxtel. Assumption 1.7 (description), 12.4 (on the advantage of video/DVD rental over Foxtel's 'linear movie services'), 12.5, 12.6 (The role of *FOXTEL Box Office* in seeking product differentiation and a competitive advantage).

competing products such as FTA programming and DVD movies. The digital service was designed essentially to 'give more' and 'charge less' (in a relative sense) than their existing analogue service.

150 The introduction of the digital service, in my view, reflects the dynamic process in a market, of competitors reacting to threats and opportunities presented by changing technology and consumer preferences and the actions of competitors. Foxtel was seeking to 'meet' the competition. The evidence also shows the nature and main sources of the constraints on Foxtel's ability to exercise any market power, being the competing offers of FTA broadcasting and other forms of television entertainment.

151 Differentiated products can give a supplier some competitive advantage. Foxtel introduced its digital service in order to try gain a competitive advantage over the FTA networks. However, competitive advantages are difficult to sustain in competitive markets. In such a market, changes in technology, consumer preferences and actions of competitors can quickly erode one's market share. By 'going digital', Foxtel is trying to remedy the factors that led to stagnation in its subscriber growth – that is, it is seeking to offer better picture and sound quality, building in greater interactivity, more channels for the money.

152 As I noted in section 2.2.4, where temporary competitive advantages are part and parcel of the process of competition, the market needs to be defined with a longer-term focus in order to take into account the threats and constraints over time, the transient nature of any competitive advantages at a single point in time, and the role of investment in the introduction of new products and infrastructure in the process of rivalry.

### **3.7 CONCLUSION: THE MARKET IN WHICH FOXTEL'S DIGITAL TELEVISION SUBSCRIPTION SERVICE COMPETES**

153 I have now defined a market in which Foxtel's television subscription service and facilitating services are produced and supplied. Foxtel's digital television subscription service offers a range of enhancements on its analogue television subscription service. However, the market in which the services compete is the same market.

154 I have sought to define a market which identifies the constraints on the activities of Foxtel in its production and supply of its digital television subscription service. The relevant activities in this case are those concerned with Foxtel's production, marketing and distribution of the Foxtel service. Foxtel's activities in producing, marketing and distributing the Foxtel service are bound together by substantial complementarities in demand and supply. The activities of Foxtel include both the selling of content (the Foxtel subscription television service) and the delivering of this content (DSTUS and buying carriage from Telstra).

155 Foxtel is constrained in its activities by all television broadcasters - including both FTA and subscription broadcasters. In recent times, it has also become more constrained by other forms of entertainment, or television entertainment such as DVD sales and rentals. Nevertheless, the strongest constraints seem to be from other television broadcasters.

156 Foxtel has relationships with the other Australian pay TV broadcasters that are a mix of competition and co-operation. Its relationships with the FTA networks are principally competitive. Competition from the FTA networks increases the cost of Foxtel's programming; competition

from the FTA networks affects the types of programming that Foxtel shows; and competition from the FTA networks affects the revenue that Foxtel is able to generate – both from subscriptions and from advertising. Of most relevance to this enquiry is that competition from the FTA networks was a key influence on the form and timing of the introduction of Foxtel’s digital subscription television service.

157 The strategies of both the pay TV broadcasters and the FTA networks so constrain the price and product policies of Foxtel that they should be classified as operating in the same market as Foxtel. This market embraces the activities of producing, marketing and distributing television broadcasting services – both digital and analogue.

158 In undertaking this range of activities, Australian television broadcasters constrain the price and product policies of Foxtel by limiting the freedom that Foxtel has to reduce its costs or increase its revenue. I shall refer to this group of activities as the Australian television broadcasting market.

159 By drawing these boundaries to the Australian television broadcasting market, I do not wish to give the impression that competition stops at the borders of the market. I acknowledge, for example, that video and DVD stores may constrain the activities of the television broadcasters in their showing of movies<sup>112</sup> – and that Foxtel’s introduction of its digital service was, in particular, a response to increased competitive pressure from DVDs. Rather, I have sought in defining the market in this way to identify the principal competitive constraints on the price and product policies of Foxtel for the purpose of assessing the effect of the SAU on the promotion of competition.

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<sup>112</sup> Assumptions 12.4-12.10.

## 4 Whether the SAU would promote competition

160 This section seeks to determine the extent to which the SAU is likely to promote competition. For the reasons that I gave in the preceding section, I shall confine my investigation of the effects on competition to the Australian television broadcasting market.

161 First I set out the economic principles that apply in considering competition and the objective of promoting competition. I then apply these principles to the question of whether competition in the Australian television broadcasting market would be promoted by the SAU.

### 4.1 PRINCIPLES OF PROMOTING COMPETITION

162 I am instructed that the promotion of competition requires a consideration of the future states of competition in the relevant market with and without the declaration. The present state of competition however may be informative of the likely future states of competition.

#### 4.1.1 What is competition?

163 The essence of competition is the process of rivalry between providers that constrains prices and costs. These constraints generally arise from the availability of alternative sources of supply, the substitutability of these alternative supplies in the eyes of consumers, and knowledge on the part of consumers of the available alternatives.

164 The process of rivalry (the behaviour of enterprises) is very much dependent on the structure of the market in which those enterprises compete. Standard analysis of the effectiveness of competition will examine: (i) features of market structure – such as concentration, barriers to entry and so on; (ii) patterns of behaviour of the enterprises within the market; and (iii) the profit performance of the enterprises in the market.<sup>113</sup>

165 Economics views market power and competition as opposites: “market power and competition are but the inverse of each other”.<sup>114</sup> One way of thinking about whether competition would be promoted would be to consider whether market power would be reduced.

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<sup>113</sup> For a standard exposition of the links between market structure, market conduct and market performance see F M Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3<sup>rd</sup> edition, Houghton Mifflin Company, 1990, 4-7.

<sup>114</sup> Maureen Brunt, “Market Definition’ Issues in Australian and New Zealand Trade Practices Litigation”, *Australian Business Law Review*, 1990, Vol 18, No 2, 86-128, at 95.

- 166 A standard benchmark for economists in illustrating the process of competition and how it benefits consumers is the purely competitive model of economic analysis.<sup>115</sup> In this model, there are numerous well-informed sellers and buyers of a homogeneous good. Under these assumptions any differences in the prices of sellers are transitory and prices tend toward the minimum costs of provision.<sup>116</sup> Any attempt by an individual seller to raise price above prevailing prices will result in the well-informed buyers switching their consumption to other sellers so the price difference would be eventually eliminated. Moreover, this competitive process will encourage firms to seek more efficient modes of production as they will be able for some time to earn higher than normal profits at the pre-existing price.<sup>117</sup> However, as other firms (and perhaps new firms attracted by the high profits) adopt the more efficient means of production, prices will eventually come to match the new minimum costs.
- 167 The purely competitive model is rarely observed in practice and certainly does not reflect conditions in television broadcasting. However, the benefits to consumers (i.e. prices based on minimum costs and pressure for more efficient production) have been shown to hold under a broad range of assumptions and models.<sup>118</sup> The common theme in all these models is that rivalry or the threat of rivalry constrains the ability of a provider or providers to more than temporarily raise price above cost or lower quality.
- 168 In practice, firms do not simply compete on the basis of price but also through attributes such as quality, service, and the timeliness of delivery. Moreover, competition does not only occur between providers of identical products or services. Firms offer consumers a variety of products that seek to better match their demands. This means that consumers' evaluations will not be confined to a comparison of price but extend to the actual or perceived ability of the product or service to suit their needs or wants. What matters in any such case is the substitutability in use as perceived by consumers.

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<sup>115</sup> For a more detailed discussion of this model see most undergraduate introductory economics textbooks, for example, Gans J., S. King and N.G. Mankiw (1999), *Principles of Microeconomics*, Harcourt Brace.

<sup>116</sup> It is important to remember that the costs referred to here are the payments to all factors of production, including capital, which are necessary to keep the factors employed in the particular activity. Hence, these costs, as conceived by economists, include 'normal' profits.

<sup>117</sup> In fact, at a price slightly below the pre-existing price, the firm can earn even higher profits by bidding business away from competitors. The latter would have to adopt the more efficient processes as well or otherwise face losses (and bankruptcy).

<sup>118</sup> For example, it is not necessary that there are numerous firms actually competing head-to-head. Firms in a market which is susceptible to entry from potential rivals can face similar pressures. See Baumol, W.J. (1982) "Contestable markets: an uprising in the theory of industry structure", *American Economic Review*, 72(1), March.

### 4.1.2 Competitive advantage

169 In effectively competitive markets one would observe ongoing actions by firms to obtain a competitive advantage over their rivals.

170 More specifically, competition encompasses: (i) the process by which an enterprise seeks to develop (temporary) sources of competitive advantage (that generate profits in excess of the opportunity cost of shareholders' funds); and (ii) the process by which other enterprises seek to emulate sources of competitive advantage and, thereby, eliminate any rates of return in excess of the opportunity cost of shareholders' funds.

171 In developing a competitive advantage one may increase market power at least in the short run. In effect, the prospect of (short-lived) market power creates the incentive for firms to undertake the risky activity of innovation.

### 4.1.3 The meaning of the phrase 'promotion of competition'

172 The essence of competition is the process of rivalry or potential rivalry between providers which acts to constrain revenues and costs. It follows that if the SAU were to increase competition, then it would need to change the underlying basic conditions (demand and costs) or the structure of the market to make it more competitive. If the market were already competitive, actions which advantage or disadvantage individual providers without making the basic conditions or the structure of the market more competitive (for example, through changes in the costs of entry) would not affect competitive outcomes (i.e. prices, quality, etc.).

173 I am instructed that, in considering whether the SAU will promote competition in any market, I should adopt the meaning given to that phrase by the Tribunal in *Sydney International Airport*.

174 In *Sydney International Airport* (2000) ATPR ¶41-754, the Tribunal stated that the notion of 'promoting' competition in the context of s 44H(4)(a) under Part IIIA of the Act does *not* require there to be:

...an advance in competition in the sense that competition would be increased. Rather the Tribunal considers that the notion of "promoting" competition in s 44H(4)(a) involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.<sup>119</sup>

175 In *Seven Network Limited* (No 4) [2004] AcomptT 11 (23 December 2004) (at para 123 and 124), considering the LTIE test applied by the ACCC in their decision to

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<sup>119</sup> *Sydney International Airport* (2000) ATPR ¶41-754 at para 106.

grant an exemption under s152ATA, the Tribunal accepted that its definition of ‘promotion of competition’ that it had made in *Sydney International Airport* with respect to that phrase in Part IIIA also applied to the phrase in Part XIC. Citing the same passage above from *Sydney International Airport* the Tribunal stated:

In our view, this description is apt for the criterion established under s 152ATA(6) and s 152AB(2)(c). In addition, we consider that this description is equally applicable to assessing whether the “particular thing” encourages economically efficient use of, and investment in, infrastructure pursuant to s 152AB(2)(e).

## 4.2 DEGREE OF COMPETITION IN THE BROADCASTING MARKET WITHOUT THE SAU

176 In order to assess whether the SAU might promote competition in the television broadcasting market, one must compare the likely extent of competition in the future with the SAU with the likely extent of competition in the market without the SAU.

177 One indication of the degree of competition in the market in the absence of the SAU is the extent to which those with access to the bottleneck service have been able to exercise market power in the past. In this section of my Report, I shall assess the market power of Foxtel during the recent past. I have defined market power (following the well-known definition of the United States Attorney-General’s National Committee) as the freedom from competition which gives an enterprise the power to choose its level of profits by giving less and charging more.

178 I shall examine various indicia of market power; and I shall classify these indicia according to the structure-conduct-performance schema that I discussed in section 4.1.1. I shall first examine indicia of Foxtel’s market power based on the structure of the market that I have defined for this purpose in the preceding sections: the Australian television broadcasting market. I shall then examine the behaviour of Foxtel to see if that gives indications of market power. I shall then examine the profit record of Foxtel to see if that is consistent with the proposition that Foxtel has a substantial degree of power in its market.

### 4.2.1 Structural indicia of Foxtel’s market power

179 As I noted in section 4.1.1 of this Report, one of the principal elements of market structure is the number and size distribution of buyers and sellers. If products are differentiated, these measures may be misleading because some producers may be competing in product space that is somewhat distant from those of others. As I noted in the preceding section, the assumptions that I have been given suggest that the television broadcasters do compete with each other by differentiating their products. In particular, the broadcasting services offered by subscription broadcasters are differentiated to some extent from the broadcasting services offered by the FTA broadcasters.

## Whether the SAU would promote competition

180 As I noted in the preceding section, there are multiple dimensions to the constraints that the FTA networks place on Foxtel. I have chosen to use the number of viewers as a proxy for these various dimensions. As noted in that section, the number of viewers affects subscription revenue (of pay TV providers), the advertising revenue of FTA and subscription broadcasters and the ability of FTA and subscription broadcasters to bid for programming. For these reasons, it is appropriate to use ratings as indicative of market shares in the Australian television broadcasting market.

181 I have been provided with data of market shares in the Australian television broadcasting market. Frontier Economics was provided with an electronic version of the OzTam ratings data. The data were provided in two separate panels: the Metropolitan Panel and the National Subscription TV panel. I enlisted the assistance of Amar Breckenridge of Frontier Economics to assist me in the analysis of this data.

182 I was instructed that the Metropolitan Panel was designed to be representative of the population of the metropolitan centres of Australia and, accordingly, includes both subscription TV and non-subscription TV homes in proportion to the penetration rate of subscription TV. This panel currently comprises approximately 3,000 households.<sup>120</sup> The data from the Metropolitan Panel are broken down into the following categories: All TV, subscription TV, ABC, Seven, Nine, Ten and SBS.

183 The OzTam data comprise estimates of viewing numbers for each half-hour block of a viewing day, where one viewing day runs from 2.00 am to 1.59 am of the following calendar day. We used data for the thirty-three week period from 30 May 2004 to 15 January 2005, the last date for which data were available.

184 We discovered some inconsistencies in the data. In particular, the total number for All TV viewers was always greater than the sum of viewers for each of the categories of broadcaster. We sought further instructions as to the cause of this inconsistency. We were instructed that it was caused by two principal factors:

- a. certain viewers are included in the sample are able to pick up both network broadcasters and regional broadcasters, so they are included as watching TV while they are not necessarily watching a network broadcaster; and
- b. certain viewers in the sample were watching local community channels.

To deal with these discrepancies, we created an extra category, 'other', which is the difference between the sum of the viewing of the listed broadcasters and the total number of households recorded as viewing.

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<sup>120</sup> We decided not to use the data from the National Subscription TV Panel because that comprised only viewing in homes that subscribed to pay TV.



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The data for each week are listed Annexure D to this Report. The market shares varied from week to week as shown in Figure One.

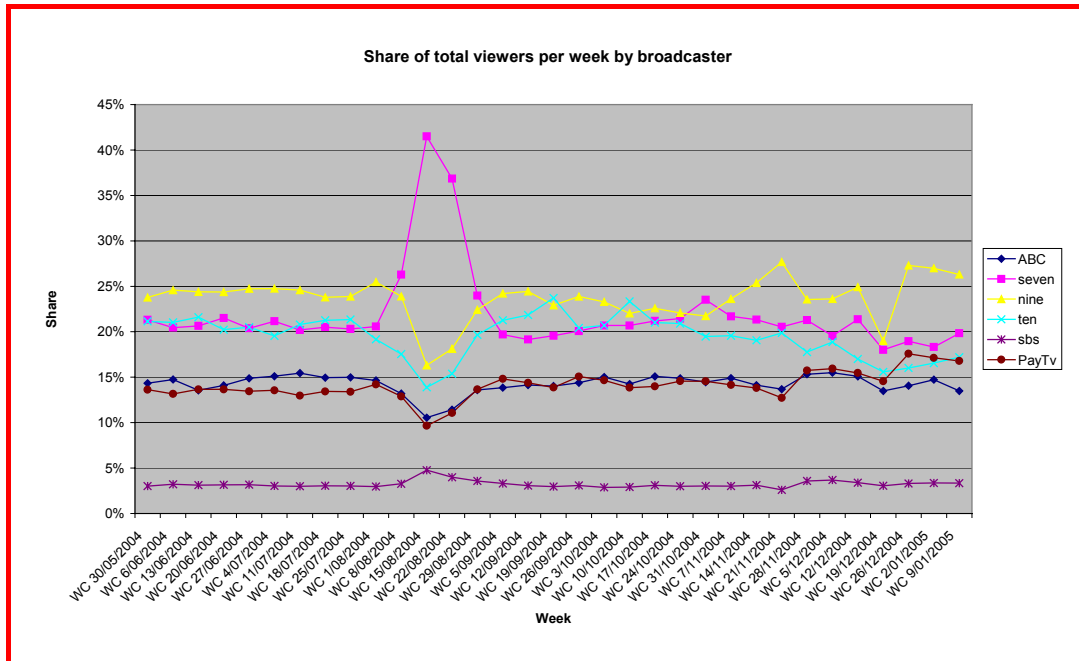


Figure 1: Share of total viewers per week by broadcaster

Source: OzTAM metropolitan panel

186 Table 2 presents the average of the weekly data.

Broadcaster	Percentage of Viewers
ABC	14
Seven	22
Nine	24
Ten	20
SBS	3
Pay TV	14
Other	3
Total	100

Table 1: Percentage of viewers in OzTAM metropolitan panel 30/5/04 to 15/01/05

Source: OzTAM

187 Our analysis of the OzTAM data showed that pay TV attracted an average of 14 per cent of viewers during the period – much the same as the ABC. The proportion of viewers watching the Foxtel service would be less than this. The percentage of viewers captured by pay TV seems to be increasing during the period of the data.

188 Market concentration data give some insight into the strength of competition among the incumbents in the market. Competitive pressure can also come from potential entrants to a market. So an investigation of the structure of a market will usually cover at least both market concentration and the condition of entry.

189 Entry to the Australian television broadcasting market is not easy. There are two obvious forms of barriers to entry: (i) government policy as reflected in statute and regulation and (ii) a combination of economies of scale coupled with sunk costs.

190 The first, and most obvious, form of barrier to entry is government policy. I am instructed that the *Broadcasting Services Act 1992* (Cth) (BSA) is the principal instrument governing broadcasting services in Australia.<sup>121</sup> Commercial, community, subscription and international broadcasting services require individual licences.<sup>122</sup> There are 27 licence areas for television across Australia

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<sup>121</sup> Assumption 3.1

<sup>122</sup> Assumptions 3.3 and 3.4.

and the BSA limits the number of commercial television licences in any licence area to a maximum of three.<sup>123</sup>

191 The second type of barrier is formed from a combination of economies of scale/scope coupled with sunk costs. Economies of scale arise because once the content of a program or a channel is produced, the cost of supplying it to an extra household is very low or zero. Economies of scope arise because, once a distribution system is established, the cost of adding an extra channel (in the case of pay television) is relatively low.<sup>124</sup> By themselves, economies of scale and scope do not create barriers to entry: they merely require entry on a large scale if entry is to be sustainable. But they can form a barrier if they are combined with significant sunk costs, that is, costs that are not recoverable upon exit from the market.

192 The observations I have presented above regarding government policy and economies of scale and scope have implications for the extent to which potential entry into the market is liable to constitute a competitive constraint. In the presence of economies of scale and scope, entry must occur on a large scale if it is to constitute a competitive constraint on incumbents. Entry on a large scale in free-to-air broadcasting is not feasible due to the nature of licensing conditions. In the case of subscription broadcasting, licensing conditions are less of an issue; however entry on a large scale is unlikely to be attractive when one considers that large scale entry in subscription broadcasting has to date not been profitable for incumbents (see section 4.2.3 below for evidence regarding profitability). Entry in subscription broadcasting on a small scale, is unlikely to be sustainable in the presence of economies of scale and scope, and is therefore not likely to constitute a competitive constraint on incumbents.

193 In summary, the facts that I have been asked to assume suggest that the barriers to entry to the Australian television broadcasting market are high. This would mean that potential entrants to the market are not likely to exercise a constraint on the market power of Foxtel. Nevertheless, the Foxtel service attracts less than 14 per cent of viewers. This suggests that rivalry from other incumbents in the market may act as an effective constraint on the market power of Foxtel. That is, the structure of the Australian television broadcasting market does not suggest that Foxtel has any particularly great discretion in bidding for programming or in pricing its outputs for subscribers and advertisers.

#### **4.2.2 Behavioural indicia of Foxtel's market power**

194 Direct observation of forms of competitive conduct can serve as indicia of the presence or absence of market power.

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<sup>123</sup> Assumption 3.2.

<sup>124</sup> See Cento Veljanovski, *Pay TV in Australia, Markets and Mergers*, Institute of Public Affairs, 1999, pp 27-28.

195 In section 3.5, I referred to conduct on the part of Foxtel and its competitors (in particular, the FTA networks) that suggested that the FTA networks should be included in the same market as Foxtel. In that section I expressed the opinion that Foxtel faced competition from the FTA networks in its activities of:

- a. bidding for rights to broadcast major Australian sporting events on television;
- b. bidding to acquire programming;
- c. lobbying government;
- d. attracting subscribers; and
- e. attracting advertisers.

In addition, the behaviour of Foxtel in launching its digital product indicated that it was reacting to constraints imposed by the behaviour of the FTA broadcasters. I proceeded to express the opinion that these various constraints affected the prices that Foxtel paid for programming, the extent to which Foxtel produced or commissioned original content, the prices that it could charge subscribers and the prices that it could charge advertisers.

196 Section 3.5 referred to these factual assumptions in the context of an analysis of the definition of the market for the purpose of assessing Foxtel's market power. My analysis of the factual assumptions led me to form the opinion that the FTA networks (along with the other pay TV broadcasters) should be included in the market in which Foxtel produces, markets and distributes the Foxtel service.

197 Although I have defined the Australian television broadcasting market to include the FTA broadcasters, it does not follow from this definition that the FTA networks effectively constrain the market power of Foxtel. However, the factual assumptions I reviewed in that section suggest that Foxtel is constrained to a significant degree by the behaviour of the FTA networks in particular. I shall not repeat that discussion in this section – except to note that it is relevant to an assessment of the market power of Foxtel – as it was relevant to the determination of market boundaries.

198 In my opinion, the behaviour of participants in the Australian television broadcasting market suggests that Foxtel faces keen competition from its fellow incumbents - and from the FTA networks in particular. This competitive pressure increases the prices that Foxtel pays for rights to televise major sporting events, increases the prices that Foxtel pays for programming, affects the kinds of programming screened by Foxtel, decreases the price that Foxtel can charge for subscriptions and decreases the prices that it can charge for advertising.

### 4.2.3 Evidence of monopoly profits

199 Market power is the freedom to choose one's level of profits – by giving less and charging more – free of the constraint of competition. Competition limits the freedom of an enterprise (or group of enterprises) to choose its level of profits because competitors (and potential competitors) will seek to emulate the sources of competitive advantage. This definition of market power suggests a direct way of assessing whether Foxtel has had market power, which may perhaps be by virtue of its access to the bottleneck service. The method is to examine Foxtel's profit record directly to see whether it has enjoyed the sort of profits that it might choose – where profits refers to the rate of return on funds invested. There is no evidence that Foxtel has been able to choose its level of profits in this manner.

200 However, caution must be exercised in using accounting data to draw any inferences about monopoly profits. In my opinion, the best approach to determining whether Foxtel has earned monopoly profits is to examine its cash flows. The cleanest approach is to remove any interest payments from the cash flows. This enables all financing costs (both debt and equity) to be considered in the same way. The cash flows reported in Table 3 below include both operating and capital expenditure and do not include financing costs.

**[CONFIDENTIAL]**

Table 3: Foxtel's cash flows net of any financing costs

*Source: Foxtel Profit and Loss Accounts*

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**[CONFIDENTIAL]**

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**[CONFIDENTIAL]**

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**[CONFIDENTIAL]**

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**[CONFIDENTIAL]**

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**[CONFIDENTIAL]**

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**[CONFIDENTIAL]**

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The profit data and projections of Foxtel are consistent with the conclusion that I drew above from the structure of the Australian television broadcasting market and from the behaviour of the competitors within that market. Although barriers to entry to this market seem to be high, the internal rivalry among the competitors within this market is reasonably strong. The result of this competition is that Foxtel has been, and continues to be, struggling to make even a competitive return on the funds that its shareholders have invested (and plan to invest) in it.

#### 4.2.4 Conclusions as to state of competition in the television broadcasting market without the SAU

- 208 Competitive pressure in a market can come from incumbents in that market or from potential entrants to the market.
- 209 Competitive pressure from potential entrants to the Australian television broadcasting market is relatively weak. Barriers to full-scale entry by a television broadcaster are very high. These barriers take the form of government licensing (in particular, of FTA broadcasters) and the high sunk costs coupled with economies of scale in the operation of a subscription broadcaster.
- 210 The various television broadcasters differentiate the services they offer by a variety of factors such as: (i) content; (ii) the locations in which the service is offered; (iii) whether it is analogue or digital – and the range of characteristics offered by a digital service; (iv) whether it is FTA or subscription.
- 211 The subscription sector of the overall television broadcasting market has existed for just over a decade. Its profit performance has been poor. This seems to be due principally to strong competitive pressure from the FTA broadcasters.
- 212 The Commercial FTA broadcasters attract far more viewers than the largest of the subscription broadcasters. This enables them to generate far more advertising revenue than is available to the subscription broadcasters. This advertising revenue creates a vicious cycle for the subscription broadcasters and a virtuous cycle for the Commercial FTA broadcasters. The lower the audience for subscription broadcasters (the greater the audience for commercial FTA broadcasters), the lower (higher) is their advertising revenue. The lower (higher) the advertising revenue, the more (less) revenue they have to generate from subscriptions and the less (greater) the amount of money they have available to bid for popular programming.
- 213 The result of these vicious (virtuous) cycles is that subscription broadcasters, such as Foxtel, have struggled to become viable – when viability is taken to mean providing a return to shareholders that covers the opportunity cost of the funds they have invested. There is little prospect that this position will change in the foreseeable future.

#### 4.3 EFFECT OF THE SAU ON COMPETITION IN THE TELEVISION BROADCASTING MARKET

- 214 I am now in a position to assess the effect of the SAU on competition in the market in which Foxtel's subscription television service competes – that is, the Australian television broadcasting market. As I have observed in the preceding section of this Report, the segment of this market in which Foxtel has positioned its activity is subject to vigorous competition – in particular, from the FTA broadcasters. The result of this vigorous competition, is that Foxtel has been unable to produce a positive cash flow (net of financing costs) for the first



decade of its existence; and it has little prospect of securing a return to compensate it for the opportunity cost of its shareholders' funds in the foreseeable future.

215 In making this observation, I do not wish to give the impression that all participants in the Australian television broadcasting market are subject to similar competitive pressure.<sup>125</sup> I merely observe that the subscription television segment is subject to severe competitive pressure.

216 The most-obvious effect of the SAU on competition in the television broadcasting market is that it would facilitate entry into the activity of producing a digital subscription television service in competition with Foxtel. This is not to say that the SAU would encourage *de novo* entry by a full-scale subscription television broadcaster. The disastrous profit records of Optus and Foxtel would be sufficient to discourage entry into this segment of the television broadcasting market.

217 Furthermore, the SAU will do little or nothing to reduce barriers to entry to this market. As I noted in the preceding section of this Report, the principal forms of barriers to entry are (i) government licensing; and (ii) the combination of economies of scale/scope coupled with sunk costs. Although sunk costs may be reduced somewhat through the sharing of the digital carriage service, the sunk costs associated with long-term contractual commitments to secure supplies of content would remain.

218 Although the SAU is highly unlikely to encourage *de novo* entry by a full-scale subscription television broadcaster, it is possible that the SAU will facilitate entry in the future by niche broadcasters who specialise in particular types of content. I am instructed that one such niche broadcaster (TVN) has entered under the digital access arrangements.<sup>126</sup>

219 For the SAU to facilitate entry by a specialist niche broadcaster, two conditions would need to hold. In the first place, the SAU would have to make entry more attractive than the provisions for access that would otherwise exist. I am instructed that in December 2002, Foxtel gave undertakings to the ACCC under s87B of the *Trade Practices Act 1974 (TPA)* in connection with its approval of the CSA. The 87B Undertakings included an Analogue Access Undertaking and a Digital Access Undertaking. Both of these undertakings still stand.<sup>127</sup>

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<sup>125</sup> Indeed, it may well be that these effects are quite asymmetric – that is, that the subscription television broadcasters face a great deal of competitive pressure from the FTA broadcasters but the FTA broadcasters are under little competitive pressure from the subscription broadcasters.

<sup>126</sup> Assumption 14.5.

<sup>127</sup> Assumption 14.4.

220 I am instructed that the terms of the SAU are similar to, but more commercially attractive to a potential entrant than the terms of the 87B Undertaking. In particular, the SAU:

- a includes access to “modem” services, allowing access seekers to use the modem in the STU in order to provide return-path interactivity;
- b sets out the term of access (including price) to Foxtel’s electronic program guide (*EPG*) rather than relying on “good faith” negotiation;
- c extends the term of access from 5 years to between 5 and 8 years at the access seeker’s election and also gives access seekers a unilateral right to terminate on 1 month’s notice; and
- d allows access seekers to use any satellites with a footprint over Australia (not just the C1 satellite).<sup>128</sup>

221 The second condition that would need to hold if the SAU were to facilitate entry by a specialist niche broadcaster is that the niche broadcaster must expect to generate more revenue from retail access than it would from wholesale access. The circumstances in which this second condition might hold may not be immediately obvious – because retail access would mean that the new entrant would be unable to take advantage of economies from the joint marketing that would be available from wholesale access.

222 In order to overcome this disadvantage and for retail access still to be more attractive to a potential entrant than wholesale access, there would need to be a substantial difference between the potential entrant’s estimation of the value of the content (judged by the willingness to pay of viewers) and the estimation of Foxtel. If these estimates were at all close, Foxtel would be prepared to offer the potential niche broadcaster a (wholesale) price for the content that would make wholesale access more attractive than retail access.

223 Differences in valuation may well arise. In particular, those who develop new products often do so because they believe they will be well-received. For this reason, it is quite possible that they are far more optimistic about the reception their products will receive than would be some third party – such as a full-scale subscription television broadcaster.

224 These two conditions suggest that acceptance of the SAU is likely to facilitate entry by specialist niche broadcasters who are more optimistic about the reception their products are likely to receive than would be a full-scale subscription broadcaster. In such a case, the SAU would enable the niche broadcaster to sell its product direct to subscribers without the need to persuade the full-scale television broadcaster that the product was a winner.

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<sup>128</sup> Assumption 14.6.

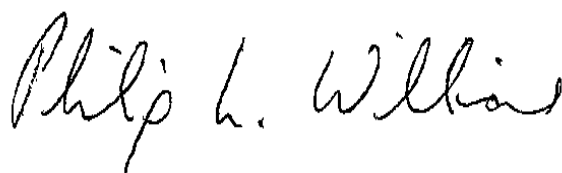
#### 4.4 CONCLUSIONS ON THE EFFECT OF THE SAU ON COMPETITION IN THE TELEVISION BROADCASTING MARKET

225 The SAU may promote competition in the Australian television broadcasting market by facilitating entry by niche broadcasters into the subscription segment of that market.

226 It is unlikely that this effect will be very great. The SAU will only facilitate entry by niche broadcasters that: (i) find the conditions for digital access under the SAU more attractive than they would be under the 87B undertaking; and (ii) place a much higher estimate on the value of their content than do the incumbent subscription broadcasters.

227 Entry by these niche broadcasters is unlikely to have a large effect on competition in the television broadcasting market as a whole. Subscription television is a relatively small segment of the television broadcasting market; and subscription broadcasters have been, and are likely to continue to be, under a great deal of competitive pressure from commercial FTA broadcasters, other subscription broadcasters and (in the area of movies) DVD suppliers.

228 However, I have been instructed that the construction of the phrase 'promotion of competition' adopted by the Tribunal involves merely the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the test is whether the opportunities and environment for competition given the SAU, will be better than they would be without the SAU. Because I have been instructed to adopt this test, I have to conclude that the SAU will promote competition in the television broadcasting market because it will facilitate entry to that market by niche subscription broadcasters



Signed \_\_\_\_\_

Philip L. Williams, 5 October 2005.





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