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Confidential Email

Dear Mr Cosgrave

FOXTEL Digital Set Top Unit Service Special Access Undertaking

Request for further information

Please see attached.

Attach

Our Ref MLBS:JUAS:205097683

juas A0107065091v3 205097683 11.4.2006

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Dear Mr Cosgrave

**FOXTEL Digital Set Top Unit Service
Special Access Undertaking
Request for further information**

We refer to your letter dated 23 March 2006.

In response to the request by the Australian Competition and Consumer Commission (the **Commission**), pursuant to s 152CBB of the *Trade Practices Act 1974* (the **Act**), for further information about the special access undertaking (**SAU**) given by FOXTEL, FOXTEL provides the following information.

Question 1

Yes. FOXTEL also refers to section 9.2 of its supplementary submission to the Commission, which was provided to the Commission on 29 March 2006 (the **FOXTEL Supplementary Submission**).

Question 2

FOXTEL has prepared an Operational Procedures manual, which it provided to the Commission in December 2003. The manual will be available to an access seeker who has entered into a Digital Access Agreement (**DAA**) once the access seeker has complied with the terms of cl 2.4(b) of the SAU, including executing a confidentiality agreement pursuant to cl 2.4(b)(i) of the SAU. Through an oversight, the template for the confidentiality agreement between FOXTEL and an access seeker, which will form Appendix 3 to the SAU, has not yet been provided to the Commission. A copy is **Annexure 1**. It is in substantially the same form as Annexure C to the s 87B undertaking given by FOXTEL on 21 November 2002.

Question 3(a)

FOXTEL had not published its Modem Services Protocol at the date of the Commission's information request because the protocol was still being finalised by FOXTEL, based on a document used in another context. The protocol has now been completed and a copy is **Annexure 2**.

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Question 3(b)

FOXTEL refers to section 2 of the supplementary technical report, which was Attachment 8 to the FOXTEL Supplementary Submission.

Question 3(c)

Of the 77¹ channels which comprise FOXTEL Digital, there are currently 17 channels in this category. They are:

- | | | |
|-----------------|------------------------|---------------------------|
| 1. Arena | 7. Fox Sports 2 | 13. The History Channel |
| 2. Channel [V] | 8. MTV | 14. The LifeStyle Channel |
| 3. Fox 8 | 9. MusicMax | 15. The Weather Channel |
| 4. Fox Classics | 10. Nickelodeon | 16. TV1 |
| 5. Fox Footy | 11. Sky News | 17. UKTV |
| 6. Fox Sports 1 | 12. The Comedy Channel | |

Question 4(a)

Between approximately [confidential] [end confidential] of FOXTEL's installed digital STUs have a modem installed.

Question 4(b)

Since October 2005, FOXTEL has not required cable or satellite digital subscribers to have a return path installed. FOXTEL still requires subscribers who take FOXTEL's personal digital recorder, FOXTEL iQ, as part of their package to have a return path installed, unless this is not possible for technical reasons. These technical reasons include the following:

1. the subscriber does not have a fixed telephone line;
2. the subscriber only has a digital fixed telephone line installed;
3. the subscriber only has a pre-paid fixed telephone line installed which requires a multi-digit personal identification number to be entered in order to make calls; and
4. the subscriber has a PABX system which makes the installation of a return path not possible.

Question 5(a)

Of the 77 channels which comprise FOXTEL Digital, there are currently 14 channels in this category. They are:

- | | | |
|-----------------|----------------|---------------------------|
| 1. Arena | 6. MTV | 11. The LifeStyle Channel |
| 2. Fox 8 | 7. Nickelodeon | 12. The Weather Channel |
| 3. Fox Classics | 8. Sky News | 13. TV1 |

¹ This number includes time-shifted channels but excludes retransmitted terrestrial channels, audio channels, FOXTEL Box Office channels and the Games portal

- | | | |
|-----------------|-------------------------|----------|
| 4. Fox Sports 1 | 9. The Comedy Channel | 14. UKTV |
| 5. Fox Sports 2 | 10. The History Channel | |

Question 5(b)

The return path is via the PSTN network.

Question 6(a)

Cable IBAC

In support of FOXTEL's application to the Commission for an exemption order in relation to its (then) proposed digital subscription television service, FOXTEL and its experts advocated a methodology for calculating the cable IBAC based on measuring unrecovered costs from the analogue phase of its business. FOXTEL and its experts calculated this amount at \$858m, but offered a reduction in that amount to \$278m. Provided with this letter is a spreadsheet entitled 'Cable and satellite IBAC' which, on the tab labelled "Installed base access cost cabl", shows how the amount of \$858m was derived.²

In assessing FOXTEL's digital exemption application, the Commission adopted a different methodology to calculate the cable IBAC. In its Final Decision on FOXTEL's digital exemption application,³ the Commission accepted that FOXTEL's cost base should include an amount reflecting the efficient costs of developing the customer base during the analogue period.⁴ However, the Commission did not accept FOXTEL's methodology for assessing IBAC costs. Instead, the Commission formed the view that the costs should reflect the costs that a hypothetical digital STU provider would incur to generate a customer base. This would exclude analogue STU and smart card costs (which were treated by the Commission as effectively scrapped or fully depreciated), but would include customer acquisition costs, being primarily net installation, an allocation of sales and marketing, disconnections, service calls and an allocation of overhead costs because those investments would not sensibly be treated as scrapped or fully depreciated.⁵

In relation to measurement, the Commission concluded that there was no reason to believe or evidence to suggest that FOXTEL's costs in these categories were otherwise than efficiently incurred, and accordingly historic costs were an appropriate proxy for replacement costs. The Commission then applied depreciation over the assumed asset life, and the assessed WACC.⁶

FOXTEL understands that the Commission used the financial model 'FOXTEL TSLRIC v07.09.01E-adjust' in estimating the cable IBAC. A copy of this model is provided in electronic format with this letter. **Annexures 3 to 5** are pages relevant to the Commission's calculation of the cable IBAC that have been printed from 'FOXTEL TSLRIC v07.09.01E-adjust'.

² The final IBAC amount of \$858m is calculated by adding the amounts in the cells B66 through to B99

³ The Commission, "Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by FOXTEL - Final Decision", December 2003

⁴ page 52

⁵ page 53

⁶ page 54

The following is a description of the methodology FOXTEL understands the Commission used in calculating the cable IBAC.

First, the Commission calculated the asset investment in each period based on those costs that the Commission determined were relevant to the cable IBAC. **Annexure 3** is a printout of the tab labelled 'O&M' from 'FOXTEL TSLRIC v07.09.01E-adjust'. The total asset investment in each period allowed by the Commission is shown on the line marked M, which is the total of operational and maintenance costs less:

1. logistics refurbishments (line marked A) – this comprises the costs of STU loss, STU parts and labour, repairs and packagings;
2. smart card costs (line marked B) – this comprises the management cost of the conditional access system and the cost of smart cards including refurbishments and holding; and
3. foreign exchange and parts (line marked J) – this comprises realised foreign exchange gains or losses on budgeted foreign exchange rates associated with US dollar denominated STU purchases.

The operational and maintenance costs that were therefore included in the Commission's cable IBAC calculation were the following:

1. warehousing (line marked C) – operating expense associated with STU storage;
2. engineering (line marked D) – costs of STU related equipment specification, development and testing;
3. installation less installation revenue (lines marked E and F) – costs associated with STU installation for new subscribers, transferring subscribers and reconnecting subscribers less the associated revenues;
4. MDU backboning (line marked G) – costs associated with body corporate negotiations and building backboning to allow STU installation in individual premises;
5. disconnections (line marked H) – the cost of STU recovery and related disconnection activities;
6. service calls (net) (line marked I) – change orders and replacements net of associated revenues;
7. sales and marketing (line marked K) – an allocation of non-branded sales and marketing expense;
8. other common costs (line marked L) – includes the non-STU depreciation expense, the allocated corporate overhead (again based on known cost proportions) and call centre costs using a method consistent with sales and marketing.

Secondly, the Commission calculated the cable IBAC using the depreciation method. This calculates the cumulative asset investment value less depreciation and plus the cost of capital. The calculations are shown on **Annexures 4** and **5**, which are printouts of the tab labelled 'annuity deprec (3)' using different inputs. The lines are as follows:

1. Opening depreciated asset value inclusive of the cost of capital (line marked A).
2. Investment in a particular year (line marked B). This figure is carried across from the line marked N in Annexure 3.

3. The sum of the opening depreciated asset value and the investment in a particular year (line marked C).
4. The asset life (cell shaded green).
5. The cost of capital (cell shaded pale blue).
6. The depreciation in a particular period (cells shaded yellow). The depreciation is calculated by using the PMT function (the description of the PMT function from Microsoft Excel 'help' is **Annexure 6**).
7. The sum of depreciation in each period (line marked D).
8. The figures in the row marked C inflated by the cost of capital in the cell shaded pale blue.
9. The closing asset value, which is the line marked E less the line marked D (the depreciation in the period)

In the column in **Annexure 4** for the financial year 2003/2004, it can be seen that the sum of the opening depreciated asset value and the investment in that year was \$321m. If the assumed asset life is adjusted from 20 years to 12 years (shown in **Annexure 5**), this number becomes \$267m (consistent with the Commission's Final Decision at page 54, which refers to a cable IBAC of "around \$270 million"). Accordingly, the Commission accepted as reasonable FOXTEL's proposed cable IBAC.

For the purpose of the SAU, FOXTEL is prepared to accept the methodology, data inputs and assumptions used by the Commission to assess the cable IBAC for the purposes of FOXTEL's digital exemption application and has accordingly specified an assumed IBAC of \$280m in cl 4.1 of the DAA.

Satellite IBAC

The spreadsheet entitled "Cable and satellite IBAC" also shows how FOXTEL calculated the assumed satellite IBAC specified in cl 4.1 of the DAA. On the tab labelled 'Installed base access cost sat' the amount of \$115m⁷ is calculated. The amount is shown in cell B65 of that tab.

Question 6(b)

FOXTEL's submission that non-brand marketing costs have been excluded from the IBAC is supported by the PwC report at Attachment 11. Schedule I to that report, which deals with sales and marketing costs incurred by FOXTEL, contains an analysis of FOXTEL's expenditure on marketing based on an analysis of FOXTEL's audited accounts. PwC appear to have analysed FOXTEL's budget for the financial year 2000/01 to identify the projected expenditure in that period on brand and non-brand marketing. PwC identified that, of FOXTEL's projected marketing spend, **[confidential]** **[end confidential]** was to be spent on brand marketing, which represented 32% of the total marketing spend budgeted for that financial year.

From PwC's report, it is clear that FOXTEL's annual marketing spend was, or was projected to be, in the range **[confidential]** **[end confidential]** per annum throughout the period from FOXTEL's launch to the time of the 2000/01 budget. FOXTEL submits that it is reasonable to apply the percentage projected to be spent by FOXTEL on brand marketing in the 2000/01 budget

⁷ The exact figure is \$114,659,563

to the entire period covered by the IBAC calculation, particularly in circumstances where FOXTEL's total expenditure on marketing was broadly similar throughout the period. Further, FOXTEL submits that 68% is a conservative estimate of the level of non-brand marketing in FOXTEL's early years, as FOXTEL considers that a higher amount would have spent in that period on non-brand marketing as FOXTEL endeavoured to educate Australian consumers about the general features and benefits of subscription television.⁸

Question 7(a)

The assumed value of franking credits can be incorporated as an adjustment to either the discount rate or to cash flows (prices). To the extent that franking credits have value, they can be thought of as reducing a firm's cost of capital, so that a lower return, and therefore lower prices, are needed. Alternatively (and equivalently) franking credits can be thought of as reducing the amount of corporate tax payable and therefore lower revenues are required as they will be taxed less harshly. If the second approach is used, the gamma value has its impact via the (tax) cash flows.

This is illustrated by the following example. Suppose the asset base is \$100 and the regulated WACC is 10%. In this case, the regulator will let the regulated business charge prices such that a profit of \$10 is achieved. If the corporate tax rate is 30%, regulated prices will have to be such that the pre-tax profit is \$14.3 (in which case tax of \$4.3 is paid and after-tax profit is \$10, as required).

If the gamma value is set to 0.5, it is equivalent to assuming that half of the corporate tax will be rebated against personal tax obligations. So the corporate tax rate is, in effect, not 30% but 15%. That is, shareholders get half of the corporate tax back via the personal tax system. In this case, a firm only needs a pre-tax profit of \$11.8 to produce an after-tax profit of \$10.

Accordingly, prices would need to be lower if gamma is assumed to be 0.5 rather than zero.

Question 7(b)

FOXTEL submits that a gamma value of zero should be used to derive access prices in accordance with the SAU.

Currently, the DAA⁹, the Regulatory Accounting Procedures Manual (*RAPM*)¹⁰ and the Digital Access Pricing model (the *Pricing Model*) all assume a gamma value of 0.5, because this is the value specified by the Commission in its Final Decision on FOXTEL's digital exemption application.¹¹ As the Commission noted in its decision, FOXTEL made no representations at the time of its application in relation to the appropriate gamma to apply to FOXTEL.¹²

However, in relation to the SAU, FOXTEL has provided the Commission with a report and supplementary report of Professor Stephen Gray in support of its submission that the appropriate

⁸ This submission is consistent with the findings of PwC in Appendix 2 to their report in relation to the marketing cost of access to the home, where they examined the procedures in relation to the allocation of brand marketing costs.

⁹ page 68

¹⁰ page 15

¹¹ page 53

¹² *ibid*

gamma value is zero. If the Commission accepts FOXTEL's submission, the DAA, the RAPM and the Pricing Model will be amended to reflect a gamma value of zero.

FOXTEL notes that its submission that adopting a gamma value of zero would not affect the WACC specified in the DAA was not strictly correct, because the gamma value is included in the formula for the calculation of the equity beta and therefore has a small effect on the calculation of the WACC. Accordingly, adopting a gamma value of zero will result in a small adjustment in the WACC from 13.99% to 13.975%.

Question 8

FOXTEL confirms that the costs associated with excluded services are excluded from the base of shared costs that are used to calculate the Rate Card for access seekers.

Question 9

FOXTEL claims confidentiality over this letter as marked in the text above and will provide a copy of this letter with those sections masked for publication on the Commission's website.

As regards the annexures and other documents provided with this letter, FOXTEL claims confidentiality over Annexure 2 (Modern Services Protocol), Annexures 3 to 5 (extracts from 'FOXTEL TSLRIC v07.09.01E-adjust') and the spreadsheets provided in native format with this letter (which are entitled 'Cable and satellite IBAC' and 'FOXTEL TSLRIC v07.09.01E-adjust').

Any requests for access to the confidential information described above should be directed to James Arnott, whose contact details are below.

Yours sincerely

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