

Emerging market structures in the communications sector

A report to Senator Alston,
Minister for Communications,
Information Technology and the Arts

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Glossary

The following table describes acronyms and terms used in this report.

3G	Third generation is a mobile communications network that is capable of transmitting voice, data and multimedia services using radio spectrum. The identification of mobile communications technology evolution is defined in generations, with 3G following the first and second generations.
ABA	Australian Broadcasting Authority
ABS	Australian Bureau of Statistics
ACA	Australian Communications Authority
ADSL	Asymmetric Digital Subscriber Line is a digital technology that supports high speed services over conventional copper telephone lines. It is a high bandwidth downstream service (towards the customer) with a lower bandwidth upstream service. That is, the service is asymmetrical.
AFL	Australian Football League
Analogue	A term used to describe a continuously variable signal that directly represents a wave form. Contrasts a digital signal which is represented in the form of a stream of binary digits.
ASTRA	Australian Subscription Television and Radio Association
ASX	Australian Stock Exchange
BAG	Broadband Advisory Group

Bandwidth	The physical characteristic of a telecommunications system that indicates the speed at which information can be transferred. In analogue systems, it is measured in cycles per second (Hertz) and in digital systems in binary bits per second (Bit/s).
Basic access	The service connecting consumers to a PSTN network for a standard telephony service.
BSA	<i>Broadcasting Services Act 1992</i>
BTCE	Bureau of Transport and Communications Economics, which subsequently was included in DCITA.
CAN	The Customer Access Network enables the connection of telephones and other customer premises equipment to switching technology. It consists of a network of conduits and pipes in the ground with a mixture of cables containing copper wires and fibre optics.
Carrier	Holder of a carrier licence granted under the <i>Telecommunications Act 1997</i> .
CAS	The conditional access system is incorporated into STUs to control the supply of pay TV services. There are two main components of a CAS: the subscriber management system and a smart card.
CDMA	Code Division Multiple Access is a technical standard for a second generation mobile communications network.
CHAMP	Castle Harlan Australian Mezzanine Partners
Commission	Australian Competition and Consumer Commission
CPI	Consumer Price Index
CSA	Refers to the Content Supply Agreement between Foxtel and Optus.
CSP	A Carriage Service Provider as defined under the <i>Telecommunications Act 1997</i> .
Datacasting services	A range of interactive services, such as news, financial and weather information and educational programs that are provided using the broadcasting spectrum.
DCITA	Department of Communications, Information Technology and the Arts
Digital transmission	The representation of a signal in the form of a stream of binary digits. The opposite is an analogue signal.
Downloading	Retrieval over a telecommunications network of any data, text, software, music, graphic or other multimedia application.
EPG	Electronic Program Guide

FCC	Federal Communications Commission (telecommunications regulator in the United States)
Fibre optic	Cable made of glass fibres through which signals are transmitted as pulses of light.
FTA	Free-to-air television is television broadcasts that are intended to be received by viewers free of charge at the point of consumption.
GSM	Global systems for mobiles is a technical standard for a second generation mobile communications network. The technology has been adopted by much of the world with the exception of the USA.
HDTV	High definition television is a generic term that may refer to analogue or digital television and provides improved resolution to a standard definition television. It also provides audio quality approaching that of compact discs.
HFC cable	A Hybrid Fibre Coaxial cable network consists of both fibre optic and coaxial cabling. Fibre optic cable may be used to the local exchange or up to the curb, with coaxial cable running from either of these points to the customer's premises.
IP network	A network that uses Internet Protocol, which is the method or protocol by which messages are sent across the Internet or similar networks. The Internet is a public IP network.
ISDN	The Integrated Services Digital Network is a network that has evolved from the PSTN. ISDN services enable end users to send and receive information at faster speeds and with greater reliability than is possible using the standard PSTN service. ISDN services are used for the carriage of information such as voice, data, high quality sound, text, still images and video.
ISP	An Internet Service Provider is a company that provides individuals and companies with access to the Internet. They may offer other related services such as website building and hosting. The services of ISPs accessed by modem and telephone line from a customer's premises are referred to as 'dial-up' services.
LCS	The Local Carriage Service is a service for local call resale. That is, the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone. (Standard zones is defined in the <i>Telecommunications (Consumer Protection and Service Standard) Act 1999</i> .)
Leased line	Transmission leased along a particular route in a network that is dedicated to a customer's exclusive use.
Line rental	Charge for the supply of a standard telephone service to a customer.
MDS	Multipoint Distribution System is a radio communications system providing line of sight transmission from a fixed station to multiple receiving facilities using microwave transmission.

Microwave	A form of wireless transmission at a very high frequency that can be used for providing telecommunications links and television services. It requires line of sight and can be used for open air transmission and satellite communications.
Minister	Minister for Communications, Information Technology and the Arts
MSG	Minimum Subscriber Guarantees
Multi-channelling	The transmission of more than one discrete stream of programming over a single television channel.
News Corporation	News Corporation Limited
NCC	National Competition Council
NERA	National Economic Research Associates
NRL	National Rugby League
OECD	Organisation for Economic Co-operation and Development
OFT	Office of Fair Trading (United Kingdom)
OFTA	Office of the Telecommunications Authority (telecommunications regulator in Hong Kong)
Oftel	Office of Telecommunications (telecommunications regulator in the United Kingdom)
Optus	SingTel Optus Pty Ltd
Pay-per-view	A system of paying to view individual programs for pay TV subscribers.
Pay TV agreements	The agreements between Foxtel and Optus, Foxtel and Telstra, and Foxtel and Austar are collectively referred to in this report as 'the pay TV agreements'
PBL	Publishing and Broadcasting Limited
PMP	Premium Movie Partnership
PSTN	The Public Switched Telephone Network is the standard fixed-line telephone network. It is used primarily for the supply long-distance, fixed-to-mobile and mobile-to-fixed calls to end-users in Australia.
RAF	Telecommunications Industry Regulatory Accounting Framework
RRRs	Record-Keeping Rules are rules issued by the Commission pursuant to section 151BU of the TPA that require carriers or CSPs to keep and retain records and to give any or all of the reports to the Commission.

SAOs	Standard access obligations are imposed on providers of services declared under Part XIC of the TPA with regard to technical and operational standards, fault detection and rectification and other services.
SDTV	The Standard Definition Television is a generic term that distinguishes ‘standard’ from ‘high’ definition formats.
STU	A set-top unit is a combined receiver and decoder which processes digital transmissions and connects to TV displays, VCRs and other devices. A STU may also convert digital transmission to analogue for display on an analogue television set.
Subscription television (pay TV)	Television services usually delivered by HFC cable or satellite, and supplied on payment of subscription fees. In this report it is generally referred to as ‘pay TV’.
TARBS	Television & Radio Broadcasting Services Australia Pty Ltd
Terrestrial transmission	Television broadcasting from land-based transmitters to conventional television aerials within the line of sight.
TIO	Telecommunications Industry Ombudsman
TPA	<i>Trade Practices Act 1974</i>
ULLS	The Unconditioned Local Loop Service involves the use of unconditioned lines (typically copper) between end-users and a telephone exchange, where the line terminates. This service enables the supply of advanced, high-speed data services, such as xDSL, to customers as well as local and long-distance voice services.
VDSL	Very high data rate Digital Subscriber Line is an xDSL service that offers very high data rates over relatively short distances.
‘Wi-fi’	‘Wi-fi’ (short for ‘wireless fidelity’) is a particular high-frequency digital wireless local area network.
xDSL	A generic term for Digital Subscriber Line technologies which enable broadband services to be provided over copper wires.

Summary

Introduction

The regulation of telecommunications and related markets has presented some of the most significant challenges faced by the Australian Competition and Consumer Commission (the Commission) in its role as competition regulator.

Telecommunications regulation has contributed to many positive outcomes for consumers, including improved service quality and significant price falls. However, the ongoing lack of effective competition in many telecommunications markets means consumers continue to pay higher prices and receive lower quality services across the entire communications sector than they otherwise would.

The Commission believes the communications sector in Australia is now at a crossroad.

Technological advances have enabled consumers to receive information and experience entertainment in ways generally unavailable to residential consumers a decade ago, such as via the internet, digital television and broadband services delivered over the fixed copper and HFC network.

The removal of restrictions on markets has been an important aspect of this change, particularly the legislative opening up of the telecommunications markets to competition and the removal of the prohibition on the delivery of pay TV services.

The future promises even more change. Developments such as the further digitisation of Telstra's copper network and the impending digitisation of the Telstra HFC network have the potential to deliver new or improved services to homes and businesses, such as:

- more television channels and content, at higher picture and sound quality
- interactive services via the television, such as email, internet and video-on-demand
- broadband internet providing richer multimedia services, including full video services.

These services not only have the potential to revolutionise home entertainment, but will have a significant impact on the business, education and health sectors, by delivering technology such as video-conferencing and other enhanced applications that are likely to increase the efficiency of Australian businesses.

However, Telstra's control of both a copper and a cable network and the lack of competitive discipline it faces as a result of this dual ownership, means Telstra is in a position to largely dictate the type of services that consumers will be able to access and the time at which these services become available.

Digitisation and the ability to offer broadband services over existing networks also present a real opportunity for genuine competition in the delivery of broadband services, if the Commission's recommendations in this report are accepted.

The minister's request for advice

This report responds to a request by the Minister for Communications, Information Technology and the Arts, Senator Alston, for advice on the extent to which emerging market structures are likely to affect competition across the communications sector.

By letter dated 12 March 2002, the minister asked the Commission to advise on:

[T]he extent to which emerging market structures are likely to affect competition across the communications sector, including through the provision of bundled pay TV, telephony and broadband services.

This request followed the announcement of the pay TV content supply arrangements between Foxtel and Optus and between Foxtel and Telstra, which the Commission subsequently accepted subject to conditions.

The minister noted:

Areas of particular concern to the government include the implications for:

- competition in pay TV;
- access for aspiring pay TV content providers to delivery platforms;
- access to Foxtel pay TV content for other 'bundled service providers' to facilitate competition in pay TV, telephony and broadband, including in non-metropolitan areas in Australia; and
- competition in the provision of consumer reception equipment for broadcasting, telephony and broadband services.

The Commission was also invited to address any other issues it considered relevant to the nature of pay TV, telephony and broadband services likely to be available to Australian consumers.

In responding to the minister's request, the Commission is informed by its charter to further the long-term interests of consumers of telecommunications services, by promoting competition and the efficient use of, and investment in, telecommunications infrastructure.

Therefore, the Commission has made recommendations where it believes, from a competition perspective, there is a strong case for reform or further review. The Commission recognises that the government may have other policy objectives on particular issues.

As the minister's request was initiated in light of the Foxtel pay TV agreements, this report focuses on those parts of the communications sector particularly affected by those agreements, namely telecommunications, pay TV and free-to-air (FTA) broadcasting. These are significant areas of commerce—together, the revenue of these sectors is over \$33 billion a year.

The recommendations made in this report are generally consistent with, and complement, the undertakings accepted by the Commission when considering the pay TV content supply arrangements. Those undertakings provide for, amongst other things, terms for access to programs for pay TV operators and access to Telstra's HFC network and Foxtel's set-top units (STU) for the purposes of providing pay TV services.

However, as noted by the Commission when accepting the pay TV arrangements, the undertakings only relate to the specific competition issues raised by the pay TV arrangements. Given the Commission was only considering the supply of Foxtel pay TV channels to Optus and the re-selling of Foxtel's services by Telstra, it is not realistic to expect the Commission should have sought, or would have been offered, undertakings to alleviate the Commission's broader competition concerns across the communications sector which predated the arrangements.

It is these pre-existing concerns, and the Commission's views on what policies could be introduced to address or mitigate them, that form the basis of this report.

Is the supply of telecommunications and broadcasting services currently competitive?

Whilst regulation has generated some positive outcomes in the telecommunications, pay TV and FTA sectors, the Commission believes significant competition concerns remain in each of the sectors outlined below.

Telecommunications

The Commission's analysis indicates that the progress of competition in telecommunications markets is slowing. To date, the type of benefits that have arisen from the introduction of competition in telecommunications markets have largely flowed from competition at the retail level of the market as opposed to competition between telecommunications infrastructure providers (the wholesale level of the market).

The incumbent, Telstra, remains a dominant firm in telecommunications. It is one of the most integrated communications companies in the

world, continuing to be the major wholesale and retail supplier of telecommunications services, including:

- local, national, long-distance, international and mobile telephony
- dial-up and broadband internet
- data
- printed and on-line directories
- pay TV (through its 50 per cent ownership interest in Foxtel).

Importantly, Telstra owns two of the three major local access networks outside the CBDs of major cities. In addition to owning the copper (PSTN) network that connects virtually every household in Australia, Telstra owns the largest cable (HFC) network, which passes 2.5 million homes. The second largest carrier in Australia, Optus, owns the other HFC network. This network passes approximately 2.2 million homes.

The extent of Telstra's dominance of the sector is demonstrated by the fact it receives almost 60 per cent of total industry revenue, which is almost four times the revenue that its closest rival, Optus, receives. It is reported to receive over 90 per cent of total industry profits.

Pay TV

In pay TV, Foxtel has emerged as the dominant supplier to metropolitan subscribers, with supply to over 90 per cent of pay TV subscribers in that area (this now includes subscribers who receive Foxtel content via Optus and Telstra). Similarly, Austar is the dominant supplier in the non-Foxtel supply areas.

Whilst the recent content supply agreements have strengthened Optus' pay TV offering, the similarity of the services offered by Foxtel and Optus may mean that customers see little choice in programming and pricing.

Free-to-air broadcasting

In Australia FTA broadcasters are provided a level of protection from competition that is not given to firms in other industries. Entry into the FTA sector is strictly controlled by government regulations that limit the number of commercial broadcasting licences to the three incumbents, channels Seven, Nine and Ten and their regional affiliates. In addition, a number of other regulations restrict how FTA broadcasters can broadcast. For example, each commercial broadcaster is restricted to supplying only one channel.

The increase in capacity resulting from digitisation of FTA broadcasting could provide increased opportunities for new services, greater choice and perhaps new entry into this market. However, government regulations prohibit many of these opportunities from emerging as they otherwise could.

As a result, the market remains concentrated, with FTA broadcasters having less flexibility to develop business plans to meet consumer demand, and FTA and pay TV broadcasters being insulated from competing against each other. Less competitive pressure and flexibility reduce the incentive to innovate and provide high-quality services.

Competition in telecommunications and broadcasting infrastructure

The transmission of signals to consumers, whether by fixed (copper, cable), satellite, or wireless (FTA broadcasting, wireless local loop etc) networks, is an essential aspect of the supply of telecommunications and broadcasting services.

In applying its access regulation responsibilities the Commission has sought to ensure the efficient use of infrastructure in the supply of telecommunications and pay TV services by permitting competing providers to supply their services over key existing networks.

The Commission believes access regulation and conduct regulation (which prohibits anti-competitive conduct) both have an important role in promoting competitive markets. However, experience suggests that incumbents or suppliers with substantial market power can stifle the promotion of competition via access regulation by delaying negotiations, provisioning networks in ways not conducive to access and by favouring supply of their own services over those of access seekers.

Without competition between telecommunications infrastructure providers, it is likely that:

- networks will not be developed and used to their full potential
- new services (such as high-speed internet) will not be introduced as early as they otherwise would
- services will not be provided efficiently and at least cost for consumers.

Regulation should seek to promote investment that is efficient and avoid encouraging unnecessary duplication of infrastructure as this can result in substantial costs. Access regulation must operate as effectively as possible to ensure that investment in infrastructure does not occur when more appropriate access-based solutions are available.

It follows that this report recognises the importance of ensuring both existing infrastructure is used as efficiently as possible and that efficient new infrastructure investment is promoted.

Ensuring existing infrastructure is used efficiently

The current ownership by Telstra of both a copper network and the largest HFC network reduces the opportunities for competition between existing infrastructure. For so long as Telstra owns or has an interest in a copper network and an HFC network, Telstra will be concerned about maximising the combined

revenues of both networks, and will therefore be hesitant to introduce new services or pricing on one network which cannibalises its revenues on the other.

Divestiture of the HFC network by Telstra would address this problem by introducing a new infrastructure competitor into the market against Optus and Telstra, establishing conditions for increased rivalry and innovation in the supply of a full range of telecommunications services. This competitor would have the potential to supply voice, broadband internet and pay TV services directly to 2.5 million households passed by the HFC.

Increased competition would also provide better incentives for Telstra to invest actively in its copper network to provide for the delivery of a range of advanced broadband services. Overseas experience and independent analysis (including by the OECD) strongly suggest that the enhanced competition between independent networks should improve broadband price and service offerings and thereby increase the take-up of broadband services.

The Commission believes significant competition and efficiency benefits are likely to follow from divestiture. However, the Commission recognises that divestiture of the HFC network by Telstra requires further analysis, with particular focus on the costs of such divestiture.

Divestiture of the HFC network by Telstra may also reduce the need for more interventionist approaches aimed at improving the competitive environment, such as actual separation of Telstra's wholesale and retail businesses or separation of the local loop from the rest of Telstra's business. A consideration of such policies is beyond the scope of this report, however the Commission notes the National Competition Council's comments that the government should further consider the structure of Telstra, including the option of the structural separation of the fixed network.

Media regulation

The Commission is also concerned that current media regulation is restricting competition between existing services, particularly pay TV and FTA broadcasting. This is most evident in the restriction on sports broadcasting as a result of the anti-siphoning provisions, but also relates to current restrictions in the use of the FTA broadcast spectrum.

Liberalisation of these restrictions could provide significant benefits for consumers, particularly by increasing content choice. Given the various interrelationships between the media regulations a fundamental reconsideration of media regulation is required. That is, the media regulations cannot be examined in isolation and any reform needs to take place 'across-the-board'.

Promoting efficient new infrastructure investment

The Commission currently sees that there are three main obstacles to efficient infrastructure investment. These are: inability to access premium pay TV content; the underlying incentives that are created by Telstra's ownership interest in Foxtel; and the potential for leverage of market power into otherwise competitive markets.

Importance of access to premium pay TV content

Broadband networks are capable of providing a range of services such as telephony, high-speed internet and e-commerce as well as pay TV.

There are significant sunk costs associated with the development of broadband networks. In order to achieve adequate returns on such a substantial investment it is necessary to offer a full range of broadband services, including pay TV.

Premium pay TV content is critical to the development of pay TV offerings and therefore an inability to access premium pay TV content may act as a barrier to entry to new broadband investment. This may lead to less competition in the supply of broadband and telecommunications services.

Although in-roads have been made to ensure pay TV content, including premium pay TV content, is distributed beyond Foxtel's and Austar's pay TV networks, access to key pay TV content remains an important issue that requires the policy attention of government. Without this, the Commission is concerned that opportunities for efficient infrastructure competition, particularly in areas with limited infrastructure such as regional Australia, will be delayed or lost.

Telstra's interest in Foxtel

Telstra's 50 per cent ownership of Foxtel also concerns the Commission. Through its partial ownership of Foxtel, Telstra has the ability to veto supply of pay TV channels by Foxtel to other networks. This places Telstra in the unique position of controlling important inputs of supply for its potential and actual broadband network competitors, and for pay TV operators competing against Foxtel (on the Telstra HFC network).

An example of the effect of Telstra's commercial interest in Foxtel is that Telstra was only prepared to allow supply of pay TV content to one of its telecommunications competitors (Optus) if Telstra was also able to bundle Foxtel's pay TV service. This is even though Foxtel had identified the content supply arrangements with Optus to be in Foxtel's commercial interest.

Further, the Commission expects that digitisation of the Telstra/Foxtel HFC network will provide increased opportunities for Foxtel to provide interactive pay TV services which can be increasingly competitive with Telstra's communications services. For example, following digitisation, Foxtel will be able to provide data services like e-mail and internet access over its pay TV network. However, Telstra will have every incentive to restrict the development of such services by Foxtel where they would compete with services provided by Telstra. In so doing, a potential new source of competition in the future may therefore be diminished by Telstra's ownership of Foxtel.

Leverage of market power into otherwise competitive markets

When incumbents retain substantial market power there is a real risk that they can use their advantaged position in one market to protect or extend their market power in that market or other markets (including markets for the provision of new services). There are a number of ways that incumbents may use their market power, such as targeted price cutting and seeking to disadvantage other firms in the supply of key inputs.

A number of service providers have raised concerns about Telstra's bundling conduct, which they allege involves Telstra using its advantage in the telephony and pay TV markets to restrict opportunities for its competitors, such as Hutchison's new 3G mobile service. The introduction of new services can be 'disruptive' insofar as they have the potential to reduce Telstra's market power to some extent.

The Commission is conscious of these potential problems, and has introduced formal information-collecting processes to monitor bundling conduct. Introduction of increased accounting separation and related requirements for imputation testing of Telstra's services will assist in this regard. However, the information before the Commission does not indicate that bundling conduct is currently of sufficient concern that the government needs to formulate a specific legislative response, such as requiring an up-front competition assessment before new bundled offerings can be introduced. However, the Commission will continue to monitor bundling conduct, and will comment further to the government if required.

Ensuring access regulation is as effective as possible and commercially-negotiated access is as efficient as possible

The Commission remains committed to ensuring that the administration of access regulation is timely and effective. To this end, an independent review of the Commission's processes was

undertaken and last year released guidelines reflecting the outcomes of this review. Recent legislative amendments will enhance the effectiveness of access regulation.

However, there are two issues relating to access to telecommunications infrastructure that concern the Commission, both of which are discussed in this report.

First, as noted above, Telstra's part ownership of Foxtel results in strong incentives to prevent or restrict other pay TV businesses or channels from gaining access to Telstra's HFC network. Effective access to the Telstra/Foxtel HFC network for the provision of pay TV services is yet to occur, notwithstanding continuing arbitrations before the Commission. While Telstra and Foxtel have offered access undertakings, which the Commission is currently assessing, it is pertinent that they only chose to offer these to assist in meeting the Commission's concerns about the content supply agreements. Some of these undertakings could have been offered to the Commission when disputes about access to the analogue pay TV service first arose, in 1999 and 2000.

Second, FTA broadcasters have raised concerns about not being allowed access to pay TV subscribers for the provision of FTA services over digital pay TV networks, when such networks are introduced. The Commission is monitoring current negotiations between FTA broadcasters and Foxtel for transmission of FTA services on the Telstra/Foxtel HFC and satellite network. At this stage, the Commission does not believe action is required by the government in relation to this issue.

The Commission's recommendations

The Commission has made a series of recommendations which it believes will promote the infrastructure-based competition that is required to ensure the development of a competitive environment for the delivery of telecommunications and pay TV services.

A summary of the key recommendations follows. The Commission then provides a more detailed explanation of the reasons for these recommendations in the next section.

Table of recommendations

Issue	Key recommendations
A. Telstra's ownership of an HFC network and Foxtel Chapter 4	1. The Commission recommends that the government introduce legislation requiring Telstra to: <ul style="list-style-type: none">• divest the HFC network in full, and• divest its 50 per cent shareholding in Foxtel unless it can be shown that the costs of such divestiture outweigh the benefits flowing from the increased competition that divestiture would promote.
B. Regulation of FTA and pay TV broadcasting Chapter 5	2. The Commission believes that there is a strong case for bringing forward the review of the moratorium on the number of commercial FTA licences. As the media regulations cannot be examined in isolation, the Commission recommends the government conduct an 'across-the-board' review of the regulations applying to the media sector, in particular those that have a direct impact upon competition. These include regulations that apply to multi-channelling, datacasting and anti-siphoning.
C. Access to pay TV content for pay TV networks Chapter 6	3. The Commission recommends that the government introduce legislation to increase access to pay TV content for broadband networks.
D. Access to carriage for FTA retransmission Chapter 7	4. At this stage the Commission does not recommend any networks for the delivery of digital FTA services or interactive services.
E. Bundling of telecommunications and other services Chapter 8	5. At this stage no amendments are recommended to the current legislative provisions that apply to bundling conduct. However, it is recommended that where pay TV services are provided as part of a bundled telecommunications offering, the Telecommunications Industry Ombudsman be given jurisdiction to investigate complaints about the provision of the pay TV service.

Summary of main issues and key recommendations

A. Telstra's ownership of Foxtel and the HFC network

The Commission recommends that the government introduce legislation requiring Telstra to:

- divest the HFC network in full, and
- divest its 50 per cent shareholding in Foxtel,

unless it can be shown that the costs of such divestiture outweigh the benefits flowing from the increased competition that divestiture would promote.

The Commission believes that significant benefits would result from divestiture of Telstra's HFC network, and its 50 per cent ownership of Foxtel.

Potential benefits of divestiture of Telstra's HFC network

At present, Telstra owns two of the three major fixed telecommunications networks. As firms do not compete with themselves, Telstra's

continuing focus is not to maximise the revenue from each network separately but rather to maximise revenue across both networks. In seeking to protect the revenues of both networks, investment will not be made, or will be delayed, in services that would cannibalise the revenue of the other network. For example, unlike Optus, Telstra does not seek to supply telephony services on its HFC network which would reduce the revenue that Telstra receives from its PSTN network.

At the time open entry was permitted for telecommunications markets there was a widespread expectation that infrastructure alternatives to Telstra's copper network would be developed, at least over time, to act as viable competitive substitutes. This expectation did not extend to anticipation for nation-wide infrastructure competition—rather that infrastructure competition was likely to be limited to major cities and larger regional centres. However, to date this type of competition has not materialised to the extent hoped.

Optus' cable network roll-out had the potential to offer a competitive threat to Telstra's dominance of the telephony market. However, Telstra's actions in duplicating Optus' broadband network was intended to, and was successful in, reducing the competitive impact of Optus' cable network. Telstra's investment in the HFC network also decreased incentives for a new entrant to construct or develop alternative infrastructure, such as wireless-based technologies, at least in the areas already supplied by the HFC networks.

Convergence—or the increasing ability of networks to deliver a broader range of services—does have the potential to stimulate competition by providing greater opportunities for competition between what have been (and in most cases currently still are) diffuse services such as television and the internet.

However, the Commission is sceptical that in the current environment, convergence will create significant new sources of competition. This is because Telstra's market power in telecommunications and its ownership interest in Foxtel give Telstra considerable scope to extend its market power into markets for the delivery of new services.

The Broadband Advisory Group and the OECD have both noted the importance of infrastructure competition for the provision of broadband services. This is reflected in international comparisons of broadband penetration, which suggest a correlation between broadband take-up and competition between independent network providers. For example, the OECD notes that a major reason for Canada's rapid development of broadband services is competition between

different networks owned by independent carriers. It has also stated that separation of cable TV and the copper networks may help infrastructure competition.

Infrastructure competition would place pressure on Telstra to upgrade its PSTN network to a fully integrated broadband network that would be capable of delivering various services such as the supply of advanced broadband services, and potentially including pay TV or advanced video services.

Potential benefits of divestiture of Foxtel

Through its partial ownership of Foxtel, Telstra has the ability to veto supply of pay TV channels by Foxtel to other networks. Foxtel and Telstra also have an interest in preventing other pay TV businesses or channels from gaining access to Telstra's fixed customer access network. Therefore, Telstra is in a position where it controls important inputs of supply for its potential and actual broadband network competitors, as well as for pay TV operators competing against Foxtel (on the Telstra HFC network).

It is recognised that Foxtel is presently supplying content to other carriers such as Optus and AAPT, and the proposed access to content arrangements will help to facilitate this further. However, Telstra's influence on these agreements remains, and access regulation will only go so far to reduce this influence. For example, AAPT has an agency agreement with Foxtel, where it receives a commission for signing up customers to Foxtel. Telstra resupplies Foxtel as a wholesale customer of Foxtel (with retail-minus pricing and other differences).

Requiring Telstra to divest its Foxtel shareholding would remove Telstra's influence in preventing Foxtel supplying its pay TV channels (particularly premium channels) to other networks. Additionally, such divestiture would likely provide Telstra with a greater willingness to allow other pay TV businesses or channels access to Telstra's HFC network (in the event it is not divested).

Finally, with possible convergence between broadcasting and telecommunications services occurring in the future, an independent Foxtel is more likely to become a competitor to Telstra across the range of services that convergence may bring.

Potential concerns about the effect of divestiture on investment

Telstra has made significant investments in both the HFC and Foxtel. Concerns may be raised that in requiring divestiture such action will deter future investment, and that the divestiture is inappropriately limiting Telstra from receiving returns from its investments.

However, these concerns not only need to be weighed against the benefits of divestiture, they also need to be placed in context. Telstra's initial investment, made when it was 100 per cent government owned, was largely a defensive exercise to protect its copper network revenues. Further, Telstra Multimedia, which is responsible for management of the Telstra HFC network, comprises only five per cent of Telstra Corporation's total assets.

Costs of divestiture and implementation issues

The option of divestiture is obviously a significant policy intervention, which will require further analysis and public consultation.

The potential costs of divestiture include the loss of production efficiencies arising from the existing level of integration between the entities. These include loss of economies of scope and/or scale and an increase in transaction costs compared to contract-based commercial arrangements between separate firms.

The Commission believes that, in relation to the divestiture of the HFC network and Telstra's interest in Foxtel, the costs are likely to be minor relative to the ensuing benefits and there is therefore a strong case for divestiture.

Introducing legislation to require divestiture would also require further analysis of specific implementation issues, such as whether a separate HFC company is established with a separate share register or whether the HFC is sold in an auction to potential bidders. If the assets are opened to potential bidders, or even if separately listed on the stock exchange, the pool of potential buyers includes telecommunications carriers interested in establishing a local access network, other utility companies, media companies and infrastructure funds. Such firms might either act alone or on a joint venture basis.

In all cases, the Commission's general merger provisions would provide some protection against anti-competitive purchases. However, if the government decides to proceed with divestiture, the government should consider providing the Commission with vetting powers to ensure that acquisition by potential bidders would be pro-competitive.

Whatever method of divestiture is used, constitutional law provisions would ensure fair compensation for existing shareholders should this be required.

Other implementation issues that would require further consideration by the government is whether full divestiture is necessary, or whether Telstra should be free to retain some ownership in the HFC infrastructure or Foxtel. Options short of divestiture include selling down Telstra's ownership of the HFC and Foxtel to a level below 50 per cent, or removing Telstra's voting rights with respect to its Foxtel shareholding.

The Commission is concerned, however, that these options do not preclude the possibility of ongoing influence. It is the Commission's view that full divestiture is likely to be required to produce fundamental changes in behaviour. Ongoing ownership still provides opportunities for the integrated entities to favour themselves through measures such as cross-subsidisation and discriminatory access either explicitly or tacitly. All else being equal, such favouritism will be greater the higher is the extent of integration or ownership.

A potential concern in relation to a requirement that Telstra divest its interest in Foxtel is that such divestiture may strengthen the market power of the other owners of Foxtel (PBL and News Corporation). However, the Commission is not proposing a line of business restriction on Telstra—it has sought only to require Telstra to divest Foxtel due to Telstra's position of dominance in telecommunications and pay TV serving to reinforce each other to the detriment of competition. Telstra's divestiture of the HFC and Foxtel will increase the opportunities for other media companies to enter the pay TV market if they chose to do so.

B. Regulation of FTA and pay TV broadcasting

The Commission believes that there is a strong case for bringing forward the review of the moratorium on the number of commercial FTA licences. As the media regulations cannot be examined in isolation, the Commission recommends the government should conduct an 'across-the-board' review of the regulations applying to the media sector, in particular those that have a direct impact upon competition. These include regulations that apply to multi-channelling, datacasting and anti-siphoning.

The FTA and pay TV broadcasting sectors are highly regulated. Many of these regulations have a direct impact upon competition within and between the FTA and pay TV broadcasting sectors.

The Productivity Commission finalised an in-depth review of broadcasting regulation in 2000 and concluded that the costs imposed by many media regulations often exceeded the benefits delivered to consumers by such regulation.

The legislation for the introduction of digital television in Australia in 1998 was relatively new

at the time of the Productivity Commission review. However, many of the Productivity Commission's concerns about the regulatory framework have been borne out in practice. Examples of these concerns include that narrowly defining the services that can be provided by datacasters and prohibiting multi-channelling decreases opportunities to develop business cases to entice customers to use digital services.

Like the Productivity Commission, the Commission is sceptical that there is a case for

the current extent of regulation in the media sector. It is the Commission's view that the debate on broadcasting regulation has focused on the benefits of such regulation, largely overshadowing consideration of the costs of broadcasting regulation.

Current restrictions on FTA broadcasting reduce competition both within and between the pay TV and FTA sectors. The Commission recognises these restrictions are intended to achieve important social policy objectives and that FTA broadcasting has specific characteristics which suggest some regulation is required. Nonetheless the Commission believes these objectives may be achieved in a less restrictive manner.

The Commission is particularly concerned about:

- the restrictions placed on the use of broadcasting spectrum, especially in relation to datacasting and the number of FTA licences
- the current prohibition on multi-channelling by FTA broadcasters
- the anti-siphoning provisions, which reserve particular sporting events for FTA operators.

Of particular note is the possibility of modifying the anti-siphoning provisions to provide for 'dual rights'. A simple dual-rights regime would mean that neither pay TV nor FTA broadcasters could acquire exclusive rights to nominated events on a single list. The aim of this model is to maximise the availability of premium content to all broadcasters in Australia, while preventing the migration of such content to subscription television broadcasters.

The government has already planned a review of the moratorium on the number of commercial FTA licences for 2005. Given that it is now five years since the government introduced the digital television amendments, this is sufficient time to enable a consideration of whether the digital television regulatory framework is operating as intended, achieving its objectives, and whether the benefits outweigh the costs of the regulation. Therefore, the Commission

believes that it is appropriate to review the effectiveness of the digital television amendments now.

The Commission also believes that an early review will assist potential new entrants and existing firms in making decisions about investment. The recent developments in FTA and pay TV, and the proposed digitisation of the Foxtel/Telstra pay TV network strengthens the case for an early review.

Any review would, in the Commission's view, need to consider the broader perspective on the interrelationship of various aspects of media regulation. Therefore, the Commission believes the government should conduct an 'across-the-board' review of regulations applying to the media sector, in particular those that have a direct impact on competition.

C. Access to pay TV content

The Commission recommends that the government introduce legislation to increase access to pay TV content for broadband networks.

In the Commission's experience, a number of factors have made it difficult for network operators to obtain access to premium pay TV content (local sport and movies). These factors include:

- incentives for channel suppliers and pay TV operators, such as Foxtel and Austar, not to on-supply content
- the exclusivity of premium pay TV content.

Both Foxtel and Telstra (through the bundling of Foxtel's pay TV services with its telephony services) have incentives to protect their retail pay TV operations and therefore limit or withhold access to premium pay TV content from their competitors. Channel suppliers with common ownership interests, such as Fox Sports, have similar incentives.

Further, Telstra's interest in Foxtel reduces the incentives for Foxtel to supply channels to competing network providers, who pose the threat of facilities-based competition in the supply of broadband and telecommunications services.

Austar's incentives in relation to the on-supply of content are similar to Foxtel's in terms of protecting its own retail operations.

The operation of these incentives has been evidenced by the past difficulties Optus and other network providers such as Neighborhood Cable and TransACT have had in gaining access to premium pay TV content. While the pay TV and recent resale agreements with Optus, Telstra and AAPT may indicate an increased willingness to on-supply pay TV content, the Commission notes that Foxtel's underlying incentives remain unchanged.

Regardless of whether restricting access to premium content has an anti-competitive purpose, it is apparent that it is having an anti-competitive effect, as detailed below.

While the Foxtel and Austar undertakings relating to the supply of their content to network providers go some of the way to addressing the Commission's broader concerns about access to premium pay TV content, it is considered this framework for access needs to be legislated. Further, where the government wishes to promote competition in the supply of pay TV services as well as broadband and telecommunications services additional measures are required. These are also outlined below.

In recommending these measures the Commission acknowledges that access regimes in general have limitations. Further, there are several implementation issues which may introduce difficulties, including possible just compensation claims if access to individual premium sports and movie channels is introduced. While noting these difficulties and potential costs, the Commission's recommendation is based on the considerable benefits that will flow from access regulation, including the prospect of greater facilities-based competition and broadband penetration.

Competition and efficiency concerns in the supply of broadband and telecommunications services

The economies of scale and scope associated with broadband networks mean the business case for deployment of these networks is typically reliant on multiple revenue streams from pay TV, broadband and telecommunications

services. In the presence of economies of scale and scope, a lack of access to premium pay TV content is likely to have competition and efficiency implications in the supply of broadband and telecommunications services. Essentially, it acts as a barrier to entry and has the potential to significantly delay or foreclose investment totally.

While network providers may have access to non-premium pay TV content, it is premium pay TV content which is most important to consumers and drives demand for the pay TV service. Therefore, for economic entry to occur, network providers must have certainty that they will be able to provide pay TV services that are comparable or similar to those of pay TV operators with exclusive access to the premium pay TV content.

Any delay in the availability of broadband facilities to residential consumers, particularly in some metropolitan and regional areas of Australia, could impose an economic cost in terms of the foregone consumer benefit of access to those services. Further, it is likely to result in less competition in the supply of these services as well as a less than efficient level of investment in infrastructure.

The Commission considers that in order to promote competition and efficient investment in broadband and telecommunications services the section 87B framework that enables network providers to retransmit the Foxtel and Austar basic and tiered packages needs to be legislated. This would provide existing and prospective network providers with greater certainty going forward. In developing such a legislated framework, the Commission also considers that there would be benefit in reviewing the pricing principles associated with this requirement.

Competition concerns in the supply of pay TV services

As pay TV content is sold as a bundle of channels, and premium pay TV content acquired exclusively is often combined with other content, then a lack of access to premium content may reduce competition in the supply of pay TV services more generally. If network providers are not able

to supply bundles that include the premium pay TV content consumers demand then their ability to compete is limited.

Given pay TV services generally comprise bundles of content then exclusive premium pay TV content is likely a differentiating point for many consumers. This is reinforced by the costs of switching to another pay TV operator which unlike changing channels on FTA services are not insignificant.

Therefore a lack of access to premium pay TV content may reinforce the highly concentrated structure of the pay TV market and limit consumer benefits that would otherwise occur as a result of competition, such as lower prices.

The Commission considers that in order to promote competition in the supply of pay TV services, access to individual premium sports and movie channels is required. The Commission's proposed approach involves breaking the exclusive content agreement that exists for the supply of Fox Sports content. This goes further than the section 87B undertakings provided to the Commission in the context of the pay TV agreements and is intended to give network providers the opportunity to supply differentiated pay TV services.

However, the Commission recognises that the breaking of exclusive content agreements may have implications for channel suppliers and pay TV operators, impacting on their viability. Further, such an approach also raises the risk of just compensation claims for the government. These are issues that would need to be considered further before any such approach is introduced.

Proposed approach

In this report the Commission makes a number of recommendations relating to the on-supply of pay TV content and the non-exclusive acquisition of premium channels. In order to promote competition in the supply of broadband and telecommunications services, the Commission considers that a legislated framework should enable network providers to re-transmit Foxtel and Austar's basic and tiered packages. Wider

competition benefits would result if access is provided to individual premium sports and movie channels, as pay TV competition would also be promoted. However, the Commission recognises that there are costs associated with such a measure that would require further consideration before such an approach is implemented.

D. Access to carriage for FTA retransmission

At this stage the Commission does not recommend any regulatory intervention relating to access to digital pay TV networks for the delivery of digital FTA services or interactive services.

Access to pay TV delivery platforms by aspiring pay TV content providers, and competition in the provision of consumer reception equipment, are closely related issues.

Pay TV consumer reception equipment refers to devices that provide the interface between the end-user and the telecommunications network. For pay TV carriage, these are STUs containing software that is specifically designed to be compatible with a particular network.

STUs can be used to deliver a number of services to end-users beyond just pay TV, including analogue and digital FTA services and interactive services such as email or internet access.

Foxtel and Telstra have already provided undertakings relating to third party access to their pay TV network in response to the Commission's competition concerns about the impact of the content supply agreements.

However, a number of submissions to the Commission have called for further regulatory intervention to address concerns about the potential for pay TV operators to control the STUs that are the gateway for the provision of

digital FTA and interactive services.

The Commission believes that it is premature for the government to consider legislation in this area while it is unclear if pay TV operators will control the gateway for digital services to pay TV subscribers, and while there may be opportunity for current commercial negotiations between pay TV operators and the FTA broadcasters to be finalised.

That said, the Commission is continuing to monitor developments in this area and recognises that, in the event that pay TV networks become 'gateways' to their subscribers for digital services, there may be a case for regulatory intervention. In particular, the Commission is at present investigating concerns about current negotiations between Foxtel and the commercial FTA broadcasters for retransmission of the FTA services when Foxtel proceeds with its digitisation plans.

E. Bundling of telecommunications and other services

At this stage no amendments are recommended to the current legislative provisions that apply to bundling conduct. However, it is recommended that where pay TV services are provided as part of a bundled telecommunications offering, the Telecommunications Industry Ombudsman be given jurisdiction to investigate complaints about the provision of the pay TV service.

Telstra and other telecommunications carriers have increased the number and scope of bundled telecommunications offerings. Telstra, for example, offers bundled telephony, internet, pay TV and mobile services in the 'Telstra Rewards Packages'.

Many telecommunications operators, and in particular Telstra, have publicly stated the importance of bundling to drive customer take-up and improve customer retention.

The Commission has received a number of submissions arguing that bundling of telecommunications services by Telstra may be restricting the ability of entrants to win customers from Telstra, and that bundling is being used as a strategic tool to create barriers to entry in the supply of new or emerging services.

The Commission has released draft guidelines on its approach to determining whether bundling conduct in telecommunications markets is anti-competitive. It has received submissions on the draft, and it is in the process of finalising the guidelines in an information paper. The Commission may make further comments to the minister on the need for legislative amendments when this process is completed.

The Commission has also required Telstra to report on its bundling conduct in order to monitor the adoption by end-users of Telstra's bundled service offerings. The government's

accounting separation amendments will assist in assessing bundling conduct and increasing the information available to the industry.

The Commission has also received submissions suggesting that the government should introduce a clearance process, similar to the current third line force notification processes. A clearance process would promote fuller consideration of the public benefits and anticompetitive detriments of a bundling offering, prior to the service being introduced. It may also provide greater certainty for carriers and carriage service providers about whether certain conduct is anti-competitive.

The Commission believes that an *ex ante* clearance process may have a number of advantages over the current *ex post* consideration of bundling conduct but a decision about adopting such a process hinges on a cost/benefit analysis and the weighing up of the likelihood of competitive concerns being raised by specific bundling conduct.

The Commission's consideration of telecommunications bundling is continuing. However on the basis of the information currently before it, and the analysis it has undertaken to date, the Commission does not believe that there is a case for a clearance process.

Rather, the Commission believes the government should focus its attention on the merits of Telstra's continued ownership of Foxtel and the HFC network, as these have a much larger potential to improve competition within telecommunications and pay TV markets.

The Commission does recommend an amendment to section 127 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* that would give the Telecommunications Industry Ombudsman jurisdiction to investigate complaints about the provision of pay TV services where such services are offered as part of a bundled telephony package. As these services are typically provided on a single bill, often with a discount applying across the package, it would be sensible for the jurisdiction of the Telecommunications Industry Ombudsman to be extended to cover pay TV services where they are included as part of a bundled telephony package.

1 Introduction

On 12 March 2002 the minister wrote to the Australian Competition and Consumer Commission (the Commission) about the announcement on 5 March 2002 of an agreement between Foxtel and Optus. This announcement concerned arrangements involving: the resale of Foxtel subscription television channels by Optus; bundling of broadband and telephony services by Telstra; and a proposal for Foxtel to lease satellite capacity from Optus on the Optus C1 satellite.

In this letter from the minister, it was noted that the proposed arrangements could significantly affect the state of competition in both subscription television (pay TV) and telecommunications markets and, in particular, the provision of bundled pay TV, telephony and broadband services.

There was a subsequent pay TV supply agreement between Foxtel and Austar which is also relevant to the competitive environment in these markets. The agreements between Foxtel and Optus, Foxtel and Telstra, and Foxtel and Austar, are collectively referred to in this report as 'the pay TV agreements'.

Advice was sought from the Commission on the 'extent to which emerging market structures are likely to affect competition across the communications sector, including through the provision of bundled pay TV, telephony and broadband services'.

The particular areas of concern to the government included:

- competition in pay TV
- access for aspiring pay TV content providers to delivery platforms
- access to Foxtel content for other 'bundled service providers' to facilitate competition in pay TV, telephony and broadband, including in non-metropolitan areas of Australia
- competition in the provision of consumer reception equipment for broadcasting, telephony and broadband services.

The Commission was also invited to address any other relevant issues regarding the pay TV, telephony and broadband services likely to be available to Australian consumers.

This report forms the Commission's response to the minister's request for advice. The Commission emphasises that its response is from the perspective of a competition regulator, and therefore its particular focus is on competition and efficient outcomes.

This report relies on information received from the Commission's investigation into the Foxtel/Optus content supply arrangements and the Commission's assessment of Telstra's notification

on the bundling of pay TV services with telephony services. However, further information was needed to make recommendations and to update the commentary where significant events have occurred. Additional information was obtained from third parties where necessary.

In compiling this report the Commission has drawn widely on various sources of information. Some of the information has been provided in confidence and in many cases this has restricted the Commission's ability to comment on the identity of the parties or to quote from the arguments and submissions. Where the Commission has relied on public sources of information it has ensured, as far as possible, that it is consistent with the confidential information it received.

This report aims to focus on the key competition issues in the communications sector, rather than replicate the information and full analysis of the Commission's decision on the Foxtel/Optus content supply arrangements and the Telstra notification. However, the report does set out some early background chapters to place the various comments in context.

2 Background

2.1 Overview

This report is concerned with three important sectors of the broader ‘communications sector’ most relevant to the pay TV agreements- the pay TV, telecommunications and free-to-air (FTA) sectors. Because the pay TV sector and its relationship to the telecommunications and FTA sectors form the central concern of this report, it is necessary to describe the pay TV sector in some detail. Therefore, this chapter begins by analysing the pay TV sector. The chapter then examines the various relationships within and between the pay TV, telecommunications and FTA sectors. Finally, it describes the concepts of broadband supply, digitisation and convergence. An understanding of these concepts and their potential effect on the communications sector is necessary to place the following substantive chapters in context.

2.2 Pay TV sector

This section provides background on the pay TV industry in Australia. It outlines the supply chain for the pay TV industry and then notes important aspects of the Australian pay TV industry including market participants and a number of market characteristics, in particular barriers to entry.

2.2.1 Supply chain for pay TV

Pay TV supply involves the sale of pay TV broadcast rights to channel suppliers that aggregate the content to create channels. Alternatively, the channel suppliers create or commission content to include in such channels. These channels are then sold to pay TV operators. Pay TV operators use distribution infrastructure such as satellite and HFC cable to supply the service to consumers. Figure 2.1 over the page depicts the supply chain for the pay TV industry.

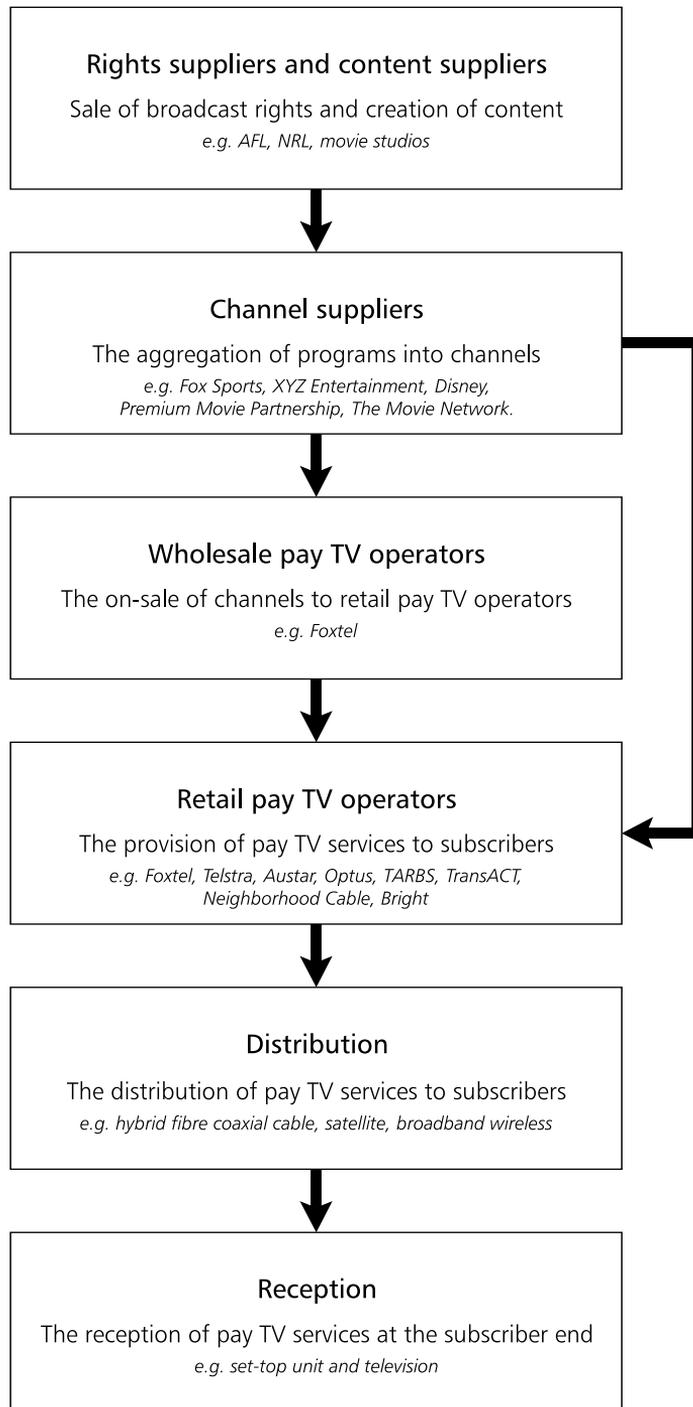
Content

Pay TV content can comprise a range of different types of programs, for example movies, sports events, documentaries and general entertainment programs. The content can be domestic or foreign.

It is generally considered that movies and local sports content is premium content that is critical to creating an attractive pay TV service, although other types of content can also be important, such as children’s programs.¹ This report uses

¹ Content suppliers may provide ‘rights windows’ whereby the buyer has a specified time period in which it is able to show the content. For example, recent release Hollywood movies are not shown on pay TV until after a set period of time at the cinema, but generally before being broadcast on FTA television. Windowing allows the content supplier to price discriminate by segmenting viewers according to their willingness to pay.

Figure 2.1 Pay TV supply chain



the term premium content to refer to movies and domestic sports content. The concept of premium content and why it is critical to retail pay TV services is explored in depth in chapter 6.

Channel suppliers

Channel suppliers aggregate the content produced into a pay TV channel. Channels currently supplied on pay TV are often classified into key genres: sports, children, entertainment, music, documentaries, and news and information. Also, FTA channels may be re-transmitted on pay TV networks.

Wholesale and retail supply of pay TV services

Pay TV operators aggregate/bundle channels to provide a pay TV service to consumers. Ancillary services are also required to provide a retail pay TV service, such as marketing, provisioning and servicing subscribers (including activation, disconnection, customer call centre, fault rectification, subscriber management and billing services). The general model of pay TV provision in Australia (and overseas) is that consumers must take a basic tier of channels (the size of which varies between pay TV operators) and then have the option of buying one or more additional tiers of channels and/or *a la carte* channels.

There is a wholesale pay TV market for the on-supply of channels between some pay TV operators.² The on-supply may be of the entire pay TV package, such as the supply of the Foxtel pay TV service to Telstra.

The major retail pay TV operators in Australia are Foxtel, Austar and Optus Television. The smaller operators are Television & Radio Broadcasting Services Australia (TARBS), TransACT, Neighborhood Cable and Bright. More detailed descriptions of these operators are provided below.

² For example, Foxtel has supplied individual channels such as the Premium Movie Partnership (PMP) channels and the Fox Footy channel (partly as required by its contract with the AFL) to some retail pay TV operators.

Pay TV is generally supplied to residential subscribers. Licensed premises can also acquire pay TV services. The supply to licensed premises differs from residential subscribers. It tends to be focused only on the supply of sporting events—particularly horse racing and the various football codes— and unlike residential subscribers is generally not supplied as a bundle of channels containing different genres. For example, Fox Sports and Sky Racing supply their channels directly to licensed premises on a stand-alone basis.³

Distribution

Pay TV providers require the use of infrastructure, or a 'delivery platform', to supply services to its customers. Currently in Australia, pay TV is predominantly broadcast on hybrid fibre coaxial (HFC) cable⁴, satellite, and to a lesser extent by broadband wireless (MDS).

As at 30 June 2002 approximately 52 per cent of the subscribers of the major three pay TV providers were serviced by HFC cable, 46 per cent were serviced by satellite and two per cent by MDS.⁵ Almost all Optus subscribers, 61 per cent of Foxtel and two per cent of Austar subscribers⁶ are supplied via HFC network. Of Foxtel's subscribers, 39 per cent are supplied by satellite and 90 per cent of Austar's subscribers are supplied by satellite. The remaining eight per cent of Austar's subscribers are supplied by MDS.⁷

New pay TV providers have entered the retail pay TV market using different technologies: TARBS provides mainly ethnic or foreign language channels, using the PanAmSat-8 satellite (an international satellite), to a small number of

³ Before ceasing its supply of C7, Optus also supplied the C7 channel as a single channel to licensed premises.

⁴ HFC cable consists of fibre optic cable from the head-end to the local access switch, and then coaxial cable to the customer premises.

⁵ Foxtel figures derived from Telstra Corporation's 2002 Annual Report. Austar and Optus supplied figures to the Commission.

⁶ Austar has a HFC network in Darwin.

⁷ Austar intends to migrate all of its MDS customers to satellite during 2003.

subscribers Australia-wide; Neighborhood Cable offers telecommunications and pay TV services over its own HFC cable network in Mildura, Ballarat and Geelong; and TransACT offers its services over a VDSL network which carries telephony, pay TV and internet services in the Canberra region.

The various technologies have different characteristics. While satellite potentially offers national coverage for retail pay TV services, HFC cable and MDS have limited coverage. The supply of pay TV services over HFC cable is obviously only available where the HFC cable has been installed. MDS and satellite both rely on wireless communications, but MDS uses a microwave radio signal from a radio transmitter at a central point within a geographical area to subscribers who have the necessary microwave radio reception equipment within that geographical area. It requires line-of-sight from the base station to the receiver, and coverage therefore depends on geography, weather and the density of buildings.

These distribution technologies, but particularly the HFC, can supply telecommunications services such as voice telephony and broadband internet access and other data services. The most significant HFC networks in Australia, owned by Telstra and Optus, can be used to deliver services other than pay TV, including telephony and high-speed internet. These cable networks have been deployed in Melbourne, Sydney, Brisbane and in some areas of Adelaide and Perth.⁸

Reception

Pay TV signals are encoded and sent to pay TV subscribers through a delivery platform. A set-top unit (STU) receives the encoded signal, which it decodes and sends to the subscribers' television set. The STU requires a tuner/demodulator specific to the delivery platform and the signal's transmission mode (i.e. analogue/digital). For example, to facilitate the display of a digital signal transmitted by satellite, the STU would

require a digital satellite tuner/demodulator.

STUs are usually supplied and installed by the pay TV operator. The cost could be recovered through leasing arrangements, but in Australia it has typically been cross-subsidised as part of the monthly pay TV charges. STUs are discussed further in chapter 7.

2.2.2 Suppliers of pay TV services in Australia and pay TV penetration

The Australian pay TV industry is highly concentrated, with three major players (Foxtel, Optus and Austar) and limited niche and/or regional players. Austar generally competes in a different geographical area to Foxtel and Optus.⁹ Despite the fact that the Foxtel and Optus HFC distribution networks are approximately 80 per cent overbuilt, the Optus HFC cable extends to less than 50 per cent of households in the total Foxtel service area.¹⁰ The coverage of the Optus pay TV service is more limited because Optus does not supply its pay TV services by satellite as Foxtel does (in 'non-Austar' areas).

Table 2.1 on the next page provides a summary of current suppliers of pay TV services.

Table 2.1 illustrates that Foxtel has the largest market share by subscriber. The next largest pay TV operator, Austar, has approximately half that number of subscribers.

⁸ BIS Shrapnel, *Telecommunication Infrastructures in Australia 2001: A Research Report prepared for ACCC*, July 2001, p. 19.

⁹ The regions in which Austar and Foxtel operate were decided through programming arrangements entered into by Austar and Australis, which Foxtel inherited. These agreements divided Australia into 'Austar' and 'non-Austar' areas and restricted the abilities of Austar and Foxtel to provide pay TV services by MDS and satellite in those areas.

¹⁰ Based on Telstra estimates that 2.2 million of the 4.6 million households serviceable by Foxtel have a choice between Foxtel and Optus as major providers of pay TV services. Refer to Telstra Corporation Limited, *Submission to the Australian Competition and Consumer Commission in support of Telstra's notification to resell subscription television services with Telstra's telephony and other telecommunications services*, 15 July 2002, p. 8.

Table 2.1 Current suppliers of pay TV services

Operator	Owner/ controller	Service areas	Delivery systems	Number of subscribers
Austar	UnitedGlobalCom and CHAMP	Regional/remote areas of NSW, Qld, SA, Vic, NT, and Tasmania. Also Gold Coast area.	Satellite (Optus B3) MDS Cable (Darwin)	406 545 ^a
Bright Tele-communications	Western Power Corporation	Parts of Perth	Own broadband network	In extended pilot stage ¹¹
Foxtel	Telstra (50%) News Corporation (25%) PBL (25%)	Adelaide, Brisbane, Canberra, Central Coast (NSW), Geelong, Melbourne, Newcastle, Perth, Sydney, parts of WA	Telstra Multimedia HFC Cable Satellite (Optus B3)	800 000 ^b
Optus Television	SingTel Optus	Parts of Brisbane, Melbourne and Sydney	HFC Cable	270 000 ^c
Neighborhood Cable	Neighborhood Cable Limited	Regional Victoria	HFC cable	Not publicly available
TARBS	Television and Radio Broadcasting Service Pty Ltd	National footprint	Satellite (use of five transponders from PanAmSat)	Approaching 50 000 ^d
Telstra (reselling Foxtel)	Telstra	Same as Foxtel	Telstra Multimedia HFC Cable Satellite (Optus B3)	100 000 ^e
TransACT	ACTEW (~ 25%) AGL (~ 15%) ^f	Canberra region	Own VDSL cable network	Not supplied to the Commission

a. Figure at 31 March 2003, Austar United Communications, *Austar maintains momentum in Q1 2003*, media release, 7 May 2003.

b. Figure at 30 June 2002, Telstra Annual Report 2002, 28 August 2002.

c. Figure at 30 June 2002, supplied by Optus.

d. Information supplied by TARBS.

e. Figure at May 2003, Telstra, *Telstra signs up 100,000th FOXTEL Rewards customer*, media release, 15 May 2003. Note that this figure may include Foxtel customers who have churned.

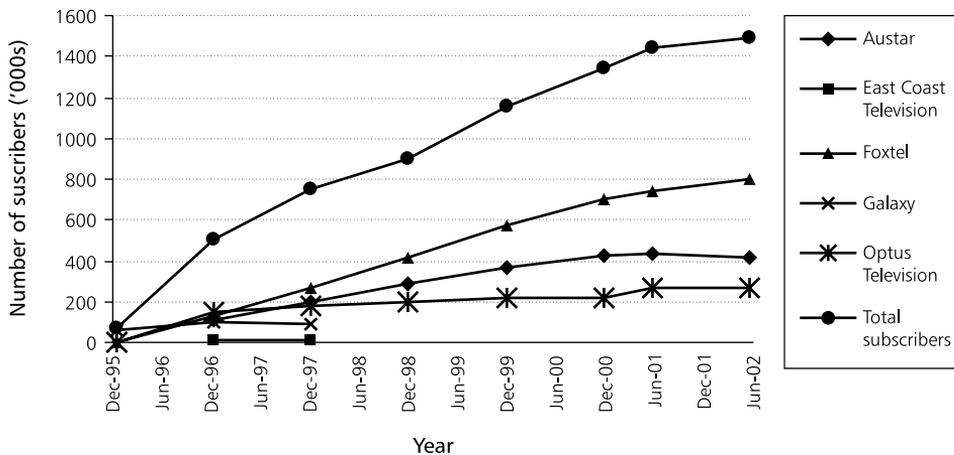
f. Information supplied by TransACT.

¹¹ Western Power anticipates that it will make a decision on whether to launch a full commercial roll-out during 2003.

Penetration of retail pay TV services

Subscriptions for pay TV services were taken-up quickly after the introduction of pay TV in 1995, but the take-up rate slowed after that. Foxtel has obtained much of the later growth. Figure 2.2 below depicts the number of subscribers to pay TV services in Australia over the period 1995- 2002.

Figure 2.2 Pay TV subscriber numbers from 1995–2002



Source data: 1995- 2000: Digital Broadcast Australia cited in Australian Film Commission, 'Get the picture', <www.afc.gov.au/GTP/wptvsubsxops.html>, accessed 2002; 2001- 02: obtained from annual reports of Telstra, Optus and Astar excluding the Optus figure for June 2002 which it supplied to the Commission.

The penetration rate of pay TV in Australia is relatively low by OECD standards (22 per cent of Australian households, compared to the OECD average of approximately 52 per cent, in 1999).¹² Penetration rates in the United States, United Kingdom and New Zealand are higher: approximately 69, 44 and 43 per cent respectively.¹³

¹² OECD, *Communications Outlook 2001*, p. 139.

¹³ United States figure for cable penetration of TV households sourced from National Cable & Telecommunications Association, 'Industry Statistics', <www.ncta.com>, February 2002; United Kingdom pay TV penetration figure obtained from Independent Television Commission, *Annual Report and Accounts 2001*, 15 April 2002, p. 14; New Zealand cable and satellite penetration figure obtained from Bloomberg Television, 'Broadcast Business', <www.broadcastpapers.com/broadbiz/BloombergPayTVAP200209.htm>, December 2002.

There are a number of possible reasons for a lower penetration rate in Australia. These include:

- the relative immaturity of the pay TV market in Australia (although the 2001- 02 information provided by Optus and Astar indicated a plateauing of their subscriber numbers)
- current regulation of pay TV and FTA services (particularly the anti-siphoning provisions)
- VHS video and DVD penetration
- consumer preferences in Australia (i.e. a hesitancy to buy broadcasting services)

- exclusive distribution of premium content¹⁴
- consumer response to pricing or programming.

The last point highlights that perceptions of comparative low penetration are not conclusive of the need for concern. Subscriber penetration rates not only reflect structural factors but the offerings within the market. Pay TV operators may decide to supply at a higher price/lower subscriber number price point to maximise revenues. For example, regional retail pay TV operator Neighborhood Cable offered cheaper basic pay TV services with fewer channels than the metropolitan operators. In July 2002, before the Commission's acceptance of the pay TV agreements with section 87B undertakings, Neighborhood Cable's basic package contained only five pay TV channels for \$19.95 per month, whereas Foxtel's basic packages contained at least 25 channels and was offered for \$39.95 per month.

2.2.3 Barriers to entry

The Commission believes that there are several significant barriers to entry for smaller retail pay TV operators, such as obtaining access to key pay TV content and the sunk costs of distribution. Access to key pay TV content also has implications for existing smaller pay TV operators. These barriers are likely to provide the major pay TV operators with market power in the supply of pay TV services. The combination of these barriers may also create strong first mover advantages for retail pay TV providers and distribution network suppliers.¹⁵

Access to key content

The Commission believes that the inability to gain access to necessary programming is a significant barrier to entry. Of particular concern is that 'premium content'— recent release movies and premium local sport— is often supplied to particular pay TV operators by way of exclusive contracts.¹⁶ There are only two suppliers of recent release movies (PMP and the Movie Network) and, after Optus stopped supplying C7, there are now only two suppliers of premium sport (Fox Sports and the Fox Footy Channel).

Access to quality content appears to be critical, with access to premium content important in terms of attracting subscribers and driving a high volume pay TV business.¹⁷ The presence of exclusive contracts can lead to a market which takes on 'winner-takes-all' type characteristics. At the risk of over-simplification, this idea can be shown with reference to Figure 2.3 below.

Essentially, Figure 2.3 demonstrates that pay TV operators seek to obtain premium content exclusively to drive subscriber numbers. Larger subscriber numbers can improve bargaining power and also enable the retail pay TV operator to capture economies of scale. Improved bargaining power also means that pay TV operators are in a better position to buy more content on an exclusive basis.

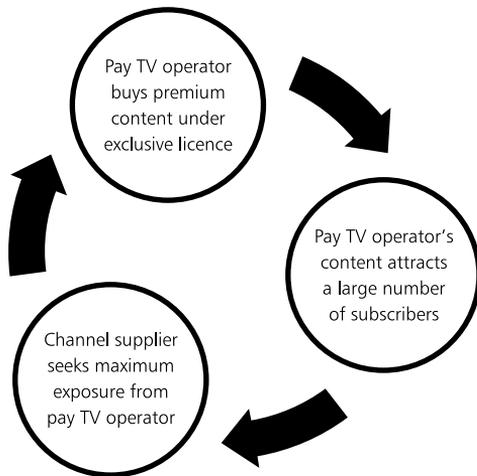
¹⁴ See, for example, comments of Cable & Wireless Optus (now Optus) to the Productivity Commission in Productivity Commission, *Telecommunications Competition Regulation*, Report no. 16, 2001, p. 518.

¹⁵ The Productivity Commission noted in its Telecommunications Competition Regulation inquiry that, due to the barriers to entry and exit for pay TV, market power once established would be hard to reverse, and consumers could face long-term higher prices. Refer Productivity Commission, *Telecommunications Competition Regulation*, p. 535.

¹⁶ The Office of Fair Trading in the United Kingdom noted in its recent investigation into whether BSKyB had abused its dominant position in two pay TV markets that 'there are barriers to entry by potential rivals in premium channel supply, not least BSKyB's exclusive control of prime content rights'. Refer: OFT, *BSkyB: The outcome of the OFT's Competition Act investigation*, December 2002, p. 5.

¹⁷ This was a finding of the Productivity Commission in its Telecommunications Competition Regulation inquiry report (see p. 514). See also M. Shurmer, 'Future Demand for pay TV in the UK', *Telecommunications Policy*, vol. 21, no. 7, 1997.

Figure 2.3 The programming 'vicious circle'



Therefore retail pay TV operators have an incentive to purchase premium content on an exclusive basis. While the costs of obtaining such content may be high, the longer term remuneration for doing so may be higher. In particular, the pay TV operator may strengthen its own position while simultaneously weakening the position of its competitors by sending them into a 'vicious circle'.

The vicious circle occurs when competitors cannot obtain premium content, which decreases their ability to attract a large number of subscribers. Channel suppliers with premium content would not be able to maximise exposure of content by exclusively providing to the competitors and therefore the cycle is further entrenched. The competing retail pay TV operators struggle under existing content costs and low subscriber numbers.

High sunk costs of distribution networks

Establishing a distribution network capable of delivering pay TV services involves considerable sunk costs, such as launching a satellite or deploying a cable network. As these sunk costs are irrevocably committed, the risk of entry is increased.

Retail pay TV providers may commercially negotiate access to existing distribution networks, which may also enable distribution network owners to lower the risk of network investment by capturing greater economies of scale and scope which may in turn assist their viability.

Access regulation can provide for third party access to pay TV distribution networks. However, access regulation has not resulted in effective access to date, and the regulation appears to have had limited effect in pay TV.¹⁸

Importantly, capacity constraints on the existing analogue HFC cable networks have also limited opportunities for access seekers. Capacity will be greater when the Telstra HFC network is digitised.

Importance of economies of scale

The ability to achieve economies of scale is an important consideration for potential entrants to the pay TV industry. Scale is required to disperse fixed costs over a high number of subscribers, thereby decreasing the cost per subscriber. The ability to achieve these economies of scale may determine the pay TV operator's success, and may also act as a barrier to entry.

Regulation

Regulatory barriers to entry for pay TV operators are considerably lower than for operators in the FTA sector, particularly as the number of licences is not restricted. However, while perhaps not as significant as the barriers to entry noted above, the pay TV sector is subject to particular regulations which may affect entry and expansion decisions.

¹⁸ The Commission deemed broadcasting access services to be declared in 1997, and subsequently declared the analogue-specific subscription television broadband carriage service after concluding that it would promote the long-term interests of end-users. Following declaration, the Commission was notified of two disputes, by TARBS and C7, relating to access to the Telstra/Foxtel network. In 2001, the Commission released an interim determination. However, a number of technical issues associated with access are yet to be resolved and the arbitrations remain outstanding.

The current anti-siphoning rules restrict the available sporting content shown by pay TV operators. The *Broadcasting Services Act 1992* (BSA) prevents pay TV operators from obtaining exclusive rights to televise events listed on the anti-siphoning list.¹⁹ The list extends to many important sporting events, such as AFL and NRL premiership competition matches, all test and one-day cricket matches involving Australia, the soccer FIFA world cup tournament, grand slam tennis tournaments, golf majors and Formula 1 World Championship (Grand Prix) motor racing.

Pay TV operators are also subject to some local content requirements. The *Broadcasting Services Amendment Act (No 3) 1999* enforced the requirement that pay TV drama services devote ten per cent of total program expenditure to new Australian (or New Zealand) drama programs.²⁰ Any shortfall in reaching this target is carried over to the following financial year.

Finally, the BSA also stipulated that, after 1 July 1997, subscription revenue must be the predominant source of revenue for pay TV services.²¹ In other words, advertising revenue must not exceed subscription revenue.

These regulatory factors may affect the decisions of firms to enter the industry, or to expand offerings. For example, while content is considered a key driver of increased penetration, the anti-siphoning rules prevent pay TV operators from securing exclusive rights to key sports content— which may retard subscription and revenue growth.

2.3 Key relationships in and between the pay TV, telecommunications and FTA sectors

The following section looks at the vertical integration of Foxtel, Optus and Austar in the pay TV supply chain and the implications of this integration. This section also examines the supply relationships between participants in the pay TV sector and the implications of these supply relationships. Finally, the chapter looks at the relationship between Telstra and Optus, the relationship between PBL and the Nine Network, and the importance of economies of scope to infrastructure investment.

2.3.1 Vertical integration of Foxtel

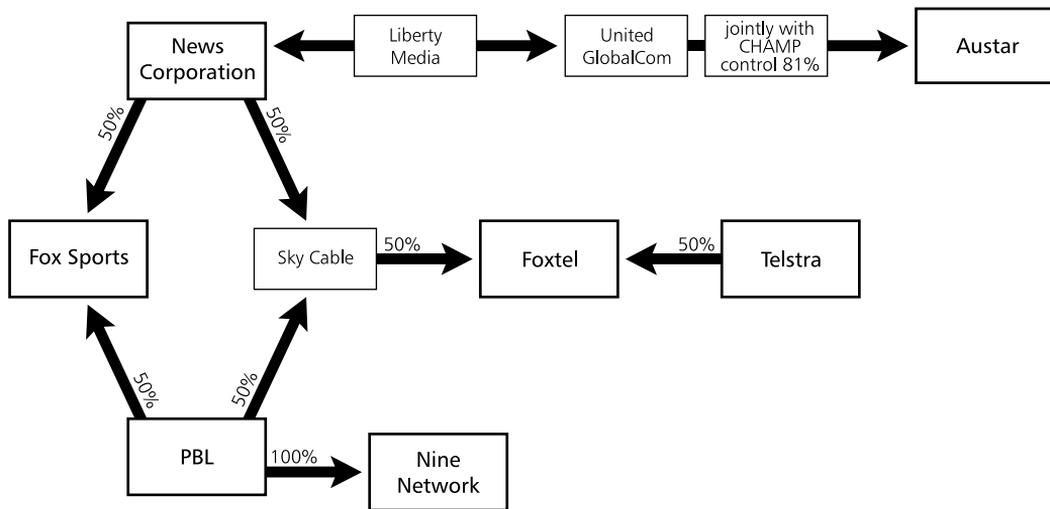
Foxtel is the most vertically integrated of the pay TV operators in Australia. It supplies the television service which is managed by Foxtel Management on behalf of two partnerships. Essentially the interests in the partnerships are held 50 per cent by Telstra Media, which is a wholly owned subsidiary of Telstra, and 50 per cent by Sky Cable, which is in turn owned 50 per cent by News Corporation and 50 per cent by Publishing and Broadcasting Limited (PBL). These relationships are depicted in Figure 2.4 on the next page.

¹⁹ BSA, section 115.

²⁰ As required by legislation, the Australian Broadcasting Authority is currently reviewing this requirement.

²¹ Paragraph 10(2)(b) of Part 6 of Schedule 2 of the BSA sets out that each subscription television licence is subject to the condition that subscription fees will continue to be the predominant source of revenue for the service.

Figure 2.4 Ownership interests in Foxtel



The ultimate shareholders in Foxtel have interests at other levels of the supply chain. Briefly, these include:

- Telstra is the incumbent telecommunications company which owns various telecommunications distribution networks including the HFC distribution network used by Foxtel to partly deliver its services. Telstra has a 50 per cent interest in Foxtel.
- News Corporation has extensive ownership interests in media and sport, both domestically and overseas. Not only does News Corporation hold a 50 per cent stake in program supplier Fox Sports, but it also holds interests in channel providers, including PMP (a supplier of premium movie content), through its majority stake in Fox Entertainment Group.
- In addition to PBL's 25 per cent interest in Foxtel, PBL also has a 50 per cent stake in channel supplier, Fox Sports.²² PBL also has a 100 per cent ownership of the Nine Network,

the highest-rating commercial FTA operator in Australia. PBL also owns Australian Consolidated Press, a corporation which has a wide range of media publishing interests.

Foxtel itself also has ownership interests at other levels of the pay TV supply chain. Foxtel, in a joint venture with Astar and Optus, has a 33 per cent interest in channel supplier Main Event Television, which supplies the Adults Only channel and the pay-per-view channel called Main Event. Foxtel, in a joint venture with Astar, also has a 50 per cent interest in channel supplier XYZ Entertainment. XYZ supplies six channels to both owners, being Nickelodeon, Channel [V], LifeStyle Channel, arena, musicmax and the Discovery channel.

2.3.2 Vertical integration of Optus

Optus Television is a service supplied by SingTel Optus (Optus), a wholly-owned subsidiary of the Singapore telecommunications company, SingTel. Optus owns the delivery platform over which the Optus Television services are supplied. Optus also has a 33 per cent interest in channel supplier

²² PBL reported for the financial year to 30 June 2002 that it had an equity accounted loss of \$22.7 million in Foxtel, but an equity accounted profit of \$20.6 million in Fox Sports. Therefore, in considering the two investments together, PBL incurred a small overall loss in the industry.

Main Event Television, and produces the MTV and Ovation channels in-house.

2.3.3 Vertical integration of Austar

Austar United Communications is jointly controlled by CHAMP and UnitedGlobalCom, the latter a United States-based broadband communications company.²³ Austar has ownership interests in channel suppliers, including The Weather Channel and TVSN Limited (which supplies the TVSN and Expo channels) and the aforementioned XYZ Entertainment and Main Event Television.

2.3.4 Implications of ownership and supply relationships

Vertical integration is a common aspect of supply in many industries, including the communications sector. However, vertical integration means that companies are concerned about maximising profits in the supply of joint services, which may have a negative effect on competition and efficiency in markets which rely on supply of one of the services.

Where a firm is vertically integrated into other levels of the same supply chain, it has particular incentives for behaviour which may affect competition in the markets in which the vertically integrated firm operates. Take, for example, a pay TV operator that is vertically integrated with a distribution network. The incentives of an independent retail pay TV operator are to drive penetration and maximise subscriptions. One of the incentives of an independent distribution network owner is to maximise use of the network. However, when integrated, these incentives can change. In particular, while the incentives appear to be aligned in terms of driving penetration, the pay TV operator has the incentive to minimise the ability of competing retail pay TV operators to use the distribution network, thereby increasing the likelihood of the retail pay TV operator maximising its own subscriptions.

²³ Liberty Media has direct ownership stakes in both UnitedGlobalCom and News Corporation.

Similarly, when a content or channel supplier is vertically integrated with a retail pay TV operator the incentives of this vertically integrated entity will be different from a firm who operates at only one level of that supply chain. An independent content or channel supplier wants to maximise revenues, but where the supplier is vertically integrated with a retail pay TV operator, the supplier may have incentives to supply the content in a way to maximise joint revenue. This may involve not supplying the content to other pay TV operators to decrease downstream competition.

2.3.5 Relationships between participants in the communications sector

Relationships between Optus and Telstra, and Optus and Foxtel

Like other carriers or carriage service providers, Optus relies on access to Telstra's ubiquitous local access network to supply a number of its services to end-users. While Optus is in a better position than most of the smaller players in the market, it still relies heavily on access to Telstra's local access network for national coverage. There are also supply relationships between Telstra and Optus for services like data interconnection and local call resale. Even on Optus' own network, a key service- pay TV content- is provided by Foxtel which is 50 per cent owned by Telstra.

Optus supplies satellite services to Foxtel and Austar for the delivery of pay TV services. Optus has also recently transferred ownership of its digital play-out centre to Foxtel, and contracted to receive these services from Foxtel (if Optus initiates a digital pay TV service). Play-out services involve carrying out the monitoring, quality control and service restoration functions for a pay TV service.

These supply relationships between Optus and Foxtel, and Telstra's relationship with Foxtel and its bundling of telephony with Foxtel's pay TV services, signify a partial alignment of interests between the two biggest telecommunications

service providers (Telstra and Optus) and the first and third largest pay TV service providers (Foxtel and Optus) in Australia.

PBL's joint ownership of Foxtel and the Nine Network

The Commission does not believe that pay TV and FTA broadcasting are currently in the same market, for reasons explained in chapter 5. However, PBL's joint ownership of a significant FTA broadcaster (the Nine Network) and PBL's 25 per cent ownership of the most significant pay TV provider (Foxtel) may still raise competition issues given the important linkages between the FTA and pay TV markets. In particular, these linkages are the potential for the joint purchase of FTA and pay TV rights and the retransmission of FTA channels over the Foxtel pay TV network.

The Commission discusses in chapter 4 its concerns relating to Foxtel/Fox Sport's market power in acquiring some pay TV content. Joint purchase of FTA and pay TV rights may cause competition concerns when it advantages the Nine Network over other FTA broadcasters when acquiring FTA content.

Retransmission of FTA channels over the Foxtel pay TV network is discussed further in chapter 7. The possible competition problem is that joint ownership provides an incentive for Foxtel to discriminate in favour of the Nine Network compared with other FTA broadcasters for retransmission of the FTA channels on the pay TV platform. This concern might extend to other services in the future, such as interactive services over the Foxtel pay TV platform.

Importance of economies of scope to infrastructure investment

The Commission understands that the economic deployment of broadband networks typically relies on multiple revenue streams, particularly those from broadband, telecommunications and pay TV services. By supplying these three services over the one network, economies of scope are achieved and the additional cost per subscriber is

diminished compared to offering the services over different networks.

In Australia economies of scope for broadband networks are suggested by the fact that most such networks supply multiple services. In this regard, the Commission notes that Telstra, Optus, TransACT and Bright all supply pay TV, broadband internet and telephony services. Neighborhood Cable also supplies both pay TV and broadband internet services. Although the network deployed by Neighborhood Cable is capable of supplying telecommunications services, the cost of the customer premise equipment (for example, handsets) is too expensive at this stage.

In the presence of economies of scope, if a network provider is not able to supply one of the above services then economic entry may not be possible and there is the possibility of foreclosure.

2.4 Digitisation, broadband supply and convergence

The telecommunications and pay TV industries are continually evolving, introducing new or updated technologies to provide goods or services. Technological advancements are also occurring in the provision of FTA services. A major cause of change in these markets is because of developments in digitisation, which is facilitating the increasing closeness or 'convergence' of aspects of the communications sector.

It is clear that telecommunications, pay TV and FTA broadcasting are all subject to technology change. What is less clear is the rate of change and what the eventual markets and services provided will look like. Such advancements may also lead to the development of new markets, further changing traditional market boundaries.

2.4.1 Digitisation and broadband supply

Digitisation is essentially the process of coding information, irrespective of its form, as streams

of binary digits. This coding considerably reduces the amount of information that has to be transmitted for full reproduction of the original signal by the receiver and frees up spectrum that can be used for the transmission of other signals, thereby increasing the network's capacity. Digital networks therefore can provide for higher capacity, greater functionality and improved quality compared to traditional analogue networks.

The word 'broadband' is sometimes used to describe digital networks. However, not every broadband network uses digital transmission.²⁴ Broadband essentially describes the capacity to transmit large quantities of information quickly. It is a reference to capacity as opposed to the form (analogue or digital) in which the information is being transmitted. Broadband access can be provided by infrastructure such as copper (using xDSL technology), fibre-optic, satellite or terrestrial microwave.

Digitisation of the Telstra and Optus HFC networks

Digitisation of the Telstra and Optus HFC pay TV networks would mean that content carried on this network would be carried in a digital rather than an analogue form all the way to the viewer's STU. As carriage of content in a digital form requires considerably less bandwidth than the same content carried in an analogue form, digitisation of the Telstra HFC network will significantly increase the capacity available on the that network. To fully digitise their pay TV networks, both Foxtel and Optus would need to replace current analogue STUs with digital STUs.

Digitisation will mean that many more channels can be made available to end-users. The increased capacity will also increase functionality

and quality, allowing higher picture and sound quality, greater interactivity and new services, such as electronic program guides (EPG) and parental control features. The greater number of potential channels also allows near video-on-demand. True video-on-demand can also be provided if sufficient capacity and functionality exists in the digital network.²⁵

Foxtel has commented that digitisation of the Telstra HFC network, and the installation of digital STUs, will have a significant effect on the number of pay TV channels available:

During the initial phase, more than 100 channels of enhanced content and new services will be available to consumers, with a substantial range of additional channels to be made available on the FOXTEL system to channel providers who wish to operate independently of FOXTEL through access arrangements. In the second phase, the system will have more than 400 channels.²⁶

A recent media report noted that Foxtel's pay television subscribers will have access to 30 near video-on-demand channels as part of a new 120-channel product when Foxtel completes the first phase of the digitisation of its pay TV network later this year.²⁷

Interactivity

Interactivity provides an additional avenue to offer different types of services and therefore a potential opportunity to generate increased revenue. Interactive services are two-way- that is,

²⁴ The FCC defines 'broadband' in the following manner: 'Broadband is a descriptive term for evolving digital technologies offering consumers a single switched facility offering integrated access to voice, high-speed data services, video-demand services, and interactive information delivery services. Broadband also is used to define an analog transmission technique for data or video that provides multiple channels. A cable TV system, for example, employs analog broadband transmission': FCC, *A Glossary of Telecommunications Terms*, p. 5.

²⁵ A video-on-demand service provides for a program or film to be independently sent to a consumer upon request at any time. This contrasts with broadcast television which is sent simultaneously to all consumers able to receive it and is obviously subject to set times. With a video-on-demand service consumers are able to access the latest video release movies, or other program content, from their home at any time and can stop, start, pause, fast-forward or rewind a program.

²⁶ Foxtel, *Foxtel announced undertakings to the ACCC to improve television services and commence digital roll-out*, media release, 5 September 2002.

²⁷ D. Kitney, 'Foxtel's 30 Video-on-Demand Channels', *The Australian Financial Review*, 18 February 2003, p. 6.

they allow the end-user to send and receive information. They therefore require a return path from the end-user to the service provider. At present in Australia, the only pay TV operator to offer interactive services is Austar, with around two-thirds of its customers having STUs with interactive capability.²⁸ Interactive services are discussed further in chapter 7 which deals with access to carriage regulation.

Digitisation of the copper network

The use of xDSL (Digital Subscriber Line) technology on the copper network allows for broadband access via the copper network that connects virtually every household in Australia to the publicly switched telephone network, or PSTN. The term xDSL refers to the family of digital subscriber line services. The most common form of xDSL utilised, particularly in residential applications, is ADSL, or Asymmetric Digital Subscriber Line. ADSL is a high bandwidth downstream service, coupled with a lower bandwidth upstream service. Such asymmetric services are well suited to internet access where more data is going to the customer than is being sent by the customer.

The attraction of xDSL is that, with some limitations,²⁹ it can provide broadband access to the majority of the Australian population, as the copper network covers 99.75 per cent of Australian households.³⁰ Telstra aims to provide ADSL coverage to 90 per cent of Australian homes and businesses, although provisioning and copper quality issues mean the current coverage is likely to be less than this.³¹ This can be contrasted to the relatively limited coverage of the Telstra and Optus HFC networks which pass 2.5 million households (approximately 35 per cent of

Australian households) and 2.2 million households (approximately 28 per cent) respectively.³²

Depending on several conditions, including decisions by a carrier about how to provision the network and the distance of the end-user from the exchange, xDSL over a copper network can provide speeds of up to 8 Mbps per second—sufficient to provide a high quality broadcast stream. For example, MPEG movies with simulated VCR controls require 1.5 or 3.0 Mbps.³³ The high speed available using xDSL technology means that it is possible to use xDSL to provide not only high-speed internet, but also pay TV, video-on-demand, interactive TV and advanced multimedia services.

The Commission understands that Telstra's current configuration of its ADSL network makes it unsuitable to provide pay TV services. Telstra's ADSL network is therefore, at the moment, unable to provide or guarantee the type of data transfer speeds that would be necessary to deliver pay-TV-type services. The Commission understands that alterations could be made to the network to enable pay TV-type services to be offered. However, such alterations would be of a relatively significant nature.

Telstra uses the same network to deliver wholesale and retail ADSL services and, therefore the current limitations on speed and quality of service would likely limit resale customers from providing pay TV-type services.³⁴ Operators who supply xDSL services using the unbundled local loop service (ULLS) from Telstra are able to configure their services to take better advantage of the high speeds that can be achieved using xDSL, and potentially provide pay-TV type services to end-users.

²⁸ Australian Communications Authority, *Telecommunications Performance Report 2000-01*, p. 212.

²⁹ One important limitation is the distance of the end-user from their local exchange. ADSL is normally only available to end-users within three and a half kilometres from an ADSL enabled local exchange.

³⁰ BIS Shrapnel, above n. 8, p. 32.

³¹ See Telstra, 'High speed Internet and data service on ADSL - frequently asked questions', <www.telstra.com.au/adsl/sfaq.htm>, accessed 4 March 2003.

³² BIS Shrapnel, above n. 8, p. 103.

³³ *ibid.*, p. 64.

³⁴ Indeed, not only is the Telstra ADSL network unable to provide the guarantees of speed that would be required to provide pay TV-type services, but it is also not suited to providing business grade broadband services that require a high level of service quality. That is, currently the Telstra ADSL network is designed to provide residential broadband access where a 'best efforts' service is sufficient.

Alternative xDSL networks, such as those deployed by Request Broadband and TransACT have the capability of providing the speed and the quality of service required to provide pay TV-type services.³⁵ The TransACT network, which is a combination of fibre-to-the-curb and then VDSL over copper to the home, offers downstream speeds of up to 52Mbps and is currently used to provide pay TV services to end-users.³⁶

2.4.2 Digitisation of terrestrial broadcasting

The FTA channels are broadcast terrestrially, historically in analogue format. Broadcasting terrestrially refers to, in this context, television signals broadcast from local radio towers. Homes with antennas capable of picking up the broadcast signals are able to receive the television program.

Digital FTA television was introduced to Australian capital cities in 2001, with regional areas to have digital broadcasting introduced progressively from that time. All areas should have received digital broadcasting by 1 January 2004. Digital signals are currently being simulcast with analogue signals; however, the analogue system is scheduled to be switched off in 2008. At this stage the take-up of FTA digital television services is low, with approximately only about 35 000 to 55 000 digital receivers having been bought to date.³⁷ While the analogue spectrum currently used for analogue FTA television is due to be returned to government in 2008, a further review of this will be conducted by 2005.

Digital transmission of television makes the transmission of more than one discrete stream of programming possible over the spectrum space previously used for a single analogue TV channel. Compression techniques employed for digital transmission would allow a broadcaster to transmit three or more standard definition signals in that spectrum space- this is referred to as multi-channelling.³⁸

It is noted that FTA channels are currently re-supplied or 're-transmitted' by pay TV operators, meaning that end-users can move seamlessly between pay TV and FTA channels. Pay TV operators generally do not resupply the FTA channels to end-users who receive their services by satellite because of the cost of the satellite capacity required to re-transmit the FTA channels.

2.4.3 Convergence

The term 'convergence' has been used in a number of different ways, but broadly it refers to the increasing ability of networks to deliver a broader range of services, and for previously disparate markets to merge. The International Telecommunication Union describes the relationship between broadband and convergence by saying that 'broadband is at the heart of the convergence of telecommunication, information technology and broadcasting'.³⁹

Generally speaking, convergence refers to the increasing substitutability of platforms to deliver communications, broadcasting and other services. This includes variations of traditional consumer devices able to receive different services, for example interactive television or voice-over Internet Protocol (IP) networks. This substitutability is made possible by technological advancements, such as improved capacity on existing network infrastructure (for example, compression

³⁵ The Request Broadband network can offer downstream speeds of up to 6Mbps and offers a 99.9 per cent service level agreement: Request, 'FAQs' and 'Service level agreement' <www.requestbroadband.com.au>, accessed May 2003. Pay TV services are not currently being provided over the Request Broadband network.

³⁶ TransACT Communications, 'Technical information', <www.transact.com.au/about/technical.asp>, accessed 25 February 2003.

³⁷ There are in excess of 12 million TV sets in Australia. See ABN AMRO, *FTA Television: Time to face the FACTS*, July 2002 p. 22, where it is stated that 99 per cent of the 7.2 million households in Australia have at least one TV and 66 per cent have more than one.

³⁸ Productivity Commission, *Telecommunications Competition Regulation*, p. 559. Although note that multi-channelling by commercial FTA broadcasters is currently prohibited- see chapter 5.

³⁹ International Telecommunication Union, 'Broadband', <www.itu.int/osg/spu/ni/broadband/background.html>, 30 October 2001, accessed January 2003.

techniques), new broadband infrastructure and digitisation of delivery platforms.

Third generation (3G) and other broadband wireless technologies such as Wi-fi may also provide rich 'multimedia' services. Increased bandwidth enables greater volumes of data to flow to mobile receivers, thereby enabling full broadband services, such as full colour screens, video conferencing, full motion video, picture emails and full web facilities.⁴⁰ These services may be specifically tailored to the 'small screen' nature of mobile phone receivers or computers.

The extent to which, and the time period over which, convergence will evolve is uncertain. This is not only because the technological developments that may take place are unknown, but also because current regulatory restrictions on certain markets or services will impact in possibly unforeseeable ways on the process of convergence. What is clear is that digitisation, broadband supply and convergence have the potential to affect the telecommunications, pay TV and FTA sectors in a significant manner.

2.4.4 Changing dynamics

Digitisation, broadband supply and convergence will potentially affect the entry of new firms, the ways in which services are provided to the market and the boundaries of different markets.

Emerging technologies may provide complementary or substitute services to existing services (for example pay TV services with potentially greater enhancements). They may, overtime, even give rise to completely new types of services.

The process of digitisation and convergence may mean that traditional market definitions need to be re-examined because of the increased complementarity between services being offered and the bundling of these services. While traditional approaches to market definition will remain relevant, convergence affects the manner in which competition issues are analysed because

market boundaries that have previously been defined may need to be reassessed.⁴¹ Boundaries of markets are determined by what is regarded as substitutable for the particular good or service concerned. A good is substitutable when buyers will swap between goods or services if given sufficient price incentive.⁴²

There is also the potential for new firm entry to be facilitated by technological change. As broadband supply increases the range of services for consumers, it may generate new revenue sources for existing networks and/or opportunities for new market entry.

New entry and innovative service offerings have the potential to deliver significant benefits for consumers and result in increased competition between previously separate markets. However, the key converging markets of telecommunications, FTA broadcasting and subscription broadcasting are concentrated markets, and market power may be retained by the existing major firms. This may occur because market power in existing markets may be leveraged into new, emerging markets.

A particular concern is that the relationships between the markets will mean that the major firms in the existing markets will be able to leverage market power into emerging markets and for the delivery of new services. That is, the Commission is concerned that Telstra and Foxtel, in particular, will be able to protect or even reinforce existing market power, by utilising the advantages currently gained from their market power. The prospect of greater competition through new entry or between incumbents as a result of innovation will be lost- the status quo will remain.

⁴¹ The term 'market' is defined in section 4E of the TPA as: '... a market in Australia and, when used in relation to goods or services, includes a market for those goods and services and other goods and services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services'.

⁴² See for example *Re QCMA and Defiance Holdings* (1976) 25 FLR 169 at 190 and *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177.

⁴⁰ BIS Shrapnel, above n. 8, p. 108.

2.5 Conclusions

In summary, this chapter noted that there are three main pay TV operators in Australia: Foxtel, Austar and Optus. Other operators are TARBS and three relatively new regional entrants in Neighborhood Cable, TransACT and Bright (Western Power). Pay TV operators use a variety of distribution platforms to deliver services to subscribers, including HFC cable, satellite, xDSL and wireless MDS networks.

The pay TV sector exhibits a high degree of vertical integration, particularly given the ownership links between the channel suppliers, pay TV operators and distribution platforms. Vertical integration can create competition concerns by distorting incentives to maximise use of infrastructure and distribution of content.

The pay TV sector is also characterised by significant barriers to entry and expansion for smaller pay TV operators. These barriers include the sunk costs of distribution and the need for economies of scale, current regulations and access to content.

Convergence is arising from technological advancement, in particular digitisation and broadband supply. Convergence potentially offers increased scope for new entry and the possibility of greater competition between previously separate markets. However, there is a need to be vigilant to ensure that major firms in existing markets, in particular Telstra and Foxtel, are not able to leverage market power into emerging markets and markets for the delivery of new services.

3 The pay TV agreements

This chapter provides a summary of the pay TV agreements, the Commission's competition concerns arising from these agreements and the subsequent undertakings provided to the Commission to address those concerns.

3.1 Overview

On 5 March 2002, Foxtel and Optus approached the Commission with a proposal relating to the supply of Foxtel content to Optus governed by an agreement, the CSA. The CSA was conditional upon the parties being notified that the Commission did not intend to intervene should the parties give effect to the CSA. That is, the parties essentially sought clearance of the agreement by the Commission.

Following market inquiries and analysis, the Commission announced on 21 June 2002 that it believed the proposed arrangements between Foxtel and Optus raised several concerns in a number of markets and therefore the arrangements, if implemented, were likely to breach the TPA.¹

¹ Australian Competition and Consumer Commission, *Foxtel/Optus proposal likely to breach Trade Practices Act*, media release, 21 June 2002.

Subsequently an agreement between Foxtel and Austar was also submitted to the Commission for consideration. This agreement provided for the supply of certain pay TV rights to Austar.

A number of parties, namely Foxtel, Optus, Telstra and Austar, then approached the Commission with draft section 87B undertakings which were designed to address the competition concerns that the Commission had identified.² The Commission released the undertakings for public comment on 5 September 2002, although the undertakings were amended before and after this date as a result of discussions with the parties.

The Commission announced on 13 November 2002 that it believed the undertakings finally offered to the Commission addressed the competition concerns that it had identified.

² Section 87B of the TPA provides that the Commission may accept a written undertaking in connection with a matter in relation to which the Commission has a power or function under the TPA. Undertakings given under section 87B are court enforceable insofar as the Commission may apply to the court for various orders where the Commission considers that a term of an undertaking has been breached. Such orders can include an order directing the provider of the undertaking to comply with the undertaking or to compensate a person who has suffered loss or damage as a result of the breach, as well as any other order that the court considers appropriate.

It is important to note that in developing the section 87B undertakings with Foxtel, Optus, Telstra and Austar, the Commission was restricted to dealing with the competition concerns that would arise if the pay TV agreements were implemented. The undertakings were not designed to deal with competition concerns that did not arise as a result of the pay TV agreements— that is, the undertakings could not address pre-existing competition concerns.

3.2 Content Supply Agreement

The CSA provides for Foxtel to supply its channels to Optus for resale on Optus' HFC network until 31 December 2010. The agreement does not apply to other delivery mechanisms such as satellite or MDS. Optus will be supplied with all of Foxtel's pay TV and pay-per-view channels, but the agreement excludes supply of, among other things, video-on-demand, FTA retransmissions and interactive pay TV services.

Also under the CSA, from 1 November 2002 to 31 December 2010, Foxtel will pay (up to certain maximums) the liabilities and commitments, with one exception, of Optus disclosed as at the date of the CSA, in relation to any of Optus' existing programming contracts (including any minimum subscriber guarantees) with channel or program providers.

The CSA places a number of obligations on Optus and restricts the way Optus can resupply the Foxtel services. For example, the agreement sets out the order in which Foxtel channels will be added to the Optus line-up, as analogue capacity becomes available (given current capacity constraints on the Optus analogue HFC cable network). If and when Optus fully digitises its HFC network, Optus will be required to supply all the Foxtel channels.

When Optus acquires a channel from a supplier other than Foxtel after 30 January 2002, the agreement prevents Optus supplying that

channel in its basic package. Optus generally has the right to elect the tier on which the channel is provided, although when that channel is of the same or a similar genre of programming as a Foxtel service, Optus must place the new channel service on a higher tier than the Foxtel channel. The license also stipulates that if Optus acquires any movie or sports rights that it or Foxtel does not currently have, then Optus must arrange for those rights to be made available to Foxtel for distribution on Foxtel's cable service. This also applies to programs produced by Optus.

Optus is free to set the retail price of its pay TV service, including the Foxtel channels, at its discretion. Optus is also free to supply its pay TV service as a stand-alone or bundled product offering, although if it chooses to supply the Foxtel service as part of a bundle, it can only do so as part of a retail bundled offering comprising Foxtel services and Optus branded telecommunications services and/or Optus branded associated information, entertainment or managed services.

The fee which Optus is to pay Foxtel for the Foxtel services is calculated on a 'retail-minus' pricing model. That is, Optus will get Foxtel's basic package at the basic retail price minus x per cent.³ If Optus wishes to supply a tier package or pay-per-view service, then Optus will acquire these from Foxtel at retail tier price minus x per cent⁴ or amount equal to the incremental Foxtel retail price respectively.

The CSA places restrictions on the use of Optus' cable by third parties for pay TV services. Originally, the CSA prevented third parties from using the Optus cable to provide pay TV services, but it was subsequently amended so that access could be obtained under two scenarios. First, Optus may grant third parties access to its cable network and STUs where each subscriber taking the access seeker's pay TV service through the Optus STU is also taking the Optus basic package. Second, Optus may grant third party access to its

³ Confidential information.

⁴ Confidential information.

cable network (but not the STUs) to provide a pay TV service to a subscriber who does not take the Optus basic package, provided that Foxtel receives a specified proportion of the access charges received by Optus, and provided there is no connection between Optus and the access seeker's pay TV service.

The CSA also restricts the disposal of assets by Optus. In particular, Optus must notify Foxtel if it proposes to dispose of any of its programming contracts, the Optus pay TV business, the Optus cable network or shares in Optus or Optus Vision Media, or if there are certain ownership changes in Optus or some of its related entities. Certain specified payments must be made to Foxtel in the event of Optus proceeding with such disposals. Disposals by Optus in the ordinary course of business generally do not trigger this requirement.

Under the original CSA, Foxtel had some first and last rights of refusal to buy the Optus programming contracts, pay TV cable business assets or HFC network should Optus decide to dispose of any, or all, of these assets or any shares in Optus or Optus Vision Media. The Commission expressed concern about the potential anti-competitive effect of this clause. It was subsequently deleted from the CSA.

Under a related agreement– the satellite services agreement, Foxtel will lease 12 out of 20 transponders from Optus, with an option to lease a further two transponders, on the C1 satellite.

3.2.1 Foxtel/Austar agreement

Although not a party to the CSA, Austar agreed to vary certain existing agreements to enable Foxtel and Optus to give effect to the CSA. These agreements resulted in consequential changes to existing channel supply agreements and related arrangements between Austar, Foxtel and Optus.

Under previous arrangements, Foxtel supplied Austar with nine channels and Austar held exclusive rights for four of these channels on MDS and satellite delivery platforms in the Austar areas. Austar could not sub-license these channels without Foxtel's consent. The arrangements were

altered to make Austar's rights to the Foxtel-related channels exclusive on all platforms throughout the Austar areas, except the Gold Coast. Austar is now permitted to sub-license those channels (within an Austar branded package of pay TV services) to any third party for bundling with any telecommunications service. Austar may also provide its package of pay TV services to another owner, controller or operator of a cable, satellite or MDS service (as long as the operator owns or controls the STUs).

Under the new arrangements Austar also gains the option to acquire the distribution rights to additional channels owned by Foxtel⁵ and also gains the option to acquire new programming services created or produced by Foxtel.

3.2.2 Key competition concerns arising from the CSA

The CSA fell for consideration under the competitive conduct provisions of the TPA. A contravention of the TPA under the relevant competitive conduct provisions requires that the agreement has the effect, or likely effect, of substantially lessening competition in a market(s).⁶ While the Commission can take action under these provisions of the TPA, third parties also have a right of private action under these provisions.

On 19 June 2002 the Commission announced that it believed that giving effect to the CSA would likely result in a substantial lessening of competition under the TPA in a number of markets, namely:

- the market for acquisition of broadcast rights for pay TV
- the market for the wholesale aggregation and supply of programming for pay TV

⁵ These channels are: Showtime 2, Fox Classic and Fox News.

⁶ The agreement did not fall for consideration under section 50 of the TPA as it does not involve the acquisition of a legal or equitable interest in, or assets of, a body corporate or person. The agreement was not submitted to the Commission for consideration under the authorisation provisions of the TPA, thus it was not subject to a public benefits test.

- the market for the supply of retail pay TV services
- the market for telecommunications fixed customer access networks.

The Commission was concerned that the arrangements would diminish incentives for Optus to acquire programming. Even if Optus continued to acquire content, it would face restrictions under the CSA about how the channels it acquires can be positioned and packaged.

This reduction in content-based competition between the parties would likely lead to less competitive tension for the acquisition of content. It would considerably enhance Foxtel's negotiating power in the acquisition of content. The agreement therefore strengthened Foxtel's ability to dictate the price and terms for the supply of content (including positioning/tiering of programming, viewing times, exclusivity, relative splits of revenue between suppliers and Foxtel) and to largely determine who gets access to content. Vertical integration affords Foxtel the ability and the incentive to disadvantage or foreclose suppliers of competing non-affiliated programming.

The Commission also believed that the arrangements would result in a lessening of independence and rivalry between Foxtel and Optus in the retail pay TV market. In particular, there would be a reduction in content-based competition and less differentiation between Foxtel and Optus on price.

The Commission considered that the agreement gave rise to a number of competition concerns in the market for telecommunications fixed customer access networks. In particular the Commission was concerned that the agreement would result in increased barriers to entry for competing pay TV operators as access to pay TV content would be even more difficult to obtain given Foxtel's enhanced bargaining position in the acquisition of content.

The increase in the concentration of control of key programming would be likely to make it even more difficult for competing networks to access premium programming. Exclusive channel supply contracts

and ownership links between Telstra, Foxtel and some key channel suppliers provide the means by which key programming can be withheld. The arrangements enhance Foxtel's market power such that Foxtel could be placed in a position to exert considerable influence over the availability and supply of a large range of programming.

Finally, the arrangements represent the development of a much closer association between the first and the third largest pay TV operators (and the only major suppliers of pay TV services in metropolitan areas) and of the largest and second largest telecommunications carriers. Therefore the arrangements may also increase the scope and incentive for tacit collusion.

3.3 Undertakings offered

Foxtel, Telstra and Optus originally approached the Commission with proposed undertakings on 5, 12 and 16 July 2002 respectively. Austar subsequently offered its content supply undertaking on 30 August 2002. Some discussion followed between the Commission and the parties that resulted in amendments to the original undertakings.

On 5 September 2002, the Commission released the draft undertakings and a discussion paper. The Commission used the submissions received from interested parties in analysing the various iterations of the section 87B undertakings offered by Foxtel, Optus, Telstra and Austar and in framing discussions with these parties.

The undertakings offered by Foxtel, Optus, Telstra and Austar, and finally accepted by the Commission are summarised below.

3.3.1 Access to carriage for pay TV services

Telstra undertook to give the Commission an analogue access undertaking under section 152BS of the TPA. This access undertaking sets out the terms and conditions for access to the declared analogue pay TV service. Through the section 87B

undertaking, Telstra also undertook to change its current capacity allocations so as to make ten channels in respect of the declared analogue service available on its cable network for use by persons other than Foxtel.

In relation to the declared analogue service, Foxtel also undertook to give to the Commission an access undertaking under section 152BS of the TPA. This undertaking specifies the terms and conditions of access to analogue cable STUs for ten analogue channels.

In terms of the supply of a digital pay TV carriage service, Telstra undertook to supply this service should Telstra commence to operate a digital service. Similarly, Foxtel undertook to supply a digital STU service should it commence a commercial retail digital cable pay TV service.

The digital access undertakings providing for access to these digital services are stated to be in force until 31 December 2007, but they can be extended to 31 December 2015 if Telstra/Foxtel gives notice that they intend to continue their respective digital access undertakings.

3.3.2 Commitment to digitise

Foxtel and Telstra gave a commitment to digitise as long as the government passed legislation that extends the ability to give exemptions under Part XIC before declaration of a service.⁷ This is subject to the condition that certain regulatory change does not occur.⁸ Both Telstra and Foxtel

⁷ The *Telecommunications Competition Act 2002*, which provides for exemptions to be granted before the declaration of a service, was assented to on 19 December 2002.

⁸ Regulatory Change is defined in the undertaking as the Government passing legislation which has the effect of:

- (a) preventing providers of subscription television service or any one of them from acquiring subscription television rights or subscription television rights to television programs or channels (other than rights, programs or channels consisting predominantly of movies) on an exclusive basis;
- (b) requiring providers of subscription television services or any one of them to supply television programs or channels to other providers of subscription television services; or
- (c) allowing open broadcasters to multi-channel prior to January 2007 or provide subscription television services using the terrestrial broadcasting services bands.

undertook to commence supplying retail digital cable and satellite services not later than 12 months after the date on which Foxtel and Telstra obtain a decision to exempt the digital cable pay TV carriage service, if such a decision is made.

If either Foxtel's or Telstra's application for an exemption is rejected, the party in question undertakes that it will, within two months of the Commission advising it of the reasons for rejection, make a further application for an exemption and will submit a variation to the section 87B undertaking under section 87B(2) based on a revised access undertaking. This is provided the variations required by the Commission are acceptable to Foxtel and Telstra acting reasonably.

3.3.3 Access to content

Both Foxtel and Austar undertook to enter into agreements with infrastructure operators who request to be supplied with the Foxtel or Austar pay TV service. Both Foxtel and Austar also undertook to supply infrastructure operators of ADSL networks on the same terms in the event that Foxtel/Austar commences supplying a retail pay TV service using ADSL.

The arrangements are based on a retransmission model with no ability for the infrastructure operators to repackage or alter the Foxtel/Austar product and are based on a retail-minus pricing model. Infrastructure operators are, however, able to supply other non-Foxtel/Austar programming over their networks either as a basic package or on tiers provided that a subscriber does not need to buy-through these channels to receive the Foxtel/Austar services. Foxtel undertook that if the discount at which Foxtel supplies its subscription television services to Telstra increases, Foxtel will increase the discount at which it supplies infrastructure operators by the same amount as the proposed increase to the Telstra discount.

Foxtel also undertook that, as long as it has exclusive rights to AFL, it would sub-license that match coverage (or in the event that Foxtel was producing a dedicated AFL channel, that channel) to infrastructure operators or resellers on terms that do not discriminate unfairly between them.

3.3.4 Acquisition of content

Foxtel and Optus have provided undertakings to the Commission in relation to the acquisition of content. Foxtel and Optus undertook not to acquire the pay TV rights to various shared channels⁹ on an exclusive basis. Further, Optus undertook that it would not acquire the pay TV rights to the Movie Network or PMP channels on an exclusive basis. A similar undertaking by Foxtel provided that it would not exclusively obtain the Movie Network and PMP channels upon termination of current agreements, unless it is a requirement of the licensor of those channels that the channels are to be acquired exclusively, or an exclusive bid has been made for those channels by a competing bidder.

Other undertakings relevant to the acquisition of content included:

- Foxtel providing an undertaking that at least 30 per cent of the pay TV video channels in its basic package will comprise non-affiliated channels¹⁰
- Optus' undertaking that it would, for the duration of the CSA, continue to provide in its pay TV service two channels compiled by Optus and which comprise programming that Optus has created or acquired from sources other than Foxtel or a Foxtel shareholder group member
- both Foxtel and Optus provided undertakings regarding expenditure on Australian drama programs
- in relation to any 3G, internet or high-speed broadband content rights that are provided with pay TV service rights, Foxtel undertook not to jointly bid for these rights with Telstra, Telstra Media, Sky Cable, News Corporation

⁹ Shared channels are channels that both Foxtel and Optus broadcast prior to the CSA: Antenna; BBC World; Cartoon Network; CNBC; CNN; Disney; National Geographic; RAI; Sky News; Sky Racing; TCM; TVSN; World Movies; and ESPN International.

¹⁰ The definition of affiliate includes any channels in which Foxtel or its shareholders or their related parties hold shares in the operator of that channel, or otherwise have management or control over the programming decisions.

or PBL, or their related parties, nor license these content rights to these parties on an exclusive basis. If Foxtel does acquire any of these rights and sub-licenses them on a non-exclusive basis, it will offer to sub-license those rights to all third parties on comparable terms and conditions.¹¹

3.4 Commission decision

On 13 November 2002 the Commission announced that the undertakings offered by the various parties addressed its specific competition concerns arising from the proposed arrangements.

While, on balance, the Commission found that the undertakings offered in response to the CSA were likely to be sufficient to overcome its competition concerns, the Commission recognised at the time that some concerns were likely to remain even if it accepted the undertakings.¹² That is, the concerns that pre-dated the CSA and did not arise as a result of the CSA remained.

3.4.1 Market for the acquisition of broadcast rights for pay TV and the market for the wholesale aggregation and supply of programming for pay TV

In the markets for the acquisition of broadcast rights for pay TV and the wholesale aggregation and supply of programming for pay TV, the Commission was concerned that the pay TV agreements would act to reduce competitive pressure for the acquisition of pay TV content.

¹¹ Foxtel is also prevented from acquiring pay TV rights from a related party where that party was used to warehouse bundled pay TV rights and 3G rights. This clause is essentially an anti-avoidance provision.

¹² Australian Competition and Consumer Commission, *ACCC accepts Foxtel-Optus Pay TV deal*, media release, 13 November 2002.

The Commission found that the undertakings increased the opportunity for pay TV competition through the Telstra/Foxtel HFC network and through new infrastructure operators.

This raised the issue of whether new pay TV operators would be able to establish themselves as viable competitors. Clearly access to content is a key issue to consider in this context. In this regard, the undertakings protect against the exclusive purchase of the Movie Network, ESPN and shared channels and provided for the on-supply of Fox Footy. Also PMP channels are likely to be non-exclusive in the future. As a result of these undertakings, pay TV operators have some certainty about access to movie and sport content that can be sourced independently of Foxtel.

In deciding whether the undertakings addressed concerns about Foxtel's increased market power, a judgment was required about the degree of competitive pressure that Optus would provide in the absence of the CSA. There was evidence that Optus' competitive position in the market was being adversely affected by its inability to access and supply key content to its customers. In these circumstances the competitive pressure in pay TV without the CSA and the undertakings was likely to diminish over time.

The various undertakings that Foxtel and Optus gave concerning the acquisition of content also assisted in addressing the competition concerns in these markets. On balance, the Commission found that the competition concerns identified in these markets were mitigated by the section 87B undertakings.

3.4.2 Market for retail pay TV services

The Commission's concerns around the CSA resulting in less differentiation between Foxtel and Optus in terms of price and product were in part addressed by Optus gaining greater quality product. While product differentiation may be diminished, Optus' ability to compete on price and bundled offerings would be heightened.

The Commission's concerns about heightened barriers to entry for new pay TV operators as a result of Foxtel's enhanced buying power and its increased ability to foreclose content were addressed through undertakings allowing potential new entrants to enter the market using either the access to carriage or access to content undertakings. The undertakings relating to the non-exclusive acquisition of content would also assist new entrants. The Commission found that by reducing these barriers to entry, the undertakings would act to facilitate the entry and strengthening of other pay TV operators.

Concerns that Optus' ability to compete was limited to its HFC network were addressed through an amendment to the CSA permitting Optus to access content under the access to content arrangements should it ever decide to launch a satellite service. Also, concerns that the restriction under the original CSA, which effectively prevented Optus from allowing any other pay TV operator to supply pay TV services over its HFC cable, were largely addressed by amending the offending CSA clause.

In view of the limited competition in the retail pay TV market to date and the difficulties Optus and other infrastructure operators faced in gaining access to key content, the Commission considered that the undertakings offered were sufficient to ameliorate the competition concerns that it had identified in the retail pay TV market.

3.4.3 Market for telecommunications fixed customer access networks

The competition concerns that the Commission identified in the market for fixed customer access networks were largely addressed by the access to content undertakings given by Foxtel and Austar. The undertakings given in relation to the non-exclusive acquisition of content also ensure that certain programming is not foreclosed to potential suppliers of retail pay TV services.

3.5 Future statutory processes and timing for these processes

There are two important regulatory processes that the Commission is required to conduct following its acceptance of the section 87B undertakings offered by the various parties.

First, the Commission must conduct an assessment of Telstra's and Foxtel's analogue access undertakings under section 152BS of the TPA. The Commission received these analogue access undertakings on 21 November 2002 and it released a discussion paper concerning these undertakings on 19 December 2002. Submissions closed on 7 February 2003.

The Commission has also received exemption applications that relate to digital pay TV services under section 152ATA of the TPA from Telstra and Foxtel. These applications were received in December 2002 and the Commission released a discussion paper calling for public submissions in relation to the applications in January 2003. The closing date for submissions was 28 February 2003.

The Commission's assessment of both processes is ongoing and will be finalised later this year.

It is important to note that these are statutory processes that the Commission is yet to finalise. The Commission will make its decisions on these matters in light of the facts and circumstances that exist at the time. Acceptance by the Commission of the undertakings does not imply that the Commission will make a particular decision or follow a particular course regarding those other matters.

4 Ownership of Foxtel and the Telstra/Foxtel HFC network

4.1 Overview

Access regulation is a key feature of current telecommunications policy. It aims to address market power in integrated upstream facilities that are necessary for downstream competition. Chapters 6 and 7 comment further on regulation for access to content and access to carriage respectively.

However, access arrangements have some limitations in promoting effective competition. One of the main deficiencies of access arrangements is that they do not change the underlying incentives of a firm not to provide fair, timely and non-discriminatory access to its upstream inputs when the firm also competes in downstream markets that rely on those inputs. As a consequence access regulation may not provide timely outcomes, may be open to gaming (from both access providers and access seekers) and may cause a high level of uncertainty. Access arrangements also have significant regulatory costs, which are exacerbated when there are strong incentives for access to be frustrated.

Since 1997 various measures have been adopted to strengthen the legislative access regime to try and improve its effectiveness and address the limitations identified above. Most recently this has included removing the possibility of merits review for Commission arbitration determinations,

publishing indicative prices for Telstra's copper access network services and the enhanced accounting separation of the wholesale and retail operations of Telstra.

This strengthening is noteworthy as it is contrary to the expectations held when telecommunications competition regulation was introduced- that less rather than more regulation would be required over time. The amendments to access regulation, while they are improvements which the Commission has generally supported, are a manifestation of the lack of effective competition in many markets. An obvious question is whether additional reforms are required to improve competition in telecommunications markets.

To date the success of the telecommunications access regime in introducing competition to the industry has been mixed.¹ Consumer choice has improved, prices have fallen and consumer satisfaction with competition and services is generally high.

Nevertheless Telstra still possesses significant market power in many telecommunications markets. It presently owns the two most extensive fixed-line networks in Australia (its copper access and HFC networks), which enjoy the largest

¹ Australian Competition and Consumer Commission, *ACCC Telecommunications Reports 2000- 01: Report 1- Telecommunications competitive safeguards*, 2002, p. 17.

market shares for residential broadband access. Telstra is also one of the most integrated telecommunications companies in the world, and continues to be the major supplier in all major telecommunications markets and in pay TV (through its 50 per cent shareholding in Foxtel).

Of particular concern is Telstra's control of inputs essential to providing downstream services. Few of Telstra's competitors have any real alternative to using Telstra's network services as an input for providing their own services, and many are simply competing at the retail level by reselling Telstra's services. In the last two years Telstra's market share in most markets has plateaued or even increased (in the pay TV market) because of some market consolidation and a levelling or reduction of competitive pressures.

Optus, the second largest player in the industry, is in a better position than most of the smaller players in the market, but it still relies heavily on access to Telstra's customer access network for national coverage. There are also supply relationships between Telstra and Optus for services like data interconnection and local call resale. Even on Optus' own network, a key service (pay TV content) is provided by Foxtel.

Telstra's market power means it continues to gain strong first mover and other advantages in the supply of new services. The absence of effective competition also reduces opportunities for innovation. Telstra will largely determine the nature and timing of new technologies. It will always be concerned about cannibalising existing revenues and protecting its dominant position when making decisions about the investment in, and supply of, new services.

In consideration of these issues, the Commission has previously stated that:

[A]ccess regulation alone may not be sufficient to curb market power in converging markets such that it may be necessary to consider whether structural separation of ownerships of inputs to these services is required.²

² *ibid.*, p. 18.

A number of international precedents illustrate the types of competition concerns that arise in relation to ownership of media, pay TV and telecommunications companies. Several OECD countries have prevented incumbent telecommunications companies from owning cable networks. The European Commission has also objected to a number of merger proposals between traditional telecommunications companies, cable companies and content providers on the grounds that they would be damaging to competition through foreclosure of key inputs to competitors and/or that they would allow leverage of market power across markets.

4.1.1 Vertical separation

Given the above considerations, it is not surprising that there has been recent debate about the current and future industry structure in telecommunications, with a focus on the vertical separation of Telstra. This is a debate the Commission welcomes, as it promotes discussion about the various merits of regulatory responses to meet the government's objectives of promoting the long-term interests of telecommunications consumers.

The Commission notes that the National Competition Council has recently expressed support for the option of the vertical separation of Telstra. In a letter to the recent House of Representatives Inquiry in to the Structure of Telstra, the President of the Council cited the Council's 2002 assessment that:

[T]he government should further consider the structure of Telstra, including the option of the structural separation of the fixed network.³

Vertical separation is also an issue that has been discussed internationally, notably by the OECD.⁴

³ G. Samuel, President National Competition Council, Letter to P. McMahon, Secretary, House of Representatives Committee on Communications, Information Technology and the Arts, 20 January 2003, p. 2.

⁴ OECD, *Restructuring Public Utilities for Competition*, 2001.

Broadly defined, vertical separation would involve separation of Telstra's wholesale or network operations and its retail functions. This is a complicated issue requiring sophisticated analysis of the costs and benefits and a comparison with the regulatory alternatives. There would likely be lost economies of scope and significant costs to implement vertical separation,⁵ but there should be substantial ongoing benefits in terms of improving incentives for network access and encouraging greater competition in downstream markets. Crucially, such benefits would be enduring while the implementation costs will only be incurred once.

The Commission acknowledges the issue of the vertical separation of Telstra is beyond the scope of the Minister's request, and consequently has not examined it in any detail in this report. The Commission has however examined issues surrounding the ownership by Telstra of a HFC network and 50 per cent of the Foxtel pay TV business. The Commission considers that the potential divestiture of these entities by Telstra is a significantly more restrained policy option than the vertical separation of Telstra as a means of increasing competition in the telecommunications sector.

4.1.2 Telstra's ownership of different networks and 'lines of business'

In Australia, whilst there has been recent debate around the vertical separation of Telstra, there has been a notable lack of discussion on the ownership of different networks by Telstra and how the control of multiple networks may negatively affect competition.

Like vertical separation, responses to limit ownership of different networks or lines of business raise complicated issues. Although policy responses that operate to limit ownership of different networks or lines of business may give

rise to substantial benefits if they increase competition, they may also result in lost economies of scope and implementation costs. However it is unlikely that such costs will be of the same magnitude as the costs associated with vertical separation— for example, vertical separation of Telstra's copper access network from its retail functions.

The types of ownership restrictions on Telstra proposed in this report— specifically Telstra's HFC network and its 50 per cent interest in Foxtel— relate to areas of the Telstra businesses that are less integrated and smaller than the network/wholesale and retail functions of the entire Telstra copper access network.

In this chapter the Commission focuses on structural remedies that deal most directly with issues that arise in regulating telecommunications and media services as a result of the pay TV agreements. By increasing infrastructure competition, the Commission also notes that ownership restrictions across networks will address, to an extent, the issues that cause some to advocate the vertical separation of Telstra.

Divestiture of the HFC would introduce a new infrastructure competitor into the market, creating conditions for increased rivalry and innovation in the supply of a full range of telecommunications services, including broadband services. The Commission believes that if the HFC is divested, divestiture of Foxtel would become even more important so that Telstra could not use its influence in Foxtel to deny the new network owner access to Foxtel pay TV content.

The Commission believes that there would be substantial competition benefits from requiring Telstra to, in particular, fully divest its HFC network and to divest its 50 per cent shareholding in Foxtel. These benefits would arise from Telstra and Foxtel's improved willingness to supply their services to competitors. This would mean more competitive market structures, which would help to address Telstra's continued market power and its ability to leverage such market power across telecommunications and pay TV markets.

⁵ For example, compensation of minority shareholders has been raised as a significant hurdle to vertical separation: Institutional Analysis, *Separating Telstra: protecting the interests of minority shareholders*, January 2003.

Further work will be required to assess the full costs and implementation issues of divestiture. However, it appears there are significant and sustained benefits to competition that would flow from divestiture and that the costs may not be substantial in comparison.

4.1.3 Other ownership issues

This chapter also discusses the competition issues raised by PBL's ownership of both Foxtel and a FTA broadcaster. These ownership interests may raise competition concerns about:

- the possible leverage of market power from pay TV to FTA broadcasting through the joint purchase of pay TV and FTA rights
- the potential incentive for Foxtel to discriminate in favour of the Nine Network compared to other FTA broadcasters for retransmission of the FTA signals on the pay TV platform and other transactions between FTA broadcasters and Foxtel.

The Commission is continuing to monitor potential anti-competitive joint bidding between pay TV and FTA broadcasters, and is investigating complaints about the competitive effects of Foxtel's agreements with the Nine Network for retransmission. At this stage, the Commission does not believe the government should consider limiting joint ownership of FTA and pay TV broadcasters. However, it may provide further comments on this relationship in the future.

Having said that, the Commission focuses on competition issues and it recognises the government may consider the ownership of a divested Foxtel by PBL and News Corporation from other policy perspectives. This may include consideration of whether full ownership of Foxtel should be transferred to PBL and News.

4.1.4 Structure of the chapter

The chapter begins by outlining the current structure of telecommunications markets in Australia. It then details the limitations of access arrangements in creating the appropriate

conditions for increased competition. This is followed by an analysis of the potential benefits and costs within the various telecommunications and pay TV markets of ownership restrictions on Telstra in relation to its HFC network and Foxtel. A subsequent section discusses the once-off implementation costs (and related issues) that could be expected with divestiture of the HFC and Foxtel. Finally, the Commission examines the potential effects on competition of PBL's joint ownership of FTA and pay TV broadcasters.

4.2 Current market structures in telecommunications markets

Since the opening up of the Australian telecommunications market to full competition in July 1997, the industry has seen many new competitors, technologies and modes of service delivery. Some fixed network facilities have been built, but these have been confined mainly to the CBD areas of the major capital cities. There has been a general downward trend in the prices of most call services. The Commission estimates that between 1997-98 and 2001-02 the price of an average basket of telecommunications services bought by Australian consumers fell by 20.7 per cent in real terms. Results of annual consumer satisfaction surveys carried out by the ACA suggest consumer satisfaction with competition and services is generally high, despite some evidence of a recent decline in satisfaction levels.⁶

However, the Commission believes that several telecommunications markets are not yet effectively competitive. This largely reflects the fact that Telstra is the dominant telecommunications supplier in almost every market. It is one of the most integrated communications companies in the world,⁷ continuing to be the major wholesale

⁶ ACA, *Telecommunications Performance Report 2001-02*, November, 2002.

⁷ For comparison, British Telecom and the regional incumbent telecommunications companies in the United States do not have the same level of integration and, in the latter case, national coverage as Telstra.

and retail supplier of telecommunications services in Australia, including:

- local, national long-distance, international and mobile telephony
- dial-up and broadband internet services
- data services
- printed and on-line directories
- pay TV (through its 50 per cent ownership interest in Foxtel).

Telstra owns two of the three major local access networks outside the CBDs of major cities. In addition to owning the copper (PSTN) network that connects virtually every household and business in Australia, Telstra owns the largest cable (HFC) network, which passes 2.5 million homes. Optus, the second largest carrier in Australia owns the other HFC network. This network passes around 2.2 million homes. The two HFC networks are around 80 per cent over-built.

Telstra's market shares in key markets are shown in Table 4.1 below. It has the ability and incentive to thwart entry by other firms into these and related markets.

The extent of Telstra's dominance of the sector is demonstrated by the fact it receives almost 60 per cent of total industry revenue, which is almost four times the revenue that its closest rival, Optus, receives. It is reported to receive over 90 per cent of total industry profits.

In a report prepared for the Commission in 2001, Ovum concluded that Telstra, despite the deregulation of entry into the telecommunications industry, is still benefiting from its former statutory monopoly status:

[W]hen returns are benchmarked against our initial estimates for Telstra's WACC [weighted average cost of capital] returns greater than the WACC appear to be achieved.⁸

Table 4.1 Telstra's share of key markets (by share of total revenues)

	1998	1999	2000	2001	2002
Fixed voice revenues	81.8%	79.0%	75.2%	71.5%	68.7%
Local call market	94.8%	92.3%	87.9%	84.6%	84.5%
National long-distance market ^a	76.4%	76.2%	70.9%	66.3%	66.4%
International revenue ^b	59.7%	48.9%	44.0%	35.3%	18.3% ^c
Mobile revenue	56.7%	49.2%	52.6%	48.9%	49.3%
Data revenues	77.1%	71.4%	67.9%	63.0%	62.0%
Pay TV subscribers (Foxtel) ^d	46%	49.1%	52.3%	53.2%	55.1%

Source: ABN AMRO, *Australian Telecommunication Markets 2003*, 9 December 2002. The Telecommunications revenues are calculated on a retail basis (excluding resale) and relate to financial years ending 30 June.

^a National long-distance includes fixed to mobile calls.

^b Includes incoming and outgoing revenues.

^c Telstra's inbound calling business incorporated into its overseas-based business, Reach, in financial year 2001.

^d Figures for pay TV market share taken from Digital Broadcast Australia cited in Australian Film Commission, 'Get the picture' <www.afc.gov.au/GTP/wptvsxops>, accessed February 2003. These are December figures except for 2002, which is at September.

⁸ Ovum, *Telstra Financial and Economic Profit Analysis: a report to the ACCC*, 31 October 2001, p. 4.

Although Optus' market shares are generally much smaller than Telstra's in the various telecommunications markets, it is firmly positioned as the second largest market participant. The relative market shares of Telstra and Optus dampen incentives for vigorous competition, instead providing conditions more conducive to duopoly or 'follow the leader' conduct. This outcome is more likely given the various supply relationships between Telstra and Optus, which include the supply of data interconnection, local call resale and access to Telstra's local access network.

Other supply relationships result from the pay TV agreements, where Foxtel and Optus have entered a content supply relationship, and for Foxtel to lease satellite capacity from Optus. The Commission noted at the time it approved the pay TV agreements, subject to the various undertakings given by the parties, that the undertakings did not deal with all of the Commission's competition concerns across the pay TV industry.

4.2.1 Local call services market

The local call services market has not shown major improvement in competition since the deregulation of the telecommunications markets in 1997. Telstra is still dominant in this market because it owns the only ubiquitous fixed-line local access network in Australia (the customer access network or 'CAN'). Telstra had an overall market share of 94.1 per cent for the 2001-02 financial year (which includes basic access lines resold by its competitors) in basic access services. The remaining market share of 5.9 per cent is held by Optus.⁹ Telstra's high wholesale basic access market share has not changed significantly in the last five years.

At the wholesale level of the local access market, Telstra's strong presence has created a difficult barrier for competitors to overcome. While some infrastructure competition has emerged, Telstra's local access network is unchallenged in terms of ubiquity in most metropolitan areas (excluding some of the CBDs of the major capital cities) and

less densely populated geographic areas. Telstra's competitors therefore have no real alternative but to seek access to, or interconnect with, Telstra's local access network for supply of a range of services including basic access, local calls, national long-distance calls, international calls, fixed to mobile calls and xDSL services.

Telstra's control over the cost of wholesale access to its local access network allows it to significantly influence the retail prices of its competitors, and therefore restrict downstream competition in the markets in which access to Telstra's CAN is necessary.

Access regulation tries to minimise monopoly profits and promote downstream competition by introducing non-discrimination in pricing and other terms and conditions of supply between the access provider's retail operations and those of its competitors. However, access regulation has a number of inherent limitations, which are discussed further in section 4.3 below.

A wide range of technologies can be used to provide local access to end-users, such as copper networks, HFC, fibre optic, fixed wireless and satellite. Telstra and Optus own HFC networks that either supply or can potentially supply, voice telephony, internet and pay TV services. Both cable networks have been deployed in parts of Melbourne, Sydney and Brisbane; and by Telstra only in some areas of Adelaide, Perth and the Gold Coast.¹⁰

To date, competitors have been unable to use either the Telstra or Optus HFC networks to supply any access services. This may need inquiry by the Commission, including consideration of whether further access declarations are required, particularly if Telstra retains ownership of its HFC.

The Commission does not expect alternative technologies to significantly diminish Telstra's near monopoly of copper local access in the foreseeable future. The Commission notes, for example, that past proposals for widespread

⁹ ACA, above n. 6, p. 142.

¹⁰ Australian Competition and Consumer Commission, *Declaration of an analogue subscription television broadcast carriage service*, October 1999, p. 11.

unwired local access have either been abandoned or are proceeding very slowly. The take-up of the unconditioned local loop service (ULLS) by access seekers has been minor since its availability at the end of 2000.

4.2.2 National long-distance and international call markets

Superficially there appears to be strong competition within the national long-distance and international call markets. However there is some evidence which suggests a more cautious view should be taken of the state of competition in these markets. In particular, Telstra and Optus hold the largest shares of these combined markets, and imputation analysis performed by the Commission comparing Telstra's retail prices and the costs faced by access seekers indicates that substantial price-cost margins continue to exist for these services. This is suggestive of a lack of strong competition in the markets for these services.

Several entrants (Optus, PowerTel and Macrocom) have established independent long-distance transmission facilities on major routes, especially between capital cities. However, there is a clear lack of effective competition on non-major routes. There are no alternative means for suppliers of long-distance and international calls to reach the majority of their potential customers without access to Telstra's fixed customer access network.

4.2.3 Markets for data and internet services

Data and internet services are increasingly becoming a core part of business operations and residential demands, amounting to 17 per cent of total telecommunications revenue in 2002.¹¹ Broadly speaking, data and internet services can be used to achieve data transfer (text, still images, video, voice and high quality sound) from one location to another.

Data services are primarily supplied to large corporate businesses, although they are also used by smaller businesses and (in the case of ISDN) some residential customers. These services include ISDN, frame relay and ATM services, as well as data and dedicated line (leased line) services.

Internet services are supplied to large corporate businesses, small-to-medium enterprises and residential consumers. These include narrowband dial-up internet services supplied over the fixed-line network as well as broadband internet services supplied using xDSL technology over the copper fixed-line network or HFC. Internet services are supplied to end-users by a large number of internet services providers (ISPs) although Telstra is the largest ISP in Australia with a market share of 40.8 per cent in 2002.¹² There was also some consolidation in 2001-02 with the number of ISPs dropping from 665 to 571.¹³

Of particular concern is that Telstra's xDSL broadband internet capability lags behind the best overseas networks (see table 4.2 below). For example, Telstra's current maximum ADSL data-download speed for residential customers (1.5Mbps) is significantly below that in Canada (3Mbps), Sweden (4Mbps), Korea (8Mbps) and Hong Kong (6Mbps).¹⁴ To put these in perspective, speeds of at least 2Mbps are required for interactive TV and video-on-demand.¹⁵ It is understood that good quality video transmission requires 10Mbps per stream.¹⁶

Limitations on the availability of Telstra's ADSL services may also provide evidence of under-investment in the network. The proportion of customers that cannot be served by Telstra's ADSL network because of technical and distance reasons is reportedly much higher than the

¹¹ ABN AMRO, *Australian telecommunications markets 2003*, December 2002, p. 13.

¹² *ibid.*, p. 46.

¹³ ACA, above n. 6, p. 141.

¹⁴ Telstra's ADSL network was essentially designed as a residential grade service for the carriage of data, requiring it to be upgraded to supply a range of advanced broadband services (including pay TV).

¹⁵ ABN AMRO, *ADSL - Mining Copper*, 12 September 2000, p. 13.

¹⁶ Paul Budde Communications, *Australia - Broadband Infrastructure*, 5 March 2003, p. 1.

Table 4.2 Comparison of current minimum and maximum ADSL speeds (residential customers, selected countries)

Country	Company	Minimum plan		Maximum plan	
		Upload	Download	Upload	Download
Australia	Telstra	64 Kbps	256 Kbps	256 Kbps	1.5 Mbps
Canada	Bell Canada Sympatico	64 Kbps	128 Kbps	640 Kbps	3 Mbps
Germany	Deutsche Telekom	128 Kbps	768 Kbps	65 Kbps	1.5 Mbps
Finland	Sonera	na	256 Kbps	na	2 Mbps
New Zealand	Telecom New Zealand	128 Kbps	128 Kbps	na	na
Singapore	SingTel	128 Kbps	256 Kbps	256 Kbps	512 Kbps
United Kingdom	British Telecom	64 Kbps	128 Kbps	256 Kbps	500 Kbps
Sweden	Telia	64 Kbps	250 Kbps	400 Kbps	4 Mbps
United States	Qwest	256 Kbps	256 Kbps	1 Mbps	1 Mbps
	AT&T	128 Kbps	384 Kbps	128 Kbps	1.5 Mbps
	SBC	128 Kbps	384 Kbps	384 Kbps	6 Mbps
Hong Kong	PCCW	na	na	256 Kbps	6 Mbps
Korea	KT	64 Kbps	1.5 Mbps	640 Kbps	8 Mbps

Sources: Company websites, accessed May 2003 except Korea which is from OECD, *The Development of Broadband Access in OECD Countries*, October 2001, p. 53.
na = information not available.

expected rates of 10 to 15 per cent. According to one wholesale customer the proportion is over 30 per cent.¹⁷

The HFC networks owned by Telstra and Optus pass only around one third of households. The take-up rate of cable internet on these networks at the end of 2002 was 3 per cent for Telstra and 3.8 per cent for Optus. For pay TV services the take-up rates for pay TV services were 19.2 per cent for Telstra and 11.1 per cent for Optus. These rates are very low by OECD country standards.¹⁸ Australia's overall broadband penetration (subscribers out of total inhabitants) of less than 2 per cent is well below that of leading OECD countries.¹⁹

4.3 Limitations of access arrangements and supplementary regulation

Access arrangements provide a mechanism whereby competitors can use bottleneck infrastructure inputs controlled or supplied by another provider when it is uneconomical for these inputs to be duplicated, so that these competitors can supply their own services in downstream markets. There are currently access arrangements for the carriage of a number of telecommunications services and analogue pay TV, although the majority of telecommunications services remain unregulated.

Access arrangements provide a means of circumventing bottleneck supply by a vertically integrated supplier of a particular service or of breaking down exclusive contractual arrangements between an upstream (or wholesale) and

¹⁷ M. Sainsbury, 'Copper-wired for DSL trouble', <www.australianit.news.com.au>, 30 May 2002.

¹⁸ OECD, *Broadband and telephony services over cable television networks*, Working Party on telecommunications and Information Services Policies, May 2003, pp. 16-17.

¹⁹ OECD, *Communications Outlook 2003*, May 2003, p. 123.

downstream (or retail) supplier of a service. They are intended to ensure that natural monopoly and other efficiencies in production such as economies of scope are preserved in upstream markets while introducing the benefits of greater competition in downstream markets. Access arrangements have the dual purpose of reducing monopoly profits of the access provider and promoting competition in downstream markets.²⁰

Access arrangements are one of the cornerstones of telecommunications regulation in Australia. Declarations for access to wholesale telecommunications services have permitted a range of carriers and carriage service providers to use Telstra's infrastructure to provide their own retail services. This has been one of the main ways of introducing competition across a range of telecommunications markets and has led to associated price, variety and quality gains to consumers. This has, however, meant that the type of benefits arising from competition have largely flowed from competition at the retail level of the market as opposed to competition between telecommunications infrastructure providers (ie access both the wholesale and retail levels of the market).

The Commission has a central role to play in establishing and administering access arrangements for telecommunications services. It remains committed to rigorously administering the telecommunications access provisions. This includes advocating and participating in the process of improvements to these arrangements.

The Commission has also sought to ensure that its own arbitration of access disputes and other processes work as efficiently, effectively and fairly as possible.²¹

²⁰ Productivity Commission, *Telecommunications Competition Regulation*, Report no. 16, 2001, pp. 48-49.

²¹ For example, in 2001 the Commission engaged independent consultants Phillips Fox and Resolve Advisers to review the Commission's arbitration and other dispute resolution processes. The Commission subsequently released the draft dispute resolution guidelines for public consultation on its arbitration processes. These guidelines were finalised in October 2002 and have subsequently been updated to reflect the Government's December 2002 amendments to the TPA.

However, there are several limitations to access arrangements that prevent them from being an effective substitute for other regulatory measures, such as structural separation or measures that promote infrastructure competition. Such limitations include:

- the inability to alter the incentive for, or to often prevent, discriminatory treatment by the access provider between its downstream operators and those of access seekers
- regulatory costs and the creation of on-going high-level dependence on regulatory intervention
- time-consuming processes of resolving disputes about the terms and conditions of access, leading to potential corresponding negative impacts on investment.

The significance of these limitations has become apparent through the operation of access arrangements in the Australian telecommunications market over the past several years. Such limitations were foreshadowed by the Hilmer review of national competition policy which stated:

Where the owner of the 'essential facility' is vertically integrated with potentially competitive activities in upstream or downstream markets ... the potential to charge monopoly prices may be combined with an incentive to inhibit competitors' access to the facility.²²

More recently the OECD has observed that:

When a regulated firm also provides essential inputs to its competitors in a related competitive sector, the regulated firm may have both the ability and a strong incentive to restrict competition. Attempts to control the behaviour of the regulated firm to offset this incentive are difficult and regulators may face an up-hill battle.²³

²² Independent Committee of Inquiry (F Hilmer, chairman), *National Competition Policy*, 1993, p. 241.

²³ OECD, 'Restructuring public utilities for competition', *OECD Observer*, February 2002, p. 9.

4.3.1 Discrimination between access provider and access seeker

The telecommunications access regime requires access providers to comply with standard access obligations (SAOs). The SAOs are designed to ensure the same standards for an access provider's own operations are adhered to by that access provider when providing services to access seekers.²⁴

When an upstream access provider participates in a downstream market it has the incentive to discriminate in favour of its own downstream operations. When reviewing the Commission's access arbitration process in 2001-02, Phillips Fox observed that the disparate commercial incentives of the disputing parties and the complexity of issues to be resolved presented significant challenges to the dispute resolution processes.²⁵

The Commission's experience is that this issue of discrimination can be particularly problematic for non-price terms and conditions of access because they can be more difficult to observe and enforce than terms and conditions that relate to the price of access.

Forms of non-price discrimination can include fault rectification procedures, customer poaching, building of artificial capacity constraints, locking in customers and failure to divulge plans relating to the network— such as network enhancements or equipment deployment.²⁶ The Commission, like other regulators, has found it difficult to respond quickly and effectively to these complicated technical matters.

The enhanced accounting separation regime will increase the Commission's role in specifying and monitoring qualitative conditions of access. The Commission will be required to determine a range of non-price terms and conditions of access

for core telecommunications services and to establish a range of performance indicators as part of the new accounting separation regime for Telstra.

Other legislative amendments will also give the Commission an increased *ex ante* responsibility in specifying price terms and conditions of access through the requirement placed on the Commission to publish indicative prices for core telecommunications access services. The Commission believes that these changes will lead to an improved regulatory regime by increasing the amount of information in the marketplace, but that they stop short of providing the necessary incentives for vastly improved commercially negotiated access outcomes.

4.3.2 Regulatory costs, dependence and delays

An access regime involves regulatory costs. These include the direct administrative costs of regulation and also the costs to access providers and seekers in complying with regulation. Access price determination can be very complicated and the process of facilitating access can be protracted.²⁷

Delays in obtaining access can be a major barrier to effective competition in telecommunications markets. Such delays are likely to be exacerbated when the access provider and the access seeker have substantially different bargaining power. Negotiations and any subsequent arbitration by the regulator on the terms and conditions of access can be both time consuming and costly. This delay can be to the commercial advantage of the access provider.

It has been well documented that access seekers have experienced difficulties gaining access to Telstra's network. A total of 34 out of 47 arbitration disputes brought before the Commission have involved Telstra as an access provider. Many of these disputes have taken years to resolve and several have involved significant monetary costs to the access seeker

²⁴ Section 152AR of the TPA.

²⁵ Phillips Fox, *Review of Telecommunications Arbitration Processes: Report to ACCC, 2002*, pp. 10-12.

²⁶ Productivity Commission, *Telecommunications Competition Regulation*, p. 49.

²⁷ *ibid.*, pp. 49-50.

and provider, as well as the Commission. The Commission believes that in the interests of commercial certainty and given the difficulties associated with conduct of arbitrations against a well resourced incumbent, access seekers have accepted prices to access services on Telstra's network that are above the efficient levels the Commission would have specified if it were requested to set these prices in arbitration.

Although the number of disputes before the Commission is presently confined to two pay TV disputes, this is believed to partially reflect cyclical factors related to the length of agreements entered into previously. Significantly, the pay TV access disputes brought before the Commission for arbitration have been among the longest and most complicated considered by the Commission to date. The disputes brought by TARBS and C7 against Telstra/Foxtel were notified in September 1999 and September 2000 respectively.

Delays in resolving access disputes can increase uncertainty for all industry participants. This can negatively affect the investment decisions of carriers and other industry participants, resulting in diminished competition and consequential losses to consumers in terms of price and service offerings.²⁸

4.4 Structural separation

The 1993 Hilmer review of national competition policy strongly supported structural reforms over more intrusive forms of conduct regulation. The review recommended that, at the very least, structural separation— be it the separation of natural monopoly elements of a business from the potentially competitive activities or the separation of potentially competing businesses—should be subject to a detailed assessment of the benefits and costs. It considered that there should be a presumption in favour of full

structural separation, leaving it to those who supported a lesser type of reform to establish why that would more likely be in the long-term public interest.²⁹

In 2001, the OECD Council recommended that countries assess the benefits and costs of structural separation for regulated industries when in the process of liberalisation and regulatory reform. This was in recognition of the role of industry structure in influencing competition and the limitations of behavioural remedies as an alternative means of promoting competition in these industries.³⁰

The government explicitly instructed the Productivity Commission not to consider Telstra's structural separation in the review of telecommunications-specific competition regulation that commenced in June 2000.³¹ The government also recently abandoned a parliamentary inquiry into the question of structural separation. Consequently, issues surrounding the possibility of structural separation of Telstra have not been subject to a comprehensive assessment.

Given that access regulation has only been partially successful in introducing and continuing to promote growth in competition in retail or downstream markets, there have been calls for significant structural changes in the industry. Such changes include separating the potentially competitive elements from the non-competitive elements of vertically integrated incumbents, as has occurred in a number of energy markets.

Structural separation can take several forms. Vertical separation involves the separation of complementary upstream and downstream functions of a business. It is based on the separation of a non-competitive element of a business from potentially competitive activities. Another type of separation (loosely characterised

²⁸ Australian Competition and Consumer Commission, *Submission to the Senate Environment, Communications, Information Technology and the Arts Legislation Committee*, September 2001, p. 8.

²⁹ Independent Committee of Inquiry, above n. 22, pp. 221-222.

³⁰ OECD, *Restructuring public utilities for competition*, p. 3.

³¹ Productivity Commission, *Telecommunications Competition Regulation*, p. V.

as horizontal separation) involves the splitting of ownership of potentially substitute functions of a business— such as parallel networks.³²

Implementing one type of structural separation or ownership restriction may serve to reduce the need for another. If Telstra were to divest its HFC, leading to the creation of another competing full service telecommunications network, there is likely to be less benefit from splitting Telstra's copper network business into wholesale and retail businesses. The effects and relative costs and benefits of such initiatives also differ. For example, divesting Telstra of its Foxtel shareholding would be likely to increase Foxtel's willingness to provide access to pay TV content on commercial terms, which the vertical separation of Telstra's copper network does not address.

The types of ownership separation considered in this chapter go under the broad heading of ownership restrictions because there are vertical as well as horizontal features to the types of ownership separation considered. These include the possible separation from Telstra of, or dilution of Telstra's ownership in, the HFC network and/or Foxtel, and consideration of PBL's ownership of both a FTA broadcaster (the Nine Network) and a 25 per cent interest in a pay TV operator (Foxtel).

4.5 Ownership restrictions

Broadly speaking, ownership has a bearing on market structure which is a key determinant of market conduct. As has been observed for mergers matters, factors such as the research, production, marketing, pricing and selling decisions of firms are often a function of the structure of a market. Addressing anti-competitive structures can foster a more efficient, resilient and responsive national economy through the positive effect that greater competition can have on product pricing and quality, promoting innovation, instilling more effective management, better use of resources

³² OECD, *Restructuring public utilities for competition*, p. 8.

and responsiveness to consumer demands.³³ This has been demonstrated by the outcome of many of the microeconomic reforms in Australia over the past twenty years.

The Commission's specific concerns are that Telstra has full ownership of the main HFC pay TV distribution network and a copper network, as well as a 50 per cent shareholding in the major pay TV operator in Australia. This ownership has several specific effects.

Telstra's ownership of a HFC network:

- diminishes opportunities for competition by actual and potential network competitors
- means Telstra's copper and HFC networks do not compete with each other denying potential price and service benefits that such competition could deliver to consumers.

Telstra's partial ownership of Foxtel provides it with the incentive to:

- foreclose supply of pay TV channels by Foxtel to other networks competing with Telstra for the supply of telecommunications services
- prevent other pay TV businesses or channels from gaining access to Telstra's HFC network.

As is detailed below, Telstra is in a unique position to control important inputs of supply for its potential and actual broadband network competitors,³⁴ and for pay TV operators competing against Foxtel on the Telstra HFC network. The corresponding market power provides Telstra with a means to dampen competition or foreclose entry by competing entities through discrimination in supply, vertical foreclosure of upstream inputs and gaming of access arrangements where these exist. A key issue is that Telstra's dominance in telecommunications markets and Foxtel's dominance in the pay TV market can act to reinforce each other.

³³ This discussion draws on A. Fels, 'The Trade Practices Act: are we becoming a Branch Office Economy?', *ACCC Journal*, no. 39, March- April 2002, pp. 6- 12.

³⁴ In addition to a requirement to reach agreement on the terms and conditions of interconnection between the networks.

Therefore, the Commission believes that the government should consider restrictions on ownership to improve the competitive conditions in the telecommunications and pay TV sectors in Australia. Such restrictions would involve passage of legislation to restrict ownership in relation to:

- Telstra's HFC network³⁵
- Telstra's shareholding in Foxtel.

In relation to the HFC network, ownership restrictions could require:

- full divestiture of the network, via sale to a third party or parties, or by transfer of ownership to a new company independent of Telstra
- that Telstra sell a percentage share in its HFC network sufficient for it to relinquish control, or
- that Telstra establish its HFC network as a completely stand-alone business.

The objective would be to introduce a new, independent supplier into the fixed customer access market, and thereby:

- increase infrastructure competition in the supply of telecommunications services such as broadband internet, pay TV and voice services
- encourage competition between HFC and copper access networks.

Ownership restrictions in relation to Telstra's shareholding in Foxtel might take the form of:

- full divestiture (sale of Telstra's 50 per cent shareholding)
- reduction in Telstra's shareholding to a level below 50 per cent, or
- removal of voting rights in respect to Telstra's shareholding.

³⁵ If Foxtel is interested in buying the HFC cable, this could be assessed under section 50 of the TPA. Section 50 prohibits acquisitions that would result in a substantial lessening of competition.

The objective in each case is to address the incentives of Telstra to stop Foxtel from supplying its pay TV channels to other networks and to prevent other pay TV businesses or channels from accessing Telstra's network.

The expected outcomes of the various options are discussed below. The focus is on the benefits and costs of the full divestiture options. The other options are considered to see if the key objectives of the full divestiture options might be achieved through less costly alternatives. They are therefore contrasted with the full divestiture options.

4.5.1 General comments on the benefits and costs of alternative ownership restrictions

Ownership restrictions will have several potential benefits and costs. The key benefits of ownership restrictions are the prospect of greater competition, the associated price and quality improvements and the possibility of lower regulatory costs with less reliance on access regulation even if the current scope of regulation is maintained.³⁶

The costs centre on the potential loss of production efficiencies resulting from the existing level of integration between the entities. These include loss of economies of scope and/or scale and an increase in transaction costs. Separation in the absence of price regulation in upstream or downstream markets may also lead to higher prices than in the integrated state, under what is referred to as 'double marginalisation'.³⁷

³⁶ In the context of declaration and related decisions under Part XIX of the TPA, the Commission considers that the concept of promoting or improving competition means that conditions are established which will increase the likelihood or potential for competition to increase. See: Australian Competition and Consumer Commission, *Telecommunications services- declaration provisions*, 1999, p. 48.

³⁷ Double marginalisation refers to the outcome when as a result of separating a vertically integrated firm with market power, the continued existence of market power in the downstream market in combination with the firm's market power in the upstream market leads to higher prices than previously. See S. King and R. Maddock, *Unlocking the infrastructure*, 1996, pp. 88-91.

There are also a number of one-off implementation costs that must be considered, such as potential disruption to investment plans and transaction costs to implement any divestiture option. These are considered in the section on implementation costs.

The benefits and costs of the various ownership restrictions are considered for the fixed customer access and related telecommunications markets and pay TV markets.

The fixed customer access and related telecommunications services markets comprise the infrastructure used for the supply of the physical connection with homes and businesses to deliver a number of telecommunication services, such as voice and high bandwidth carriage services.

The pay TV markets include:

- the market for acquiring broadcast rights for pay TV
- the market for the wholesale aggregation and supply of programming for pay TV
- the retail market for the supply of pay TV services.

It would be expected that current access regulation would still be necessary, even after divestiture (although the reliance on this regulation for the provision of access may diminish). Therefore, the benefits and costs of the divestiture are assessed in the context of existing and proposed access arrangements. In particular, these existing and proposed access arrangements include:

- declaration of analogue pay TV services supplied by HFC networks
- Foxtel and Telstra's section 87B undertakings providing for access to carriage for digital pay TV services
- Foxtel and Austar's section 87B undertakings providing for access to pay TV content, and further access to content regulation proposed by the Commission in chapter 6 of this report

- access to digital satellite STUs as provided for in the section 87B access undertakings
- declarations of key telecommunications services.

4.5.2 Divestiture of Telstra's ownership of its HFC network

This section discusses the on-going costs and benefits of three types of ownership restrictions that could be imposed on Telstra's current ownership of a HFC network.

The Commission has identified three possible ways to improve competition:

- sale of the HFC to a third party or parties
- sale of 50 plus per cent of the HFC network to a third party or parties
- strengthening the operation of the HFC network as a stand-alone operation from Telstra Corporation.

In a concentrated market where Telstra continues to have market power in the supply of telecommunications services, the limited infrastructure competition between Telstra's two networks has a significant negative impact on competition.³⁸ The cost that this lack of infrastructure competition imposes on society needs to be assessed against any lost economies of scope for separation of the copper access and HFC networks.

Divestiture of the HFC and Foxtel are separate issues. However, the benefits of reducing Telstra's control or ownership of the HFC are likely to be less if Telstra retains ownership of Foxtel. This is due to Telstra's probable interest in restricting the supply of Foxtel services to any competing providers of telephony services.

³⁸ The same arguments for restrictions on ownership do not apply to the Optus HFC network on the basis that Optus does not command the same market position as Telstra in telephony or pay TV (via Foxtel) and its HFC serves as its primary fixed customer access network.

Sale of the HFC to a third party

The sale of the HFC to a third party would require Telstra to divest its shareholding in its HFC network to an independent provider. The major effect would be to introduce a new independent infrastructure supplier into the broadband internet, voice and pay TV markets. The importance of efficient infrastructure competition is well recognised and discussed in more depth below.

Divestiture of the HFC is a significant policy intervention, requiring detailed consideration of how it could be best implemented. The major implementation costs are discussed further below in section 4.6.

Fixed customer access and related telecommunications services markets

One of the main benefits of divesting the HFC would be the creation of a new infrastructure competitor to Telstra and Optus in the provision of wholesale and/or retail broadband services. This would give the buyer the opportunity to compete for around 2.5 million homes passed by Telstra's HFC.

This competitor, apart from normal interconnection agreements, will be less constrained by the need to gain access to Telstra's networks for essential inputs, and therefore has greater flexibility to supply services to consumers. This will benefit competition in the supply of telecommunications services, improving incentives to invest and innovate by all industry participants and possibly requiring less regulation to achieve efficient outcomes.

Telstra, for example, stated to the Productivity Commission:

[C]onsiderable benefits would flow if the impediments to efficient investment, and notably to investment in competing networks, could be eliminated. These benefits have been expressed in the following terms:

"Facilities based competition is much more beneficial to economic efficiency than is resale competition... Facilities based competition creates important dynamic efficiencies as carriers compete to lower

their costs so they can lower their prices. Carriers also compete to offer new services to consumers which are another important form of dynamic efficiency. To the contrary, resale competition does not cause these dynamic economic efficiencies to occur... Facilities based competition [also] eliminates the need for further regulation because market based competition determines prices and services offered."³⁹

In the United States, the Federal Communications Commission (FCC) encourages new infrastructure and multiple delivery platforms to homes as a means of promoting broadband deployment.⁴⁰ According to the FCC, infrastructure competition will lead to greater choice, innovation and investment, and ultimately to more households taking up broadband.⁴¹ A former chief economist at the FCC contends that more head-to-head cable competition is needed to drive advanced services.⁴² It has also been claimed that cable competition is the greatest long-term threat to Bell's local telecom franchises, due to its greater success in gaining broadband customers— as customers switch to cable broadband they often chose to take voice services from the cable supplier as well.⁴³

³⁹ Telstra, *Public Submission to the Productivity Commission inquiry into Telecommunications Specific Competition Regulation*, 30 August 2000, pp. 24-25. The quote is from J. Hausman, cited in Cable & Wireless Optus, *Submission to the Productivity Commission's Inquiry into International Telecommunications Market Regulation*, May 1999, p. 14.

⁴⁰ This occurs in the context where in 2001, cable passed 96 per cent of households in the United States and 69 per cent of those passed were connected. In actual figures, cable operators alone served 67.7 million subscribers with *alternative* competing platforms such as direct broadcast satellite serving approximately another 13.7 million subscribers. The issue is therefore not simply about getting people connected to networks, but creating the conditions where networks are upgraded to provide advanced services at prices people are prepared to pay.

⁴¹ *Written statement of Michael K. Powell, Chairman Federal Communications Commission on Competition Issues in the Telecommunications Industry before the Committee on Commerce, Science, Transportation United States Senate*, 14 January, 2003, p. 13.

⁴² G. Faulhaber, 'Policy-Induced Competition: The Telecommunications Experiments', *Information Economics and Policy* (forthcoming), 2003, p. 16, < rider.wharton.upenn.edu/~faulhaber/research.html >.

⁴³ 'Cable competition could hurt local Bell services, report says', *Warren Communications News*, 22 May 2003.

Similarly, a European Commission review in 1997 found that the joint ownership of telecommunications and cable TV networks by the same company stifled the development of telecommunications markets, discouraged innovation and prevented the full exploitation of the benefits of convergence between telecommunications, media and information technology markets. It also found that one company jointly owning telecommunications and cable TV networks substantially reduced the incentive for that company to upgrade its existing telephony network to full-scale broadband capability with technologies such as xDSL.⁴⁴

More recently, staff from the consulting firm McKinsey writing on broadband developments across countries have observed:

Strong infrastructure-based competition, notably from independent cable companies, characterises the markets with the most robust penetration and competition. But in many markets, cable has yet to achieve its full potential, either because cable networks belong to incumbent telecom companies that don't want to cannibalize their voice and data traffic or because the core TV business of the cable companies is subject to regulations that make it hard to accelerate broadband's diffusion. If the technology's full potential is to be unlocked in these markets, regulators must ensure that infrastructure-based competition flourishes there.⁴⁵

The introduction of a further independent supplier in the market would create pressure on Optus and Telstra. This additional competitive

pressure is likely to result in better price and non-price offerings, ultimately delivering more competitively priced services, greater innovation and potentially more investment. Unlike increased downstream competition from access regulation, competition between infrastructure providers is across all elements of supply.

At present, Telstra's significant market power in many telecommunications markets diminishes its drive to innovate, and therefore investment can be determined by its own commercial imperatives rather than by a competitive discipline to invest. This is highlighted by Telstra choosing not to supply voice telephony services on its HFC network and the limited approach it has taken to developing its ADSL broadband network.

Divested of its HFC network, Telstra would be expected to focus on promoting investment in its copper access network to provide broadband services, in competition with its previously owned HFC network. Telstra already appears to focus investment in areas where it faces infrastructure competition. In particular, the scheduling for Telstra's upgrading of exchanges in small towns appears to have been influenced by the presence of alternative infrastructure providers.

The new owner of the HFC would probably respond with competitive price and service offerings on its network. Competition from both Telstra and Optus would be likely to prompt the new owner to proceed with digitising the network if this had not occurred already.

Divestiture may also have competitive implications beyond those geographical areas covered by the Telstra HFC network. First, telecommunications pricing is often national and therefore competitive pressure in a particular area may result in wider benefits to consumers. Second, at present Telstra does not appear to have any intention (or incentive) to extend the HFC network where this would serve to take customers from its PSTN based networks. However, a new owner without the same commercial concerns may consider further investment. The new network owner would also have the advantage of established economies of

⁴⁴ The European Commission subsequently issued a directive in June 1999 requiring that if a dominant telephony company is controlled by a member state or which benefits from special rights and owns a cable TV network in the same geographic market, such a network be operated by a separate legal entity: European Commission, 'Commission Directive 1999/64/EC of 23 June 1999 amending Directive 90/388/ECC in order to ensure that telecommunications networks and cable TV networks owned by a single operator are separate legal entities', *Official Journal of the European Communities*, 10 July 1999.

⁴⁵ S. Beardsley, A. Doman and P. Edin, 'Making sense of broadband', *The McKinsey Quarterly*, no. 2, 2003, accessed at <www.mckinseyquarterly.com>.

scale which may facilitate it undertaking an incremental roll-out.

It follows that increased competition is likely to provide better conditions for both the supply and take-up of broadband services. For example, the BAG noted the importance of competition, especially in providing 'last mile' services. It stated:

It is recognised internationally that contestability and competition at both the retail and infrastructure level are likely, as long as they are sustainable, to be a major spur to the take-up of existing services and innovation and the development of new services.⁴⁶

OECD analysis suggests that competition between independently owned competing networks or platforms can be an important spur to the pace of broadband take-up. Specifically, countries in which incumbent telecommunications carriers own cable networks, in whole or in part, have a lower overall average broadband take-up in terms of both the number and growth rate of subscribers contrasted with countries where the incumbents do not have an ownership interest in cable networks.⁴⁷

The Commission understands that in only nine countries of the 29 OECD countries with cable and standard telecommunications networks, does the incumbent telecommunications carrier own both the standard telecommunications network and a cable network. In four of these nine countries the incumbent does not own the largest cable network. In two of these countries the incumbent only owns the underlying network infrastructure— that is, the incumbent does not provide retail services over the cable infrastructure. The ownership of cable networks by incumbent telecommunications carriers in OECD countries is set out in Table 4.3 below.

In some cases cable networks have had to be divested or this has occurred by the telecommunications companies' own volition. The Commission is aware of the following instances of mandatory or quasi-mandatory divestiture:⁴⁸

- In 1997 the Dutch regulator required the Dutch incumbent operator KPN to reduce its shareholding in its cable network to 20 per cent to limit its control over that network. In response KPN sold the cable network to France Telecom.

Table 4.3 Ownership of cable networks by incumbent telecommunications carriers in OECD countries

Incumbent carrier does not own cable network	Incumbent carrier does own cable network
Austria, Belgium, Canada, Czech Republic, Germany*, Iceland, Ireland*, Italy, Japan, Korea, Mexico*, Netherlands*, New Zealand, Poland, Slovak Republic, Spain, Sweden*, Switzerland, United Kingdom, United States.	Australia (largest), Denmark (second largest), Finland (share of largest), France (third largest), Hungary (second largest), Luxembourg (only infrastructure), Norway (second largest), Portugal (largest), Turkey (only infrastructure).

* Indicates cable network previously owned by the incumbent and divested.

Source: OECD, *Broadband Access for Business*, Committee for Information, Computer and Communications Policy, October 2002, p. 23, Table 4 with updates as applicable.

⁴⁶ BAG, *Australia's Broadband Connectivity: The Broadband Advisory Group's Report to Government*, January 2003, p. 20.

⁴⁷ OECD, *Broadband Access for Business*, Committee for Information, Computer and Communications Policy, October 2002, pp. 20- 21.

⁴⁸ Key sources of information on these are OECD, *Cross-ownership and convergence: policy issues*, Working Party on telecommunications and Information Services Policies, November 1998 and OECD, *Broadband and telephony services over cable television networks*, May 2003.

- The Irish Government required the incumbent operator Telecom Eireann to privatise its 75 per cent shareholding in the country's largest cable network, Cablelink, via a tender process during 1999. The government's aim was to ensure the upgrading of the Cablelink network to enable Cablelink to become an important provider of advanced multimedia services and to promote competition.
- Deutsche Telekom progressively sold its cable network from early 1999, after the European Commission draft cable separation directive of 1997 (a final directive was made in 1999).⁴⁹
- The European Commission approved a merger between Sweden's Telia and Finland's Sonera in 2002 on condition that the former divest its cable network to provide for an alternative local loop in Sweden.

Finally, as a major infrastructure owner, the new HFC owner would have a degree of countervailing power when negotiating for interconnection and other agreements. This improves the dynamics in the market for suppliers to reach commercial agreements without regulatory recourse.⁵⁰ By introducing greater competition at least in the area currently covered by the Telstra HFC network, divestiture would lessen reliance on regulation.

Pay TV markets

Whether divesting the HFC would lead to increased competition and growth in the supply of pay TV services would depend partly on Telstra's response— whether it would upgrade its DSL network to supply pay TV services (either Foxtel's or its own) over its copper network.⁵¹ Because of the economies of scope derived from supplying

telecommunications and pay TV services on the HFC network, the new HFC owner would have strong incentives to supply a competing pay TV service, and/or seek to maintain Foxtel's supply on the HFC network.

The first option (establishing a competing pay TV service) may have important consequences for price and non-price competition in the pay TV market. The second option (maintaining Foxtel's supply on the HFC network) would mean that any competition is likely to be more limited and to be more focused on the price elements of supply.⁵²

The viability of the first option will probably partly depend on the introduction of access regulation for premium content, as recommended by the Commission. As noted in chapter 6, industry generally accepts that such content is critical for a viable pay TV operation.

Foxtel's ownership of the HFC STUs means that Foxtel currently has partial control over the end-to-end network supply of pay TV carriage, and it also has incentives to restrict access to its STUs for pay TV competitors. Control of the STUs is therefore a critical aspect of supply. If the new owner was seeking to provide an independent pay TV operation or provide pay TV carriage services for non-Foxtel pay TV operators, the government would need to consider further the merits of additionally requiring divestiture of the Foxtel STUs to the new HFC owner.

Finally, particularly as existing pay TV networks are digitised and pay TV operators and telecommunications networks can provide higher functionality services, the benefits from infrastructure competition discussed above will apply also to the delivery of pay TV and related services.

⁴⁹ The sale exceeded the requirements of the directive, which only required the creation of a separate legal entity.

⁵⁰ OECD, *Restructuring Public Utilities for Competition*, p. 47.

⁵¹ Pay TV services can be supplied over ADSL technology, but Telstra's current ADSL network would need to be upgraded to supply pay TV (the Commission understands that Telstra dimensioned its ADSL network to supply a residential customer grade service for the carriage of data). It is understood that HFC is presently regarded as a superior technology to ADSL for residential services, on the

basis of its proven use, technological maturity and lower costs per customer. However, ADSL has advantages of greater customer coverage and suitability for advanced interactive services such as video on demand. It is being used for supplying pay TV overseas albeit on a limited basis, by Kingston Communications in Hull, England and by Manitoba Telecom Services in Canada.

⁵² It will also partly depend on the terms and conditions of supply from Foxtel.

Potential costs

The costs of divestiture might include potential disruption to current investment plans and diminished economies of scope. Telstra would also possibly have less flexibility to provide network and retail services.

Foxtel and Telstra have agreed to digitise their customer equipment and cable delivery systems respectively subject to certain conditions, and requiring divestiture could delay such investment (unless it has occurred already). The trade-off, however, is that more infrastructure competition is expected to encourage infrastructure operators to invest to gain competitive advantage over each other. Therefore, it may be that digitisation of the HFC is likely to occur in any event, as the industry-wide pressures for efficient investment would increase.

Divesting the HFC would be likely to result in lost economies of scope between this network and Telstra's other infrastructure (mainly the copper network) where shared inputs are used. However the extent of these losses may be relatively small because:

- the HFC was designed as a stand-alone network with only minimal sharing of systems between the copper and HFC networks
- although Telstra's copper network and the HFC do share long-distance fibre optic transmission and trench facilities, new contracts for continued supply could be made after divestiture, albeit with added contracting costs.⁵³

This suggests that the lost economies of scope would mainly comprise corporate overheads. Moreover, while Telstra may lose certain economies, they may not be lost to the broader economy if they can be exploited by another firm in a similar way (e.g. a company that operates another network service such as electricity distribution).

⁵³ A contractual agreement with the new owner for rental of the trench space would be consistent with current commercial practices whereby Telstra shares its copper access network trench with other carriers. Long-distance transmission services could be purchased from Telstra, self-supplied or purchased from other suppliers, such as Optus.

The new owner may also be able to generate new economies of scope, particularly by supplying more services over the HFC than Telstra currently does. This again reflects the fact that Telstra only makes limited use of its HFC.⁵⁴

The government would need to consider whether divesting Telstra of the HFC restricts Telstra's ability to provide telecommunications services. However, the HFC was not intended to be an integrated network with the copper network. Also, the copper network can provide high-speed services via DSL technology. Although xDSL has limitations, Telstra has the option to supplement and upgrade the network to ensure it provides comprehensive and high quality broadband services to most households and businesses.

A potential concern might be the likely viability of another infrastructure competitor in the fixed customer access market given the presence of two other networks in Melbourne, Sydney and Brisbane. However, there are some factors that diminish these concerns.

First, the network is already built and operating as a separate network (i.e. it is not integrated into Telstra's copper network)- divestiture is aimed at increasing its independence to increase competition between the networks. Secondly the Telstra HFC network is not currently used to its full potential, thereby opening up potential revenue streams for a new owner. Finally, the price a new owner pays to purchase the HFC will be determined by the earning potential of the network.

Further, the viability of additional networks is expected to rise with greater demand for services that require high levels of broadband capacity. One of the key benefits to the competitive environment from divestiture is that it reduces the market power of Telstra in the network supply market. Therefore, increased competitive rivalry becomes the basis upon which the viability of all suppliers, including Optus, will be determined.

⁵⁴ Internet services only account for a small part of the cable capacity and Telstra does not supply voice services over its HFC.

A related issue is whether divestiture would result in inefficient investment. Customer access networks have high sunk costs and economies of scale, which may mean that limited customer access infrastructure may actually be efficient, albeit that competition concerns occur, as noted above. One of the objectives of access regulation is to ensure that efficient decisions are made by carriers between building new infrastructure or accessing existing bottleneck infrastructure.

However, the HFC is already a sunk asset and it is already a stand-alone asset to the Telstra copper network. Therefore, it is not clear that there will be significant risk of inefficient investment arising from divestiture.

The aim of creating independence between the HFC and copper networks could be frustrated if the new HFC owner and Telstra entered contracts upon divestiture that reduce this independence. Continuing contracts between Telstra and the new HFC owner may need to be examined, once Telstra's ownership is removed. However, the likelihood of anti-competitive contracts being entered into would depend both on how divestiture occurred, and the eventual owner. If the new owner operates independently and competitively to Telstra, it is unlikely that contracts would require independent checks above normal TPA processes.

The Commission would also need to assess potential bidders for the HFC network to ensure such bids do not contravene the general merger provisions of the TPA. The government could require such clearance as part of the bidding process as has occurred for some privatisation processes if the HFC was sold by tender.

Sale of 50 plus per cent of the HFC to a third party

Partial divestiture of the HFC, so that Telstra's retains an interest of 50 per cent or less, would seek to achieve the outcomes detailed above but with less impact on Telstra and at less cost. Key issues in considering this option are the extent of operational separation needed and what level of sell-down would be needed to motivate the necessary changes in behaviour.

There is some international precedent for partial divestiture. For example, the United States *Telecommunications Act 1996* restricts cross-shareholdings between cable and telephony operators. In particular, the legislation prevents ownership of more than 10 per cent between cable television providers and local telephone companies operating in the same area. It also prohibits joint ventures between cable television providers and local telephone companies to provide pay TV or telecommunications services in the same geographic market. These measures are designed to promote competition between these platforms.

A key issue would be what level of ownership would be required to relinquish Telstra's control or influence over the HFC business. For example, Telstra's 25 per cent shareholding in the satellite business AUSSAT (before selling it to Optus) was enough to thwart AUSSAT becoming a major competitor to Telstra in the few market segments where the two services were allowed to compete, by giving Telstra the ability to restrict and pre-empt AUSSAT's expansion.⁵⁵ Ongoing influence may stem from rights as a minority shareholder, which can permit substantial influence and protections, or simply the relative size of the shareholding vis-a-vis other shareholders.

It is also not clear what benefits would result from Telstra maintaining any level of ownership interest, given its objectives would be unlikely to match those of the new part-owner. Retaining some ownership interest may continue to allow Telstra to limit the degree of competition from the HFC network, so that it could maximise joint profits between its ownership in the HFC network and copper access network, while not incurring all of the costs of not utilising the HFC network as efficiently as possible.

Further, Telstra's continued ownership interest in the copper access network and part ownership of the HFC will also discourage it from upgrading its ADSL network. It will also be likely to prevent

⁵⁵ Some local and international precedents in relation to ring-fencing suggest that a shareholding as low as 5 to 10 per cent would be needed to limit the influence of one company over another.

the emergence of an entity with countervailing power in negotiating any interconnection arrangements.

A partial sell down of the HFC investment would likely mean establishing the HFC as a completely independent operation with arms length dealings between Telstra and the HFC asset. This would be likely to increase contracting costs and result in losses of economies of scope similar to full divestiture but without all of the compensating benefits.

HFC established as a stand-alone operation

Establishing the HFC as a separate business would create the conditions and incentives for greater competition between delivery platforms but without requiring full divestiture. It would involve measures to extend the independence between the two networks, potentially by requiring arms-length agreements, increased transparency of transactions between the two and creating separate management and board structures.

The European Commission has required separation of HFC and copper access networks under its 1999 cable-separation directive. The European Commission reasoned that cable separation would lead to greater transparency of assets and costs compared to accounting separation and that it would help the Commission to monitor cable network operations to ensure as far as possible that the dominant telecommunications organisation did not abuse its position in the market. The Commission also left open the possibility that in specific cases further measures might be required, such as opening the cable to third-party access or requiring its sale.⁵⁶

If Telstra retains full ownership interest in the HFC it is likely to still focus on maximising joint profits of the two networks. Increased transparency of transactions between the copper network and HFC may provide some benefit. However, it would not alter Telstra's investment incentives or otherwise significantly improve competition outcomes.

Establishing an independent entity in this way would mean that some economies of scope would be lost between Telstra's other networks and the HFC if any functions had to be duplicated, although these are likely to be relatively minor. However it would have the disadvantage that such economies would not be able to be regained by another entity as may be the case under full divestiture.

Conclusion

The Commission believes there would be significant benefits from divestiture of Telstra's HFC network. This view is based on the likely improvement in the competitive dynamics for basic telephony and broadband services flowing from the creation of a new independent facilities competitor.

A new owner would have a greater interest in supplying all services capable of being delivered on the HFC, and to compete head-to-head with Telstra and Optus. This would place increased competitive pressure on Telstra to focus on developing its copper access network, leading to greater competition in the broadband market and higher broadband take-up. If Telstra were to make the necessary upgrades to its copper access network, the copper network could serve as another network over which pay TV services could be delivered.

The Commission is not convinced that there would be a significant loss of economies of scope given the limited technical integration between the two networks. Some types of economies could be captured by other entities if they operate related businesses. On-going sharing of trenches would mean that one of the most important economies of scope between the copper access network and the HFC would continue.

The Commission believes that full divestiture of the HFC network would be considerably superior to more minimal ownership restrictions on the HFC. The more minimalist divestiture approaches risk not being sufficient to create the right incentives for greater competition between Telstra's copper access network and the HFC network.

⁵⁶ See European Commission, above n. 44.

4.5.3 Restrictions on Telstra's shareholding in Foxtel

The effect of the various ownership restrictions on the incentives and conditions of competition in the different fixed customer access and related telecommunications markets and pay TV markets are outlined below.

Divestiture of Telstra's 50 per cent shareholding

Under this option Telstra's 50 per cent share in Foxtel would be sold, either by a tender process, public float or to the other Foxtel shareholders, PBL and News Corporation. Ordinarily, divestiture would also involve a prohibition on the divesting firm subsequently re-acquiring any ownership in the company being divested.

An important implementation issue is whether Telstra should have a wider line of business constraint imposed on it to prevent it from forming its own wholesale and retail pay TV operation to replace its Foxtel ownership if it chose to do so.

The competition concerns from Telstra's ownership in Foxtel are a function of Foxtel's dominant position in pay TV supply, which new entrants would be unlikely to displace in the foreseeable future, and Foxtel's control of premium programming. It would therefore not appear sensible to introduce a line of business constraint on Telstra in addition to divestiture of its Foxtel shareholding preventing it from operating its own wholesale or retail pay TV service.

Fixed customer access and related telecommunications services markets

Should Telstra be required to divest its interest in Foxtel, the main immediate effect in the fixed customer access and related telecommunications services markets is that Foxtel, free of Telstra's ownership, no longer has a shareholder with a primary focus on telecommunications (and importantly, competition in telecommunications markets). That is, if divestiture occurred, Foxtel

would be unlikely to have the same incentives to limit supply to other network providers and even other telecommunications providers, as it does with Telstra's ownership interest.

However Foxtel will still seek to supply its content, if at all, on terms and conditions most advantageous to itself. Therefore, in the absence of new regulation providing for access to content, Foxtel may be unwilling to only offer supply of sports and movies to other providers as it may allow greater pay TV competition. Further, it may only offer to supply the entire Foxtel package at prices which provide limited opportunities for network providers. For these reasons, content access regulation is still likely to be beneficial to ensure broader telecommunication market competition.

This issue extends to the retail bundling of pay TV and telecommunications services, although the effects are less clear at present. As the minister said in his letter of 12 March 2002, a significant concern is whether bundling by Telstra, especially the bundling of pay TV and telecommunications services, has an anti-competitive effect. The Commission's views on the bundling of pay TV services with telephony services are provided in chapter 6 and more generally in chapter 8.

The Commission's analysis of bundling in respect of pay TV services indicates that there is no evidence of anti-competitive conduct at the moment. It is recognised that Foxtel is presently supplying content, albeit on a bundled channel basis, to other carriers such as Optus and AAPT. However, concerns remain that Telstra can gain advantages over its competitors. For example, AAPT's supply agreement with Foxtel is an agency agreement, where it receives a commission for signing up customers to Foxtel. This is in contradistinction to Telstra which resupplies Foxtel as a wholesale customer of Foxtel (with retail-minus pricing and other differences).

Clearly, however, there is some evidence of bundling being an important element of competition. For example, Telstra only agreed for Foxtel pay TV content to be supplied to Optus under the pay TV agreements on the basis that

the Commission allowed Telstra to bundle its telecommunications services with Foxtel.

Through the process of convergence, platforms delivering communications, broadcasting and other services are becoming increasingly interchangeable. This includes variations of traditional consumer devices being able to receive different services, for example interactive television or voice over IP. Convergence is made possible by technological advancement such as improved capacity on existing network infrastructure (for example compression techniques), new broadband infrastructure and digitisation of delivery platforms (which increases bandwidth and allows existing network infrastructure to provide more services).

As a result of the greater functionality and services available on high-capacity broadband networks, pay TV and broadband internet could become greater substitutes for each other. Foxtel could therefore become an important new competitor to Telstra in delivery of a range of telecommunications services, possibly carving out its own market niche independent of Telstra. This may in turn require Telstra to respond by supplying a range of competing services of its own. The opportunity to capture such benefits of competition between Telstra and Foxtel are more likely to arise where the interests of Telstra and Foxtel are no longer aligned- that is, where Telstra has divested its interest in Foxtel.

Pay TV markets

In the absence of any ownership rights in Foxtel or contracts limiting supply to Foxtel and Telstra, Telstra no longer has an incentive to discriminate in favour of Foxtel in the supply of HFC carriage for pay TV services. This would *prima facie* produce a more competitive environment for the delivery of pay TV services. However, the competitive outcome would depend on Telstra's supply decisions after divestiture- on its HFC network (depending on the government's decision about Telstra's continued ownership of the HFC network) and in the future, potentially through xDSL.

In particular, Telstra's options could include: establishing its own pay TV operation; reselling Foxtel content; and even focusing on being an infrastructure provider. Due to the competitive outcomes expected to emerge if the HFC were divested, it is not expected that Telstra would voluntarily sell the HFC after the divestiture of its Foxtel shareholding if this had not occurred already.

The first option would mean Telstra establishes its own pay TV/media operation, potentially in partnership with other media or entertainment companies, to supply services over its HFC and/or its copper access network.⁵⁷ Telstra's ability to establish a competing pay TV operation on the HFC would depend on Telstra's ability to access premium content.⁵⁸ The proposed content access regulation will therefore be an important facilitator for this option. If Telstra did decide to establish its own pay TV operation, Foxtel may want to continue supply on the HFC as a second pay TV service on Telstra's HFC, or perhaps increasingly through its satellite capacity or other networks, such as the Optus HFC.

Telstra could seek to continue to operate in the retail pay TV market as a reseller of Foxtel content. Currently Telstra resells Foxtel via both the HFC and satellite. It is seeking to resupply Austar's pay TV service in the Austar areas. The Commission is currently assessing Telstra's notification to resupply the Austar pay TV service.

Telstra could operate as a wholesale supplier of HFC, either using an open access model or more limited access model (such as seeking to just supply Foxtel).⁵⁹ Telstra may look to gain at least one major 'anchor' provider (presumably Foxtel) if it was to operate as an open access model.

⁵⁷ There could be concerns that Telstra would not be prepared to re-invest in pay TV because it will have been divested of a pay TV company. Such concerns overlook the specific reason for such divestiture - that Telstra's dominance in pay TV (through its Foxtel shareholding) and telecommunications serve to reinforce each other to the detriment of competition.

⁵⁸ Acquisition of premium content for supply on the copper network (through ADSL) does not appear to be similarly constrained- see chapter 6.

⁵⁹ An open access model is more suited to a digital network due to the current capacity constraints on the analogue network.

These possible options have a number of different implications for competition in the pay TV market.

Divesting Foxtel could produce greater competition in the content and channel supply markets if Telstra did establish its own pay TV operation to replace its Foxtel shareholding or allowed direct channel access to its network. If Telstra did neither of these things, the effect would presumably be limited to how pay TV services were bundled and priced at the retail level.

An open access model for the HFC would increase the possibility of alternative pay TV operations or individual channels gaining access to the network. This could potentially expand the opportunities for customers to determine their own packages of channels, and help to drive up the rate of pay TV subscription and other uses of the network.

More generally, removing the ownership links between pay TV and carriage in this manner means that Foxtel is better placed to choose the most efficient delivery method for its pay TV services over time. This could occur through Telstra's HFC, over the fixed networks of other carriers or from greater use of its leased satellite distribution network. Such freedom could drive competition between these delivery mechanisms to obtain content and produce associated efficiencies in network supply.

The Commission understands that the European Commission has objected to a number of mergers between telecommunications/cable companies and content providers because of concerns about foreclosure of key inputs to competitors. One example is the prevention of a joint venture between subsidiaries of the Norwegian and Danish national telecommunications companies and the media conglomerate Kinnevik in 1996 on the basis that it could foreclose broadcasting content and satellite capacity to other broadcasters.

Potential costs

Whilst Telstra has strategic influence over Foxtel, the two currently operate as quite distinct companies. They have separate headquarters, management and marketing. Therefore, it

appears unlikely there would be major losses of economies of scope if Telstra were required to divest its interest in Foxtel.

Foxtel would also gain economies of scale from supplying its services to other network providers if pay TV penetration is increased. Concerns about possible double marginalisation would be lessened by the prospect of a regulated price for on-supply of Foxtel's channel package.

A sale to the other Foxtel shareholders raises issues about media ownership more broadly, given PBL's ownership of a FTA channel (the Nine Network) and News Corporation's extensive newspaper interests. Telstra or others may argue that its influence in Foxtel increases media diversity- that is, Telstra plays a role in promoting Foxtel's interests as a company over PBL and News Corporation's other media interests.

However it is not clear that Telstra's involvement creates media diversity. In particular, the Commission understands that day-to-day programming decisions are made by the independent Foxtel management, with limited involvement from Telstra. Rather, the links between the major media operators in Australia and the most significant infrastructure provider, Telstra, appears to work against the interests of robust media and telecommunications competition.

The impact of removing Telstra's ownership in Foxtel on media diversity would depend on Telstra's actions after divestiture. Telstra would have the opportunity to enter as a pay TV/media operator independent of News Corporation and PBL potentially in partnership with other media companies if it chose to do so. Divestiture of Telstra's interest in Foxtel creates the possibility of Telstra as an entrant in the media sector.

Another issue is whether the government should, in addition to any ownership restrictions, limit contracting between Foxtel and Telstra post divestiture, or alternatively require some regulatory clearance of contracts between the two. A particular concern might arise if the entities wanted to establish exclusive contracts so that the benefits to each, that currently arise from Telstra's 50 per cent ownership of Foxtel, can continue.

Parts IV and XIB of the TPA may be insufficient to properly deal with the concerns of any exclusive contracts that Telstra and Foxtel may enter into, as enforcement of these provisions in court can take many years and significant uncertainty could result. In light of this, the government could consider a process of *ex ante* clearance of current and proposed contracts between Telstra and Foxtel to ensure the competition objectives of any divestiture are achieved. This could require the Commission to vet contracts to ensure that they did not limit the competitive outcomes that divestiture seeks to capture.

Reduction in Telstra's shareholding to below 50 per cent

Diluting Telstra's shareholding as an alternative to full divestiture would aim to achieve the same objectives outlined above, but with less cost to the various entities and to the economy more broadly. To benefit competition, this dilution would also need to ensure that Telstra did not retain a veto power over any of Foxtel's key decisions.⁶⁰

A central issue is what dilution in ownership would be needed to relinquish undue influence on Foxtel. It would appear that, to the extent Telstra retains control or influence, some of the benefits of divestiture would be lost. Further, if some influence is not retained by Telstra, it is unclear what benefits remain from such ownership.

Telstra would be expected to have less incentive to establish its own pay TV operation than with full divestiture because it would retain an ongoing relationship with Foxtel. It would also have less incentive than with full divestiture to provide open access on the HFC network. Telstra would presumably have less leverage over Foxtel in Foxtel's decisions on whether or not to supply other telecommunications companies with pay TV services, but some ongoing influence nevertheless.

Whether there is a difference in loss of economies of scope or increased transaction costs would likely depend on the level of independence between Foxtel and Telstra after partial divestiture. However, if the potential for loss of economies of scope and increased transaction costs is small, as the Commission understands, then the differences are unlikely to be significant.

Removal of Telstra's voting rights with respect to its shareholding

Removing Telstra's voting rights would mainly address Telstra's ability to prevent Foxtel from supplying content to other telecommunications operators, or to influence Foxtel's decisions relating to choice of network provider for its own services.

The main concern with this option is that prohibiting formal voting may not preclude influence being exerted by Telstra on other shareholders by more informal means. Monitoring of such conduct would be very difficult.

Telstra would be expected to have even less incentive to establish its own pay TV/media operation than with partial divestiture because it would retain its existing relationship with Foxtel. As it does not change Telstra's ownership interest in Foxtel, Telstra would still have a strong incentive not to allow other pay TV operators or channels to use the HFC.

This option would appear to have fewer costs than full or partial divestiture, as it maintains existing integration between Telstra and Foxtel.

Conclusions

The Commission believes that separating Foxtel from Telstra would give Foxtel increased incentive to supply its pay TV content to other network operators. This will be of particular benefit if Telstra is divested of its HFC network. It would also give Telstra greater incentive to allow its HFC to be used by other pay TV suppliers if it were to retain the HFC network.

A major qualification to the first comment is Foxtel's current agreement to lease satellite

⁶⁰ PBL and News Corporation are understood to have veto rights even though they each have less than 50 per cent ownership of Foxtel.

distribution, which means that any major infrastructure supply decisions may not be made in the medium term. Whether divestiture of Foxtel will have a significant impact on the pay TV market will depend on Telstra's pay TV supply decisions after divestiture.

It appears unlikely that divestiture of Foxtel would result in the substantial loss of economies of scope or scale. This is because the two organisations are not highly integrated.

The more minimalist ownership restrictions canvassed are not satisfactory substitutes to full divestiture because they are probably not sufficient to eliminate influence by Telstra. Given major lost economies of scope are not likely with full divestiture, the more minimalist approaches would not be expected to retain major ongoing efficiencies between the Foxtel and Telstra entities.

4.6 Implementation costs and issues for ownership restrictions

Divesting Telstra's ownership of the HFC and/or in Foxtel would have implementation costs that need to be considered along with the ongoing costs and benefits incurred. A key point is that the implementation costs are once-off, while the ongoing net benefits from greater competition would be expected to be enduring.

The size of the telecommunications sector in the economy and the linkages to other industries means that even if implementation costs are relatively large, there is a real likelihood that they will be outweighed by the net benefits.

The alternatives to full divestiture may have some lower implementation costs than full divestiture. The specific costs from implementing such options will also likely differ. Given the Commission's concerns that the net benefits from any of the options short of full divestiture are likely to be less than those from full divestiture, the discussion below is focused on full divestiture.

The Commission is not in a position to advise the government of the full financial and legal implications of the various ownership restrictions flagged. These would require further consideration.

The various ownership restrictions on Telstra in relation the HFC or Foxtel are likely to require the government to take direct legislative action. However, the Commission sees that the government has at least three options open to it when considering how to implement a divestiture policy.

The government could require that new companies be established to hold the relevant Telstra share of Foxtel and the HFC and issue all existing shareholders with shares in these companies in proportion to their Telstra shareholdings. Another option would be that the government compulsorily acquire Telstra's HFC and/or Foxtel shareholding and on-sell these. A third option would be to require Telstra to sell its full or partial shareholdings in a trade sale.⁶¹ These options are likely to have different costs and other implications, such as potential compensation for minority shareholders and various taxation issues, and therefore require further analysis.

In general, implementation costs associated with imposing ownership restrictions could comprise:

- costs related to internal restructuring of the various entities as Foxtel and/or the HFC are separated from Telstra
- costs related to re-contracting between these and other entities
- advisers fees related to the sale of the Foxtel and/or HFC businesses
- disruption to production and effects of other industry adjustment while changes are being introduced
- costs to government, including potential compensation payments to shareholders

⁶¹ A de-merger under the provision of the *Corporations Act 2001* is considered unlikely on the basis that this would require sponsorship and support by Telstra senior management and the Board.

- potentially creating the perception of higher sovereign risk.

The internal restructuring costs of divesting Foxtel are likely to be relatively low as Foxtel is not highly integrated into the core Telstra business. Such costs, however, may be higher for divestiture of the HFC because of the requirement to establish a stand-alone business and give effect to customer transfers. Nevertheless, given the HFC was designed as a stand-alone network, these costs are likely to be relatively low. They would be significantly below the costs of separating Telstra into network/wholesale and retail businesses.

There would be a range of re-contracting costs when the entities were required to negotiate new contracts with each other (as applicable), any new entities and other businesses. This may trigger regulatory and other legal costs associated with complying with anti-competitive conduct provisions of the TPA or specific provisions protecting against anti-competitive contracting once divestiture occurs.

Advisers fees relating to sale of businesses can be a major transactions cost. For example, fees for the partial privatisations of Telstra have so far amounted to several hundred million dollars.⁶² However because the options flagged here are much smaller in terms of the asset values involved, associated fees and costs would also likely be smaller.

Disruption of production plans and industry adjustment costs may be significant. These could include loss of customers and customer acquisition opportunities as new contracts and business cases are established.

It is possible that net acquisition or facilitation costs to the government may arise if the government were required to compensate shareholders for the forced acquisition of property.⁶³ The size

of any such cost might be determined by the difference between the existing value of shareholding in the integrated businesses and the value realised by shareholders as the result of divestiture. This net cost could be substantial given that the highest valuation of the assets in the market may well be that placed on them by Telstra. The government may be able to avoid or minimise the cost depending on which of the above legislated divestiture options were selected.

Requiring some form of divestiture could be perceived as a form of regulatory intervention that adds to the sovereign risk of Australia as an investment location. However, the Commission believes this concern needs to be kept in perspective. First, the recommendations apply to confined components of a single business. Second, divestiture requirements have been imposed in other jurisdictions— for example, the break up of AT&T in the United States, and the requirement by a number of European country governments that their incumbent telecommunications carriers divest their cable networks.

The Commission recognises that its recommendation that Telstra divest the HFC may also be criticised because of the considerable investment that Telstra has made in the HFC network. In response to this, the Commission notes that:

- Telstra's investment has been loss making as a stand-alone investment so far and was largely a defensive exercise to protect its copper network revenues
- the investment was initiated when Telstra was 100 per cent government-owned
- Telstra has written down the value of its investment in the network
- the assets of Telstra Multimedia, which controls the HFC, amount to around 5 per cent of Telstra's total assets
- the payment Telstra would receive from the divestiture of the cable would be expected to reflect the future earning potential of the cable.

⁶² Institutional Analysis, above n. 5, p. 44.

⁶³ This draws from an analysis of the potential costs and associate corporate implementation issues of the structural separation of Telstra detailed in the *Joint Submission by the Department of Communications, Information Technology and the Arts and the Department of Finance to the Inquiry of the House of Representatives Standing Committee on Communications, Information Technology and the Arts into the Structure of Telstra*, 4 February 2003.

4.7 PBL's joint ownership of pay TV operator and FTA broadcaster

The Commission does not believe that pay TV and FTA broadcasting are currently in the same market, for reasons explained in chapter 5. However, PBL's joint ownership of the highest rating FTA broadcaster (the Nine Network) and 25 per cent ownership of the dominant pay TV provider may still raise competition issues, given the important linkages between the two markets. These linkages are the potential for joint purchase of FTA and pay TV rights, particularly for major sporting events and the retransmission of FTA channels over the Foxtel pay TV network.

Retransmission of FTA channels over the Foxtel pay TV network is discussed further in chapter 7 of the report. The possible competition problem is that joint ownership gives Foxtel an incentive to discriminate in favour of the Nine Network compared with other FTA broadcasters for retransmitting FTA channels on the pay TV platform. This might extend to other services in the future, such as access to interactive services over the Foxtel pay TV platform.

Joint purchase of FTA and pay TV rights may cause competition concerns when, while buying FTA content, it gives the Nine Network an advantage over other FTA broadcasters.

This sub-section discusses these potential competition problems further, from the perspective of competition policy. If these potential problems generate enough concern, then further consideration of requiring divestiture of PBL's ownership of either Foxtel (in part) and the Nine Network would be justified. The Commission does not believe current concerns justify recommending such a course of action to the government at this time.

4.7.1 Joint purchasing of FTA and pay TV content

The joint purchasing of FTA and pay TV rights would be unlikely to be a concern if the FTA and pay TV markets are both competitive markets. However, if there is only limited competition for one or other of those rights, a firm with market power could leverage that power to secure rights for itself or related firms in the other market. This issue is conceptually similar to the issue of bundling services discussed further in chapter 8, although the focus in that chapter is on bundling by suppliers with market power rather than the purchaser.

The potential concern is that Foxtel may have enough market power to leverage from its strong position as the main buyer and supplier of pay TV programming to influence how other (non-pay TV) rights are allocated. The incentive to do so is heightened when those other rights are important for one of the Foxtel shareholders. For example, Foxtel could possibly insist that any bid it made for pay TV rights was conditional on the Nine Network being granted the FTA rights. There are a number of other ways in which Foxtel could offer favourable terms and conditions for the Nine Network.

While joint bidding for content is generally of concern, it is likely that such bidding for premium sports programming content would raise the most concern, given the particular importance of that content for both FTA and pay TV broadcasting. When considering PBL's acquisition of a 25 per cent interest in Foxtel in 1998, the Commission noted:

The ACCC would be concerned if the alliance of the interests of PBL, News Corporation and Telstra in pay TV were used in future to lessen competition in pay TV and related broadcasting and telecommunications markets. This concern would apply particularly (but not solely) to the acquisition of programming rights, especially sports programming rights, for both pay TV and free-to-air broadcasting.⁶⁴

⁶⁴ Australian Competition and Consumer Commission, *ACCC not to intervene in PBL/Foxtel Acquisition*, media release, 3 December 1998.

At the time, the Seven Network's pay TV subsidiary C7 held rights to a range of popular sports programming, including the AFL, and it had an established supply arrangement with Optus. Accordingly, C7/Optus were considered to be major competitors in the supply of sports programming on pay TV, and this lessened to an extent the Commission's concerns about PBL's acquisition of an interest in Foxtel. The last round of bidding for the AFL rights indicated strong competition at that time for the FTA and pay TV rights, with Foxtel being able to combine with the FTA interests of Channels Nine and Ten to bid against a competing bid by the Seven Network/C7 (which had an interest in acquiring both the FTA and pay TV rights).

Competition from Optus has appeared to diminish since the Commission's decision in respect of PBL's acquisition of an interest in Foxtel and before the Commission's decision on the pay TV agreements. In particular, market inquiries by the Commission indicated Optus was a less active acquirer of content and, previously, C7 had ceased supply over any pay TV platform. The Seven Network/C7 has since initiated legal action against Foxtel, its shareholders and a number of other parties alleging anti-competitive conduct in the joint bidding for certain sports rights.

The Commission continues to monitor joint bidding for premium rights, especially given the changed competitive structure of the market increases the potential for anti-competitive joint bidding. The Commission's proposed regulation of access to content would partially reduce competition concerns about the distribution of premium content.

4.7.2 Retransmission of FTA channels on the Foxtel pay TV network

Foxtel currently re-transmits the FTA channels over the Telstra HFC network. This retransmission occurs without payment by Foxtel to the FTA channels for the signal, or vice versa. However, concerns have been raised with the Commission about future supply of FTA channels once Foxtel

provides a full digital service. In particular, the concern is that the Nine Network may receive favourable treatment, particularly when the pay TV service is delivered via satellite, which is more costly than retransmission via the HFC network. As this concern has only been raised since Foxtel has started to consider providing a full digital service, the Commission did not consider the matter when making its initial decision on PBL's co-ownership of Foxtel.

Market inquiries have indicated that pay TV subscribers seem to value the FTA and pay TV services being provided on the one platform, to facilitate switching by the one remote control between the two services. Therefore, Foxtel has an incentive to re-transmit the FTA channels on its network and FTA operators also have an incentive to have their channels retransmitted.

Given PBL only owns 25 per cent of Foxtel, any significant discriminatory treatment favouring the Nine Network on retransmission would still need to be acceptable to the other two partners as each has a power of veto over Foxtel decisions. However, this does not preclude the possibility of other arrangements or understandings between the Foxtel partners being reached in exchange for favourable retransmission treatment. For example PBL could agree not to veto other Foxtel business decisions in return for favourable treatment of the Nine Network over other FTA broadcasters.⁶⁵

The Commission is currently investigating concerns about the competitive impact of the Nine Network's agreement with Foxtel for retransmission. The Commission may provide further comment to the government on the issues of ownership of Foxtel and retransmission of FTA broadcast channels if competition issues arise.

⁶⁵ The Nine Network's agreement with Foxtel could also be a strategy to entice one FTA broadcaster to agree to retransmission so that the other commercial FTA broadcasters believe they need to also reach agreement or suffer competitive advantage.

4.8 Conclusions and recommendations

Whilst increasing transparency, the Commission has grave reservations that access arrangements and enhanced accounting separation and related provisions are sufficient of themselves to address ongoing competition concerns in the Australian telecommunications market. Therefore it believes that the government should consider introducing ownership restrictions.

The Commission believes substantial competition benefits would be derived from requiring Telstra to fully divest its HFC network and its 50 per cent shareholding in Foxtel. Divestiture of the HFC would introduce a new infrastructure competitor into the market, establishing conditions for increased rivalry and innovation in the supply of a full range of telecommunications services. If Telstra were divested of its Foxtel shareholding, both Telstra and Foxtel would have improved incentives to supply their services to competitors and Telstra would have diminished ability to use its market power to leverage into converged markets.

The Commission also believes that if the HFC is divested, then it would become more important that Foxtel is also divested so that Telstra could not use its influence in Foxtel to deny the new network owner access to Foxtel pay TV content.

The Commission believes that the ongoing costs involved in divestiture of the HFC and Foxtel are likely to be minor compared with the ensuing benefits— and there is therefore a strong case for divestiture. It is also recognised that the costs involved in divesting the HFC are likely to be higher than those for divesting Foxtel. In both cases, there are implementation costs that the government will need to consider further.

The Commission therefore recommends that the government introduce legislation requiring Telstra to:

- divest the HFC network in full, and
- divest its 50 per cent shareholding in Foxtel,

unless it can be shown that the costs of such divestiture outweigh the benefits flowing from increased competition.

Only full divestiture is likely to produce fundamental changes in behaviour where there is presently joint ownership. This is based on the truism that integrated firms maximise joint profits whereas structurally separate firms maximise their own individual profits.

Flowing from this, wherever there is ongoing integration, the incentive remains for the integrated entities to favour themselves through measures such as cross-subsidisation and discriminatory access, either explicitly or tacitly. All else being equal, such favouritism will be greater the higher the extent of integration or ownership.

5 Government regulation of pay TV and free-to-air TV broadcasting

5.1 Overview

The current regulation of pay TV and FTA broadcasting was relevant to the Commission's consideration of the pay TV agreements. In particular, the Commission considered that, *inter alia*, regulatory restrictions on the operations of pay TV and FTA TV broadcasters limit competition between the two sectors. These restrictions include: the current prohibition on multi-channelling by FTA broadcasters; restrictions on the use of broadcasting spectrum, particularly regulations relating to datacasting and the number of FTA licences; and the current anti-siphoning regime.

Regulatory restrictions that may limit competition between the pay TV and FTA sectors are also relevant to the pay TV agreements and emerging market structures in the communications industry insofar as these sectors have the potential to provide a degree of competitive constraint on the other sector. Regulations such as those mentioned above prevent this potential from being realised and therefore deny consumers the benefits that could flow from an increased degree of competition between, and within, the pay TV and FTA sectors.

Competition between and within the pay TV and FTA sectors is important because these markets

are relatively immune to competitive pressure from the threat of new entry, given the high barriers to entry to both sectors. This is particularly so in the FTA broadcasting sector where government regulation rules out new entry. If competition between the pay TV and FTA sectors were allowed to develop, the competitive discipline on pay TV operators would be likely to increase.

Many broadcasting regulatory instruments affect competition in the communications sector, such as ownership and content regulations, and spectrum planning. However, because this report focuses on those parts of the communications sector which are particularly affected by the pay TV agreements (telecommunications, FTA television broadcasting and pay TV broadcasting), this chapter concentrates on the main regulatory instruments that directly raise competition issues in the FTA and pay TV markets.

This chapter initially outlines the Commission's analysis of market definition for pay TV and FTA services when considering the pay TV agreements and, importantly, some of the key reasons for considering the markets to be distinct.

The chapter then considers the costs and benefits of introducing a less restrictive model of FTA broadcasting, for example:

- easing restrictions on multi-channelling
- easing the limitations on spectrum use (that is, the related issues of restrictions on the use of datacasting licences and the number of FTA licences)
- regulations relating to anti-siphoning.

In part this chapter draws upon the Productivity Commission's inquiry report into broadcasting, released in 2000. Like the Productivity Commission, the Commission is sceptical that there is a case for the current extent of regulation in the media sector. It appears to the Commission that much of the discussion on broadcasting regulation has focused on the benefits of such regulation which has largely overshadowed consideration of the costs of current broadcasting regulation.

This chapter finds that there is a strong case for bringing forward the review of the moratorium on the number of commercial FTA licences. As the media regulations cannot be examined in isolation, the government should conduct an 'across-the-board' review of the regulations applying to the media sector, in particular those that have a direct impact upon competition. These include the prohibition on multi-channelling, the restrictions on datacasting and the current anti-siphoning regime.

It is particularly important that the Commission's recommendations about the current regulations applying to the FTA and pay TV sectors not be seen as discrete or as 'either/or' options. The regulations applying to the FTA and pay TV sectors should be considered in a comprehensive manner- that is- a broad review of the regulations applying to pay TV and FTA broadcasting is necessary. It would be undesirable for further amending of the media regulatory framework to occur in a piecemeal fashion - a thorough assessment of the regulations and how they relate to each other is necessary.

5.2 Background

5.2.1 Incentives in broadcasting

FTA operators are mainly funded through advertising revenues. This means that FTA operators have an incentive to broadcast programs that attract large audiences, and not necessarily to broadcast programs that cater for the tastes of minority interests. FTA operators therefore need to balance maximising audience numbers against the goal of minimising program costs.¹

A public broadcaster, whose main source of revenue is not advertising, has different incentives to commercial broadcasters. The importance placed on the role of public broadcasters is demonstrated by the fact that virtually every OECD country has some form of public broadcaster even in countries where there are many competing FTA channels. This may be interpreted as evidence that the market outcomes from FTA broadcasters may not be adequate in themselves to satisfy policy objectives.

The main source of revenue for pay TV operators is from subscriptions rather than advertising. Therefore, the incentive of pay TV operators is to provide sufficiently attractive programming that consumers are prepared to pay for it. Also, because pay TV operators can provide numerous channels, they can cater for minority-interests in a way that FTA operators cannot. If FTA operators were permitted to operate more than one channel, that is to 'multi-channel' (discussed below), they would have a greater ability, though not necessarily an increased incentive, to broadcast programs that would appeal to smaller or niche audiences.

¹ B. Owen and S. Wildman, *Video Economics*, 1992, pp. 101-150.

5.2.2 Broadcasting policy objectives

While various regulatory restrictions that apply to the FTA and pay TV sectors may impede competition between FTA and pay TV operators, these restrictions may also have potential benefits in terms of the policy objectives they seek to achieve.

Some policy objectives are explicitly set out in section 3 of the BSA and include:

- promoting a diverse range of television services offering entertainment, education and information
- promoting the role of broadcasting services in developing and reflecting a sense of Australian identity, character and cultural diversity
- promoting high quality and innovative programming by providers of broadcasting services.

The BSA also aims to ‘provide a regulatory environment that will facilitate the development of a broadcasting industry in Australia that is efficient, competitive and responsive to audience needs’.²

Other stated policy goals that may in part draw upon the policy objectives enshrined in the BSA include:

- protecting the ‘fledging’ pay TV industry from potential competition from the FTA operators by prohibiting the FTA operators from multi-channelling
- protecting the FTA industry from new entry by restricting the number of commercial licences available to assist FTA operators in meeting obligations relating to, for example, Australian content, children’s programming quotas and digital transmission.

This last point reflects a concern that without such restrictions the FTA industry would not have

the financial means to meet the social objectives stated in the BSA.

The Commission recognises that a number of policy objectives can only be met through regulation— that is, that market outcomes may not be adequate in themselves to deliver the policy objectives that the government believes are desirable. An unregulated market may not deliver all the social objectives sought because of the commercial incentives that drive the broadcasting industry.

However, where restrictions on competition are implemented to achieve a particular policy, it should be recognised that such restrictions may impose significant costs on society. The Competition Principles Agreement provides that because regulations that restrict competition typically impose significant costs, the use of such regulations to achieve a particular policy outcome should only be used as a last resort and a clear social benefit that outweighs the costs of restricting competition should be identified and explained.³

In many regards the BSA appears to be in conflict with the Competition Principles Agreement. As the Productivity Commission noted in its inquiry report into broadcasting:

The [Broadcasting Services] Act predates the development of National Competition Policy, and is out of step with competition policy settings... Regulation should be targeted to achieve objectives rather than to balance *quid pro quos* among producers. Those regulations that do not contribute should be removed. Policies will also generally work better if

³ See clause 5 of the Competition Principles Agreement which provides:

The guiding principle is that legislation (including Acts, enactments, Ordinances or regulations) should not restrict competition unless it can be demonstrated that:

- (a) the benefits of the restriction to the community as a whole outweigh the costs; and
- (b) the objectives of the legislation can only be achieved by restricting competition.

National Competition Council, *Compendium of National Competition Policy Agreements*, second edition, June 1998.

² Section 3(b).

they are set up so market forces and competition aid their achievement.⁴

In short- it is important that impediments to the development of markets and services that are created by regulation be minimised.

Another important element of regulation is that regulations should embody the principle of competitive neutrality- that similar services are regulated similarly. For example, datacasting has been defined in legislation as services transmitted using parts of the spectrum set aside for broadcasting. However, a service with the same content as a datacasting service could be transmitted over the internet or as an interactive service provided as part of a satellite or cable pay TV service and would not be subject to the same restrictions that apply to datacasting services.

Where similar services are regulated differently on the basis of how they are delivered, investment decisions may become biased simply by the presence of such regulations. Therefore it is important when developing a regulatory regime that applies to converging markets, that there is, as far as possible, competitive neutrality between the markets.⁵

5.3 The Commission's views on the pay TV and free-to-air markets

The Commission's view when considering the competition implications of the pay TV agreements was that retail FTA and pay TV services are provided in separate markets. In assessing the retail market for pay TV services the Commission has found there is a retail market for the supply of pay TV services to members of the public wishing to subscribe to such services.

⁴ Productivity Commission, *Broadcasting*, Report no. 11, 2000, p. 8-9.

⁵ See for example: R. Albon and F. Papandrea, *Media Regulation in Australia and the Public Interest*, November 1998, p. 76.

In particular, the Commission's report on the declaration of the analogue subscription TV broadcast carriage service over HFC networks sets out its analysis identifying the relevant market in which analogue pay TV cable carriage services are provided.⁶

While some substitutability exists between FTA and pay TV services, several factors distinguish the two. Various products have been identified as possible alternatives to pay TV including: FTA broadcasting; cinema; VHS video and DVDs; video-on-demand/near video-on-demand; and video and online games.

The Commission believes that some substitutability exists between pay TV and FTA services as, to some extent, demand for pay TV is influenced by programmes shown on FTA. Also, some competition exists between pay TV and FTA operators in bidding for programming rights.

However, on balance, the Commission considers there is persuasive evidence to suggest that pay TV services are in a separate market from FTA services. This view is based on several factors, including differences in funding (whether funding is primarily through advertising or subscription) and range of programming, and the regulatory restrictions that limit the level of competition between FTA and pay TV operators.

5.3.1 Difference in funding and range of programming

FTA broadcasting is funded by advertisers who pay to place advertising on particular channels at particular times. FTA broadcasters do not sell programs to audiences, they sell audiences to

⁶ Australian Competition and Consumer Commission, *Declaration of Analogue Subscription Television Broadcast Carriage Service: A Report on the Declaration of an Analogue-specific Subscription Television Broadcast Carriage Service under Part XIC of the Trade Practices Act 1974*, August 1999. When considering the Foxtel/Australis merger in 1997 the Commission also found there was a market for the supply of pay TV services to members of the public wishing to subscribe to such services. A discussion of broadcasting markets and competition issues can be found in Trade Practices Commission, *Market Definition and Competition Issues in Commercial Broadcast Radio*, 1994

advertisers.⁷ Pay TV on the other hand relies predominantly on revenue from subscribers—that is, selling programs to audiences.⁸

These differences in funding suggest that the business models for FTA broadcasting and pay TV are significantly different. In the case of FTA broadcasting, the audience share and advertising rates are the key parameters, as opposed to pay TV, where the key business factor is the shaping of programmes to meet the interest of target groups of viewers. Therefore, pay TV providers will try to maximise subscriber revenue by transmitting programmes which directly appeal to existing and potential subscribers while FTA broadcasters will try to maximise advertising revenue by broadcasting programs with mass appeal which will therefore attract advertisers.⁹

This difference in funding also has demand-side implications. On the demand-side, viewers must be persuaded that pay TV is a unique product and one which cannot be substituted by FTA broadcasts.

5.3.2 Separation of pay TV and FTA sectors though government regulation

Current regulations applying to FTA and pay TV operators creates some division between the services supplied by FTA and pay TV operators. For example, multi-channelling would be likely to increase the substitutability for pay TV services. Similarly, if restrictions on datacasting were lifted and FTA operators used the spectrum that had previously been set aside for datacasting to provide services to end-users, FTA services may become more competitive with pay TV services. The anti-siphoning provisions also create a further separation of the pay TV and FTA markets.

⁷ See for example the Commission's analysis of the product market for commercial radio stations see: Trade Practices Commission, above n. 6.

⁸ Paragraph 10(2)(b) of Part 6 of Schedule 2 of the BSA sets out that each subscription television licence is subject to the condition that subscription fees will continue to be the predominant source of revenue for the service.

⁹ B. Owen and S. Wildman, above n. 1, p. 154.

The effect of these regulations on the degree of competitive restraint that pay TV and FTA operators could potentially exert on each other is examined below.

5.4 Regulations applying to FTA and pay TV operators

While acknowledging that restrictions on competition in the media sector have been implemented to achieve various social policy objectives the Commission believes that they may be inhibiting consumer choice, competition, economic growth and innovation in this sector. Additionally, in some cases, such as the datacasting licence restrictions, they have not achieved their social policy objective.

The burden should be on those arguing for continued regulatory restrictions on FTA and pay TV broadcasting to demonstrate that the benefits of such policies outweigh the costs, and that the policy objectives can not be achieved using less restrictive means. The Commission does not believe this case has been successfully argued. In the Commission's view, this policy analysis should occur as a priority and in a public and transparent manner, with a very clear evaluation of the harm to consumers flowing from the existence of the restrictions as against the benefits delivered by the restrictions on competition. Where regulations do not deliver tangible benefits, they should be removed.

Of particular concern are the current limitations on FTA multi-channelling, statutory barriers to entry for FTA broadcasting, restrictive datacasting licence conditions and the current anti-siphoning regime. The Commission outlines the reasons for its concerns below.

The various regulations applying to the pay TV and FTA sectors should not be considered in isolation. As noted by the Productivity Commission:

Participants have emphasised how broadcasting policy is a structure built by *quid pro quos*: barriers to entry are balanced against programming obligations; free to air networks are prohibited from multi-channelling to help subscription services which in turn are disadvantaged by restrictions on advertising and anti-siphoning rules; free to air networks are required to broadcast in high definition because they have been lent the spectrum to do so; and so on and on.¹⁰

One key relationship between the various regulations is the relationship between datacasting licence restrictions and the moratorium on additional commercial FTA licences. The removal of restrictions on datacasting would allow datacasting licences to closely replicate the services provided by existing FTA broadcasters. Therefore, datacasting licence restrictions could not be fully considered without also addressing the issue of the moratorium on additional commercial FTA licences. Additionally, as competition potentially increases between previously separate sectors, the differences in regulation applying to these sectors, including spectrum management, should be considered.

Removing regulation affecting FTA broadcasting and datacasting may also diminish the need for other regulation such as cross-media and foreign ownership regulation. Lower barriers to entry and fewer licence conditions offer greater opportunities for new entrants. This is likely to result in greater diversity of services offered, which is the aim of many of the current regulations applying to the FTA industry.

These relationships between different policies mean that the government should consider legislative amendment comprehensively. Unscrambling the current restrictive regime should occur across-the-board, and not be limited to individual changes. In particular, it may be poor policy to allow multi-channelling by FTA incumbents using spectrum that the government has 'loaned' the FTA operators at the expense of not allowing new FTA entry.

¹⁰ Productivity Commission, *Broadcasting*, p. 254.

5.4.1 Multi-channelling

Multi-channelling is the transmission of more than one discrete stream of programming over a single television channel. Given current spectrum allocation, the 7MHz channel provided to FTA broadcasters can accommodate the broadcast of three or four separate signals using standard definition (576i) broadcasting.¹¹

The government's 1999 decision to mandate high definition television (HDTV) broadcasting and require simulcast of HDTV and standard definition television (SDTV), restricts the opportunity for any multi-channelling by commercial FTA broadcasters under existing spectrum allocations. If the decision to mandate HDTV was rescinded, this should not necessarily mean that the FTA broadcasters should automatically have the right to the full 7MHz channel. The remaining spectrum could be allocated by auction, to promote the most efficient allocation.

While the commercial FTA operators can provide enhancements directly linked to programs simulcast on their analogue channel, they cannot use their digital spectrum to provide multi-channelling or pay TV services under current regulations.¹² The government's stated reason for prohibiting multi-channelling by the FTA broadcasters was to 'ensure that the developing pay TV sector is not unfairly disadvantaged by digital conversion of existing commercial and national television broadcasters'.¹³

The potential benefits of removing the prohibition on multi-channelling

Multi-channelling by FTA operators could heighten competition both between the FTA

¹¹ *ibid.*, p. 227.

¹² An exception is that FTA broadcasters are allowed to multi-channel when certain events, such as sports matches, extend over time due to circumstances beyond the control of the broadcaster, and overlap with a regularly scheduled news program: BSA, Schedule 4, paragraph 19(8).

¹³ Explanatory Memorandum, Television Broadcasting Services (Digital Conversion) Bill 1998 and Datacasting Charge (Imposition) Bill 1998, p. 16.

operators and between the FTA and pay TV sectors. Competition in the FTA market is not dynamic, largely because of its status as a protected oligopoly, and multi-channelling may provide a mechanism to alter this— potentially giving rise to innovation and a wider variety of service offerings. The Productivity Commission, in its report on broadcasting released in 2000, recommended that multi-channelling by commercial and public television licence holders be permitted.¹⁴

The commercial FTA and public broadcasters could deliver additional services to consumers using multi-channelling. A commercial FTA provider could broadcast one or more additional channels to complement or provide substitute services to the primary channel. For example, news services could be staggered to service different consumer preferences, simultaneous sporting events could both be shown live, complementary channels could be developed¹⁵ and/or completely different content could be provided. There is no reason to assume a multi-channel would even be 24 hours in its coverage.¹⁶

The number of additional channels would depend on the available spectrum. The current HDTV requirements and decisions on spectrum-use impinge upon the available spectrum and therefore the ability to multi-channel. One of the benefits of digital technology is that digital capacity is 'dynamic'— it can be allocated between different services as required. Therefore, it would be possible to multi-channel during the time that the broadcaster is not using that spectrum to provide HDTV services. HDTV and multi-channelling are not mutually exclusive.

Pay TV operators are concerned that multi-channelling will have a deleterious impact on

their business,¹⁷ and this concern is given as one of the policy objectives for restricting multi-channelling. This concern expressed by the pay TV operators lends some support for the view that allowing commercial FTA broadcasters to multi-channel will promote greater competition between FTA broadcasters and pay TV providers.

Multi-channelling may permit FTA broadcasters to capture efficiencies in production, particularly in the production of sports programs. At a tennis tournament, for example, the 'key' match may be shown on the broadcaster's primary channel, and the other matches could be shown via one of the multi-channels. Therefore, by using multi-channelling, FTA broadcasters may be able to make more or better use of what are typically expensive sports broadcasting rights. In this way multi-channelling may also provide public benefits in terms of greater consumer choice.

Multi-channelling may also provide some scope for additional revenue as it permits greater targeting of audience.

Having said that, the competitive impact of such legislative change would be likely to be relatively limited in the short-term, given the small number of digital receivers at present.¹⁸ This, however, also highlights a further potential benefit: that multi-channelling may encourage the take-up of digital receivers and transition towards full digital terrestrial services.

In addition to other enhancements such as interactive television, digital television can provide for greater picture and sound quality and/or for

¹⁴ Productivity Commission, *Broadcasting*, p. 259.

¹⁵ Similar to 'Big Brother' using the internet to enable viewers to increase their 'consumption' via the internet.

¹⁶ A multi-channel could even be provided on a subscription basis. However, consideration would be required of *inter alia* whether this would be likely to undermine the provision of FTA broadcast services via the primary channel (as is the Government's policy).

¹⁷ In the section 87B undertaking given by Foxtel to the Commission, Foxtel's commitment to digitise its pay TV network is conditional on, amongst other things, the Government not passing legislation which has the effect of allowing FTA operators to multi-channel prior to January 2007. The reason for this is that Foxtel holds the view that multi-channelling by FTA operators would have a material adverse impact on its pay TV business and therefore on Foxtel's decision to invest in providing a digital pay TV service.

¹⁸ Industry generally reports that unit sales of digital television equipment are approximately 35 000- 55 000. This includes standard definition and high definition STUs and integrated digital television sets: see for example I. Cuthbertson, 'Battle for the Home Box Office', *The Australian*, 18 February 2003.

greater program choice. The present policy is focused only on the picture quality, by mandating HDTV but not allowing for multi-channelling. Improved picture quality may or may not be relatively important to take-up of digital services, depending partly on the price for consumer reception devices (digital televisions and STUs).¹⁹ However, relying solely on improved picture quality to encourage the take-up of digital services restricts the opportunity for services such as multi-channelling and the associated provision of additional content to provide additional impetus to the demand for digital services.

Potential risks or costs of amending the multi-channelling provisions

FTA and pay TV operators have argued that there would be potential risks or costs associated with liberalisation of the multi-channelling provisions. Some FTA broadcasters have argued that multi-channelling may result in fragmenting of viewers across the various channels and, without an increase in advertising revenue, this audience fragmentation will lead to an effective decrease in program quality. Concern has also been expressed that introducing multi-channelling before 2005 would be an unacceptable violation of the principle of regulatory certainty. These issues are considered below.

Fragmentation of audience and dilution of advertising revenue arguments

A reason why FTA broadcasters argue against multi-channelling is that it could result in 'fragmentation' of the FTA audience for television. Such fragmentation could arise where a broadcaster is providing a greater number of channels to the same number of viewers (i.e. the same amount of audience viewing time is divided across a greater number of channels).

Experience in the United States and the United Kingdom is that irrespective of whether additional FTA advertising avenues become available, the total amount advertisers spend on FTA advertising stays relatively constant.²⁰ If a FTA broadcaster chose to multi-channel, the total cost of programming would probably increase. The FTA broadcaster would be providing more content to consumers, but the operator's revenue from advertising may remain relatively constant. It might be argued that this will result in a reduction of discretionary spending and programming quality (such as an increased incentive to repeat programs).

The Commission is sceptical about aspects of this argument. In particular, two FTA operators (Nine Network and Network Ten) have opposed the introduction of multi-channelling on the basis that it would undermine the commercial viability of FTA television.²¹ However, the Seven Network supports its introduction.²² The Seven Network's backing of multi-channelling calls into question the arguments of the other FTA operators that multi-channelling will damage the FTA industry.

One of the reasons for the Seven Network's support appears to be a concern that audience fragmentation will increasingly occur in any event, as a result of increased penetration of pay TV and other communications services that provide an avenue for advertising.²³ This means

¹⁹ Digital Broadcasting Australia has commented that: 'DVD is the significant driver for digital television as it has made superior picture and sound quality and the widescreen format more attractive. People get that picture watching a DVD and they want it all the time with their free-to-air TV': see also C. Spann, 'Hi-tech Nation Warms Slowly but Surely to Digital Television', *The Courier-Mail*, p. 16.

²⁰ In both the United Kingdom and the United States FTA television's share of the total advertising pool has remained stable at 33 per cent and 22 per cent respectively, over the period that new entrants have gained advertising share: ABN AMRO, *Media Australia*, July 2002.

²¹ S. Lewis, 'Operators Align to Scuttle Digital Rules', *The Australian*, 19 July 2002, p. 19.

²² *ibid.*

²³ There are also reports that other forms of marketing are becoming more important, such as direct mailing, telemarketing and sponsorships, although there are different views about whether this is cyclical or structural. The Australian Financial Review states: 'In the current economic environment, many companies are also focusing harder on selling more to their existing customers rather than the costlier approach of finding and recruiting new customers. For many companies talking to existing customers means using non-advertising marketing tools.': N. Shoebriidge, 'Channel-changing presents a terminal problem', *The Australian Financial Review*, 17 February 2003, p.51.

any benefits flowing from maintaining the status quo may be lessened over time. The restriction on FTA multi-channelling may actually prevent the FTA operators from responding to new sources of competition.

Further, permitting FTA broadcasters to multi-channel does not amount to a requirement that FTA broadcasters offer multi-channel services. However, arguments have been made to the Commission that it is likely that were one FTA operator to begin offering services to end-users via multi-channelling, other FTA broadcasters would feel compelled to follow. This, however, is the precisely the nature of competition.

There have been some concerns expressed to the Commission about the failure of the United Kingdom multi-channeller ITV Digital, which supplied digital terrestrial broadcast to consumers. It is not clear that the failure of ITV is indicative of broader issues of terrestrial multi-channelling services. An important distinction is that ITV Digital was a subscription based service rather than a FTA service. Several complex factors contributed to the difficulties encountered in the United Kingdom digital terrestrial television sector, most of which appeared to be firm-specific. These included: that ITV Digital did not have premium sporting content and paid unsustainably high prices for second rate sporting products; high piracy rates; and the service was unreliable because of various technology problems. Additionally, ITV Digital faced strong competition from the established digital multi-channel satellite service delivered by BSkyB.

Regulatory certainty

The government has stated that a departmental review will be conducted in 2005 to assess whether FTA operators should be permitted to multi-channel.²⁴ While the Commission certainly believes that clear regulation and legislation helps encourage investment, the overall costs and benefits of good policy must be considered.

The Commission believes that there is a strong case for the government to review the prohibition on multi-channelling by FTA operators at this time as opposed to 2005 because:

- pay TV operators are currently considering substantial investment in new infrastructure. If pay TV operators are particularly concerned about multi-channelling being permitted, it would seem reasonable for the government to consider the merits of legislative change now, to help pay TV operators make investment decisions
- the market has changed substantially since the prohibition was made. These changes include implementation of the pay TV agreements and the plans to digitise the Foxtel/Telstra HFC pay TV network to provide significantly increased services to end-users
- in any event, given the potential costs of this prohibition, continued anti-competitive restrictions should be frequently reviewed.

Conclusions on multi-channelling

If FTA broadcasters were allowed to multi-channel, this could increase the potential for competition both within the FTA sector and between the FTA and pay TV sectors. FTA operators should have the choice about whether or not to multi-channel based on the benefits and costs of doing so—removing the prohibition leaves the decision to market forces. Multi-channelling may actually create new avenues of revenue and allow FTA broadcasters greater scope to maximise their content rights.

The Commission is sceptical of the need for the extent of the restrictions currently placed on multi-channelling. No persuasive evidence has been presented to date to indicate that removing the prohibition on multi-channelling would harm the FTA sector. The easing of the restrictions on multi-channelling would provide FTA operators with the ability to offer new services to consumers and has the potential to provide a wider range of services to consumers.

²⁴ Senator Alston, *Digital - A New Era in Television Broadcasting*, media release, 24 March 1998.

5.4.2 Restrictions on the use of spectrum– datacasting and additional commercial free-to-air broadcast licence

The Commission notes that the government's policy to date has been to restrict the use of spectrum, which could otherwise supply broadcast television or similar services. In particular the government decided in December 2002 to continue the current moratorium on the number of broadcast licences issued until 31 December 2006 and made a related decision to retain content restrictions on datacasting with a view to promoting 'new' services in the industry. Datacasting is a term used to define the restricted services that, under legislation, are permitted to be provided using the broadcasting spectrum.

The legislative framework for the content licensing arrangements applying to datacasting is set out in Schedule 6 of the BSA. Schedule 6 provides for the allocation of datacasting licences, stating that anyone wishing to provide a datacasting service must hold a datacasting licence.²⁵

Datacasters are subject to restrictions designed to encourage the provision of innovative services that are different to traditional broadcasting services.²⁶

The issues of datacasting and the restriction on the number of FTA licences are related because removing restrictions on datacasting provisions would allow a datacasting licence to closely replicate the service provided by existing FTA broadcasters. The Department of Communications, Information Technology and the Arts (DCITA) highlighted this point in a review conducted in 2002 on datacasting, recommending no change to the rules that specify the content which can be provided under a datacasting licence.²⁷

While the DCITA review found that businesses in Australia and overseas are yet to identify commercially sound datacasting business strategies independent of traditional television operations, DCITA was concerned that substantial changes would compromise the moratorium on new FTA television broadcast services.²⁸ This is because if the datacasting restrictions are liberalised, it could essentially result in additional commercial broadcast services.

The following section considers the benefits and costs of liberalising the datacasting licence conditions and allowing additional broadcast licences.

Potential benefits of liberalising the datacasting licence conditions

The holders of datacasting licences may not provide certain genres of television programs. In particular, datacasting licensees are limited to providing services such as: news, financial and weather information; educational programs; interactive computer games; e-mail and internet content; and parliamentary broadcasts.

The Commission continues to hold the views it gave to DCITA in its 2002 review on datacasting—that is, that the existing restrictions on the use of the datacasting spectrum have not achieved their desired policy outcome of encouraging the provision of innovative services that are different from traditional broadcasting services.

The auction for the spectrum that had been allocated for datacasting was cancelled in May 2001 as a result of lack of interest. Companies with a potential interest in datacasting were critical of the restrictions placed on the use of the spectrum. For example, in its submission to DCITA's review, Fairfax commented that:

There is... at present an irreconcilable contradiction, for as long as the current content restrictions are in place, between the investment required and the prospect of any commercial return.

²⁵ Commercial FTA television broadcasters will be required to pay a charge for datacasting on their digital spectrum.

²⁶ DCITA, *Review of the Operation of Schedule 6 of the Broadcasting Services Act 1992 (Datacasting Services)*, December 2002, p. 1.

²⁷ *ibid.*, p. 6.

²⁸ *ibid.*, p. 7.

For this reason, Fairfax will not bid on datacasting licenses that are burdened with such restrictions.²⁹

Similarly, News Limited stated in its submission that the legislative restrictions on datacasting content 'are so extreme that reducing those restrictions marginally would still render the spectrum useless'.³⁰

Currently, Broadcast Australia is preparing the first commercial trial of datacasting. The company is running the trial to 'seriously test whether there is an alternative suite of services that could be delivered within the (datacasting) restrictions'.³¹

The Productivity Commission predicted in its inquiry report that the restrictions on datacasting were not sustainable.

[T]hese new services [datacasting] cannot be readily distinguished from digital television (either free to air or subscription without the risk of regulating them into insignificance... The [Productivity] Commission's view is that restrictions of this sort on the content or format of datacasting are unlikely to be sustainable, although they made succeed in constraining innovation in content otherwise seen as culturally or socially desirable, such as drama and children's programs. Diversity is more likely to be achieved through significantly increasing the number of broadcast services than through arbitrary rules.

The Commission recommends a liberalised approach to digital television services, without recourse to prescriptive, artificial and inevitably short lived distinctions between datacasters and other digital broadcasters.³²

As the existing restrictions have not been successful in achieving their desired outcome, and- in the Commission's opinion- seem unlikely to do so in the future, the Commission believes substantial changes are warranted. Ideally, this would mean that the content restrictions imposed on datacasters should be removed. Service providers who wish to use the datacasting spectrum should be given the widest possible scope to deliver the services they wish to offer, allowing them the flexibility to test and respond to consumer tastes and demand.

The Commission recognises that if the datacasting regime is liberalised, datacasters may provide services similar to FTA or telecommunications services. This would raise the important issue of ensuring regulatory neutrality between the FTA broadcasters, telecommunications service providers and those using the spectrum that had been set aside for datacasting, to the extent they are competitive. For example, consideration would be required of licence fees and local content quotas for datacasters compared with the FTA broadcasters. Such an assessment may be complicated by potential similarities between datacasting and telecommunications services.³³

Potential benefits of reducing statutory barriers to the commercial broadcast FTA market

The government has decided to continue the moratorium on providing a fourth commercial FTA licence until 31 December 2006. The Commission's understands that the reason for this decision stemmed from concerns that FTA broadcasters needed an incentive to invest in digital television broadcasting and that any dilution of advertising arising from the introduction of another FTA broadcaster would not provide such an incentive.

²⁹ Fairfax, *Response to the Datacasting Services Review*, 24 January 2002, p. 5.

³⁰ News Limited, *A submission to the Department of Communications, Information Technology and the Arts Issues Paper, Review of operations of Schedule 6, Broadcasting Services Act 1992 (Datacasting Services)*, January 2002, p. 1.

³¹ J. Schulze, 'Datacast Trial Pushes Digital's Case for Box', *The Australian*, 22 April 2003, p. 19.

³² Productivity Commission, *Broadcasting*, p. 258.

³³ The Hilmer Report (Independent Committee of Inquiry on National Competition Policy) states that the greatest impediment to enhanced competition in many key sectors of the economy are the restrictions imposed through government regulation. Therefore, if government is to regulate industries and markets it should ensure that eventual competition between converging markets is regulated as evenly as possible. Report by the Independent Committee of Inquiry, *National Competition Policy*, August 1993, Executive Overview, p. xxiv.

However, the Commission is concerned about whether the current number of FTA licences is the most appropriate number of broadcasters and whether the current commercial FTA broadcasters are the most efficient firms to supply FTA services. The Commission comments on these issues below.

Commercial FTA broadcast commenced with two stations in 1956 in Sydney and Melbourne. From 1964/65 there were three commercial stations broadcasting in Sydney, Melbourne, Brisbane and Adelaide. By 1988, Perth also had three commercial broadcasters. Obviously, many significant events have occurred since and continue to occur. During the last decade alone in Australia the communications sector has experienced immense changes, including, in no particular order: the introduction of digital television and DVD technology; significant growth in the use of the internet; and the introduction of pay TV.

In February 1998, the then Bureau of Transport and Communications Economics (BTCE) publicly released a working paper on the likely national benefits that would arise from an additional commercial broadcasting TV service.³⁴

The BTCE stated that it is difficult to quantify the social benefits that could flow from an additional commercial network. Whilst difficult to measure, it is logical that viewers benefit if the presence of an additional network enhances their welfare. It follows that the greater the difference in the material broadcast by the additional commercial network is from that broadcast by other FTA operators, the more likely it is that the existence of an additional commercial network will enhance consumer welfare.

However, if the additional commercial network offered different programming from the existing FTA operators and perhaps concentrated on particular demographics, this could increase consumer welfare. One of the three commercial FTA broadcasters (Network Ten) has been reported as already having a counter-

programming strategy and targeting of particular audience groups.³⁵

Consideration of aggregate industry costs is important because new broadcast entrants may not generate significantly more advertising revenue (see the arguments about multi-channelling above). If there is only a small increase in total actual revenue then the cost per audience minute of providing four commercial services is likely to be greater than the cost per audience minute of providing three services.³⁶

Even if the market tends to support only three commercial FTA broadcasters, less restriction on entry will provide an opportunity for the most efficient providers of broadcast services. As the Commission noted in its submission to the Productivity Commission review of broadcasting:

It may be that the removal of entry restrictions into broadcasting markets does not lead to any increase in the number of free-to-air TV networks in the longer term. However, the current regulatory regime protects incumbent firms rather than allowing competitive forces to determine which market players survive.³⁷

Lower barriers to entry are likely to increase the contestability of the market, increasing competitive pressure on the incumbent firms.

It is also relevant that the licensing plan arbitrarily allows for four wide area coverage TV services throughout the country. It does not differentiate between cities like Sydney and Melbourne with around four million people each and regional areas with aggregate populations that are much smaller. While universal service type considerations may justify a minimum level of services throughout Australia, it should not limit the number of services in areas such as large cities if they are capable of supporting such channels.

³⁴ BTCE, *Impacts of Additional Commercial Broadcasting Services in Existing Markets: Working Paper no. 36*, February 1998.

³⁵ N. Shoebridge, 'Networks embrace the counter-culture', *The Australian Financial Review*, 10 February 2003, p. 47.

³⁶ BTCE, above n. 34, p. 6.

³⁷ Australian Competition and Consumer Commission, *Submission to the Productivity Commission's Inquiry into Broadcasting*, August 1999, p. 1.

An important factor to consider is whether the incumbent broadcasters are receiving economic rents. An ABN AMRO report on the media sector released in July 2002 reports that FTA television has enjoyed strong earnings growth over the past decade with industry earnings before income tax growing at an average annual rate of 16 per cent. The report predicts that the gross margin of Australian metropolitan television will continue to improve, assuming no potential impact from pay TV, multi-channelling or the introduction of a fourth commercial FTA licence.³⁸ The report notes that the operating margins of Australia's major FTA television companies (at an average of 28 per cent) are among the highest in the world (with a global average of 18 per cent). The report comments that this is a result of the benefits provided by the current regulatory structure of the Australian FTA industry.³⁹

FTA television is a profitable business. The Australian Broadcasting Authority reported that in 2001-02, commercial television licenses generated \$3233.1 million in revenue, with expenses of \$2822.4 million. This represented a profit of \$410.7 million.⁴⁰ Of the total revenue generated by the three major networks (\$3169.5 million), the Seven Network and its affiliates accounted for 31.9 per cent (\$1009.9 million); the Nine Network and its affiliates 44.1 per cent (\$1396.8 million); and the Ten Network and its affiliates 24 per cent (\$762.8 million).⁴¹

The Productivity Commission noted in its inquiry report into broadcasting that new entry may better meet the policy objectives of diversity in media than restrictions on entry.

Allowing new entry is the key to greater competition in Australia's broadcasting industries and to the loosening of regulatory ties that have constrained its development and growth. Competition is

relevant not only in the normal sense of the word. Lower (advertising and other) prices and better service quality are important, but more important is the presence of competing voices in the Australian media. Diversity of sources of information and opinion is a keystone in a democratic society. While the Commission accepts that diversity of information and opinion may not be inconsistent with a concentrated media sector, other factors being equal, it is more likely to be achieved where there is diversity in the ownership and control of the more influential media...

... Regulatory restrictions on entry are constraining the achievement of this important policy objective. These include bans on new television stations until 2007...⁴²

The Productivity Commission recommended that section 28 of the BSA, which prevents any new commercial television licences being allocated before 31 December 2006, be repealed.

As suggested by the Productivity Commission in the above quote, if the number of services available in an area could be expanded, which is possible once conversion to digital is complete and the spectrum currently used for analogue broadcasting can be reallocated, controls prohibiting ownership of more than one television service in a particular area may be unnecessary. The provisions of the TPA would continue to apply as they presently do to acquisitions in other industries, which would help maintain adequate competition.⁴³

³⁸ ABN AMRO, *FTA Television: Time to Face the FACTS*, July 2002, p. 29.

³⁹ *ibid.*, p. 31.

⁴⁰ ABA, *Profit Down for Commercial TV and Radio*, media release, 10 April 2003.

⁴¹ *ibid.*

⁴² Productivity Commission, *Broadcasting*, p. 328.

⁴³ See further: Australian Competition and Consumer Commission, *Submission to the Productivity Commission's Inquiry into Broadcasting*, August 1999, pp. 12-16. It would also be an option to introduce a public interest test to apply to media acquisitions. Under this option, legislation would require that any media acquisition above a certain size be notified in advance to the Commission. The acquisition would be prohibited unless the parties to the acquisition could show that the acquisition was not contrary to the public interest.

Potential risks or costs of amending datacasting restrictions and reducing statutory barriers to the commercial broadcast FTA sector

Concerns have been expressed that lifting the datacasting restrictions or reducing the statutory barriers to the commercial broadcast FTA sector would put at risk the quality and diversity of Australian broadcasting.

However, new entry, either through liberalising the datacasting regime or making additional FTA licences available is not inconsistent with the government's policy objectives on Australian content, reflecting community standards and fostering a sense of Australian identity, character and cultural diversity. The areas of Australian content on commercial TV are regulated by compulsory standards determined by the Australian Broadcasting Authority (ABA). These standards require a minimum standard of points, acquired by airing Australian content of different types. Offering additional scope for market entry is not inconsistent with providing minimum standards. Standards can be set and broadcasters can then decide to enter or exit after assessing current profits in the industry and their likely efficiency relative to the other broadcasters.

In any case, concerns that the lack of such standards would lead to a flood of imported material may be overstated as there would be a commercial imperative for broadcasters to show popular content, which largely consists of local programming.⁴⁴ An ABA report on the commercial

television industry noted that the Australian commercial television industry has historically spent about 70 per cent of programming costs on Australian content.⁴⁵

Timing for further consideration of datacasting and additional licences

The government legislated that it would review the current datacasting regime by 2005.⁴⁶ In the recent datacasting review, DCITA stated that it was more appropriate to examine these issues closer to the time when a full assessment can be made of the market and technologies as they develop.⁴⁷

The Commission appreciates the need for investment certainty and clear directions from government. However, the Commission has concerns about whether the current restrictions are in the public interest, as noted above. In any event, the Commission believes that important investment decisions are being made now, particularly in relation to providing digital services, and an early and comprehensive review will assist in providing a more certain investment environment going forward. As it noted in its submission to the review, the Commission believes that there are some advantages to legislating the post 2006 arrangements to provide greater certainty for any potential datacasting transmitter licence bidders (and those service providers potentially providing competitive or complementary services).

The Commission therefore encourages the government to consider reviewing the current policies as early as possible.

⁴⁴ A report by the European Commission found that during the period 1999-2000, the average transmission time of European works for all European channels was 60.68 per cent in 1999 and 62.18 per cent in 2000. This rate is in excess of the requirement, which is to broadcast a majority proportion of European works. Commission of the European Communities, *Fifth Communication from the Commission to the Council and the European Parliament on the Application of Articles 4 and 5 of Directive 89/552/EEC "Television without Frontiers", as Amended by Directive 97/36/EC, for the period 1999-2000*, 8 November 2002. See further F. Papandrea and A. Daly, *The Implications of Convergence for Broadcasting and Telecommunications Regulatory Regimes*, working paper, Communication and Media Policy Institute, University of Canberra, January 2002, p. 26; and 'The One where Pooh goes to Sweden: Do American Television Channels Spread Cultural Imperialism?', *The Economist*, 5 April 2003, p. 59.

⁴⁵ ABA, *Commercial Television Industry: 1978-79 to 1998-99*, p. 17.

⁴⁶ BSA, Schedule 4, paragraph 60(1).

⁴⁷ DCITA, above n. 26, p. 7.

Conclusions on datacasting and additional commercial FTA licences

The datacasting regime has not achieved the social objective of encouraging the development of a range of innovative services that are different to traditional broadcasting services. For so long as the current restrictions on datacasting remain in place, it is unlikely that commercial operators will be able to construct a sensible business case to offer services over the spectrum currently reserved for datacasting. Therefore, the Commission believes that there is a strong case for the removal, or at least an easing, of these restrictions.

In relation to the current moratorium on additional commercial broadcasters, the Commission is unconvinced that this policy is in the public interest and that the restriction on the granting of additional commercial licences is necessary. It has not been clearly demonstrated that the benefits of the restriction on the number of FTA licences outweighs the costs of this restriction and the Commission is sceptical of the need for the current moratorium. Therefore, the Commission recommends that the planned review of the moratorium be brought forward.

5.4.3 Anti-siphoning provisions

Section 115 of the BSA empowers the minister to list certain sporting events that should be available on FTA television. The policy objective of the current regime is to provide some assurance that key sporting events, which have traditionally been available on FTA television, should continue to be available to FTA viewers.

Following amendment in 2001, the anti-siphoning provisions now allow for automatic de-listing of events six weeks before commencement. That is, if a FTA broadcaster has not acquired the rights to a listed event, a pay TV operator may do so. The de-listing aims to improve the operation of the scheme by streamlining pay TV access to listed events where FTA broadcasters do not intend to buy the broadcasting rights.

The Commission has previously expressed some concerns about the current anti-siphoning regulations.⁴⁸ It is concerned that by giving FTA broadcasters almost exclusive rights to the listed programming, the anti-siphoning list has substantial anti-competitive effects and is more intrusive than is necessary to achieve the policy objective of ensuring key sporting events are available to viewers on FTA television. Therefore, there is a need to assess whether the public benefits derived from the current anti-siphoning regime outweigh the anti-competitive effects of that regime.

Similarly, the Productivity Commission held the view in its inquiry report into broadcasting that the costs of the current anti-siphoning regime outweigh the benefits.

The Commission finds that the anti-siphoning rules are anti-competitive and that the costs of the current scheme to sporting organisations, the broadcasting industry and the community as a whole, exceed their benefits... As currently constituted, the anti-siphoning provisions of the BSA contravene the Competition Principles Agreement.⁴⁹

Potential costs of current anti-siphoning regime

Potential costs of the current anti-siphoning regime include: possible reduction in the number of sports programs that may be broadcast; less consumer choice for consumers; less competition between FTA and pay TV broadcasters in both acquiring rights and at a retail level; and increased barriers to entry for pay TV operators. These issues are considered below.

⁴⁸ Australian Competition and Consumer Commission, Submission to the broadcasting inquiry, p. 21.

⁴⁹ Productivity Commission, *Broadcasting*, p. 444.

Amount of sport broadcast

By reserving particular events for FTA operators, Australia's current anti-siphoning regime may actually reduce the broadcasting of these listed events by preventing pay TV operators from broadcasting them.⁵⁰ In relation to this issue, the Productivity Commission noted:

The anti-siphoning provisions do not actively encourage free to air broadcasters to exercise the rights reserved for them. Broadcasters have frequently provided delayed coverage, or televised only a small proportion of an event. A well documented example was when the Nine Network, having bought the rights to the 1997 cricket Ashes series, did not screen the first session of each Test because it clashed with regular prime-time programs. Thus, although the Nine Network's coverage was incomplete, subscription broadcaster Optus Vision was limited to showing the sessions that the Nine Network had 'rejected'.⁵¹

Continually reviewing the events on the anti-siphoning list can help reduce this problem. The ABA report on its investigation into events on the anti-siphoning list, released in August 2001, recommended removing several events from the list that had not been consistently broadcast by commercial or public broadcasters over the previous five years. The ABA recommended adding three sporting events to the list and removing nine.⁵² As yet, these recommendations have not been adopted.

Competition between FTA and pay TV operators

Competition between FTA and pay TV operators to acquire sports broadcast rights is not as strong as it would be in the absence of the anti-siphoning provisions. The provisions obviously

limit competition between FTA and pay TV operators for the purchase of listed content.⁵³

Prohibiting pay TV operators bidding for listed rights may have a flow-on effect for content providers selling sports broadcasting rights. The revenue of sporting organisations may be reduced as pay TV operators are effectively removed as potential buyers of the broadcasting rights for listed events.

Barriers to entry for pay TV operators

Premium content is central to the take-up of pay TV services. Therefore, anti-siphoning provisions are likely to be an additional barrier to entry for pay TV operators, given the list applies to many important sporting events. It follows from the purpose of the anti-siphoning provisions- to protect against sport migrating from FTA broadcasting to pay TV- that pay TV operators will be restricted in being able to purchase attractive content that would likely increase the take-up of their pay TV services.

That said, significant barriers to entry already exist in the pay TV market, and therefore the incremental impact of increasing the available rights to pay TV operators is unclear. However, it would seem that the additional purchases would be likely to increase pay TV penetration. Fox Sports (or other Foxtel-related channels) would be well-placed to purchase such additional content, given the distribution advantages it has over potential competitors. What impact this may have depends on the access to content regulation in place.

The section 87B undertaking providing for retransmission of Foxtel content to infrastructure networks and the CSA would mean that the potential benefits of greater availability of sports content would not only be captured by Foxtel, Telstra and Austar. However, the share of the additional revenues will depend on the wholesale price of retransmission. As chapter 6 explains, the Commission is concerned that the pricing provisions in the section 87B

⁵⁰ *ibid.*, p. 443.

⁵¹ *ibid.*

⁵² ABA, *Investigation into Events on the Anti-Siphoning List: Report to the Minister for Communications, Information Technology and the Arts*, June 2001.

⁵³ See also, Productivity Commission, *Broadcasting*, p. 434.

undertakings have limitations. In particular, it is not clear that the pricing principles contained in the section 87B undertakings will promote competition and efficient investment over the longer term. This is because they do not allow for dynamic pricing considerations, including issues such as the appropriate pricing principles to apply if the underlying content costs for Foxtel and Austar are reduced if and when content agreements are renegotiated.

The potential benefits of liberalising the anti-siphoning regime can be expected to be greater still if the government accepts the Commission's recommendation that further legislative action is required to prohibit Fox Sports being provided exclusively to Foxtel. This would allow pay TV competitors to include Fox Sports in a package of services most suited to their customers.

Potential introduction of a 'dual rights' regime

The Commission and the Productivity Commission have previously supported a 'dual rights' modification to the anti-siphoning provisions.⁵⁴ A dual rights regime means that neither pay TV nor FTA broadcasters can acquire exclusive rights to nominated events on a single list. The aim of this model is to maximise the availability of premium content to all broadcasters in Australia, while preventing migration of such content to subscription television broadcasters (e.g. premium sport).

A dual rights regime can take a number of forms. For example, the United Kingdom has two tiers of sporting rights. The first tier can only be supplied to FTA operators. The second tier has dual rights.

Possible risks and costs of introducing 'dual rights'

Some submissions to the Commission have argued against any move to a dual rights regime. Particular concerns were that it may fragment the FTA audience and could result in greater opportunities for 'gaming' the regime, which will correspondingly undermine the policy objectives of the anti-siphoning regime.

Fragmentation of the FTA audience

Several submissions to the Commission argued that reducing the scope of the current anti-siphoning list, or seeking to modify how it operates (in particular, using a dual rights list) will undermine the FTA business case for those events, resulting in migration of events currently on the anti-siphoning list from FTA broadcasting to pay TV.

More particularly, the argument is that FTA broadcasters need exclusive rights to support production of particular events on the anti-siphoning list. This means that if an event is simulcast by both pay TV and FTA broadcasters, subscribers will prefer the pay TV channel (with relatively fewer advertisements) thus reducing the audience numbers watching FTA television. This in turn reduces the advertising revenue the FTA broadcaster receives.

Any fragmentation of the audience might be compounded by two effects. First, some advertisers may pay a premium for access to a mass audience,⁵⁵ and therefore advertising revenue may be particularly sensitive to audience numbers. Second, submissions to the Commission argued that some advertisers prefer to be exclusively associated with a particular event, which may be undermined if it is broadcast on both FTA and pay TV television. However, while pay TV subscribers now have the opportunity to watch the event on pay TV and with less advertising, if advertising was to switch to pay TV, the differences in the level of

⁵⁴ Productivity Commission, *Broadcasting*, pp. 444 - 445. See also, Australian Competition and Consumer Commission, Submission to broadcasting inquiry, p. 21.

⁵⁵ BTCE, above n. 34, p. 9.

advertising between pay TV and FTA would in turn diminish.

The Commission has expressed some scepticism about this argument above. It also notes that if the FTA broadcast attracted fewer viewers than FTA broadcasters may decrease the amount they are willing to pay for particular rights. If FTA operators are protected under a dual rights regime, it is likely they would still be able to obtain the rights even if paying less. Further, the Commission understands that international and domestic experience is that pay TV take-up does not attract a proportionate amount of advertising revenue – the revenue remains with FTA broadcasting.⁵⁶

Risk of gaming under a dual list

A second concern is that a content provider could constructively refuse to deal with the FTA broadcaster. This may occur because, presumably, the content provider can obtain higher revenues from, in effect, dealing exclusively with the pay TV operator.⁵⁷

To protect against constructive refusal, protections against gaming could be introduced to mitigate this problem, as has occurred in the United Kingdom, by preventing the acquisition of pay TV rights to listed events when FTA broadcast rights have not been offered on reasonable terms. The question of reasonableness would be one for the regulator to determine based on its knowledge of common practice and evidence provided by the 'complainant' broadcasters. Such an approach would potentially mirror the

ABA's assessment of reasonable opportunity in relation to the current anti-siphoning provisions.⁵⁸

Also, the incentives of rights owners and preferences of consumers need to be considered. Many sports providers, such as the AFL, have incentives to seek mass audiences.⁵⁹ It is also relevant that it appears that many Australian consumers have an aversion to paying for broadcast television.

Joint bidding may be a concern given PBL's ownership of both the Nine Network and Foxtel. The specific concern is that because Foxtel has such market power it may be able to leverage its position as the main buyer and supplier of pay TV programming to influence the allocation of other (non-pay TV) rights. The incentive to do so is heightened where those other rights are important for one of the Foxtel shareholders. For example, Foxtel could potentially insist that any bid it made for pay TV rights was conditional upon the Nine Network being granted the FTA rights.⁶⁰

During the ABA's anti-siphoning investigation, commercial broadcasters expressed concern about third parties associated with pay TV operators (for example, Fox Sports, News Corporation) buying certain broadcast rights. The ABA concluded that there was no evidence that such acquisitions undermined the intent of the current scheme, that is, to prevent the migration of events exclusively to pay TV.

Conclusion on anti-siphoning

The Commission is of the view that the policy objective of the current anti-siphoning regime can be achieved through a less restrictive dual-rights regime. Such a regime continues to provide assurance that key sporting events, which have traditionally been available on FTA will continue to be available to FTA viewers. However, a dual-rights regime does not have same negative effects on competition as the

⁵⁶ Since 1990, the United Kingdom incumbent FTA broadcasters have lost 22 per cent advertising share, equivalent to half the viewer share loss. This has primarily been a result of pay TV which has attracted a 16 per cent share of advertising, equivalent to one third of its 46 per cent household penetration achieved to date. Similarly in the United States, the FTA networks have lost 48 per cent viewer share to pay TV and 24 per cent advertising share: ABN AMRO, above n. 38, p. 4.

⁵⁷ The FTA market has different revenue bases. FTA operators make revenue solely from advertising. A pay TV operator can capture greater consumer surplus from its subscriptions which can fund its operations.

⁵⁸ BSA, section 115(1AA).

⁵⁹ Productivity Commission, *Broadcasting*, p. 434.

⁶⁰ Joint bidding is discussed further in chapter 4.

current anti-siphoning regime. The form of dual-rights regime that the Commission advocates may result in an increase in the amount of sport broadcast, heighten competition between FTA and pay TV operators with attendant benefits for consumers, and lower barriers to entry for pay TV providers. The Commission therefore recommends that the current anti-siphoning regime be amended to incorporate a dual-rights regime.

5.5 Conclusions and recommendations

The Commission recommends that regulations that act to restrict competition in both the pay TV and FTA markets be reviewed as a matter of priority. These restrictions include the prohibition on multi-channelling, the restrictions on datacasting and the limit on FTA licences, and requirements pertaining to anti-siphoning.

The Commission recommends that the government bring forward the review on the moratorium on an additional FTA licence and, at this time, conduct a comprehensive review of the regulations applying to the media sector. The Commission is sceptical that there is a case for the current extent of regulation in the media sector.

Proper weight must be given to the benefits that a more competitive media sector could deliver to consumers. Unless it can be clearly demonstrated that the benefits of particular restrictions outweigh the anti-competitive detriment that results from the restriction, the restriction should be removed.

6 Access to content

6.1 Overview

In his letter of 12 March 2002, the minister noted that in the context of the pay TV agreements the government was keen to ensure the provision of access to pay TV content on non-discriminatory terms to other operators, including aspirant providers of broadband services in regional Australia. He also sought the Commission's advice on the implications of the pay TV agreements for 'other bundled service providers' in order to facilitate competition in the supply of pay TV, telecommunications and broadband services, including in the non-metropolitan areas of Australia.

The Commission has noted in the past that various features of the market have made it difficult for new broadband network providers (network providers) to get access to premium pay TV content.¹ These features include existing market structures, the resulting incentives that Foxtel and Austar face because of these structures and the exclusivity of premium pay TV content. The Commission believes these factors have constrained infrastructure competition for

broadband networks and services supplied over these networks (such as high-speed internet), and telecommunications services, in both metropolitan and regional areas. A lack of access to premium pay TV content has also affected competition in the market for pay TV services.

It is therefore important that network providers can get access to premium pay TV content. The Commission has proposed to both the Telecommunications Services and Telecommunications Specific Competition Regulation inquiries that legislated access to content regulation would address these concerns. The Productivity Commission concluded in its inquiry report that:

[E]ven if the control of content may not have had an anti-competitive purpose, it appears to have had an anti-competitive effect. This provides a rationale for possible regulation, but only if the regulation is well targeted and does not produce costs beyond its benefits ...²

The Commission believes that the government should consider the implications of exclusivity of premium pay TV content against the background of its broader policy objectives for telecommunications markets— promoting the

¹ See further the Australian Competition and Consumer Commission submissions to the Productivity Commission's inquiry into telecommunications specific competition regulation in 2001 and the Telecommunications Service Inquiry (the 'Besley inquiry') into pay TV and regional telecommunications in 2000.

² Productivity Commission, *Telecommunications Competition Regulation*, Report no. 16, p. 538.

long-term interest of end-users through competition and efficient use of, and investment in, infrastructure.³ This is particularly important in metropolitan and regional areas where there has been limited broadband deployment. The government should also consider whether regulating access to content should be used to address impediments to competition in pay TV markets.

The Commission's market inquiries indicate that premium pay TV content is necessary for the development of new broadband networks.⁴ Because of digitisation and convergence, broadband networks can provide a range of voice, data and video services such as telephony, broadband internet and pay TV. The economies of scale and scope associated with these networks mean the business case for deployment is typically established with all of these revenue streams and economies of scale and scope in mind.

Importantly, pay TV services supplied over broadband networks must be comparable to those of the pay TV operator with exclusive access to premium pay TV content. An inability to access premium content such as sport and movies is likely to act as a barrier to entry and has the potential to significantly delay or foreclose investment totally. This would lead to less competition in the supply of broadband and telecommunications services over these networks as well as an inefficient level of investment in infrastructure.

The pay TV agreements and recent section 87B undertakings create a framework for network providers to re-transmit the Foxtel and Austar packages. The undertakings partially address the concerns about access to content in relation to the supply of broadband and telecommunications services. However, the Commission recommends that this framework be legislated to provide existing and prospective network providers with

greater certainty. The Commission also believes that there would be benefit in reviewing the pricing principles currently associated with the section 87B access to content framework.

Access to premium pay TV content is not only important for the deployment of broadband networks but also for the competitive delivery of pay TV services. Pay TV content is sold as a bundle and premium content acquired exclusively is often combined with other content (for example, the Fox Sports channel is included in Foxtel's basic package). If network providers cannot supply bundles that include the premium content consumers demand, or if they cannot differentiate their services using such content, then their ability to compete is likely to be limited and the highly concentrated structure of the pay TV market is reinforced. Therefore, any benefits for consumers that occur as a result of competition, such as lower prices, are likely to be absent.

The section 87B undertakings that oblige Foxtel and Austar to on-supply their basic and tiered pay TV packages are unlikely to address these concerns. If network providers choose to develop their own basic and tiered packages, in an attempt to differentiate their services and compete, they will be unlikely to have access to two of the most important premium pay TV channels— Fox Sports and PMP movie channels. Therefore, network providers are unlikely to be able to compete vigorously in providing alternative pay TV services to Foxtel.

To promote competition in the supply of pay TV services, access to individual premium sports and movie channels is required. While this can be achieved by on-supply requirements, it is unclear where to best place such obligations, for example on channel suppliers or pay TV operators. The common ownership interests and incentives of channel suppliers and pay TV operators, as well as the exclusive nature of some existing content agreements, make this a difficult issue. The Commission believes it would be preferable to place the obligation on channel suppliers rather than pay TV operators (who would essentially be supplying to their competitors). However, sometimes this is not possible or appropriate—

³ Commonwealth Department of Communications and the Arts, *Australia's Open Telecommunications Market: the new framework*, 1997, p. 7.

⁴ Of particular focus are fixed broadband networks such as HFC and fibre-to-the-curb networks.

for example, when an existing exclusive content agreement is in place and due to expire after a certain time period, or when there is in-house production of a channel.

The Commission considers competition would best be promoted via an obligation to on-supply that is placed on the Fox Sports and Movie Network 'Movie One' channel suppliers. Further, the Commission considers that an obligation should be placed on Foxtel to on-supply the content from both the Fox Footy channel (which it produces in-house) and the PMP 'Showtime' channel (until the current content agreement expires, after which the obligation to on-supply should be placed on the relevant channel supplier).

Such an approach would also promote competition in the supply of broadband and telecommunications services. It would enable network providers to differentiate their pay TV service offerings and give them another possible revenue stream from their network, thereby facilitating economic entry. Greater revenues from pay TV also increases the scope (and incentive, given economies of scope on the demand side) to compete for broadband and telecommunications consumers. This would mean that a legislated framework enabling network providers to re-transmit the Foxtel and Austar packages would not be necessary.

However, there are costs associated with such obligations to on-supply premium sport and movie content. In particular, the Commission recognises that the breaking of exclusive content agreements may have implications for channel suppliers and pay TV operators which could impact on their current business plans. Further, such an approach also raises the risk of just compensation claims for the government. These are issues that would need to be considered further before any such approach is introduced.

Access regimes in general have limitations—chapter 4 detailed these limitations in regulating access to carriage. However, similar concerns exist in relation to access to content regulation. Moreover, there are additional difficulties faced in regulating access to content, including

implementation issues such as just compensation concerns for the government. However, despite these limitations the Commission believes access to content regulation will still have important benefits.

The common ownership of Fox Sports and Foxtel and the in-house production of Fox Footy raises a further issue about whether the government should require ownership separation between premium content production and pay TV carriage. The Commission believes doing so would be likely to improve the incentives for distributing such premium pay TV content, although regulating access to content would still be necessary to prohibit channel suppliers and pay TV operators (most likely Foxtel and Austar in their respective distribution areas) from entering exclusive contracts. However, as the costs of separating content and carriage are unclear and, in any event it is not apparent the benefits would outweigh the costs, the government's focus should be on implementing the Commission's proposed access to content regime.

Therefore, at this stage the Commission is not recommending any ownership separation between premium content production and pay TV carriage. However, if regulating access to content does not result in effective outcomes such an approach may need to be considered.

6.1.1 Structure of the chapter

This chapter begins by outlining the various factors which contribute to the Commission's competition and efficiency concerns. It then analyses these concerns in relation to the supply of pay TV, broadband and telecommunications services. The possible approaches that could address these concerns are then discussed. The chapter then outlines a preferred approach, detailing specific implementation issues.

6.2 Access to pay TV content concerns

The Commission has previously outlined its concerns about lack of access to pay TV content in its submissions to the Telecommunications Service Inquiry and the Productivity Commission's inquiry into telecommunications competition regulation. These concerns are detailed below, focusing on market structures, the lack of incentives of the various parties to supply pay TV content and the current supply agreements (including the section 87B undertakings).

6.2.1 Factors contributing to competition and efficiency concerns

Incentives to withhold premium pay TV content

The Commission believes that Foxtel and Austar have incentives to limit or withhold access to premium pay TV content from other network providers when this would allow significant pay TV competition.

Foxtel's incentives to withhold access to premium pay TV content are even greater because of Telstra's 50 per cent ownership interest in Foxtel. Telstra not only owns one of the distribution platforms used by Foxtel, but it also competes with network providers in the various telecommunications markets. Therefore, it is in Foxtel's interest to favour supplying the premium content over the Telstra network and to minimise the opportunity for Optus and other network providers to gain access to this content.

Generally a pay TV operator's motivation to withhold content is likely to be stronger when the network provider seeking access is a direct competitor. Therefore, Foxtel may not have as strong an incentive to withhold premium pay TV content in the Austar areas (assuming it has the rights to provide access in these areas) as it does in its own areas. However, to the extent that any on-supply, including outside its own areas, is

seen as a precedent to on-supply in its own areas then this may not be significant.

Consistent with this, the Productivity Commission's inquiry into telecommunications competition regulation concluded that there are incentives for:

- pay TV operators to use control of content to stop competition in the pay TV market
- telecommunications carriers to use control of pay TV content (through vertical integration or ownership links) to stop competition in telecommunications markets.⁵

These incentives are likely to operate most strongly in relation to premium pay TV content. While there is no clear line, sport and movies are generally regarded as premium pay TV content. Such content is widely considered to drive demand for pay TV services and strengthen any pay TV offering.⁶ Therefore, lack of access to this content makes it difficult for network providers to supply

⁵ Productivity Commission, *Telecommunications Competition Regulation*, p. 538.

⁶ There are a variety of statements supporting this claim. For example:

The Productivity Commission has stated that the key drivers of a high volume pay TV business are recent release movies and premium local sport. It then noted that there are only two providers of recent release movies: Movie Network and PMP and that there are two providers of premium sport: Fox Sports and Seven Cable Television (who was still producing the C7 channel at the time of that report but have since discontinued). Productivity Commission, *Telecommunications Competition Regulation*, pp. 514-516.

At the ASTRA *Get Connected* conference in 2002, Richard Freudenstein, Chief Operating Officer, BSKyB stated: '... It's been very important for us that we own some of the channels, the key drivers for our business. So we focussed early on the key drivers ... being sport, movies ...'. ASTRA, *ASTRA 2002 Get Connected conference transcript*, 21 February 2002, p. 5.

The recent European Commission decision regarding the merger between two Italian pay TV operators, Telepiu Spa and Stream Spa, noted that premium content such as blockbuster movies and football are what drive subscriptions to pay TV. European Commission, *Commission clears merger between Stream and Telepiu subject to conditions*, media release, 2 April 2003.

An article on the future demand for pay TV in the United Kingdom noted that premium film and sports channels have proven to be a key driver of pay TV take-up with 96 per cent of satellite subscribers and 63 per cent of cable subscribers taking at least one premium service. M. Shurmer, 'Future demand for pay TV in the United Kingdom', *Telecommunications Policy*, vol. 21, no. 7, p. 612-613.

competitive pay TV services.⁷ Market inquiries indicate that in Australia premium content is generally considered to be the Fox Sports channels, the Fox Footy channel and the recent release movie channels, Showtime and Movie One.

The Office of Fair Trading (OFT) in the United Kingdom noted that one measure of the importance of premium content is its cost.⁸ A recent analyst report by CommSec stated that the cost to Foxtel of its sporting content is at least 25 per cent of its annual programming costs (estimated at over \$340 million a year).⁹ In addition, movie content was estimated to consist of around 30 per cent of total programming costs before the pay TV agreements.

Exclusive content agreements

As well as having incentives to limit access to premium pay TV content, the exclusive basis on which Foxtel, and to a certain extent Austar, acquires premium content enables these pay TV operators to withhold access to that content.¹⁰

While ownership interests are not necessary for exclusive acquisition of pay TV content, they do facilitate it. Many of the exclusive content agreements are between entities with common

ownership interests. For example, News Corporation and PBL each have a 25 per cent interest in Foxtel and jointly own the Fox Sports channels which are the subject of exclusive content agreements. Foxtel also has exclusive content agreements for the PMP channels in which News Corporation apparently has a 16 per cent interest.¹¹

Exclusive content agreements also exist when channel suppliers are paid an exclusivity 'premium' that is enough to reimburse them for limiting the distribution of their channels. Pay TV operators are willing to pay such premiums because if they limit access to premium pay TV content the prospect of competition in the supply of pay TV is diminished. If the prospect of limiting competition reaches markets beyond pay TV, for example broadband and telecommunications, then there is even greater reason to pay these premiums and shore up exclusive supply.

Several channel suppliers and pay TV operators have argued in the past that exclusive content agreements are not necessarily of concern.¹² In particular, they have claimed there may be contractual limitations that effectively impose non-exclusivity. For example, the content agreements may be limited to a particular technology or geographic area. Further, it has been noted that commercial considerations are also important in deciding whether to supply network providers with pay TV content. In its submission to the Productivity Commission's inquiry into telecommunications competition regulation, Fox Sports stated that these factors included the cost of channel preparation and distribution, the relative size of the network provider, the price it wishes to pay (and its ability to offer minimum subscriber guarantees) as well as other transaction costs or risks such as piracy.¹³

⁷ As reported by the Productivity Commission in its inquiry report on telecommunications competition regulation, Olsen and Spiwak commented that: 'This conclusion is bolstered by a recent study which found that there was apparently an industry consensus that "the lack of more than one or two of the well know networks such as ESPN, USA, CNN and HBO would seriously handicap a multi-channel competitor to an established cable system" ... Accordingly, under certain conditions, vertical restraints that restrict a supplier's right to deal with competitors of a dominant downstream firm can have the effect of raising rivals' costs. Through such vertical relationships, a dominant firm can deter competitive entry and retain power to raise prices or reduce quality in its output market.' Productivity Commission, *Telecommunications Competition Regulation*, p. 515.

⁸ OFT, *BSkyB: The outcome of the OFT's Competition Act investigation*, December 2002, p. 5.

⁹ CommSec, *The ACCC's \$4 billion gift to Foxtel*, December 2002, p. 12.

¹⁰ In terms of premium pay TV content, the Commission understands Foxtel acquires the Fox Sports and PMP channels on an exclusive basis and produces the Fox Footy channel in-house. Further, Austar acquires the PMP channels from Foxtel on an exclusive basis.

¹¹ The Commission understands that News Corporation has an 82.8 per cent ownership interest in Fox Entertainment group which includes 20th Century Fox, one of the five movie houses that make up PMP.

¹² Productivity Commission, *Telecommunications Competition Regulation*, pp. 522- 526.

¹³ Fox Sports, *Additional submission to the Telecommunications Inquiry - In response to the Productivity Commission's Draft Report- Review of Telecommunications Competition Regulation*, May 2001, p. 4.

The Productivity Commission's inquiry report considered that, other things being equal, an independent pay TV operator would be indifferent to the ownership or technology of the delivery platform over which its content is shown.¹⁴ It noted therefore that some pay TV operators would be likely to distribute their content via the new network providers and their broadband platforms, provided that this increases overall penetration of pay TV services.

Following the pay TV agreements and section 87B undertakings the extent and nature of exclusive content agreements changed. For example, the section 87B undertakings provide for the non-exclusivity of several channels, some of which contain premium pay TV content. In particular, the undertakings provide that:

- Foxtel and Optus will not acquire the 'shared channels'¹⁵ exclusively
- Foxtel and Optus will not acquire the Movie Network channels exclusively and Foxtel will not acquire the PMP channels exclusively, although these commitments are subject to certain caveats and only relate to the PMP channels once the current PMP agreement is terminated
- Foxtel will sub-license AFL content (both AFL match coverage and any AFL channel it produces) to network providers and resellers¹⁶ on non-discriminatory terms and conditions.

The pay TV agreements and section 87B undertakings also state that Foxtel will supply Optus and network providers with its pay TV content as well as supplying Astar with additional rights. Astar will also offer network providers its pay TV content. These changes occur because of:

- the CSA, which effectively states that Foxtel will supply Optus with specified pay TV channels according to a queuing arrangement, as and when Optus has capacity to accommodate the channels
- the channel sub-licensing agreement, which effectively states that Foxtel will give Astar exclusive rights to supply and sub-license certain channels in Astar areas
- the Foxtel and Astar section 87B undertakings, which, among other things, state that Foxtel and Astar will supply network providers (termed infrastructure operators in the undertakings) with their basic and tiered pay TV packages (in their entirety), where these services are requested.¹⁷

Bundling, network effects and switching costs

Exclusive arrangements do not always create competition problems. In fact, exclusive agreements are common in the media industry. Successful authors or musicians often sign long-term exclusive contracts with publishing houses or music companies. The difference is that, in the pay TV market, unlike the market for CDs or books, consumers are almost always locked in to buying from just one company and typically face high costs switching from one pay TV supplier to another. These costs arise from several sources, such as the cost of the STU, the requirement to enter into a long-term agreement with a pay TV supplier and suppliers offering a large number of channels together in a single bundle. The costs inherent in these practices make it too expensive for consumers to buy pay TV services from two or more suppliers or to switch frequently between suppliers.

If consumers are locked in to a particular supplier for a period of time, they are keenly interested in

¹⁴ Productivity Commission, *Telecommunications Competition Regulation*, p. 524.

¹⁵ As noted in chapter 3 these consist of the following channels— Antenna, BBC World, Cartoon Network, CNBC, CNN, Disney, National Geographic, RAI, Sky News, Sky Racing, TCM, TVSN, World Movies and ESPN.

¹⁶ As a part of the sale of its rights to Foxtel, the AFL had already required that the rights must be sub-licensed to Astar and Optus.

¹⁷ The wholesale pricing is determined using retail-minus pricing principles, with the price of access to the Foxtel and Astar basic and tiered packages being determined on the basis of the retail price charged by Foxtel or Astar less a certain specified percentage discount. The extent of these discounts is confidential information.

the entire bundle of content that is available through that supplier.

Therefore, premium pay TV content that is exclusive to an operator will likely be a differentiating point for most consumers and more consumers would probably acquire services from an operator with such content. This in turn generates network effects as the more consumers an operator has, the more attractive it is as a distribution platform for channel suppliers and the more likely it is to attract premium content. This in turn means more consumers buy the pay TV services from an operator with such content and so on. The scale effects also likely mean the pay TV operator has better bargaining power and ability to acquire premium content. The operation of these effects (the programming vicious circle) is described in more detail in chapter 2.

Given pay TV content is bundled so that premium content is included with other content, if access to premium content is withheld, other pay TV operators and network providers will have a limited ability to compete.

Combined, these factors may result in a 'winner takes all' form of competition as the network effects and switching costs have the potential to result in 'tipping'— that is the tendency for one network to pull away from its competitors once it has gained an initial edge.

It is noted that similar concerns do not arise in relation to FTA broadcasting. This is primarily because FTA services are made up of a series of programs that can be consumed individually. Further, there are no switching costs associated with changing between FTA services. In this regard, it would not appear that access to specific premium content is necessary to support the entire service. Also, a lack of access to premium content does not have implications for investment in broadband networks as it does for pay TV service.

Economies of scope in broadband network deployment

Withholding access to premium pay TV content may delay or prevent broadband network entry when economies of scope exist.

The Commission understands that the economic deployment of broadband networks typically relies on multiple revenue streams, particularly those from broadband, telecommunications and pay TV services. Supplying these three services over one network achieves economies of scope and the additional cost per subscriber is lessened, compared with offering the services over different networks.

The OECD noted in its report on regulation and competition in broadcasting that in many cases downstream production technology will be subject to economies of scope and that economic entry in such circumstances requires the full range of downstream products to be produced.¹⁸ Also, cost modelling in the United Kingdom has shown that the costs of providing telecommunications and entertainment services (pay TV and video-on-demand services) by two different networks substantially exceed those of having a single supplier.¹⁹

In Australia, economies of scope for broadband networks are suggested by the fact that all such networks supply multiple services. Optus, TransACT and Bright all supply pay TV, broadband internet and telecommunications services while Telstra supplies pay TV and broadband services. Neighborhood Cable also supplies both pay TV and broadband internet services, although not telecommunications services. While IP-based networks, such as the Neighborhood Cable network, can provide telephony services, current telephony requirements under the *Telecommunications Act 1997* (including quality of service, immediate dial tone, emergency capability, emergency power) effectively mean that IP telephony needs more expensive equipment.

¹⁸ OECD, *Regulation and Competition Issues in Broadcasting in Light of Convergence*, April 1999, p. 60.

¹⁹ M. Cave and P. Williamson, 'Entry, Competition and Regulation in UK Telecommunications', *Oxford Review of Economic Policy*, vol. 12, no. 4, pp. 102- 103.

The Commission understands that, at this stage, those entities supplying pay TV services are not making profits from these services, mainly because of the high cost of pay TV content.²⁰ However, these services are still generating revenue streams that help meet capital and operating costs and reduce the additional cost per subscriber.

Economies of scope are also implied by Telstra entering into the provision of pay TV services to shore up its telecommunications business after Optus decided to provide pay TV, broadband internet and telecommunications services. The following quote from the former Chief Executive of Telstra, Mr Frank Blount, indicates Telstra considered that the strategy posed a significant threat given the presence of economies of scope:

[T]he decision to go into pay TV was based on the need for Telstra to defend its telephony business after it learned C&W Optus was targeting its customers with a combined pay/television cable..²¹

Several firms have indicated that without access to pay TV content their full investment will be either delayed or will not proceed. For example, SaskTel stated in its submission to the Productivity Commission's inquiry into telecommunications competition regulation that it would be much more comfortable recommending to its Board of Directors that it invest in Australia if a supportive regulatory environment existed. This included access to pay TV content.²²

In addition, economies of scope may also exist on the demand-side whereby consumers who acquire various pay TV, broadband and telecommunications services do so from the one service provider. This is likely to occur if there are cost savings or other benefits for the consumer acquiring multiple services from one service provider, such as the convenience of one bill. The limited evidence available to the Commission

suggests that many consumers would prefer to take pay TV, broadband and telecommunications services from one service provider rather than from several. For example, Optus recently reported that of the 500 000 telephony customers serviced by its HFC cable network, 60 per cent also took internet or pay TV services.²³

Supplying pay TV services that are bundled with broadband internet and telecommunications services gives network providers the ability to generate economies of scale, which help reduce cost per subscriber.

When economies of scope are present (either on the supply or demand-side), if a network provider cannot supply one of the above services then economic entry may not be possible.

6.2.2 Access to content - competition and efficiency concerns as a result of limited access to premium pay TV content

A lack of access to content triggers two distinct areas of concern relating to competition in the supply of pay TV services and the supply of broadband and telecommunications services. These are detailed below and take into account the pay TV agreements and the section 87B undertakings. The Commission believes the government should consider the implications of these concerns, particularly against the objective of reducing impediments to competition in pay TV markets, and its objectives for telecommunications- promoting the long-term interest of end-users through competition and efficient use of, and investment in, infrastructure.²⁴

²⁰ Although offsetting gains may be made where entities operate at more than one level in the supply chain.

²¹ *Weekend Australian*, 30 August 1997, p. 53.

²² SaskTel International, *Submission to the Productivity Commission's 'Review of Telecommunications Specific Competition Regulation: Additional matters under reference'*, March 2001, p. 16.

²³ K. Nicholas and B. Power, 'Foxtel deal puts Harvey Norman on TV', *The Australian Financial Review*, 9 May 2003, p. 61.

²⁴ Further, implementation of access to content regulation is consistent with the policy objectives of improving broadband investment and up-take, as the Broadband Advisory Group recently recommended to the Government.

Any response to these concerns needs to be legislated to provide existing and prospective network providers with greater certainty. Certainty is especially important for firms deciding whether to make large capital investments, such as those required to deploy a broadband network.

In the past, and before the pay TV agreements and section 87B undertakings, Optus and other network providers experienced difficulties gaining access to some premium pay TV content. For example, before the pay TV agreements Optus could not get access to the Fox Sports or PMP movie channels. Also, network providers such as Neighborhood Cable and TransACT had little success negotiating access to premium pay TV content, except for Neighborhood Cable accessing the PMP movie channels from Foxtel.²⁵

The pay TV agreements and section 87B undertakings have in some respects facilitated access to pay TV content and therefore changed the nature and extent of concerns surrounding competitive supply of pay TV, broadband and telecommunications services. While on balance the Commission found that the section 87B undertakings were likely to overcome its competition concerns, it recognised that some concerns were likely to remain even if the Commission accepted the undertakings. In particular, the section 87B undertakings did not fully address the broader pre-existing competition concerns relating to access to content.

The Commission believes these issues require consideration of the appropriate legislative options (see below). The Commission also notes the importance given to addressing these issues in other countries.

For example, in the United States specific legislation was introduced after new entrants faced difficulties trying to gain access to programming. Specifically, Congress was concerned that most cable operators had market power in the supply of programming at the local level and that the use of exclusive content agreements between satellite-delivered, vertically

related, channel suppliers and cable operators could inhibit competition developing among operators.

In the United States, legislation now prohibits vertically integrated channel suppliers and pay TV operators from engaging in unfair practices which significantly hinder or prevent any pay TV operator from supplying pay TV services. In effect, the legislation prohibits exclusivity between vertically integrated channel suppliers and cable pay TV operators.²⁶ In addition, the FCC has proscribed five types of specific conduct, including that a vertically related cable operator shall not unduly influence its related channel supplier when supplying other pay TV operators or in setting the price terms and conditions for such supply.

In the United Kingdom non-statutory undertakings have operated, as opposed to any form of legislated access to content regulation. Undertakings from BSKyB in 1995 provided that it would charge itself for the supply of premium programming at the same rate as cable operators. It also undertook to adopt a wholesale pricing structure that does not excessively encourage the bundling and third line forcing of BSKyB programming. These undertakings were 'clarified and strengthened' following another review of BSKyB's actions in 1996.²⁷ The key elements of the 1996 undertakings were:

- that certain channels would be supplied separately and that a rate card would be published showing wholesale prices for cable companies with an approved discount structure; and

²⁵ Productivity Commission, *Telecommunications Competition Regulation*, pp. 523- 526.

²⁶ The *Cable Television Consumer Protection and Competition Act 1992* only applies to cable pay TV operators and their vertically related channel suppliers but not to satellite or MDS pay TV operators. It also only applies to programming delivered by satellite directly to a cable operator's head-ends for retransmission, not to programming delivered by fibre optic cable and MDS to a cable operator's head-end. The Commission understands that the reasons for these limitations are largely historical. This prohibition on exclusivity was to cease on 5 October 2002 unless the FCC found it was necessary to preserve and protect competition and diversity in the distribution of video programming. On 13 June 2002 the FCC ordered that the provision be retained until 5 October 2007.

²⁷ OFT, *The Director General's review of BSKyB's position in the wholesale pay TV market, 1996*.

- that BSKyB would submit accounts separated between its wholesale and retail business showing the notional charges for supplying its channels to its retail business.

In a subsequent review in 2000 the OFT found many of the undertakings were unnecessary, but that there were reasonable grounds to suspect that BSKyB had infringed the *Competition Act 1998*. In December 2002 a further investigation into whether BSKyB's actions were anti-competitive concluded that while BSKyB had a dominant market position it was not in breach of competition law.²⁸

An important lesson from the BSKyB undertakings is that regulatory intervention (even if not regulation *per se*) has helped establish structurally competitive pay TV and telecommunications industries in the United Kingdom. As OfTel observed:

The ability of high bandwidth networks to exploit the economies of scope between telephony and television has been of central importance to the investment in the UK and the development of competition in telephony and television. Cable companies have made commitments to invest on the basis that they would have this ability and without it there would probably not be a viable UK cable industry.²⁹

Other examples of non-statutory undertakings occurred when the European Commission recently allowed two Italian pay TV operators to merge, giving the combined entity more than two-thirds of the market. The merger was, however, subject to undertakings that mean '... blockbuster movies, football matches and other sports rights will be available and contestable in the market'.³⁰ The

²⁸ OFT, *OFT concludes BSKyB investigation*, media release, 17 December 2002.

²⁹ OfTel, *Bundling in the pay television market: submission to the Director General of Telecommunications to the Independent Television Commission*, December 1997, at 4.5.

³⁰ Specifically, the acquiring party (News Corporation) will waive exclusive rights in relation to such content for non-satellite transmission meaning cable, digital terrestrial transmission and internet operators will be able to buy content directly from rights owners. Non-satellite owners will also be able to buy premium content from News Corporation through a wholesale offer based on the 'retail-minus' principle. European Commission, above n. 6.

Spanish Government has also recently allowed the only two pay TV networks in Spain to merge. It also imposed conditions, including that Sogecable (one of the operators) waive its pre-emptive broadcasting rights for films and sporting events and its exclusive broadcasting rights with the major film studios.³¹

Competition and efficiencies in the supply of broadband and telecommunications services

When economies of scope exist a lack of access to premium pay TV content is likely to affect competition and efficiency in the supply of broadband and telecommunications services. This is because economic entry into these markets via network deployment appears to depend on being able to supply multiple services (and derive multiple revenue streams), including pay TV services.

Importantly, pay TV services must be comparable to those of the pay TV operator that has exclusive access to the premium content. Premium content drives demand and is therefore most important to consumers. While network providers may be able to access a variety of non-exclusive content, and therefore supply a large number of pay TV channels, this content appears to be less important to consumers than exclusive premium pay TV content.

Therefore, a lack of access to premium content that is acquired exclusively acts as a barrier to entry and can significantly delay or thwart investment totally. This will lead to less competition in the supply of these services (and therefore possibly higher prices and less choice) as well as an inefficient level of investment in infrastructure that could be used to deploy these services.

The OECD has previously noted that exclusive vertical agreements which result in vertical foreclosure can be anti-competitive and inefficient.³² It concluded that this is likely to

³¹ Uria & Menedez, *Pay-TV merger deal goes ahead with conditions*, 6 March 2003

³² OECD, *Regulation and competition issues in broadcasting in light of convergence*, April 1999, pp. 60 and 65.

occur when the downstream technology exhibits economies of scope so that restricting access to a key (upstream) input can restrict entry in the range of products produced with the downstream technology.

In Australia concerns about the lack of access to content exist in both metropolitan and regional areas, although they are greatest where there is currently no, or limited, broadband investment.³³ In the areas where Telstra and other network providers have rolled out broadband networks, the impact of a lack of access to content is more likely to mean lower prices being foregone than investment decisions being delayed. For example, withholding premium pay TV content from Optus would probably force it to rely on the revenue streams from broadband and telecommunications services to fund ongoing operations. The consequent loss of economies of scope (and associated higher unit costs) could result in higher prices for its broadband internet and telecommunications services. It could also result in the exit of Optus, due to the economies of scope inherent in its network and its limited ability to raise the prices of other services because of competition.

Therefore, the Commission believes that competition and efficient investment in broadband networks, and the services provided over these networks, will be promoted by regulating access to content that enables network providers to at least re-transmit the Foxtel and Austar basic and tiered packages. This would enable network providers to supply comparable pay TV services and therefore derive another revenue stream that will contribute to recovery of network costs.

³³ Telstra provides a national broadband services via satellite but at a relatively high cost (for example, two-way satellite broadband services with Telstra have a minimum cost over 18 months of \$3258 compared to \$1358 for cable broadband services). In addition, Telstra supplies xDSL services in metropolitan and regional areas. However, xDSL services may at times not be available to households attached to a DSL-enabled exchange as a result of the distance the premises is from the exchange or a choice of infrastructure in a particular location that will not support xDSL services, such as the use of line-sharing or remote integrated multiplexers (RIMS).

However, access to individual premium pay TV content channels– as described below– is likely to additionally promote competition in the supply of broadband and telecommunications services. That is, as well as enabling network providers to differentiate their pay TV service offerings it would also give network operators the ability to derive another revenue stream from their network and therefore promote competition in the supply of broadband and telecommunications services. Greater revenues from pay TV also provide increased scope (and incentive in the presence of economies of scope on the demand side) to compete for broadband and telecommunications consumers.

Existing section 87B undertakings

The changes occurring as a result of the pay TV agreements and section 87B undertakings create a framework for network providers to re-transmit the Foxtel and Austar packages and therefore address concerns relating to the supply of broadband and telecommunications services. However, the Commission considers that this framework needs to be legislated to provide existing and prospective network providers with greater certainty.

A benefit of legislated regulation would be that it is premised on the need to address specific competition and efficiency concerns and would therefore only be removed if it was found, after review, that such competition concerns no longer existed. In contrast the section 87B undertakings have been provided to the Commission for a specified time frame (31 December 2010 or the time of termination of the CSA if earlier) after which they are no longer enforceable. They are also subject to variation in the event circumstances change.

Further, only the Commission is able to enforce the section 87B undertakings, where as under legislated access to content regulation both the Commission and access seekers would presumably have direct access to court based outcomes.

In developing a legislated framework that enables network providers to re-transmit the Foxtel and Austar basic and tiered packages, the Commission also considers that there would be benefit in reviewing the pricing principles associated with this requirement. Such a review would aim to ensure that the pricing promotes competition and efficient investment over the longer term. Specific issues that should be subject to review are:

- whether the percentage discounts in the retail-minus approach sufficiently represent the quantum of avoidable infrastructure and retail costs³⁴ associated with providing pay TV services
- whether the pricing should allow for potential future changes in the underlying per subscriber content costs for Foxtel and Austar.³⁵

Competition in the supply of pay TV services

A lack of access to premium pay TV content in the presence of bundled pay TV, as well as switching costs, is likely to affect competition in the supply of pay TV services. In particular, the Commission considers that a lack of access to premium content may critically reinforce the pay TV market characteristics, pushing the market towards a highly concentrated structure in the absence of regulation.

Therefore, consumer benefits that occur as a result of competition, such as lower prices, are likely to be absent. The European Commission recently noted similar concerns when it stated that long-term exclusive agreements between studios and pay TV operators may prevent rival operators entering the market, forcing consumers to pay higher prices.³⁶

³⁴ These include STU, carriage, marketing, sales, billing and customer support costs.

³⁵ A recent report by CommSec estimated long-run content cost savings to Foxtel, including as a result of strengthened single buyer power in acquiring pay TV content, leading to significant reductions in pay TV sport and movie costs.

³⁶ European Community, *EC launches probe into pay TV rights in Hollywood*, 14 January 2003.

Monopolisation could also have important upstream effects, particularly when a single buyer of pay TV content emerges in a particular geographic area. So far Foxtel and Austar have operated in distinct geographical regions and have not competed in the supply of pay TV services, other than in the Gold Coast. Therefore, when there are only two buyers of content and those buyers do not compete, opportunities for supply of independent channels may decrease. That is, the ownership interests between various channel suppliers and Foxtel, as well as Austar, and the fact that some channels are produced in-house, means Foxtel and Austar have incentives to favour affiliated content. Other non-affiliated channel suppliers may therefore find it difficult to gain access to a distribution platform, resulting in less choice for consumers.

To promote competition in the supply of pay TV services the Commission believes network providers must have access to individual premium pay TV content channels that are currently acquired exclusively. Regulating access to content must be targeted and provide for discrete access to all premium pay TV content that is currently acquired exclusively. By providing access to individual channels which contain premium content, network providers will be able to offer comprehensive differentiated pay TV packages.

Existing section 87B undertakings

The Commission does not consider that the pay TV agreements or the section 87B undertakings provide a targeted and effective framework that will promote competition. Under the section 87B undertakings the smaller network providers may access the Foxtel and/or Austar basic and tiered packages, depending on the area in which they operate. The Commission understands that both TransACT and Neighborhood Cable have entered into such arrangements.³⁷ This enables them to supply the packaged Foxtel pay TV channels.

³⁷ The Commission understands both TransACT and Neighborhood Cable entered into such agreements with Foxtel before the section 87B undertakings were formally accepted by Commission. These agreements were negotiated in the context of consideration of the pay TV agreements and section 87B undertakings by the Commission.

While these undertakings ensure network providers have access to the same content as Foxtel, this is only the case if the network provider re-transmits the Foxtel/Austar basic and tiered packages. If network providers choose to develop their own basic and tiered packages, as either a substitute or a complement to the Foxtel/Austar packages, they will not have access to all premium pay TV content. Network providers could incorporate the Fox Footy and Movie Network channels into such packages (under the section 87B undertakings Fox Footy must be on-supplied to network providers and Movie Network channels must be supplied non-exclusively). However, a lack of access to Fox Sports and the PMP movie channels limits their ability to offer a product best suited to their customers, and which can be a comprehensive competing service to Foxtel and Austar.

The CSA gives Optus access to the premium pay TV content it previously sought from Foxtel (for example, the PMP movie channels, the Fox Sports channels and the Fox Footy channel).³⁸ However, under the CSA certain constraints were placed on Optus, including limiting its ability to determine channel positioning and acquire new premium pay TV content without ensuring it is also available to Foxtel. The specific details of the pay TV packages offered by Foxtel and Optus pre and post the CSA are detailed in attachment A of this report. Given these limitations, Optus now provides very similar services to Foxtel, both in relation to price and non-price terms and conditions.

Efficiency costs

The Commission believes that as a result of entry not occurring, or the long-term viability of network providers being undermined, benefits from access to broadband services, including lower prices for broadband, telecommunications and pay TV services, will be delayed. The Productivity

³⁸ Optus obtained access to the Fox Sports channels and Fox Footy channel under separate agreements before the CSA came into effect. The Commission did not consider these particular agreements substantially lessened competition in the relevant markets.

Commission's inquiry into telecommunications competition regulation acknowledged this concern:

[I]t seems likely that the major consequence of content foreclosure is delayed availability of very high bandwidth facilities in regional Australia. ... The economic cost of delay is the foregone consumer benefit of possibly many years without a service.³⁹

The Commission's submission noted that there were potential losses from foreclosure of content to regional and other areas. The estimated efficiency costs in supplying broadband internet services, as a result of delayed network investment, was about \$56 million if service provision was delayed for two years and up to \$750 million if a delay of ten years occurred.⁴⁰ It was noted that further efficiency costs may result from the lower level of competition in providing telecommunications services, but that these may not be substantial.

These estimates show the magnitude of benefits (through the losses avoided) that would be associated with regulating access to content which facilitates the deployment of broadband networks. While some of the above losses may be avoided as a result of the section 87B undertakings, further benefits would still result if legislated access to content regulation was implemented.

³⁹ Productivity Commission, *Telecommunications Competition Regulation*, p. 536. This inquiry was specifically asked to consider the implications of current pay TV content arrangements on the development of telecommunications competition in regional Australia and whether any additional regulatory measures were required. While its terms of reference were limited to assessing the impact on regional areas the Productivity Commission noted that a lack of access to pay content is not a regional-specific problem and that there is a case for addressing the problem on a national basis.

⁴⁰ Australian Competition and Consumer Commission, *Supplementary Submission to the Productivity Commission's Review of Telecommunications Specific Competition Regulation - Pay TV and Regional Telecommunications*, August 2001, pp. 24- 32.

6.3 The preferred approach to addressing concerns about the access to pay TV content

In section 6.2 the Commission detailed the measures it considers necessary to address the competition and efficiency concerns in supplying pay TV, broadband and telecommunications services. Use of existing provisions of the TPA, regulating access to content and/or structural change is considered. Each of these approaches is discussed below and the Commission's preferred approach is outlined.⁴¹

In determining a preferred approach, the Commission has had regard to the concerns about access to content and the government's broad policy objectives for telecommunications—promoting the long-term interest of end-users through competition and efficient use of, and investment in, infrastructure. In considering the regulation of access to content, the Commission has also been guided by the following issues:

- providing access to premium content on a non-discriminatory basis
- promoting certainty of terms and conditions relating to access to content resulting in effective and timely access
- ensuring clear dispute resolution mechanisms.

The Commission has also sought to identify the costs associated with each approach.

6.3.1 Existing provisions of the TPA

One possible approach to addressing the concerns detailed above is to examine the exclusive content agreements under the existing Part IV provisions in the TPA. For example, under:

- section 45 of the TPA which relates to contracts, arrangements or understandings that restrict dealings or affect competition
- section 46 of the TPA which relates to misuse of market power
- section 47 of the TPA which relates to exclusive dealings.

This would effectively mean adopting a case-by-case approach to establishing rights to access which would be resource intensive and unlikely to provide for timely access. This in turn would be expected to present barriers to smaller network providers. Rights of access that are defined by court enforcement of general restrictive trade practices legislation are likely to be less effective in establishing clear principles that could be applied in resolving all access issues, compared to those that would flow from a specific regulatory scheme. This is because such decisions often turn on their particular circumstances which can be more readily distinguished from other disputes.

The Commission also considers Part IV of the TPA does not allow it to adequately deal with the competition and efficiency concerns detailed above. For example, under sections 45 and 47 it may be difficult to show that exclusive content agreements have the effect of substantially lessening competition especially given sports such as AFL and NRL are being supplied to Foxtel, Optus and Austar and there are two suppliers of recent release movies, one of which is non-exclusive. Another complication is that the exemption for exclusive contracts for assignment of copyright material (section 51(3)) might apply.

In relation to section 46, it may be difficult to prove that any program supplier has market power in pay TV and that they used that market power for a proscribed anti-competitive purpose. The Commission notes that in its previous considerations market power has not been found to exist in program supply sufficient to invoke competition law. Even if market power was determined, it is still a relatively demanding test to establish that a refusal to supply is done so with the purpose of damaging a competitor

⁴¹ Pay TV operators service both residential subscribers and licensed premises. The Commission is aware of some concerns relating to licensed premises, however, it does not consider at this stage that these concerns justify regulating access to content that extends beyond residential subscribers.

or deterring or preventing competitive conduct. As noted by the Productivity Commission:

Overall, the [Productivity] Commission's view is that anti-competitive conduct rules of s. 46 of the TPA are not, by themselves, well suited to making access to telecommunications bottleneck facilities available in a timely and efficient fashion and in determining efficient access prices.⁴²

For these reasons the Commission does not consider that applying the existing provisions of the TPA to address concerns about the access to pay TV content is to be preferred to access to content regulation.

6.3.2 Access to content regulation

An alternative to using the existing provisions of the TPA is regulating access to content. While this may take various forms, it would essentially put in place a framework that ensures network providers have access to premium pay TV content.⁴³ Such regulation does not change Foxtel and Austar's incentives to withhold access to premium content, but as outlined below it alters their conduct by virtue of the on-supply requirements put in place.

There are a variety of ways in which access to content regulation can be specified. A key issue is where the positive obligation to on-supply premium pay TV content is most effectively placed. Broadly speaking, the Commission believes access regulation could take the following forms:

- a non-exclusivity measure prohibiting rights holders (for example the AFL or ACB) and channel suppliers from entering into

exclusive content agreements to supply premium pay TV content rights and requiring non-discriminatory on-supply- an alternative form of this measure would limit the length of time channel suppliers can acquire pay TV content rights exclusively

- a non-exclusivity measure prohibiting channel suppliers and pay TV operators from entering into exclusive content agreements to supply premium pay TV content and requiring non-discriminatory on-supply by channel suppliers
- an access to content measure on pay TV operators to provide access to exclusively contracted premium pay TV content (as separate channels) to competing network providers and to do so on non-discriminatory terms and conditions⁴⁴
- a retransmission measure on pay TV operators who have exclusive content agreements for them to supply their pay TV content, as it is packaged for sale to its own consumers, to competing network providers and to do so on non-discriminatory terms and conditions.

While requiring non-exclusivity between rights holders and channel suppliers is a possible approach the Commission does not believe it would result in efficient or effective outcomes. For example, if rights holders, such as the AFL and ACB, had to supply their rights to multiple channel suppliers this could then lead to the creation of multiple channels with the same content, making it difficult to control quality. Also, achieving on-supply on the basis of non-discriminatory terms and conditions would be extremely difficult. Limiting the length of time which rights holders can have exclusive agreements with channel suppliers may not be effective. Exclusive content would still be locked to one channel supplier for that period of time. Therefore this approach is not considered further below.

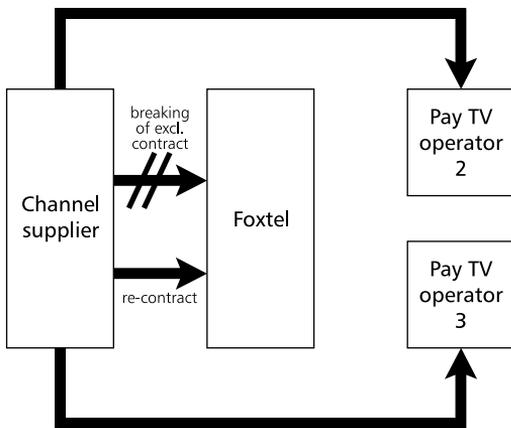
⁴² Productivity Commission, *Telecommunications Competition Regulation*, p. 51.

⁴³ All of the requirements outlined in the following section would only apply to access seekers who were broadband network providers. This is to ensure that access to content regulation is targeted at addressing the access to content concerns. Widening the scope of access seekers is discussed below.

⁴⁴ The access to content requirement would apply to pay TV operators who have exclusive rights to distribute premium pay TV content in their area.

The remaining non-exclusivity measure obliges the channel suppliers and pay TV operators to negotiate existing and new content agreements on a non-exclusive basis. This measure also places a further obligation on the channel supplier to provide for non-discriminatory on-supply. An on-supply requirement is necessary to avoid the situation where there are non-exclusive content agreements but channel suppliers withhold this content from some network providers.⁴⁵ This measure is illustrated below in Figure 6.1.

Figure 6.1 Non-exclusivity measure for channel suppliers and Foxtel



The access to content and retransmission measures oblige particular pay TV operators to on-supply, via sub-licensing agreements, either individual channels of exclusive premium pay TV content or all pay TV content. Both arrangements would be on a non-discriminatory basis. These measures are illustrated below in figures 6.2 and 6.3 respectively.

Figure 6.2 Access to content measure

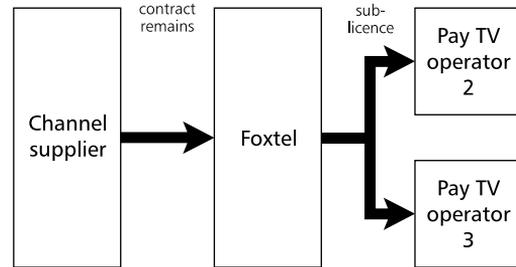
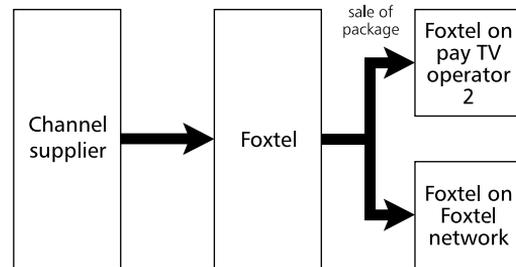


Figure 6.3 Retransmission measure



The non-exclusivity, access to content and retransmission measures all have a similar objective in that they attempt to remove the barrier to entry created by a lack of access to premium content. However, the non-exclusivity and access to content measures provide for access to individual pay TV channels whereas the retransmission measure provides access to a bundle of pay TV channels.

⁴⁵ There are incentives for this to occur where there is a degree of common ownership between the channel suppliers and pay TV operators.

Retransmission measure

To address the competition and efficiency concerns in the supply of broadband and telecommunications services, as outlined above, the Commission believes a retransmission measure is necessary. This would ensure network providers have access to pay TV content, including premium content, and should therefore facilitate economic entry of broadband network providers who rely on being able to supply multiple services.

A retransmission measure would be similar to the current section 87B undertakings in which Foxtel and Austar will supply network providers with their basic and tiered packages in their entirety. However, as discussed in section 6.2.2 this framework needs to be legislated to provide network providers with greater certainty. In implementing such a framework the Commission considers that there would be benefit in reviewing the pricing principles associated with these undertakings.

A retransmission measure would be less disruptive to Foxtel and Austar as they maintain their existing exclusive content agreements, bundling arrangements and brand integrity while maximising the distribution of their services over rival networks. Channel suppliers also maintain their exclusive content agreements, and therefore the premiums being paid to them, as well as maximising distribution of their content. It is the least interventionist of the possible regulatory approaches.

However, the Commission has also become aware of further matters that could be incorporated into a legislated framework which are not currently provided for in the section 87B undertaking. It appears that some property developers who are building greenfield housing estates are also deploying their own broadband networks. These networks are intended to provide broadband, telephony and pay TV services. However, because of their size (the networks typically service around 2 000 homes in each estate) such developers are having difficulty negotiating access to pay TV content. Their size also means these developers would prefer to

acquire content directly from Foxtel and Austar (as a package) rather than individual channels from the various suppliers.

The section 87B undertakings providing for the supply of Foxtel and Austar's basic and tiered packages in their entirety are only enforceable for networks which service at least 8 000 homes. When the Commission accepted the undertakings this figure seemed reasonable as it meant Foxtel and Austar only had to negotiate with network providers of sufficient scale (which was seen to be important both in terms of the negotiation process and the potential revenues). The result is that it does not appear that these developers will be able to access pay TV content under the section 87B undertakings.

At this stage it is not clear to the Commission whether the retransmission measure should be modified to incorporate these developers. This will probably depend on the number of greenfield housing estates that are likely to deploy HFC cable networks and therefore the materiality of any benefit from extending the requirement. While the Commission has not had enough time to consider this matter it may be something the government wishes to explore further as there could be important competition investment and public benefits in extending the access to content regime to such developers.

Non-exclusivity or access to content measure

To address the competition concerns in the supply of pay TV services, as outlined above, a non-exclusivity or access to content measure is necessary. These mechanisms would provide access to individual channels, compared with a package of channels, and therefore enable network providers to differentiate their pay TV services.

As suggested in section 6.2.2, if regulating access to content is used to promote competition in supplying pay TV, broadband and telecommunications services, then either a non-exclusivity or access to content measure would be preferred to a retransmission measure. Both of these measures promote competition in the

supply of pay TV services, by enabling product differentiation, as well as in broadband and telecommunications services, by facilitating economic entry. This suggests that if the aim of regulating access to content is to promote competition in the supply of all three of these services, a retransmission measure would not be enough (because it would not adequately promote pay TV competition).

The non-exclusivity and access to content measures also have further benefit in that if network providers have greater flexibility to compete in the supply of pay TV services, this may improve their margins on these services and enable them to develop packages of services most suited to their customers. As a result, network providers may be able to engage in price competition for broadband and telecommunications services beyond what they otherwise would.

The measures have different strengths and weaknesses and one does not clearly stand out over the other. Essentially, the differences between them relate to the likelihood of a constructive refusal to supply occurring and how closely they address the source of the problem. Also important are the issues raised by the breaking of existing exclusive content agreements under the non-exclusivity measure. This includes whether the viability of either channel suppliers or pay TV operators would be undermined as a result of the measures and, importantly, just compensation concerns for the government.

Before analysing these issues, it is useful to outline briefly the content and channels that the Commission considers should be subject to these measures. In light of the evidence available the Commission believes that the following should be subject to one of these measures: all content on the Fox Sports, Fox Footy, PMP 'Showtime' and the Movie Network 'Movie One' channels.⁴⁶

⁴⁶ The issue of specifying the content to be subject to these requirements is also discussed in the implementation section of this chapter: see section 6.4.1.

The Commission considers the content included in the Fox Sports and Fox Footy channels should be subject to these measures as:

- it is currently acquired exclusively and the extent of the ownership interests⁴⁷ for these channels suggests exclusivity will continue to exist
- it is almost impossible to duplicate
- it is content consumers demand and is therefore important to the competitive supply of pay TV services as well as broadband and telecommunications services in the presence of economies of scale and scope.

Ownership interests do not exist to the same extent for PMP, or at all for the Movie Network channels. However, the fact that the PMP channels are acquired exclusively; that the PMP and Movie Network channels also contain content which is almost impossible to duplicate;⁴⁸ and that they experience relatively high demand suggests they should be subject to regulation.

The section 87B undertakings do not provide for non-exclusivity or on-supply in relation to the Fox Sports channels.

The undertakings do provide that Foxtel will not acquire the PMP channels exclusively once the current content agreement between Foxtel and PMP is terminated and that Foxtel will not acquire the Movie Network channels exclusively. However, the undertakings do not place an onus on these channel suppliers to on-supply. As

⁴⁷ Fox Sports is owned by a partnership between News Corporation and PBL, which also each have a 25 per cent ownership interest in Foxtel. In addition, Fox Footy is wholly owned by Foxtel, although it is required as a part of its rights agreement with the AFL to on-supply its programming to Optus and Austar.

⁴⁸ It is noted that at this stage video-on-demand services only appear to be a fringe substitute for the recent release movie channels. This is because there is currently a limited supply of video-on-demand services to consumers (TransACT and Bright), they have a relatively high cost per use as compared to the monthly subscription fees for the movie channels and occupy a different 'window' in terms of being available to consumers as compared to pay TV services.

outlined above, the Commission's recommended approach to regulation of access to content would impose an on-supply requirement.

A non-exclusivity measure would be unlikely to have any effect in the case of the Fox Footy channel as the channel supplier and the pay TV operator are one and the same – that is, Foxtel.

Constructive refusal to supply

A constructive refusal to supply network providers the above content is considered to be less likely under the non-exclusivity measure than the access to content measure.

This is because the incentives that channel suppliers such as Fox Sports, PMP and Movie Network have to withhold access do not appear to be as strong as those of Foxtel and Austar. As previously noted, Foxtel is 50 per cent owned by Telstra while News Corporation and PBL each has a further 25 per cent ownership interest. Therefore, Foxtel has an incentive to frustrate its and Telstra's competitors by withholding access. Fox Sports is 50 per cent owned by News Corporation and PBL and therefore Fox Sports has incentives to frustrate Foxtel's competitors (given its common ownership interests) but has fewer incentives in relation to Telstra's competitors. Fox Sports' incentives to frustrate Austar's competitors are substantially less, except to the extent that any on-supply in the Austar areas creates a precedent for on-supply in the Foxtel areas.

Compared to Foxtel and Austar, the PMP and Movie Network have substantially fewer incentives to withhold access to content from Foxtel or Austar's competitors, given the limited extent of common ownership. However, these incentives may be increased if Foxtel or Austar offer suitable exclusivity premiums.

Addressing the source of the problem

A non-exclusivity measure is likely to operate closer to the source of the access to content concerns (the barriers to entry created by exclusive content agreements) than the access to content measure. This is because the non-exclusivity measure breaks the exclusive content agreements whereas the access to content measure retains the agreements and access is achieved via on-supply.

Therefore, under the access to content measure it is more likely that exclusivity premiums originally negotiated in the content agreements will remain and form part of the on-supply arrangements. This is not to say that the non-exclusivity measure will eliminate these premiums, just that it is more likely to.

The continuation of premiums (under either option) could be problematic, especially in instances where it results in content being on-supplied at prohibitively high (even if non-discriminatory) prices. Depending on the extent of the premiums, they may actually reduce the usefulness of regulating access to content, especially if they make it difficult for network providers to acquire premium pay TV content and therefore enter or remain in the market. The Productivity Commission's inquiry into telecommunications competition regulation noted that:

[T]here is scope for vertically related program suppliers and pay TV companies to price content at transfer prices. This could result in artificially high content prices for their competitors, even if supplied on the same terms and conditions as supplied to the related company. Thus, regulation governing discrimination between pay TV operators would need to provide for the issue of transfer pricing between related entities, as well as to ensure non-discrimination in price terms and conditions.⁴⁹

⁴⁹ Productivity Commission, *Telecommunications Competition Regulation*, p. 548.

Breaking exclusive content agreements

While the above two issues may suggest that a non-exclusivity measure is preferred, breaking exclusive content agreements in and of itself appears to raise concerns. Such a measure would essentially mean the government was breaking commercially negotiated agreements between channel suppliers, such as Fox Sports and PMP, and pay TV operators, such as Foxtel. If this was the case and pay TV operators were losing the benefit of exclusivity, they would be likely to seek to renegotiate the content agreements so that any exclusivity premiums previously incorporated into the price of content were removed. In this way, the government's involvement may cause channel suppliers to lose their exclusivity premiums and as a result face diminished revenue streams (although as noted above this may not always be the case). Conversely, benefits would flow to the pay TV operators who would probably face lower content prices.

Breaking exclusive content agreements may be most significant for the PMP channels, especially given the limited common ownership interests as well as the fact that other movie channels are likely to be available to Foxtel (i.e. the Movie Network channels). One possibility to minimise such concerns is to wait until the PMP content agreement terminates before a non-exclusivity measure is introduced. In the interim, an access to content measure could be introduced. This approach is not open to the content agreement between Fox Sports and Foxtel as this is understood to be a perpetual contract.⁵⁰

Fox Sports detailed its concerns about breaking exclusive content agreements in its submission to the Productivity Commission's inquiry into telecommunications competition regulation.⁵¹

⁵⁰ In a supplementary information memorandum regarding the euro eight billion debt issuance program Telstra noted the changes of significance to its contingent liabilities, indemnities, performance guarantees and financial support relating to Foxtel since 31 October 2001. These included that since 31 December 2001 Foxtel had increased its minimum subscriber guarantee commitments under a new perpetual content agreement for Fox Sports.

⁵¹ Fox Sports, *Submission to Telecommunications Inquiry - Productivity Commission - Review of Telecommunications Specific Competition Regulation*, May 2001, p. 4.

It noted that if access regulation was introduced, one of the results would be to eliminate any 'premium' paid by pay TV operators for exclusivity. It believed this could result in less competition for sports rights as channel suppliers would not be able to afford to compete with FTA operators.

Exclusivity is an important element of many media supply agreements and any consideration of a legislative framework to break or prohibit exclusivity needs to balance the benefits of doing so against the costs. However, the Commission has noted in chapter 5 that pay TV operators are restricted from competing for many sporting events because of the anti-siphoning provisions. Modifying these provisions to ensure that neither pay TV operators nor FTA broadcasters can acquire rights to nominated events to the exclusion of the other would increase opportunities for pay TV operators to acquire sporting content.

In any event, the Commission notes that there are currently no other suppliers of local sporting content available to Foxtel and given the relatively high demand for this content by consumers, Fox Sports would have substantial countervailing power in any renegotiation. In addition, a transaction between Foxtel and Fox Sports would not be totally independent, given the common ownership interests.

A further issue if content agreements are broken is the impact on Foxtel. Arguments have been made to the Commission that while Foxtel may benefit from a non-exclusivity measure as a result of lower content prices, its business case, marketing strategy and brand integrity may be undermined. This is because network providers could negotiate content agreements with, say, Fox Sports and PMP, buy other (potentially cheaper) content direct from channel suppliers and establish a basic package that is smaller and cheaper than that of Foxtel's.

While some network providers may establish cheaper basic packages the Commission does not believe this would necessarily undermine Foxtel's business case. Under the non-exclusivity measure network providers who would be acquiring, say, the Fox Sports and Movie Network

content, and potentially establishing cheaper basic tiers, are likely to only serve a relatively small number of customers in a limited geographical area. The Commission believes a network provider would be unlikely to choose to deploy another broadband network in the same areas as the HFC cable networks of Telstra and Optus, especially given the large capital costs involved.

Further, the content subject to access regulation would be supplied on a non-discriminatory basis. Therefore, channel suppliers would on-supply this content to Foxtel and interested network providers at the same price, taking into account factors such as the number of subscribers. If the network providers decide that the needs of consumers will be better met by using different content in their basic package, or having a smaller basic package compared with Foxtel, then this is a commercial decision for those providers. To the extent it represents increased competition in the supply of pay TV services then this is beneficial.

Both approaches may also require consideration of property acquisition and 'just terms' compensation issues under section 51(xxxi) of the Constitution. This is because breaking exclusive content agreements and/or requiring on-supply of exclusive content may be characterised as an acquisition of rights by the government. If so, then both the non-exclusivity and access to content measures could only be valid if the person dispossessed is compensated on just terms.

While the government would need legal advice about the risk that such a characterisation would be made, such advice would be best sought once a specific and detailed model has been developed.⁵² It would appear that the potential risk to the government may be greater under the non-exclusivity measure than the access to content measure, as the former requires existing content agreements to be broken. In any event, a legislated access to content framework could

use provisions that compensate for property acquisition, similar to those in Part IIIA and XIC of the TPA.⁵³ Essentially, such provisions provide that where an acquisition of property results, the Commonwealth must pay a reasonable amount of compensation.

Pricing considerations

Unlike the retransmission measure, the Commission is not proposing that the non-exclusivity or access to content measure involve pricing considerations. That is, while the non-exclusivity and access to content measures will impose obligations to on-supply at non-discriminatory prices they will not specify the particular price of doing so.

While access regulation usually involves determining the appropriate pricing for such on-supply arrangements the difficulties associated with pricing content may be considerable. Bottom-up pricing is problematic given it would be difficult to determine the cost of, say, an AFL football match or a new-release movie. Also, given the bundled nature of pay TV services (in particular that Fox Sports is part of Foxtel's basic package) it is difficult to determine top-down or retail-minus prices because single channels are not generally supplied on their own. Foxtel does not, therefore, have a retail price that could be used as the basis for a retail-minus approach. This contrasts with the retail-minus approach for the retransmission measure where the retail price of the basic and tiered packages allow a wholesale price to be determined.

Conclusion

To promote competition in the supply of pay TV services, obligations in relation to individual premium pay TV content could be legislated.⁵⁴ In particular, the Commission considers that in light

⁵² A further related issue is the extent of any 'just terms' compensation that may be payable under either requirement. However, further information of the precise contractual terms and conditions on which the content is currently acquired would be required to make such an assessment.

⁵³ These are contained in section 44ZZNN and section 152EB respectively.

⁵⁴ As noted above, where such obligations are put in place it does not appear that a retransmission measure would also be required, as competition in the supply of broadband and telecommunications services would also be promoted.

of the above analysis the following obligations for individual premium pay TV are preferable:

- a non-exclusivity measure for the Fox Sports content prohibiting Fox Sports and any pay TV operator from entering into exclusive content agreements and requiring Fox Sports to non-discriminatorily on-supply this content
- an access to content measure for the Fox Footy content requiring Foxtel to non-discriminatorily on-supply this content
- an access to content measure for the PMP 'Showtime' content, until the current content agreement between PMP and Foxtel terminates, requiring Foxtel to non-discriminatorily on-supply this content, after which a non-exclusivity measure is introduced
- a (continuation of) the non-exclusivity measure for the Movie Network 'Movie One' content prohibiting Movie Network and any pay TV operator from entering into exclusive content agreements but also requiring Movie Network to non-discriminatorily on-supply this content.

However, the Commission notes that there are costs that would need to be considered before implementing such obligations. In particular, the Commission recognises that the breaking of exclusive content agreements may have implications for channel suppliers and pay TV operators and that it also raises the risk of just compensation claims for the government.

Scope of the preferred approach

This sub-section provides further commentary on the networks, providers and content covered by access to content regulation.

Types of networks covered by the regulation

In addition to HFC and fibre-to-the curb networks there is also the possibility of including xDSL networks and satellite networks in the scope of broadband technologies covered by the regulation of access to content.

At this stage the Commission does not believe that xDSL networks, using Telstra's copper network, should be included in the scope of this regulation. The Commission understands that neither Foxtel nor Austar have content agreements relating to the supply of content over xDSL networks. Accordingly, the same concerns about access to content do not apply to xDSL at present.

It is not clear that including satellite networks would have significant benefits. In particular, the Commission believes competition in the supply of broadband and telecommunications services is unlikely to be improved as a result of the inclusion of satellite networks. Further, pay TV competition will only be promoted where the government determines that the access regime should comprise obligations to on-supply individual premium pay TV content. This may be something the government should consider further.

Widening the scope to include telecommunications carriers

It would be possible to widen the scope of the proposed measures so that telecommunications carriers (such as AAPT and Primus) could also gain access to content.⁵⁵ Such carriers differ from the network providers that are the focus of this chapter, in that they would not own and/or operate a residential broadband network.

The Commission noted in its draft information paper, *Bundling in Telecommunications Markets*,⁵⁶ that telecommunications carriers are increasingly supplying services as a part of bundled packages, including telecommunications, internet (including broadband) and pay TV. To compete, carriers need to be able to supply some or all of these services.

The Commission noted in its draft information paper that competition concerns may result if a

⁵⁵ For both of these requirements this could be achieved by widening the class of eligible access seekers to include telecommunications carriers.

⁵⁶ Australian Competition and Consumer Commission, *Bundling in telecommunications markets- an ACCC draft information paper*, January 2003.

carrier is unable to supply one service that is included in a bundled package of its competitor (for example pay TV services). In particular, the number of customers available to these competitors may be significantly reduced as a result of not being able to supply a particular service.

At present, Optus and Telstra, in particular, can bundle pay TV services, but most other telecommunications carriers cannot. The Commission considered this matter when assessing Telstra's third line force notifications relating to the bundling of telecommunications and pay TV services. The Commission determined that, at the time of the decision, the extent of pay TV subscribers was not sufficient to significantly reduce the number of customers available to Telstra's competitors and that the pricing of Telstra's pay TV service bundle was not anti-competitive. Since making this decision the Commission has not received any further information or complaints that would suggest Telstra's bundled supply of pay TV services has harmed competition. However, the Commission continues to monitor Telstra's bundling conduct.

Further, AAPT has also recently negotiated an agreement that enables it to supply the Foxtel pay TV services to its customers.⁵⁷ However, this is an agency agreement where AAPT receives a commission for signing up customers to Foxtel. This agency agreement differs from the agreement between Foxtel and Telstra under which Telstra resupplies Foxtel as a wholesale customer of Foxtel (with retail-minus pricing and other differences).

Therefore, at this point in time the Commission does not consider there are sufficient concerns to widen the non-exclusivity and retransmission measure to include telecommunications carriers. However this may change, particularly if there is significant growth in pay TV subscribers.

Widening the scope to include pay TV operators using the access to carriage regulation

It would also be possible to widen the scope of the proposed measures so that pay TV operators using access to carriage regulation or undertakings could also gain access to the premium pay TV content. Obviously these operators would not own or control a broadband network.

This possibility appears to only address the competition concerns relating to the supply of pay TV services. In particular, the non-exclusivity measure (in conjunction with an access to carriage regulation) may allow such pay TV operators to stimulate competition through differentiated product/price offerings. However, widening the scope of access regulation in this way would not lower the barriers to entry for the supply of broadband and telecommunications services. At this stage, market inquiries have not suggested that widening the regulation in this way would have major benefits.

Widening the scope to include non-pay TV content

It would also be possible to widen the scope of the proposed measures so that they included non-pay TV content. For example, content that is supplied over ADSL and 3G technologies.

The widening of these measures does not seem necessary to address the access to content concerns detailed above. Limiting the scope of access regulation to pay TV services allows the regulation to target the identified market failure. Market inquiries have suggested that further widening of access regulation is not currently necessary.

6.3.3 Separation of content and carriage

Further to using regulation of access to content as detailed above, separating content and carriage ownership interests may also be considered to complement access regulation.

⁵⁷ Wires, '... whilst AAPT signs Foxtel bundling agreement', *Communications Day*, 9 May 2003, p. 2.

Despite the fact that the Commission is proposing to regulate access to content, it recognises that such an approach has limitations. While these concerns were specifically discussed in chapter 4 in relation to access to carriage regulation they are also relevant to regulation of access to content. These limitations include that:

- access arrangements do not alter the incentive for, and often cannot prevent, discriminatory treatment by the access provider between its downstream operators and those of access seekers
- access arrangements involve regulatory costs and can create a high level of ongoing dependence on regulatory intervention
- the process of resolving disputes about the terms and conditions of access can be time consuming and create uncertainty, with potential corresponding impacts on investment.

These limitations may suggest that there is also some merit in restricting the ownership interests between pay TV channel supply and the retailing of pay TV services. This separation would be intended to improve incentives for providing non-discriminatory access to content, by reducing common ownership of premium content. Possible prohibitions on ownership interests could be that:

- PBL and News Corporation as owners of pay TV channels could not have any holdings in Foxtel
- PBL and News Corporation as owners of Foxtel could not have holdings in the channel suppliers Fox Sports and PMP.

Introducing ownership restrictions would also require ongoing prohibitions to prevent any common ownership interests between channel suppliers with premium pay TV content and pay TV operators. This would therefore prohibit Foxtel from acquiring, say, the Fox Sports content.

It would be difficult for the government to determine which level of the vertical supply chain PBL and News Corporation should exit. Rather this is a commercial decision that should be left

to the parties to make, after any such prohibition was introduced. Where Foxtel is the owner of channels, as is the case with Fox Footy, then it would be prohibited from having holdings in such channels.⁵⁸

An alternative to a complete prohibition on vertical integration and ownership interests would be to limit ownership interests. For example, it could be required that PBL and News Corporation have no greater than a 5 or 10 per cent interest in either Fox Sports and PMP or Foxtel.⁵⁹

One of the costs associated with imposing a prohibition on ownership interests is the lost economies of scope that exist in integration of content production and channel supply into pay TV aggregation. In considering the concentration and vertical integration of the pay TV industry in the United States, Congress noted:

[T]hat some level of concentration and integration produces efficiencies in the administration, distribution, and procurement of programming, and fosters investment in innovative and risky programming fare, which may benefit consumers in terms of lower rates, better services and more diversified programming services.⁶⁰

Determining the magnitude of such costs is difficult, particularly given that it would appear that Foxtel, Fox Sports and PMP are run independently. However, there may be some benefits from common ownership of ensuring

⁵⁸ It is not clear that such a prohibition would be applied to other channels in which Foxtel has ownership interests, such as the XYZ channels. This is because although these channels are favoured in distribution by Foxtel and not available to competing network providers they are not generally considered to be 'must have' premium pay TV content. There are other similar channels which competing network providers can gain access to in order to develop alternative pay TV offerings.

⁵⁹ In the United States a 5 per cent ownership rule forms a part of the access to content regime that essentially prohibits exclusive content agreements existing between vertically related channel suppliers and pay TV operators.

⁶⁰ FCC, *Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992: Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996: The Commission's Cable Horizontal and Vertical Ownership Limits*, FCC-01-263, September 2001, p. 5.

quality of programming, and coordinating decisions to acquire content.

Conclusions

The Commission believes a prohibition on ownership interests would likely improve the incentives for distribution of premium pay TV content. However, regulating access to content would still be necessary to prohibit channel suppliers and pay TV operators from entering exclusive contracts. As the costs of separating content and carriage are unclear, the Commission believes that the government's focus should be on implementing the proposed access to content regime.

Therefore, at this stage the Commission is not recommending any ownership separation between premium content production and pay TV carriage. However, if regulating access to content does not result in effective outcomes such an approach may need to be considered.

6.4 Implementation of legislated access to content regulation and interaction with the section 87B undertakings

Section 6.3 of this chapter examined the various approaches to addressing the access to content concerns and in particular proposes a preferred approach of regulating access to content. The key implementation issues associated with this approach are the focus of this section, although there will be many other specific implementation issues. Those discussed below are:

- how to specify the premium pay TV content to be subject to non-exclusivity and access to content measures
- how such regulation would interact with the section 87B undertakings.

6.4.1 How to specify the premium pay TV content to be subject to the non-exclusivity and access to content measures

The premium pay TV content covered by the access provisions could be specified or determined in a variety of ways. The key options would be to rely on either the government or an appointed regulator making such a determination (according to specified criteria) once legislation is introduced. The Commission considers there are essentially the following options:

- premium pay TV content to which access regulation would apply would be specified in government regulation (perhaps similar to the anti-siphoning list)
- the relevant regulator would determine the premium pay TV content covered after a 'declaration' inquiry.⁶¹

The Commission does not have a definite view about which regulator would undertake inquiries, if this option is favoured. However, it notes that the Commission's current functions as a regulatory body with responsibility for administering the Parts IIIA and XIC access regulations, including declaration of carriage services, may position it well to perform such a role.

These approaches need to be framed in relation to pay TV content and not just pay TV channels. Specifying those channels subject to access regulation would not be adequate as channel suppliers and pay TV operators could game any such measure by moving the exclusive premium pay TV content to other (perhaps new) channels.

Also, both of these approaches would need to allow for variation, revocation and exemption

⁶¹ A further option also exists. This would involve legislation specifying the premium pay TV content or channels that would be subject to the regulation of access to content. It may, however, be difficult to accurately specify the content covered, and to allow for sufficient flexibility in the event that changes were made to channel content.

processes.⁶² This is important to ensure there is flexibility in the way the premium pay TV content to be the subject of these measures is determined and that there are adequate review processes if circumstances change— for example, if particular premium content was no longer regarded as being a bottleneck, because of the availability of other similar content. The variation, revocation and exemption processes also allow for the possibility of public interest reasons for not requiring access to specific premium pay TV content— for example, if supply would be unlikely to occur in the absence of exclusivity.

It may be argued that a variation, revocation and exemption approach introduces a degree of uncertainty for the industry, as it would take time for the government or regulator to determine what content should be subject to the regulation and there would be the ongoing possibility of variation, revocation and exemption. However, the Commission believes that the flexibility of this approach, as well as the transparency of the decision making, outweigh these concerns. As discussed below the Commission is also proposing immediate specification of particular pay TV content that would minimise any delays in implementation.

Initial specification of content to be subject to access to content regulation

The Commission believes that to achieve efficient access regulation it would be preferable to immediately specify particular premium pay TV content that would be subject to the relevant access measures. It would mean that the government or regulator would not go through an initial process to determine whether particular premium pay TV content should be listed or declared. This would ensure, initially, that there is certainty and the likelihood of timely outcomes.

As noted above, in light of the evidence available to the Commission it believes that the following

premium pay TV content should be immediately subject to access regulation: all content on the Fox Sports, Fox Footy, PMP 'Showtime' and the Movie Network 'Movie One' channels. This said, the proposed listing or declaration approach would enable the government or regulator to determine whether additional premium content should be subject to regulation. For example, Foxtel has created a Fox Footy Extra channel. At this stage it is not apparent that such a channel would be premium pay TV content requiring regulated access to content. However, if this was found to be the case, listing or declaration provisions could be used to ensure regulation was appropriately applied.

6.4.2 Implications of legislative change for section 87B undertaking to digitise

As noted in chapter 3, the undertakings given by Foxtel and Telstra to digitise their pay TV network does not apply if there is 'regulatory change'. These provisions are likely to be triggered by a legislated access to content framework as proposed above.⁶³ However, it is likely that Foxtel has sufficient incentives to digitise its network even if content access regulations are introduced, and therefore the Commission does not believe these provisions in the section 87B undertaking should stop the government from introducing legislation for a legislated access to content regime.

6.5 Conclusions and recommendations

The Commission continues to believe a legislated access to content regime is necessary to promote competition and efficient use of, and investment in, broadband, telephony and pay TV services.

⁶² These could be similar to the variation and revocation principles in Part XIC of the TPA but could also incorporate some principles from the legislation in the United States (particularly in relation to the exemption process).

⁶³ Regulatory change is defined to include the Government passing legislation which has the effect of preventing pay TV operators from acquiring pay TV rights on an exclusive basis or requiring pay TV operators to supply programs or channels to other providers.

To promote competition in the supply of broadband and telecommunications services the Commission recommends legislating to ensure that network providers will be able to access Foxtel and Austar's basic and tiered packages with certainty.

To promote competition in the supply of pay TV services, the Commission considers that access to individual premium sports and movie content is required. Such regulation would also have important benefits for competition in the supply of broadband and telecommunications services that would mean legislated access to Foxtel and Austar's basic and tiered packages would be unlikely to be necessary.

The Commission has identified the following premium sports and movie channels which it believes contain content that should be subject to specific access regulation:

- the Fox Sports channels
- the Fox Footy channel
- the PMP 'Showtime' channel
- the Movie Network 'Movie One' channel.

In addition to prohibiting exclusivity of these channels, the Commission considers that imposing a positive obligation on the relevant channels suppliers to on-supply the content in the Fox Sports and Movie Network 'Movie One' channels is necessary. Further, Foxtel should be required to on-supply the content from the Fox Footy channel as well as the content from the PMP 'Showtime' channel.

However, there are costs associated with obligations to on-supply premium sport and movie content. In particular, the Commission recognises that the breaking of exclusive content agreements may have implications for channel suppliers and pay TV operators, impacting on their current business plans. Further, such an approach also raises the risk of just compensation claims for the government. These are issues that would need to be considered further before any such approach is introduced.

7 Access to carriage and consumer reception equipment

7.1 Overview

The minister's correspondence of 12 March sought the Commission's advice on access for aspiring pay TV content providers to delivery platforms, and on competition in the provision of consumer reception equipment for broadcasting, telephony and broadband services. The letter also noted the importance for content providers to gain prompt access to substantial audiences on reasonable terms.

The issues of third party access to pay TV delivery platforms and consumer reception equipment (i.e. STUs) are closely related. Pay TV consumer reception equipment refers to devices which provide the final interface between the end-user and telecommunications network. For pay TV carriage, consumer reception equipment currently takes the form of a STU containing software that is specifically designed to be compatible with a particular network.¹ STUs or other consumer reception devices can be designed to receive signals from different networks or service providers.

When the Commission declared the analogue subscription television broadcast carriage service in 1999, it described the service as including the

delivery of analogue signals used for the purposes of transmitting a subscription television service to an end-user's television set.² That is, the service description covered both access to the core carriage network as well as carriage through the consumer reception equipment.

Several concerns were raised in market inquiries conducted as part of the Commission's assessment of the section 87B undertakings about the effect of the pay TV agreements for third party access to pay TV networks and STUs. The major concern was that the pay TV agreements would compromise third party access to the Foxtel/Telstra pay TV network for the delivery of pay TV services and FTA services to pay TV subscribers. These concerns were particularly focused on carriage of digital pay TV services, and therefore included concerns about new digital services that can be provided with the pay TV and FTA signal, such as 'interactive services'.

The Commission considered the pay TV agreements to have a deleterious effect on third party access for the provision of pay TV services. It did not, however, believe the same concerns arose for FTA and interactive services, largely because of the independence retained by Optus for the delivery of these services.

¹ Or, more specifically, involves the combination of STU and television (which may also be connected to other devices, such as a sound amplifier).

² Australian Competition and Consumer Commission, *Declaration of an analogue subscription television broadcast carriage service*, 1999, p. 46.

In response to the Commission's competition concerns, Telstra and Foxtel gave section 87B undertakings for third party access to Telstra's HFC network and Foxtel's HFC and satellite STUs for carriage of pay TV services. These undertakings were designed to address the competition concerns the Commission had identified arising out of the pay TV agreements, in particular, competition concerns in the market for retail pay TV services. The access undertakings are still subject to further public comment and consideration by the Commission under Part XIC of the TPA.

Having said that, a number of submissions to the Commission have called for further regulatory intervention to address concerns about the potential for pay TV operators to control the gateway for digital FTA and interactive services. These submissions have argued that regulation should be introduced providing for mandatory retransmission of digital FTA services over, in particular, the Foxtel/Telstra HFC network and/or requiring that pay TV operators include a digital terrestrial tuner/demodulator in their digital satellite STUs. They further argue that the regulation should be framed in such a way that FTA operators would be assured of also having their interactive/digital enhancements delivered to pay TV subscribers in an unaltered form.

At this stage, it is the Commission's view that it is not clear regulatory intervention is justified on the grounds that digital pay TV networks will be a bottleneck service for the delivery of digital FTA services and digital enhancements to the FTA signal. That said, if it does emerge that pay TV networks are a bottleneck for the reception of FTA digital services and digital enhancements to the FTA signal, then there would be a considerably stronger case for regulatory intervention in this area.

Unlike access regimes for telecommunications services, there also appears to be benefits for both the access provider (the pay TV network) and access seeker (the FTA network) for retransmission of FTA signals. Other things being equal, this provides a greater opportunity for commercial negotiations to resolve this particular access concern.

However, the Commission has received complaints about Foxtel potentially providing favourable retransmission supply to the Nine Network. It has been alleged this favourable treatment may amount to a substantial lessening of competition under the TPA. The Commission is examining this complaint at the time of this report.

The chapter first outlines the consumer reception equipment used for reception of digital pay TV and FTA services. It then considers the implications of the pay TV agreements on the market for the acquisition of pay TV content and STUs. Finally, the chapter outlines and evaluates continuing competition concerns raised by industry participants.

7.2 Supply of pay TV, FTA and interactive services on pay TV networks

Digitisation of pay TV networks will increase the capacity of pay TV networks, and enable greater functionality, including the ability to offer interactive services. Digital STUs are necessary for the reception of digital services. The functionality of digital services that can be provided over digital pay TV networks will depend in part on the sophistication of the STU.

7.2.1 STUs

The Productivity Commission defines an STU as:

[A] combined receiver and decoder which processes digital transmissions, and connects to TV displays, VCRs and other devices. A set top box may also convert digital transmissions to analogue for display on an analogue television set.³

The actual hardware and software composition of STUs depends on what services will be supplied to consumers through the STU.

³ Productivity Commission, *Broadcasting*, Report no. 11, 2000, p. XXII.

STUs generally incorporate hardware that enables consumers with analogue televisions to receive broadcast services over the service provider's delivery platform. For example, digital terrestrial STUs currently available in the Australian retail market incorporate a terrestrial broadcast tuner/demodulator which enables consumers to receive digital FTA services using their analogue television sets.

STUs used to enable pay TV subscribers to receive pay TV transmissions have different hardware and software compositions to those used to receive FTA broadcasts. This is primarily because, unlike FTA broadcasts, pay TV signals are encoded to prevent unauthorised access and piracy. As such, pay TV STUs incorporate a conditional access system (CAS), which controls the supply of pay TV services. There are two main components of a CAS: the subscriber management system and a smart card.

The subscriber management system is a database of information about a pay TV operator's subscribers, including the viewing entitlements of all of those operator's subscribers. The subscriber management system interfaces with the CAS to disable or enable the reception of specific pay TV services by pay TV subscribers. The smart card uses information transmitted by the subscriber management system to decode pay TV signals.

7.2.2 Interactive services

Some STUs are capable of allowing service providers to supply interactive services to end-users. Interactivity can be at different levels of sophistication. For example, a degree of interactivity is provided by allowing consumers to switch between related channels on their remote controls, or sporting coverage that involves providing the option of viewing multiple camera angles.

Interactivity can also involve more complex applications, such as on-line gaming or the ability to request and retrieve information about a particular program, like sporting statistics. The hardware and software composition of an STU is

dependant upon the complexity of the interactive services to which it facilitates access.⁴

Both the simple and complex forms of interactivity described above potentially fall within the definition of interactivity. In a report on interactive TV services, the Canadian Radio, Television and Telecommunications Commission (CRTC) stated that:

ITV services are difficult to describe in a generic way since they provide an extremely wide range of functions, may be developed by various parties and may be delivered or accessed in several ways. As implied by their name, the only unifying characteristic that defines these services is their 'interactivity'.⁵

The CRTC chose not to define interactive services directly, preferring to describe interactive services as having two characteristics:

- a) a process that involves some form of two-way communication between viewer and content provider (or distributor), and which allows the viewer to provide some form of response including interaction with the set-top box.
- b) a process that provides information or viewing options (including alternative video or audio signals) in relation to the offer of programming services.⁶

The FCC defines an interactive service as a service that 'supports subscriber initiated choices or actions that are related to one or more video programming streams'.⁷

⁴ More complex interactive applications require that the STU include an application program interface (API). The API is 'the software layer between the operating system and the different applications running on the terminal' (refer H. Galperin, 'Can the US Transition to Digital TV be Fixed? Some Lessons from two European Union Cases', *Telecommunications Policy*, vol. 26, 2002, p. 7). Digital service providers generally develop applications on an API to supply their customers with interactive services.

⁵ Canadian Radio, Television and Communications Commission, 'Report on interactive TV services', <http://www.crtc.gc.ca/eng/publications/reports/interactive_tv.htm>, 10 August 2002, accessed 13 February 2003.

⁶ *ibid.*

⁷ FCC, *Non-discrimination in the distribution of interactive TV services over cable*, CS Docket no. 01-7, 2001, p. 3.

All but the most basic forms of interactivity require a return path or 'back channel'. The return path is a data connection between the STU and the service provider which enables subscribers to communicate with the service providers. A return path could be provided through a fixed or wireless network, and does not necessarily need to be the same delivery network supplying the service from service provider to subscriber.⁸

7.2.3 Enhanced and stand-alone interactive services

It is possible to define two types of interactive services: enhanced and stand-alone.

Enhanced interactive services

Enhanced TV services are traditional TV services that are enhanced in that they provide interactive features. There are two types of enhanced TV services.

- Enhanced services can provide additional features by transmitting multiple streams of content and allowing the user to switch between them. For example, the 'Long way to the top' interactive documentary, broadcast through the ABC channel on Austar's digital satellite platform, enabled viewers to select interactive options by broadcasting the material on additional, hidden channels.
- Two-way interactive enhancements to the broadcast signal also provide viewers with additional options and features, but in addition enable the user to exchange information with the pay TV operator through a return path. For example, while a sports broadcast with multiple views of the ground could be achieved without a return path, a two-way interactive enhancement to the broadcast signal could also enable a viewer to chat with other viewers of the sports broadcast through a text window.

⁸ For example, viewers of the Network Ten's Big Brother programs vote via SMS, telephone or over the internet.

Stand-alone interactive services

Stand-alone interactive services are interactive services which are not associated with TV content, such as email or online computer gaming. Stand-alone interactive services require a return path.⁹

7.2.4 Electronic program guide services

In addition to television signals, both analogue and digital STUs make electronic program guide (EPG) services available to end-users. Similar to the types of interactive services described above, there are two types of EPG services- 'now and next' EPGs and interactive EPGs.

All STUs can enable viewers to access now and next EPGs. The now and next EPG provides consumers with information about services on other channels by alternating through a slideshow of the different pages of the program guide. A type of now and next EPG is currently used by Foxtel, Optus and Austar, and takes up one channel of video capacity.

Interactive EPGs enable consumers to make channel selections from within the EPG, set reminders to watch certain programs at certain times, book pay-per-view services and bookmark shows for recording. Austar currently provides an interactive EPG to some of its subscribers on its satellite platform, ITV Home. ITV Home enables viewers to select Austar's other interactive services, access information about pay-per-view events and set reminders for upcoming programs.¹⁰

⁹ However, as convergence occurs, service definitions become more challenging. It is possible that a consumer could access a stand-alone interactive service from an interactive enhancement to the broadcast signal, i.e. a link to an advertiser's online store from an enhanced advertisement.

¹⁰ Austar, 'Austar interactive TV', <http://www.austar.com.au/default_frm.htm>, accessed 18 February 2003.

7.2.5 STUs currently used by Australian pay TV and FTA operators

At present most STUs deployed in the Australian market are either analogue or low functionality digital STUs.

- Both Foxtel and Optus have deployed analogue STUs to service their HFC pay TV subscribers.
- Foxtel's satellite subscribers receive pay TV services through digital STUs. These digital STUs currently are of a low functionality, and do not enable pay TV subscribers to access interactive services.
- Austar's digital satellite STUs enable its satellite subscribers to receive both enhanced services and two-way interactive enhancements to the broadcast signal. Austar began supplying enhanced services and two-way interactive enhancements to 300 000 of its satellite subscribers in October 2001.¹¹ It has been progressively upgrading its digital STUs to support two-way interactive enhancements to the broadcast signal using a telephone line as a return path.¹²

As part of the pay TV agreements, Foxtel and Telstra gave section 87B undertakings to digitise their network subject to the Commission exempting Foxtel and Telstra from further access regulation. As part of this network digitisation, Foxtel intends to deploy STUs capable of providing complex interactive services, such as access to sports statistics and player profiles during sporting events to its pay TV subscribers.¹³

¹¹ Open TV, *Success story: Austar- leading the pack with interactive TV*, 2001, <<http://www.opentv.com/utilities/success-stories/Austar.pdf>>.

¹² Austar currently offer enhanced versions of Channel V, Nickelodeon, and the weather service. Austar also offer a leader board game service, which enables subscribers to post their high scores on the leader board and possibly win prizes: Austar, above n. 10.

¹³ D. Craig, 'Foxtel boss outlines plans for new interactive TV services later this year', *Communications Day*, 17 February 2003, p. 1.

7.3 Concerns about access to carriage and STUs raised during the Commission's consideration of the pay TV agreements

A number of concerns that were raised by market participants about the pay TV agreements involved access to pay TV operators' STUs and/or access to carriage services for pay TV services. These concerns were that the pay TV agreements would:

- increase Foxtel's power in the market for pay TV content acquisition, and increase barriers to entry for non-affiliated pay TV channel suppliers to secure distribution for their content to the market for pay TV content acquisition
- increase Foxtel's ability to control the gateway for digital services to pay TV subscribers
- increase the scope for Foxtel to discriminate against non-affiliated FTA and pay TV channel suppliers in favour of affiliated content in EPG access and placement.

The Commission's views on these issues are provided below.

7.3.1 Increased barriers to entry for non-affiliated pay TV channel suppliers

The Commission's view was that the pay TV agreements would, to some extent, enhance Foxtel's power in the market for the acquisition of pay TV content, and placement of content on both the Optus and Foxtel pay TV services. This is because the pay TV agreements weaken Optus' incentive to buy pay TV content, allow Optus to access all of Foxtel's content, and require Optus to supply any movie or sports rights that it acquires in future to Foxtel (if Foxtel has not already acquired those rights). This requirement also applies to any content produced by Optus.

As such, a reduction of competitive tension between Foxtel and Optus in the market for the acquisition of pay TV content is likely to adversely affect the bargaining position of channel suppliers, as they will lose the benefits associated with the competitive tension and competition between Optus and Foxtel. A reduction in the bargaining power of channel suppliers may make it difficult for pay TV channel suppliers to secure adequate distribution for their content.

This issue may be particularly problematic where Foxtel affiliated and non-affiliated channels compete for subscribers (if on a tier) and advertisers. There is scope for Foxtel, as a vertically integrated pay TV provider, to provide favourable terms and conditions of access (such as tiering, pricing or EPG placement) to its platform for affiliated pay TV content. Where Foxtel affiliated channels directly compete against non-affiliated channels, any favourable supply treatment can have implications for the upstream acquisition of content, as the supply advantage means it is better placed in any competition to acquire content.

7.3.2 The access to carriage undertakings

The pay TV agreements may reduce competitive tension between Foxtel and Optus for pay TV content acquisition and, as such, reduce the bargaining position of channel suppliers. The access to digital carriage undertakings seek to mitigate this concern by providing the opportunity for non-affiliated channel suppliers who cannot reach reasonable commercial terms with Foxtel to obtain access to Telstra's cable and Foxtel's STUs to supply an independent pay TV service. To the extent that the undertakings provide the opportunity for pay TV operators to enter the retail pay TV market, they also provide channel suppliers with alternative buyers for their content.

The access to carriage undertakings (both analogue and digital) are subject to additional regulatory processes that the Commission is currently conducting. The Commission is conducting an

assessment of Telstra and Foxtel's analogue access undertaking under section 152BS of the TPA, and has received exemption applications under section 152ATA of the TPA from Telstra and Foxtel for digital pay TV services. However, the digital access undertaking applies to any future digital service offered by Foxtel and Telstra, irrespective of the Commission's decision on the exemption application.

7.3.3 The most appropriate form of access regime

During the Commission's consideration of the undertakings, some industry participants were concerned about the effectiveness of access regimes. A discussion of these concerns is contained in chapter 4.

Some industry participants believed that the Commission should provide a wholesale form of access in which a content provider's content would become a tier within Foxtel's service offering. The distinction between a wholesale form of access and the access model within Part XIC is that a wholesale form of access would not require access seekers to invest in elements of a service to manage their own customer relationships separately, such as billing and subscriber management systems. Rather, these would be provided by Foxtel.

The access model set out in Part XIC of the TPA provides that access is to a carriage service or a service that facilitates the supply of a carriage service.¹⁴ Some flexibility exists within Part XIC for the Commission to define the appropriate boundaries of those elements of a carriage service that are declared, and those which must

¹⁴ Section 152AR(8) of the TPA provides that where an access provider supplies a declared carriage service using conditional-access customer equipment, an access seeker has a right to any service necessary to enable to access seeker to supply the carriage service and/or content services by means of the declared service. One potential limitation of these provisions is that access providers may be able to introduce corporate structures to avoid their obligations to access seekers for the provision of conditional access equipment. As such, the Commission believes that the Government should consider amending section 152AR(8) so that access obligations are placed on any persons who provide the declared service.

be supplied by the access seeker. However, typically the boundary has been drawn at a point which does not result in mandated access to elements of supply that can be characterised as retail services.¹⁵

The section 87B undertakings offered to the Commission are based on the Part XIC approach. In deciding whether to accept these undertakings, the Commission recognised that the retail costs of supply may be significant for an access seeker only supplying a limited number of channels, and that Foxtel's incentives to commercially negotiate supply of such retail functionality may not be strong. However, the Commission also recognises that access to all elements of a retail pay TV service reduces opportunities for competition on such elements. It was therefore cautious to request a change in approach for access to pay TV carriage.

Having said that, the access to carriage undertakings provided to the Commission by Telstra and Foxtel are currently the subject of further regulatory processes contained in Part XIC. These statutory processes provide the opportunity for further public consultation and involve a determination on whether the analogue undertaking and/or digital exemption are in the long-term interest of end-users.

7.3.4 Control of the gateway for the provision of digital free-to-air and other digital services to pay TV subscribers

To receive FTA digital services delivered by terrestrial broadcast a consumer must have a device that can receive the FTA digital signal—either a digital STU or a digital TV which

incorporates a digital tuner (and other necessary functionality). Pay TV subscribers can receive FTA digital services through their pay TV STU if their pay TV operator retransmits the FTA digital signal. That is, the pay TV subscriber would not have to buy a separate STU to receive FTA digital services.

Some industry participants have argued that the pay TV agreements enable Foxtel to control the gateway for digital FTA and other digital services to pay TV subscribers. The term gateway appears to be intended to reflect that access to the STU and network is essential to the supply of certain digital services to pay TV subscribers.¹⁶ That is, to say that Foxtel would control the gateway for the provision of digital FTA services is to argue that pay TV subscribers will be unwilling to buy a terrestrial broadcast STU, either because of cost considerations and/or concerns about 'stacking' STUs.

The Commission is sceptical about whether or not customers will 'stack' STUs, as consumers seem willing to stack many other electronic entertainment equipment, such as amplifiers, videos and DVDs. The more relevant issue appears to be whether pay TV subscribers will also invest in a digital terrestrial STU. The future price of digital terrestrial STUs and the attractiveness of digital FTA broadcast (and potential interactive) services are likely to be important factors for consumers when deciding whether or not to buy an additional STU.

A further argument that has been made to the Commission is that only pay TV operators are likely to supply interactive services which require a return path, as FTA broadcasters do not have a business case to independently invest in the back-end infrastructure (e.g. subscriber management systems) required to supply these services. Such enhancements will permit more targeted and interactive advertising services, and third party access to this infrastructure would enable FTA broadcasters to provide such services to pay TV subscribers.

¹⁵ The access seeker and access provider are also free to commercially negotiate for the supply of such services. However, there is no obligation on access seekers or access providers to use or supply such services: see the Commission's discussion in Australian Competition and Consumer Commission, *Declaration of an analogue subscription television broadcast carriage service*, October 1999, p. 8.

¹⁶ It is therefore conceptually similar to the concept of access to bottleneck facilities.

When assessing the pay TV agreements, the Commission considered whether, as a result of the agreements, Foxtel would be in a position to control the gateway for digital FTA services and other digital services to pay TV subscribers. In particular, Optus' presence in some areas provides a potential competing digital platform for retransmission of FTA services and the supply of other digital services. While Optus does not have any plans for digitising its network at present, it is likely to have strong incentives to digitise its network once Foxtel and Telstra digitise their HFC distribution network. Even though Optus transferred ownership of its aggregation and digital broadcasting equipment to Foxtel earlier this year, it has retained rights to use these services in the future.¹⁷

It is relevant that the pay TV agreements do not allow Foxtel to determine Optus' or Austar's choice of STUs. That is, Optus and Austar appear to maintain similar levels of independence in determining the type of STUs and access arrangements to their STUs and networks as they did before the pay TV agreements.

Further, some industry participants argued that if Optus decides to supply a digital pay TV service, any STU in its subscriber's households will have to be compatible with Foxtel's STUs because it will need to take all of Foxtel's content. However, the content that Optus receives from Foxtel is either delivered without any interactive component, or, where the content has an interactive component embedded, the service will be delivered in a manner that permits Optus end-users to receive the Foxtel service without the interactive component. Optus compiles its own EPG using data supplied by Foxtel.

Having said that, the pay TV agreements established a closer relationship between Foxtel and Optus for the supply of pay TV content, which has since been further strengthened by the transfer of aggregation and digital broadcasting facilities.

The Commission has already noted its concerns about the level of integration and weak level of competition in the pay TV industry. The Commission is particularly concerned to ensure that Optus continues to maintain its rights to independently determine the nature of digital pay TV and interactive services it may provide in the future and the functionality of any digital STUs it introduces. In light of these concerns, the Commission has written to both Optus and Foxtel noting that it will be closely monitoring future developments in relation to these issues in the pay TV industry.

The Commission decided that, on balance, the agreements would not significantly increase Foxtel's ability to control the gateway for digital services to pay TV subscribers. First, there is doubt about the degree to which the Foxtel/Telstra network will be the only digital network for the delivery of FTA services to pay TV subscribers. Second, it was not clear that the agreements strengthened Foxtel's market power given Optus' continued independence in the supply of FTA and digital interactive services.

7.3.5 Access and placement on Foxtel's EPG

As the pay TV agreements strengthened Foxtel's position in the market for pay TV content acquisition, the Commission was similarly concerned about Foxtel's ability to discriminate against non-affiliated channels in relation to placement upon Foxtel's EPG. That is, potentially favourable treatment on the EPG is a subset of Foxtel potentially favouring its affiliated channels over independent pay TV channels.

In response to this concern, a provision was inserted in Foxtel's digital access undertaking requiring Foxtel to negotiate with an access seeker for EPG services. Any dispute which arises in negotiations between the access seeker and Foxtel for access to EPG services is subject to the dispute resolution provisions within the digital access agreement.

¹⁷ Optus, *Optus CMM announces strategic initiatives*, media release, 5 February 2003.

7.4 Ongoing concerns about the supply of FTA services on pay TV networks

Irrespective of the Commission's views of the impact of the pay TV agreements, some submissions to the Commission have argued that new forms of access should be introduced to provide for the supply of digital FTA channels on digital pay TV networks (and particularly the Foxtel/Telstra network).

The basis of this argument is similar to that raised for the pay TV agreements— that pay TV operators will control the gateway for all digital services to pay TV subscribers in the future, including digital FTA services. The argued implications include that a significant reduction in the audience reach of FTA broadcasters will result if they are unable to provide digital FTA services to pay TV subscribers, which will reduce the advertising revenue of FTA broadcasters, and thus affect the quality of FTA services.

Two forms of access have been proposed by those advocating the need for such legislation:

- mandatory retransmission of all digital FTA TV and enhanced services by pay TV operators, and/or
- inclusion of a tuner capable of receiving the FTA digital terrestrial broadcast signal within the pay TV operators' future digital satellite STUs.

The first form of access is focused on fixed pay TV networks (particularly existing HFC networks), and the second on satellite delivery. The reason for the proposed different treatment is that retransmission of all regional versions of FTA broadcasts may not be technically be commercially feasible due to cost and the lack of available satellite capacity (discussed further below).

Any access regulation or mandated use of technology has potential costs, and therefore an assessment of the net benefits of mandating such forms of access is required. This includes an

assessment of the benefits to promoting competition and efficient investment, to which an assessment of whether pay TV networks are a gateway to digital services is relevant. A related issue is whether the issue can be sufficiently resolved through commercial negotiations, which may result in access even if digital pay TV networks have bottleneck characteristics for the delivery of digital services. Finally, any form of access necessarily involves a determination of who is responsible for the costs of access, and in what quantum.

Notwithstanding the Commission's belief that government intervention is not required on competition grounds at this time, it does note that a more competitive pay TV market would increase the likelihood of efficient outcomes occurring in the supply of digital FTA and interactive services on pay TV networks. In a more competitive market, pay TV operators may have greater incentive to facilitate the supply of digital FTA and interactive services in an effort to seek competitive advantage.

7.4.1 Retransmission of digital FTA services

Submissions to the Commission have argued for legislation requiring retransmission of the FTA digital signal in an unaltered form, including any enhancements to the signal by pay TV operators. There have also been suggestions that this retransmission should occur at no charge and that the digital FTA services should receive prominent placement on pay TV operators' EPGs.

The issue of retransmission is complicated somewhat by PBL's joint ownership of the Nine Network and 25 per cent ownership of Foxtel, which may provide scope for favourable treatment for the Nine Network. The potential for favourable treatment may provide additional support for regulation to provide non-discriminatory treatment between FTA broadcasters.

The government may not need to consider specific legislation providing for retransmission of digital FTA services, if the existing access regulation in

Part XIC of the TPA is sufficient to potentially allow for access regulation of FTA services on pay TV platforms. However, while Part XIC could also apply to FTA services over a telecommunications network, the effect of any such declaration is not entirely clear. For example, the SAOs under Part XIC only apply if the access provider is supplying the service to itself or others, i.e. it is an active declared service. If a pay TV operator refuses to supply retransmission services to all FTA providers the service cannot be an active declared service.

Having said this, the Commission does not believe it is sufficiently clear at present whether pay TV networks will be a bottleneck for the delivery of digital FTA services to pay TV subscribers, including for interactive services. Pay TV subscribers have the option of buying consumer reception equipment capable of receiving digital FTA services if they believe the benefits associated with receiving digital FTA services outweigh the costs of buying consumer reception equipment. FTA broadcasters have multiple 'return-path' options, to provide two-way interactive services.

The Commission also notes that requiring access needs to balance potential disincentives to new investment occurring, such as maximising the use of terrestrial broadcasting spectrum. The development of digital broadcasting is at an early stage in Australia.

In making these comments, the Commission recognises that the FTA business-model may not be conducive to the introduction of high functionality digital services. It also makes this comment on the information before it, and it has not had the opportunity to consider this issue in the depth that it would to determine whether declaration of a service promotes the objectives of Part XIC of the TPA. The Commission also recognises that there is some potential for the market to develop where a single STU/pay TV network emerges as the gateway for the reception for all digital television and interactive services. Specific consideration of access provisions for FTA retransmission and interactive services might be required if this occurs.

Having said that, there appears to be some scope for commercial negotiation for retransmission on the Telstra/Foxtel HFC network. Market inquiries indicated that both pay TV and FTA operators gain some benefits from retransmission:

- pay TV subscribers value having the FTA broadcast services on one platform for ease of switching between FTA and pay TV channels¹⁸
- FTA broadcasters gain benefit from increasing distribution to areas unable to receive the terrestrial signal and, in the future, by increasing the penetration of digital TV signals.¹⁹

Foxtel has already reached an agreement with the Nine Network for retransmission of the Nine Network's FTA services as part of Foxtel's cable and satellite services in its broadcast areas across Australia. At the time, Foxtel stated:

FOXTEL will retransmit Nine's standard definition digital service on both cable and satellite together with enhancements and interactive applications (within FOXTEL defined bandwidth and technical parameters) which are also available to Nine's digital terrestrial viewers.²⁰

Foxtel has publicly stated that it also intends to reach retransmission agreements with the other FTA broadcasters.²¹

¹⁸ Over 2002 AC Nielsen ratings data indicated that pay TV subscribers spent 52.5 per cent of their total viewing time watching FTA services: M. Doman, 'Data divide steals pay-TV pulling power', *The Australian*, 16 January 2003.

¹⁹ In the absence of non-competition policy objectives, access regulation would normally provide for an access seeker (in this case FTA broadcaster) to pay the reasonable costs associated with the retransmission of the digital FTA services on the pay TV platform. Pricing may be complicated by the 'mutual benefits' for the retransmission of services by a pay TV provider and FTA broadcaster.

²⁰ Foxtel, *Foxtel announces retransmission agreement with Nine*, media release, 27 December 2002.

²¹ *ibid.*

However, it may be that the scope of the mutual benefits is insufficient for genuine bargaining. Further, the Nine Network's agreement with Foxtel may potentially be a strategy to entice one FTA broadcaster to agree to retransmission so that the other commercial FTA broadcasters believe they need to also reach agreement or they will otherwise suffer a competitive disadvantage. Concerns have been expressed to the Commission that Foxtel's relationship with the Nine Network may provide it with an incentive to favour the Nine Network over the other FTA broadcasters.

In particular, the concern is that Foxtel and Nine's relationship provide an incentive for Foxtel to discriminate in favour of the Nine Network in future transactions, such as any need for retransmission or carriage of the FTA broadcasters on the pay TV platform, and access to STUs and subscribers for the provision of any new services such as interactive services.

The Commission's discusses in more detail its views of this relationship in chapter 4. In short, it recognises there is some potential for favouritism to occur, although some factors may partly mitigate this concern (such that some favouritism may be costly for Foxtel, and therefore Telstra and News Corporation will not permit it to occur).

The Commission wrote to Foxtel in January 2003 asking to be informed about progress of negotiations with the FTA broadcasters, and has had further discussions with some of the parties. The Commission's consideration of this issue is continuing at the time of writing this report.

7.4.2 Dual terrestrial/satellite tuner digital STU

Industry participants have expressed further concern that satellite pay TV subscribers will be unable to receive all digital FTA services. In particular, some industry participants have expressed concern that the majority of digital FTA services will not be re-transmitted on the satellite platform as such retransmission is not commercially feasible.

As a solution to this problem, submissions have advocated legislation which requires pay TV operators to include a digital terrestrial tuner in their digital satellite STU (creating a 'dual tuner STU'). Those advocating this policy contend that a dual tuner STU is the only commercially feasible method of ensuring that satellite pay TV subscribers are able to access all digital FTA services, as it would also enable subscribers to receive digital FTA services through terrestrial broadcast.

An alternative solution would be to mandate a 'common STU arrangement'. Common STU arrangements differ from a dual (satellite/terrestrial) tuner STU in that they would require pay TV operators, irrespective of delivery platform, to include a terrestrial broadcast tuner in their STUs. A dual tuner STU would only enable satellite pay TV subscribers to receive digital FTA signals through the terrestrial broadcast platform.

The minister has already consulted with industry on the merits of a common STU arrangement to facilitate delivery of digital pay TV and FTA services. The Commission understands that, while there was general agreement in the minister's consultation process that a common STU arrangement is technically feasible, there was no agreement as to the commercial viability of the proposal, and the benefits of the proposal to the public. The Commission also shares the minister's view about caution being required, as regulatory intervention could soon be over-taken by rapid technological developments in the customer equipment market, or be counterproductive by inhibiting innovations that may benefit consumers.

A dual (satellite/terrestrial) tuner STU would presumably be less costly than a common STU arrangement, as it would only facilitate the reception of digital TV delivered by terrestrial broadcast in pay TV operators' digital satellite STUs. However, many of the issues in mandating a dual tuner are similar to those for a common STU.

Costs of a dual tuner STU

The Commission lacks information about the costs of introducing a dual tuner STU. Although industry participants seem to agree that the inclusion of a terrestrial broadcast tuner in pay TV operators' digital STUs would increase its cost there has not been agreement as to the magnitude of this cost. Inquiries also suggest that, while a dual tuner is technically feasible, it may need to be developed specifically for the Australian market and possibly for each pay TV operator.

In addition to the hardware costs, introducing a dual tuner STU may have other less direct costs. For example, it may affect the timeframes of the digitisation plans of pay TV operators. It is also likely that there will be ongoing maintenance costs for all deployed dual tuner STUs. Some industry participants have suggested that there would be issues regarding who would be responsible for the maintenance of STU faults relating to the terrestrial broadcast tuner/demodulator.

There may also be increased business risks on pay TV operators in installing dual tuners in their digital STUs. For example, if a dual tuner is superseded by other technical developments, there may be a need for further dual tuner STU investment.

If the government was minded to introduce a dual tuner STU, it would need to consider the impact of these costs particularly on smaller pay TV operators to enter the market or expand their operations. However, this concern may be mitigated if the FTA broadcasters contribute to the costs of introducing the dual tuner STUs, as normally occurs for access regulation.

As the Commission believes that it is not sufficiently clear whether pay TV networks will be a bottleneck for the delivery of digital FTA services to pay TV subscribers, and given current negotiations between the FTA broadcasters and Foxtel, the Commission does not recommend that the government introduce legislation requiring pay TV operators to incorporate a terrestrial broadcast tuner in their digital STUs.

7.5 Stand-alone interactive services

In addition to legislation which would facilitate pay TV subscriber's access to digital FTA television and enhanced services, some submissions to the Commission suggested access regulation for carriage of stand-alone interactive services. Submissions have argued that without such access regulation, access seekers will be unable to compete with pay TV operators for stand-alone interactive services to pay TV subscribers.

The Commission does not believe any government action is required on this issue at present. If potential providers of stand-alone interactive services are unable to reach commercial agreement, the issue of access could be considered via a public declaration inquiry under the TPA.²²

7.6 Conclusions and recommendations

Interested parties have provided comments that government legislation is required to mandate FTA retransmission on HFC pay TV networks and introduce dual tuner satellite/terrestrial STUs. The Commission believes that it is premature for the government to consider legislation in this area while it is unclear if pay TV operators will control the gateway for digital services to pay TV subscribers, and while there may be opportunity for current commercial negotiations between pay TV operators and the FTA broadcasters to be finalised.

That said, the Commission is continuing to monitor developments in this area and recognises that, in the event that pay TV networks become

²² This comment is only intended to note that stand-alone interactive services appear to be within the scope of Part XIC of the TPA, and is not any indication that the Commission would or would not declare such services if it undertook a public inquiry into potential declaration.

'gateways' to their subscribers for digital services, there may be a case for future regulatory intervention in this area. In particular, it is currently investigating concerns about current negotiations between Foxtel and the commercial FTA broadcasters for retransmission of the digital FTA services.

8 Bundling

8.1 Overview

The minister's letter of 12 March 2002 sought advice on whether bundling of pay TV, telephony and broadband services is likely to affect competition across the communications sector. The minister indicated in this letter that some carriers were surprised that Australia does not regard bundling as anti-competitive behaviour, considering the approaches adopted in Hong Kong and the United Kingdom.

Bundling generally refers to the situation where two or more products or services are sold as a single package. In Australia, such bundling may trigger pro-competitive benefits or be detrimental if it is used anti-competitively.

Parts IV and XIB of the TPA contain provisions that prohibit anti-competitive conduct. Bundling may also be considered under the notification and authorisation provisions of the TPA. All cases are assessed separately to determine whether bundling is anti-competitive or in the public interest (depending on the relevant provisions).

Telstra Corporation Limited and Telstra Pay TV Pty Limited lodged exclusive dealing notifications under Part VII of the TPA with the Commission on 15 July 2002. The notified conduct involved the inclusion of Foxtel's pay TV services, to be supplied by Telstra Pay TV Pty Ltd, in Telstra's

existing rewards packages, for which a customer receives either a 5 or 10 per cent discount off the retail price of the service. The level of discount depends on the number of services the customer obtains in the rewards package.

Many industry participants have raised concerns about the bundling of services in telecommunications markets, especially by Telstra in the context of the Commission's consideration of the Telstra notification. They have argued, for example, that Telstra's bundling of pay TV with telecommunications services is anti-competitive. Some participants have also raised concerns about the general increase of bundling in telecommunications, including the perceived lack of transparency of Telstra's costs.

After assessing the Telstra notification, the Commission decided on 12 November 2002 that the immunity for the notified conduct should be allowed to stand, and therefore that Telstra be able to bundle pay TV and telecommunications services. However the Commission may revisit its decision if its continued general monitoring reveals that the impact of the notified conduct is different from the Commission's expectations.

Given the more general concerns about bundling, the Commission released a draft information paper on bundling in telecommunications markets in January 2003. The paper provides

guidance to carriers, CSPs, and other industry stakeholders (including end-users) on the Commission's likely approach to assessing whether specific bundling conduct in the telecommunications industry is anti-competitive. It details key factors the Commission will consider in determining whether a carrier or CSP has engaged in, or is engaging in, anti-competitive conduct.

The paper also discusses the Commission's information gathering powers, outlining how it proposes to use these powers, especially its record-keeping rule (RKR) power to help monitor bundling conduct. This RKR will allow the Commission to investigate and evaluate potential anti-competitive behaviour.

Two reports prepared by National Economic Research Associates (NERA) for the Commission were released with the draft information paper. The first was on the application of imputation tests to a bundle of services in the telecommunications industry. The second report discussed anti-competitive bundling strategies, focusing on instances where the bundling of a carrier or CSP may effectively reduce the customer base available to its competitors- the 'addressable market' of competitors.

Naturally, the draft information paper is premised on the current provisions of the TPA. The minister's letter raises the broader issue about whether the current regime is too permissive for bundling by telecommunications providers with market power and that some *ex ante* or modified regulation may be required. Other interested parties have also raised this issue with the Commission.

The Commission has commented on the most obvious modifications that could be made to the TPA, which are either potentially some type of clearance process for bundling conduct or limiting such conduct in the telecommunications industry (such as prohibiting some types of bundling).

More specific *ex ante* consideration of some types of bundling conduct in telecommunications may offer some benefits, as occurred when the Commission considered the Telstra pay TV

bundling conduct.¹ However, the Commission does not believe there is a clear case for such a process to apply more generally to bundling conduct, given a lack of evidence that current bundling conduct in telecommunications is anti-competitive. However, the Commission is finalising its guidelines on bundling and has issued an RKR to Telstra in relation to its bundling practices. Depending on the outcome of these processes, the Commission may provide further comment to the minister in the future on this issue.

This chapter briefly outlines the Commission's views about the potential benefits and costs of bundling behaviour. It then explains the Commission's decision on Telstra's notification, and more general views about determining whether specific bundling conduct is anti-competitive. The chapter also reviews the current legislation and comments on its appropriateness to deal with bundling behaviour in telecommunications and pay TV markets.

8.2 Background on bundling in communications markets

Bundling generally refers to the situation where two or more products or services are sold as a single package.² The price of the package is usually at a discount to that of acquiring given amounts of the products separately, and a residential consumer is likely to receive only one bill for all of the bundled services.

¹ The reason this specific conduct was notified to the Commission, was that it qualified as 'third line force' conduct under section 47 of the TPA. Such conduct is prohibited, unless notified to the Commission. The Commission can decide to issue a notice revoking the notification, if it does not believe the public benefits of the conduct outweighs the respective social costs.

² Most products can be considered a bundle of inputs, depending on the level of specificity. In this chapter, the primary focus is on bundling between well-established product categories within communications markets, such as national long-distance calls and dial-up internet services.

Carriers and CSPs use various strategies to sell bundled telecommunications services. A 'mixed bundling' strategy means the products are available both individually and in a package. For example, Telstra's GSM and CDMA mobile telephony services can be bought separately or bundled with fixed telephony services in its rewards packages.

In a 'pure bundling' strategy a product is sold only on a bundled basis. In telecommunications, line rental and local calls generally are not sold as individual services but are only sold together in a pure bundled package. In pay TV, the basic content package consists of a bundle of channels that are not sold individually.³

A further strategy involves making the supply of one service (the tying product) conditional on one or more other services (the tied products) also being supplied. This is commonly referred to as tying. In this case the tying product is only available on a bundled basis. For example, Telstra will only supply pay TV if the customer buys at least fixed telephony services. Also, pay TV content tiers such as the movies tier can only be bought in conjunction with the basic package.

Both Telstra and Optus have publicly stated their views on the importance of bundling in retaining and attracting new customers.⁴ For example, Dr Switkowski, Telstra's Chief Executive Officer, made the following statement:

We began by introducing single bill options for customers with fixed and mobile services early last year. More than 700 000 customers, or just over 10%, now get a single bill. This alone has a significant impact on reducing churn for both fixed and mobile customers.

Last September, we introduced 'true' bundled product offerings to the residential market, where customers receive discounts when they group together their fixed, mobile and internet services. The early results are

very pleasing, with nearly half a million customers signing up in the first three months. These customers are twice as likely to be high value and three to four times as likely to remain loyal to Telstra.⁵

Smaller carriers and CSPs also offer an array of bundled packages, although often with more limited services than those offered by Telstra and Optus. For example, Primus offers a discount for a single bill bundle comprising long-distance calls, international calls and internet access.

8.2.1 The potential benefits and detriments of bundling

Bundling can result in greater efficiencies and competition, benefiting both consumers and the carrier or CSP supplying the bundled services. It can allow carriers or CSPs to exploit economies of scope between bundled goods, and economies of scale if the bundling has a major impact on consumer demand. Because it can be a cost effective way of marketing goods and services to consumers, bundling can also enhance the ability of carriers or CSPs to compete.

Consumers gain when the benefits of economies of scope and scale are passed on as lower retail prices or quality improvements. Consumers may also enjoy lower transaction costs by buying a range of related and compatible products from a single supplier, or otherwise prefer receiving one bill for a range of different services.

Bundling can enable carriers or CSPs to discriminate between the price of services when they are supplied as a part of a bundle or individually, allowing them to set prices so that profits are maximised and efficiency is increased.⁶

³ A pay TV service is itself a pure bundle of a transmission service and programming.

⁴ For commentary on the importance of bundling in converging markets, see Europe Economics, *Market Definition in the Media Sector- Economic Issues- Report by Europe Economics for the European Commission*, DG Competition, November 2002, p. 61.

⁵ Z. Switkowski, speech to Salomon Smith Barney conference, Melbourne, January 2001. The text of the speech is available from the company announcement part of the Australian Stock Exchange website <www.asx.com.au> dated 11 January 2001.

⁶ Price discrimination can be defined as the practice of charging different prices to different consumers, for the same goods, if the price differences do not reflect differences in the cost of supply. Carriers or CSPs can also price discriminate via other means, such as different pricing for different geographical areas, and discounts for 'consumer loyalty'.

However, in competitive markets with few firms, a carrier or CSP may use bundling as a strategic tool, and while this may offer short-term benefits it can cause long-term harm if competition decreases. They may also use bundling for anti-competitive purposes or resulting in anti-competitive effects which again can be detrimental for consumers and competitors of the carrier or CSP supplying the bundled services.

Used anti-competitively, bundling may foreclose or reduce competition by enabling the carrier or supplier to leverage market power from one market to another. In this way bundling can diminish competition or significantly reduce the ability of competitors in a particular market— who may not be able to match the scope of a bundle—to effectively compete. The pricing of a bundle of services may also be anti-competitive, particularly if it is predatory or results in a vertical price squeeze.

8.2.2 Enforcement of bundling conduct under the Trade Practices Act

The effects of bundling can be assessed under several provisions of the TPA, depending on the specifics of the conduct. The different provision may have different criteria to evaluate whether the conduct breaches the TPA. Both Part IV and the telecommunications-specific Part XIB of the TPA may be used to take enforcement action against anti-competitive conduct in telecommunications markets. If assessed under the anti-competitive conduct provisions, the behaviour may be subject to:

- a competition test, i.e. whether the conduct has the effect of substantially lessening competition in one or more of the affected markets (refer sections 45, 47 or 151AJ), and/or
- a purpose-based test, i.e. whether the conduct engaged in by the corporation has the purpose of substantially lessening competition (also refer sections 45 or 47); or that the corporation took advantage of its substantial market power for one of the proscribed purposes set out in section 46.

It is important to note that the Commission will assess bundling conduct on a case-by-case basis, taking into account the specifics of conduct. These specifics include the extent of market power held by the carrier or CSP providing the bundled services, the types of services being offered in the bundle, and the structure of the markets for these services.

The Commission can investigate whether the conduct is anti-competitive by using its information gathering powers (these are discussed below). When it determines that the conduct is anti-competitive, the onus of proof is on the Commission to demonstrate to the court that such behaviour breaches the TPA.⁷

A carrier or CSP is able to apply for an authorisation for conduct that may otherwise be anti-competitive. The effect of an authorisation, if granted, is that where the conduct is engaged in, no party to the authorised conduct will be in breach of Part IV of the TPA. The relevant test for authorisation is whether the public benefits likely to flow from the conduct outweigh the detriment.

A special case is third line forcing conduct, which involves the supply of goods or services, or their supply at a discount, on condition that the buyer acquire goods or services from a particular third party.⁸ This conduct is a *per se* breach under the anti-competitive conduct provisions, meaning that the conduct is illegal irrespective of its impact on competition. However, such conduct can be notified and as such is effectively subject to a public-interest based test.

⁷ An exception to this is where the Commission issues a Part B competition notice under section 151AN.

⁸ The TPA distinguishes between conduct known as third line forcing and full line forcing. In particular the TPA prohibits a corporation from forcing the product of another company, even its related company, or offering a discount on that basis (a third line force). However, if the same practice was to occur within the one corporate entity, the practice would be considered full line forcing and be subjected to a competition test under sub-section 47(2). The conduct would be lawful if it did not have an adverse effect on competition.

Information gathering powers

The Commission has specific information gathering powers relevant to its role under Parts XIB and XIC of the TPA. It also has a broader information gathering power under section 155 of the TPA.

The telecommunications specific powers, which are the tariff filing direction and RKR powers, allow the Commission to examine the pricing conduct of carriers and CSPs when there are concerns about anti-competitive behaviour, or to assist in the performance of the Commission's other statutory functions in respect of telecommunications. These powers also enable the Commission to monitor market behaviour within the telecommunications industry, allowing it to develop appropriate regulatory responses.

The general tariff filing powers allow the Commission to direct a carrier or CSP, with a substantial degree of market power in a telecommunications market, to provide it with certain information on present or future tariffs for any service. Information must be given to the Commission seven days in advance of imposing new charges, varying or ceasing to impose those charges for goods or services coming within the direction.

The *Telecommunications Competition Act 2002* allows the minister to direct the Commission in how it uses the RKR power in a particular instance. Under this Act, the minister has outlined a proposal to extend the accounting separation regime in the RAF RKR.⁹

The Commission's draft information paper on bundling outlined the information gathering powers and how the Commission proposed to use these powers in relation to bundling. The Commission has since issued a RKR to Telstra seeking information to assess the effects of bundling on competition across a range of telecommunications markets. The information being sought includes discounts on a bundle of services, the number of customers receiving

bundled services and whether customers acquiring a bundled service previously received the services which form the bundle from Telstra or another provider. The Commission is at present considering whether to publish some of this information.¹⁰

The Commission is likely to seek further information relating to bundling in the near future from other providers of bundled services.¹¹

8.2.3 Industry concerns relating to Telstra bundling pay TV services and telecommunications services

On 12 November 2002 the Commission decided to allow Telstra's immunity under the notification to stand. The Commission was satisfied that the likely benefit to the public would outweigh the any detriment from the conduct.

Many carriers and CSPs were concerned that the conduct (that is, Telstra including Foxtel's pay TV services in its rewards packages) would reduce the ability of less-integrated telecommunications providers to compete (the 'addressable market' argument). Many submissions argued that telecommunications carriers and CSPs who could not bundle pay TV services would not be able to compete with a Telstra bundle that included the Foxtel pay TV services as they would not have access to the same customer base as Telstra. The reasons stated for this inaccessibility of customers were: the convenience of a bundled service offering and a single bill; the discounted pricing available from a bundled service offering; the length of contracts for some services within the bundle; and increasing consumer preferences for pay TV services.

⁹ Section 151BUAAA requires that the Minister provides such a direction.

¹⁰ A copy of the RKR is available at <www.accc.gov.au/telco/rkr/RKR_Telstra.pdf>. Further consultation processes would have to occur prior to any final decision being made about the proposed changes to the RAF.

¹¹ Australian Competition and Consumer Commission, *ACCC issues Record Keeping Rule to Telstra for bundling*, media release, 21 March 2003.

In making its decision the Commission was restricted to considering the effect of the notified conduct (including pay TV services in the rewards package) and not the effect of the rewards package or the effect of bundling in telecommunications markets more generally. The Commission also considered the pay TV agreements simultaneously with the notified conduct.

The Commission also analysed the dynamics of the affected markets and the specifics of the conduct. It took into account: the level of discounts offered, including the 'anniversary discount' available to existing customers; the current level of pay TV penetration; and Telstra's forecasts for the uptake of its rewards packages.¹²

The Commission concluded that the likely effect of the conduct would be a small net public benefit because:

- The conduct would cause a modest increase in competition in markets for pay TV services. In particular, the additional supply of Foxtel would increase consumer choice and price competition for customers that can currently receive Foxtel or Optus, although this benefit may be limited by the terms on which Foxtel supplies Telstra Pay TV, Telstra's 50 per cent equity interest in Foxtel (which may reduce incentives to compete), and Optus' lack of programming differentiation from Foxtel.
- The conduct would cause a modest increase in competition in markets for telecommunications services. This is because the conduct allows some, albeit a relatively small number, of existing Telstra internet and mobile telephony customers to acquire services from other providers without affecting the discounts they receive on their fixed line services. The conduct is also likely to stimulate competitive tension in telecommunications markets, while not

materially affecting the ability of less-integrated service providers to compete or imposing a vertical price squeeze within markets for telecommunications services.

The reasons for this view were that currently customers do not have to subscribe to Telstra's rewards packages to acquire retail pay TV services because they are available from various providers. For example, Foxtel, TARBS and Neighborhood Cable supply stand-alone pay TV services while others such as Optus and TransACT supply bundled pay TV and telecommunications services in areas where Telstra will now be able to supply.

The Commission notes that some carriers such as TransACT and Neighborhood Cable can also access pay TV content through Foxtel's infrastructure operators content supply undertaking.¹³ However, particularly as some carriers and CSPs are unable to obtain content this way, the Commission will continue to monitor bundling in the industry, including pay TV content, to see if there is a material change in how the notification affects the addressable market of these participants.

- The conduct would help the long-term viability of the pay TV industry. The Commission was not satisfied, however, that the conduct would increase penetration rates other than by a modest although appreciable amount, in turn only modestly lowering unit costs, and so the Commission attributed a small public benefit to this factor.
- The conduct would avoid costs that would be incurred if Telstra supplied retail pay TV and telecommunications services through the one entity. These costs could comprise either a one-off cost to amend the constitution of Telstra Corporation allowing it to supply services other than telephony services, or ongoing costs of churning those Telstra Corporation customers to Telstra Pay TV that subscribe to retail pay TV services. While the

¹² The anniversary discount is a further 15 per cent discount to relevant charges incurred by a customer in the anniversary month, after the usual discount for that month, which is applied to the customer's account in the anniversary month of subscription to the rewards package each year.

¹³ This agreement was provided by Foxtel to mitigate the Commission's concerns relating to the CSA.

Commission considered that this could be considered a public benefit, it gave relatively little weight to this matter.

The Commission's decision to allow the resulting immunity to stand only applies to the notified conduct including the specified discounts, although Telstra has disputed this.¹⁴ In any event, the Commission believes this decision does not preclude it from reconsidering the matter or revoking immunity, if appropriate.

8.2.4 General industry concerns relating to bundling

Industry participants have expressed concerns to the Commission about the bundling practices of other carriers or CSPs in the industry, mainly those of Telstra. These concerns are in addition to those raised specifically about Telstra's third line force notification.

Industry participants are also concerned about the possible use of bundling to foreclose competition through tying or leveraging market power and that Telstra's ability to bundle fixed line services with competitive products allows it to use its market power to significantly damage competition. This would occur if Telstra extends its dominance in fixed line telephony to foreclose or adversely affect competition in those competitive markets.¹⁵

Similar concerns have been raised that Telstra's bundling can allow it to foreclose competition in new and emerging markets. In particular, Hutchison believes there is a real danger that Telstra's bundling practices, including other bundling behaviour before its notification, will enable it to deter or prevent competition in the

emerging market for 3G mobile communications services.¹⁶

Industry participants have also raised concerns about the pricing of bundled packages, in that bundling removes full price transparency to consumers, competitors and regulators, thereby potentially disguising anti-competitive pricing. Potential anti-competitive pricing includes a price squeeze or predatory pricing.

- A price squeeze occurs when a vertically integrated carrier tries to harm its competitors in the downstream market by reducing the margin between the price for access to an essential facility and the price it charges for a retail product in the competitive downstream market. The integrated carrier can reduce this margin by either lowering its retail price for a product or raising its wholesale price for an essential input, to a level that makes it unviable for its competitors or potential competitors to provide these services.
- Predatory pricing occurs when a carrier or CSP with substantial market power takes advantage of that power by setting prices below a particular measure of cost which results in it foregoing short-term profits.

One major difference between these two types of conduct is that losses are not necessarily incurred in a vertical price squeeze, unlike predatory pricing.¹⁷ In both cases, however, bundling conduct is only likely to raise anti-competitive conduct concerns when the carrier or CSP has market power in the supply of at least one of the bundled products.

¹⁴ See Telstra's letter to the Commission dated 21 November 2002, and the Commission's response dated 6 December 2002. This correspondence is available on the public register and the Commission's website at <www.accc.gov.au/adjudication/fs-adjudicate.htm>.

¹⁵ Optus, *Submission on Telstra bundling notification*, 23 September 2002, p. 1.

¹⁶ Hutchison Telecommunications (Australia) Limited and Hutchison 3G Australia Pty Limited, *Submission to the Australian Competition and Consumer Commission: Telstra- notification of Exclusive Dealing*, 3 October 2002, Appendix A, p. 2. This submission is available at <www.accc.gov.au>.

¹⁷ In the recent *Boral* case, the High Court noted that the likely ability of a firm to recover losses incurred through predatory pricing conduct is not legally essential to a finding of pricing behaviour in contravention of section 46, but it may be of factual importance. In particular, that recoupment may be useful evidence of market power. Refer *Boral Besser Masonry Limited (now Boral Masonry Limited) v Australian Competition and Consumer Commission* [2003] HCA 5, 7 February 2003, per Gleeson CJ and Callinan J, at 130.

The Commission's draft information paper, *Bundling in Telecommunications Markets*, outlines its proposed approach to assessing whether a carrier or CSP is engaging in a vertical price squeeze or predatory pricing. This includes the use of imputation testing to assess whether a price squeeze is occurring. An imputation test can be used to assess whether or not a vertically integrated carrier is engaging in a price squeeze.

An imputation test takes account of the wholesale access price an integrated carrier or CSP charges for the essential input that it supplies to its downstream competitors. An imputation test is designed to determine whether the margin between the price for a wholesale input and the retail price of a downstream service is sufficient to cover the retail costs of the integrated carrier. The Commission notes that imputation tests are not conclusive that the conduct in question is anti-competitive but they are important diagnostic tools to help determine whether the conduct is likely to have an impact on competition.¹⁸

The Commission has received 12 submissions in response to its draft information paper. The submissions generally supported its approach to assessing bundling in telecommunication markets, although many noted the difficulties in assessing the competitive implications of bundling in complex telecommunications markets. While the submissions generally supported the Commission's proposed approach to imputation tests there was concern that the Commission would rely too heavily on the tests, which can be inconclusive and subject to regulatory gaming.

Submissions generally welcomed the Commission's proposed further use of its information gathering powers to identify anti-competitive behaviour, although concerns were raised about the Commission's ability to expeditiously enforce the TPA if such behaviour were identified. In this regard, suggestions were made that the current

provisions may not be adequate, and proposals for legislative amendments to restrict bundling conduct or to consider bundling conduct more on an *ex ante* basis. Legislative amendments were also suggested in light of the High Court's *Boral* decision.

Finally, some submissions recommended that the Commission further investigate Telstra's current bundling practices as soon as possible, with one submission stating that its business case to provide a niche service became unviable as a result of Telstra's bundling of pay TV and telecommunications services.

The Commission will consider the responses in the submissions, including further consideration of suggested legislative changes and investigations into specific conduct, before finalising its information paper on bundling in telecommunications markets. The paper should be completed in the near future.

8.2.5 Consumer complaints in relation to pay TV services

The Telecommunications Industry Ombudsman (TIO) also raised concerns in response to Telstra's third line force notification that it would not be able to address consumer complaints as a result of jurisdictional issues.

Telstra provides its bundled pay TV services through its subsidiary Telstra Pay TV, which is not an 'eligible carriage service provider' under section 127 of the *Telecommunications (Consumer Protection and Services Standard) Act 1999*. As a result, Telstra Pay TV's conduct is outside the TIO's jurisdiction. Similarly, Foxtel's and Optus Vision Media's conduct is outside of the TIO's jurisdiction.

As the TIO is not able to fully address consumer complaints that involve pay TV and telephony services, such as billing disputes relating to Telstra's rewards packages, consumers will be left to pursue more than one avenue for redress. As these services are typically provided on a single bill, often with a discount applying across the package, it would be sensible for consumers to have a 'one-stop' shop for redress of complaints.

¹⁸ For example, imputation tests do not demonstrate whether the carrier or CSP is taking advantage of its market power for anti-competitive purposes, or is simply engaging in robust competition by legitimately exploiting economies of scale and scope. This may need to be considered when establishing the elements of the relevant section of the TPA.

The Commission recommends that the jurisdiction of the TIO be extended to cover pay TV complaints where those services are provided in a bundle with telephony products. This could be implemented by amending section 127 of the *Telecommunications (Consumer Protection and Services Standard) Act 1999*.

8.3 Relevant jurisprudence from overseas regulators

The minister's letter noted that some carriers were surprised that Australia does not regard bundling as anti-competitive behaviour, especially considering the approaches adopted in Hong Kong and the United Kingdom.

This section outlines the Commission's understanding of approaches adopted in Hong Kong and the United Kingdom.

8.3.1 Hong Kong

In Hong Kong the Telecommunications Authority, using its powers under the *Telecommunications Ordinance*, licenses telecommunications carriers. Under the terms and conditions of the licence, dominant operators are prohibited from abusing market power.

The licence conditions for PCCW, the Hong Kong incumbent carrier, include two clauses that are directly relevant to bundling telephony services.

- General condition 20(4) prohibits a telecommunications carrier in a dominant position from offering discounts on services without approval from the regulator (OFTA).
- General condition 20(5) provides that a licensed telecommunications carrier shall not, without approval of the regulator, bundle a number of services into a single tariff without also offering each of the constituent services under separate tariffs.

Under these conditions, PCCW cannot bundle fixed line local telephony with other services, including internet access and long-distance services, without approval from OFTA.

The Commission understands that PCCW has obtained approval from OFTA to provide bundled services in cases where OFTA considers the conduct would not have an anti-competitive effect. Otherwise, OFTA may refuse an application on the basis that it constitutes an abuse of its dominant position. The Commission also understands that some of these refusal decisions are currently under review by the relevant Board.

8.3.2 United Kingdom

In the United Kingdom bundling and tying arrangements can be considered under general competition law. The *Competition Act 1998* prohibits conduct by one or more firms which amounts to the abuse of a dominant position¹⁹ in a market.²⁰ The Office of Telecommunications (OfTel) has indicated that the following forms of bundling are likely to be prohibited under the Competition Act:

- when a dominant telecommunications operator ties supply of products in a market in which it is dominant to the supply of products that are supplied competitively, for example, if a dominant operator ties the supply of access to its network to the supply of its own telephone equipment
- when a dominant operator bundles together physical services that could be supplied separately.²¹

¹⁹ The European Court has defined a dominant position as a 'position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of consumers'. Case C27/76 *United Brands v EC Commission* [1978] 1 CMLR 429.

²⁰ OfTel, *The application of the Competition Act in the Telecommunications Sector*, January 2000, at 2.3. <www.oftel.gov.uk/publications/ind_guidelines/cact0100.htm>

²¹ *ibid.*

In assessing whether bundling has anti-competitive effects, Oftel's main concern is to determine whether it has any harmful effects on competition, balancing those effects against any countervailing benefits, such as lower prices resulting from the exploitation of economies of scope.

8.4 Extending the current legislative framework

Submissions to the Commission's draft information paper on bundling in telecommunications markets have suggested various legislative amendments. For example:

- the introduction of *ex ante* regulation that would prohibit Telstra from engaging in some or all bundling conduct
- modifications to current *ex post* regulation (Parts IV and XIB), such as extending the operation of Part XIB to content service providers
- the introduction of a legislative requirement that Foxtel or Telstra be obliged to supply pay TV services to carriers or CSPs to be bundled with their telecommunications services.

The Commission sees that there are three types of general legislative responses that the government could consider in respect of bundling in telecommunications markets:

- A. prohibiting some or all bundling conduct by carriers or CSPs with market power in telecommunications markets
- B. implementing a clearance process, or some other modified assessment process, for carriers or CSPs with market power before they can supply bundles of telecommunications services, and/or
- C. requiring pay TV operators to resupply pay TV to telecommunications carriers or CSPs.

The benefits of these potential legislative changes need to be compared to the current anti-competitive provisions in the TPA, which

currently apply to bundling (and other) conduct. The Commission has already noted to Parliament its concerns about the effectiveness of section 46 of the TPA following the decision of the High Court in *Boral*.²² The decision in *Boral*, in particular the identification of market power as a threshold issue in anti-competitive conduct actions, may not significantly effect the future application of Part XIB of the TPA given Telstra's incumbent market power. However, the Commission is concerned that its ability to take action against anti-competitive conduct in what may appear as more contestable telecommunications markets, such as markets for mobile services, may be diminished.

The current tariff filing directions allow for some forewarning of proposed price changes, however this notice is only required seven days in advance and does not require 'clearance' in order for specific conduct to proceed. Further, this power does not allow the Commission to publish the information before the changes to the tariffs are effected, and does not allow the Commission to require imputation tests to accompany the lodgement of changes to bundled offerings.

Options (A) and (B) would be suitable where there were concerns that the current *ex post* process for assessing such conduct has a significant risk of error and/or that it does not otherwise provide enough oversight of bundling conduct.

Option (C) would be an appropriate solution where it was felt that bundling pay TV with telecommunications services raises competition concerns, which are better addressed via access to the pay TV service than through prohibiting the bundling conduct. As noted in chapter 6, the Commission recommends that the government regulate access to premium pay TV content, but that the case is only made (at present) for this access to be provided to network providers.

²² The Commission noted its concerns about the potential impact of the decision in *Boral* to the Senate Economics Legislation Committee in Canberra on 13 February 2003. Refer to Commonwealth of Australia, *Proof Committee Hansard- Senate Economics Legislation Committee consideration of additional estimates*, 13 February 2003, pp. E183- E187. Available from <www.aph.gov.au>.

8.4.1 Outright or specific prohibition

Bundling is currently assessed case by case, which would, *prima facie*, appear to be the most appropriate method of consideration, given such conduct can enhance efficiency and/or be anti-competitive. A case for the government to prohibit certain bundling conduct, such as bundling including new or emerging services or pure bundling, would presumably require an argument that there is a substantial probability of regulatory error in assessing the conduct, and if anti-competitive conduct were allowed it would have significant welfare costs. Any such decision would need to recognise the loss of potential benefits if the prohibition stopped potentially efficient behaviour.

The probability of error will depend on the information available to the Commission in making the decision, including information from third parties on the potential impact of particular bundling. Therefore, the use of the Commission's information gathering powers and increased clarity about the Commission's approach to assessing bundling conduct (when the information paper is finalised) will help. A potential clearance process could also diminish the probability of error.

8.4.2 A clearance process

The Commission believes that a clearance process would have several advantages over the current *ex post* consideration process.

A clearance process for bundling conduct by telecommunications providers with market power would be beneficial if it was believed there was currently insufficient oversight of such conduct. Presumably, this process would operate by the Commission only permitting certain bundling by carriers or CSPs with market power when it considers the particular conduct to be in the public interest.²³ This would allow the

Commission to consider all bundling conduct by those relevant carriers or CSPs with market power on a case-by-case basis before the conduct occurred.

A clearance process would impose administrative costs on both the regulator and industry. These costs could be mitigated by placing additional filters on the types of conduct requiring clearance. For example, and probably most relevantly, additional filters could only be required if a carrier or CSP with market power wishes to supply a pure bundle or tying of telecommunications services and/or supply a bundle including new or emerging products or services, as it is these two types of conduct that are likely to raise particular concerns.

A clearance process would ensure fuller consideration of the bundling conduct when a significant bundle is first proposed. It would place the onus on the carrier with market power to volunteer information supporting the need for bundling, and would presumably be considered by the Commission under a public interest test and via a transparent and public process. Even under Part XIB, action by the Commission against anti-competitive conduct takes time. A clearance process would stop potentially harmful conduct before it occurs.

Finally, there is uncertainty about whether current bundling is anti-competitive. A clearance process will provide greater certainty for carriers and CSPs (most particularly the notifier) about whether particular instances of bundling conduct are anti-competitive.

A critical issue when considering the introduction of a clearance process would be whether the costs of introducing such a process are outweighed by the benefits. The benefits will depend on the likelihood of competitive concerns being raised by specific bundling conduct- if specific bundling conduct seldom raises competitive concerns, the benefits of a

23 Such a regime could operate like the third line force notification provisions, where conduct is prohibited unless 14 days notification is provided to the Commission, which can decide to revoke the notice. It could alternatively- but

similarly- prohibit the conduct until clearance is obtained from the Commission. It could also presumably retain a competition test, although a public interest test would appear to be more appropriate in these circumstances.

clearance process are less. This Commission also notes that a clearance process could be seen as a departure from the existing regulatory philosophy and regarded as a partial reversion to a pre-1997 'notify and disallow' provision.

The Commission is still considering current bundling conduct, through finalising its guidelines and ongoing monitoring bundling conduct in the market. The Commission's actions in issuing a RKR to Telstra on bundling conduct and the government's accounting separation initiatives will assist in assessing such conduct, and the information paper, when finalised, will increase certainty about the Commission's approach (although a clearance process would provide even greater certainty).²⁴

The Commission also believes the government is more likely to improve competition in telecommunications and pay TV markets by focusing on considering the merits of Telstra's continued ownership of Foxtel and the HFC network.

That said, the Commission may provide further comments to the minister on bundling after fully considering the submissions received in response to its draft information paper and should any concerns about bundling conduct arise from the Commission's ongoing monitoring of bundling in telecommunications markets.

8.5 Conclusions and recommendations

When the Commission assesses bundling conduct it considers, among other things:

- whether the bundling conduct significantly reduces the addressable market of competing carriers or CSPs, so that equally efficient competitors are unable to compete on their own merits
- whether the price for the bundled services involves predatory pricing or a vertical price squeeze.

In both cases, bundling is only likely to raise anti-competitive conduct concerns when the carrier or CSP has market power in the supply of at least one of the bundled products.

Industry participants raised concerns in the context of the Telstra third line force notification that its bundling conduct may result in a price squeeze and a reduction in the addressable market of its competitors. The Commission did not find this to be the case and permitted Telstra to bundle telecommunications and pay TV services. However, the Commission will continue to monitor bundling conduct in the industry.

The Commission has also released a draft information paper outlining for carriers, CSPs, and other industry stakeholders (including end-users) the approach it is likely to follow when assessing whether specific bundling conduct in the telecommunications industry is anti-competitive. The Commission has also released a RKR to Telstra seeking information on its bundling of telecommunications and pay TV services.

The Commission does not believe the government currently needs to make any legislative amendments to address bundling conduct. However, the Commission may make further comment after finalising its information paper and in the event that any concerns about bundling conduct arise from the Commission's ongoing monitoring of bundling in telecommunications markets.

²⁴ As an aside, the Commission understands that many industry concerns relating to bundling stem from a lack of transparency of Telstra's revenues and costs. In this regard, the Commission notes that it has recently released a report outlining its views on the public-release of RAF data. The proposed information disclosure regime includes the regularly release basic market indicator information, including revenue, usage, market share, market growth for a range of retail and wholesale telecommunications services. The Commission will further consult with industry participants before implementing an information disclosure regime.

That said, the Commission does recommend that where pay TV services are provided as part of a bundled telecommunications offering, the Telecommunications Industry Ombudsman be given jurisdiction to investigate consumer complaints about the provision of the pay TV service.

Attachment A

Content packages

This attachment details the pay TV packages offered by Foxtel and Optus before and after approval of the pay TV agreements, in July 2002 and January 2003 respectively.

In these tables, shading indicates that a channel is supplied by both Foxtel and Optus. The different levels of shading distinguish between channels that are supplied on equivalent entry level or 'basic' tiers, 'entertainment' or 'movie' tiers. The shading also highlights channels supplied by both Foxtel and Optus, but on different tiers.

Asterisks indicate that the pay TV operator has an ownership interest of 5 per cent or greater in the channel. This is based on United States rules (refer to FCC, Fact sheet- cable television information bulletin, <www.fcc.gov/mb/facts/csgen.html>, June 2000, accessed May 2003).

A.1 Pre-agreement packages for Foxtel and Optus (July 2002)

FOXTEL

BASIC TIER	arena*	\$39.95 (cable)
	BBC World	
	Bloomberg Television	\$49.95 (satellite)
	Cartoon Network	
	Channel [V]*	
	CNBC	
	CNN	
	Discovery Channel	
	Fashion TV	
	Fox Classics*	
	Fox Kids*	
	Fox News*	
	Fox Sports Two*	
	Fox Sports*	
	Fox8*	
	Foxtel Weather	
	LifeStyle Channel*	
Music Country (STC)		
musicMAX*		
National Geographic*		
Nickelodeon		
Sky News Australia*		
Sky Racing		
TV1		
TVSN		
UKTV*		
E/PLUS	Disney Channel	\$9.95
	fX*	
	Hallmark	
	the comedy channel*	
MOVIES	Encore*	\$12.95
	Showtime*	
	Showtime 2*	
	Turner Classic Movies	

OPTUS

CORE CHANNELS	ABC Kids/ABC Fly	
	Australian Christian Channel	
	BBC World	
	Cartoon Network	
	CNBC	
	CNN	
	CNNfn	
	Disney Channel	
	Expo	
	Optus Weather	
E/MENT	Sky News Australia	
	Sky Racing	
	STC Country	
	Turner Classic Movies	
	TVSN	
E/MENT	Adventure One	\$37.95 with core channels
	Animal Planet	
	MTV*	
	National Geographic	
	Odyssey	
	OH!*	
SPORT	Ovation*	
	ESPN	
	Optus Sports	
MOVIES	Optus Sports Two	\$37.95 with core channels
	Movie Extra	
MOVIES	Movie Greats	\$49.95 with all of the above channels
	Movie One	

KEY:

- xxx Both providers supply the channel in their *entry level packages*
- xxx Both providers supply the channel, but on *different tiers*

A.2 Post agreement packages (January 2003)

FOXTEL

BASIC TIER	arena*	\$39.95 (cable)
	BBC World	
	Bloomberg Television	\$49.95 (satellite)
	Cartoon Network	
	Channel [V]*	
	CNBC	
	CNN	
	Discovery Channel	
	Fashion TV	
	Fox Classics*	
	Fox Kids*	
	Fox News*	
	Fox Sports*	
	Fox Sports Two*	
	Fox8*	
	Foxtel Weather	
	LifeStyle Channel*	
musicMAX*		
National Geographic*		
Nickelodeon		
Sky News Australia*		
Sky Racing		
TV1		
TVSN		
UKTV*		
E/MENT	ESPN	\$9.95
	Disney Channel	
	fx*	
	Hallmark	
	MTV	
Ovation		
the comedy channel*		
The History Channel		
MOVIES	Encore*	\$12.95
	Showtime*	
	Showtime 2*	
	Turner Classic Movies	
Movie Extra	all movie channels	
Movie Greats		
Movie One		
	\$24.95	

OPTUS

BASIC TIER	ABC Kids/ABC Fly	\$39.95
	Adventure One	
	Animal Planet	
	arena	
	Australian Christian Channel	
	BBC World	
	Cartoon Network	
	CNBC	
	CNN	
	CNNfn	
	Discovery Channel	
	Disney Channel	
	ESPN	
	Expo	
	Fox Classics	
	Fox Kids	
	Fox8	
Fox Sports		
Fox Sports Two		
Foxtel Weather		
Lifestyle Channel		
MTV*		
National Geographic		
Odyssey		
Ovation*		
Sky News Australia		
Sky Racing		
Turner Classic Movies		
TV1		
TVSN		
UKTV		
E/MENT	Channel [V]	\$12.95
	fx	
	musicMAX	
	Nickelodeon	
the comedy channel		
The History Channel		
MOVIES	Movie Extra	\$12.95
	Movie Greats	
	Movie One	
	Encore	
	Showtime	
Showtime 2	all movie channels	
	\$25.50	

KEY:

- xxx Both providers supply the channel in their entry level *basic tier*
- xxx Both providers supply the channel in their *entertainment tier*
- xxx Both providers supply the channel in their *movies tier*
- xxx Both providers supply the channel, but place it on *different tiers*