



**FOXTEL MANAGEMENT PTY LIMITED**

**PUBLIC VERSION**

**Submission to Australian Competition & Consumer  
Commission**

**FOXTEL Special Access Undertaking**

**1 December 2006**

# Submission to Australian Competition & Consumer Commission

## FOXTEL Special Access Undertaking

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## 1. Introduction

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On 1 December 2006, FOXTEL Management Pty Ltd and FOXTEL Cable Television Pty Ltd (together, **FOXTEL**) lodged a Special Access Undertaking (the **Undertaking**) with the Australian Competition and Consumer Commission (the **Commission**) under s152CBA of the *Trade Practices Act 1974* (the **Act**). The Undertaking is in relation to the Digital Set Top Unit Service.

FOXTEL previously lodged a Special Access Undertaking with the Commission on 6 October 2005 (the **2005 Undertaking**). On 30 August 2006, the Commission issued its Draft Decision with respect to the 2005 Undertaking (the **Draft Decision**), in which it indicated that its preliminary view was that it would reject the 2005 Undertaking. On 1 December 2006, FOXTEL withdrew the 2005 Undertaking.

The Undertaking is in substantially the same form as the 2005 Undertaking but has been amended in certain respects in order to address some of the issues raised by the Commission in its Draft Decision. In order to assist the Commission, and interested parties who wish to comment on the Undertaking, provided with this submission is a version of the Undertaking in which the amendments appear in mark-up.

FOXTEL submits that the Undertaking satisfies the relevant statutory tests; that is, its terms and conditions are consistent with the relevant obligations referred to in s152AR of the Act and are reasonable, having regard to the matters set out in s152AH of the Act. Accordingly, FOXTEL submits that the Commission should accept the Undertaking.

These submissions address some of the issues raised by the Commission in its Draft Decision which are also of relevance to the Commission's consideration of the Undertaking and set out why FOXTEL submits that these issues are not reasons why the Commission should reject the Undertaking.

FOXTEL also relies in support of the Undertaking on the submissions, expert reports, answers to information requests and other evidence provided by FOXTEL to the Commission in support of the 2005 Undertaking. Appendix A to this submission contains a list of this material.

FOXTEL claims confidentiality over portions of this submission. These portions have been included in Confidential Appendix B.

## 2. Price

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### 2.1 Pricing Methodology

In its Draft Decision, the Commission stated that it accepts FOXTEL's submission in regard to the pricing methodology used in the Undertaking<sup>1</sup> and, having considered whether FOXTEL's costs will be efficient, it states that it views as acceptable FOXTEL's use of actual costs in that methodology.<sup>2</sup> FOXTEL supports these conclusions.

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<sup>1</sup> ACCC, *Assessment of FOXTEL's Special Access Undertaking in relation to the Digital Set Top Unit Service - Draft Decision*, August 2006 (**ACCC Draft Decision**), p 45. References in this reply to pages from the Draft Decision are to the version of the Draft Decision provided by the Commission to FOXTEL (which version included information confidential to FOXTEL but excluded information confidential to other people).

<sup>2</sup> ACCC Draft Decision, p 49

However, there is one point the Commission makes in this context which FOXTEL wishes to address. The Commission states at page 49 that if it *"were to accept this Undertaking, the Commission would require that a periodic, independent audit of Foxtel's actual incurred costs should be conducted to determine if expenditures are necessary and if they are efficient."*

In FOXTEL's submission, an "efficiency audit" is not something the Commission needs in order to be satisfied that FOXTEL's costs are efficient, is inherently problematic and will likely be very expensive and, accordingly, it is not something it has included as a requirement on FOXTEL pursuant to the Undertaking. Each of these points is expanded below.

**(a) Unnecessary**

The Commission sets out a great deal of evidence in its Draft Decision which supports the proposition that FOXTEL's costs have been efficient historically and are likely to be efficient into the future.<sup>3</sup> FOXTEL submits that this evidence is sufficient for the Commission to be satisfied that FOXTEL represents an efficient subscription television firm, which would incur costs in an efficient manner.

The majority of costs that are pooled in order to determine the access price are shared by FOXTEL. FOXTEL could understand the Commission's concerns if there was a risk that FOXTEL could attempt to "gold plate" its network or seek to attribute unnecessary costs to the cost pools and then recover these costs from access seekers. However, the pricing methodology put forward by FOXTEL simply does not permit that to occur, as FOXTEL would be disadvantaging itself to a far greater extent through unnecessary spending than any extra revenue obtained from providing access. Unlike other access providers (for example, the providers of mobile terminating access services), FOXTEL has received and expects to receive an insignificant amount of revenue from providing access to access seekers.

Whatever view one takes about the retail market, it is clear that the widespread availability of free-to-air television imposes a constraint on FOXTEL's ability to attract and retain subscribers, a proposition supported by the relatively low penetration of subscription television in Australia. Further, during the life of the Undertaking, technology is likely to change, so that the constraints on FOXTEL will grow rather than lessen (for example, as the delivery of television via broadband takes hold). These constraints have and will continue to compel FOXTEL to operate efficiently, even as FOXTEL begins to produce positive cash flow. In this regard, FOXTEL confirms that the assumption the Commission has stated in its Draft Decision<sup>4</sup> that FOXTEL's announcement of its first operating profit refers to accounting profit, and not a positive return on investment or positive cash flows, is a correct one.

**(b) Problems with the "audit"**

The scope of the audit proposed by the Commission is not clear from the Draft Decision. It is clear, however, that the Commission would want the auditor to pursue two lines of enquiry: necessity and efficiency. However, there are significant problems with both concepts. How would a professional auditor determine whether costs are necessary and efficient? Any methodology would require a comparison of FOXTEL's actual costs to an idealised model of a hypothetical subscription television operator. But how would this

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<sup>3</sup> ACCC Draft Decision, pp 47 – 50

<sup>4</sup> ACCC Draft Decision, p 48

model be created? How many subscribers would the hypothetical operator have? Would it use low or high feature STUs? Would it provide its customers with STUs or would it require the customer to purchase an STU? Would it subsidise installation costs? Would it provide interactive services? Would it have an EPG? How many channels would it have?

These questions highlight that whether a cost is necessary or efficient is something that is so difficult to ascertain in an industry such as subscription television that the time and effort that would be expended attempting to do so would far outweigh any conceivable benefit to access seekers. The fact is that subscription television is a significantly more complicated service than other declared services. There is likely to only be one way to efficiently lay a pipeline between Sydney and Melbourne. There are many ways to efficiently run a subscription television business.

Further, FOXTEL submits that the answers to any questions put to an auditor are likely to be so subjective that it will almost be impossible for any auditor to express a conclusive view.

**(c) The cost**

The costs of providing such an audit are likely to be substantial, involving scrutiny of all aspects of FOXTEL's business and likely entailing many interviews with FOXTEL people. Further, FOXTEL considers that the cost of such an audit would be one of the "*direct costs of providing access to the declared service concerned*", within the meaning of s 152AH(d) of the Act. In that case, FOXTEL considers that it would be appropriate to include the cost of the audit as part of the attributable cost pool, which would have the effect of increasing the price of access.

For these reasons, FOXTEL submits that the Commission should not require an audit of the type specified. The Commission should decide that the circumstances in which FOXTEL operates, and the fact that it bears the most significant burden of the costs shared with access seekers, militates against inefficient and wasteful expenditure. FOXTEL submits that any possible benefits of conducting an efficiency "audit" would be significantly outweighed by the problems and costs of doing so. FOXTEL also notes that it was not suggested by the Tribunal in *Re Seven Network Limited (No 4)*<sup>5</sup> that such an "audit" was necessary, or even desirable.

## **2.2 Network enhancements**

The Commission has also expressed a concern about a perceived lack of clarity in terms of the method and objective basis by which FOXTEL will categorise the costs of required network enhancements (**RNEs**) referred to in clause 9 of the DAA and how these costs will be differentiated from "attributable costs" category as part of FOXTEL's pricing methodology.<sup>6</sup>

The Commission also states that RNEs are expected to be minimal as FOXTEL undertook to build the network ready for access. The only example the Commission refers to is the Active Customer Smartcard Database (**ACSD**) which has already been built. The Commission states that as this is a common interface between FOXTEL and access seekers it understands it is likely to be a "shared cost" rather than an "attributable cost". The Commission invites FOXTEL to clarify the basis on which RNEs will be categorised and how they will be distinguished from "attributable costs".

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<sup>5</sup> *Seven Network Limited (No 4)* [2004] ACompT 11 (23 December 2004)

<sup>6</sup> ACCC Draft Decision p 50

FOXTEL agrees with the Commission that RNEs are likely to be minimal and, aside from the ACSD, is not able to identify any expected costs of that type. However, this does not mean there will not be any such costs and FOXTEL must retain the right to pass those costs on to the access seeker if they arise. RNEs differ from attributable costs in that they involve an upfront and one-off modification to FOXTEL's system in order for the access seeker to have access and as such FOXTEL requires payment by that access seeker upfront. If there is more than one access seeker using the RNE, then the cost is prorated according to clause 9.1(b)(ii) of the DAA in the following way:

- if there are more than 5 access seekers, the cost will be treated as an attributable cost and shared between the access seekers pursuant to Schedule 3 of the DAA; or
- if there are fewer than 5 access seekers, each access seeker pays no more than 20% of the cost of the RNE. If there are fewer than 5 access seekers, FOXTEL itself therefore bears a significant portion of the cost of the RNE.

If the RNE is paid for under clause 9.1(b)(ii)(B) of the DAA, it will not be treated as an attributable cost so there is no double counting of those costs. FOXTEL has made an amendment to the definition of "Attributable Capex Costs" in Schedule 3 of the DAA attached to the Undertaking to make this clear.

Finally, the ACSD is a RNE, not a shared cost. It is an enhancement necessary in order to allow access and would not be necessary in the absence of access. Access seekers will therefore be required to contribute up to 20% of the cost of the ACSD under clause 9. FOXTEL does not, however, expect there to be any further incremental costs in allowing each access seeker to interface with the ACSD unless the access seeker requires something unusual.

### **2.3 Rate card review**

The undertaking to independently review the rate card was inadvertently omitted from the 2005 Undertaking and has now been included as a new clause 2.6 of the Undertaking.

### **2.4 Agreed upon procedures**

The Commission states that the Agreed Upon Procedures that PwC conducted in 2005 in order to verify the IBAC Input Costs schedules are inferior to an audit in accordance with Australian accounting standards.<sup>7</sup> However, the Commission concludes it is not certain that the benefit provided by a full audit of the IBAC costs would outweigh the cost of an audit to verify the IBAC costs.

FOXTEL supports the conclusion reached by the Commission that the benefits of an audit would outweigh the cost. FOXTEL submits that, while not an audit in accordance with Australian accounting standards, the Agreed Upon Procedures conducted by PwC are sufficient for the purposes of a regulatory matter. The following matters support this submission:

- PwC prepared an audit report of the satellite STU gross capital purchase costs from 1 July 1999 to 30 June 2004 dated 13 July 2005.<sup>8</sup>
- PwC prepared an audit report of gross capital cable STU costs dated January 2001.<sup>9</sup> The audit performed by PwC at that time included gross capital STU cable costs incurred up

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<sup>7</sup> ACCC Draft Decision, p 57

<sup>8</sup> Attachment 10 to FOXTEL's Submission in support of the 2005 Undertaking

until June 2000. This audit remains current, as there have been no significant purchases of analogue cable STUs since that time.

- In undertaking the Agreed Upon Procedures, PwC referred to FOXTEL's audited accounts and reconciled these with the IBAC Input Cost schedules. That is, the information presented in the IBAC Input Costs schedules have been reconciled with accounts which have been audited, and thus have the benefit of this audit.

## 2.5 Marketing costs

The Commission has raised two concerns in relation to marketing costs: the calculation of historic marketing costs, as included in the IBAC, and the calculation of future marketing costs, as included in the Digital Access Pricing Model. These concerns are addressed below.

### (a) Historic marketing costs

One of the components of the price paid by access seekers for the DSTUS is the IBAC for cable and satellite.

In 2002, FOXTEL retained NECG to develop a pricing methodology and access pricing model for access to digital cable and satellite set-top units. This work was conducted in the context of the section 87B undertaking that FOXTEL provided to the Commission on 21 November 2002, in relation to the Content Supply Agreement between FOXTEL and Optus dated 5 March 2002. Pursuant to this undertaking, FOXTEL undertook to supply the DSTUS to access seekers pursuant to the Digital Access Agreement that formed Schedule 2 to the undertaking.

NECG prepared a report in two parts, the first dated 4 June 2002 and the second dated 30 August 2002, describing the pricing methodology and access pricing model it considered appropriate for the DSTUS (the **2002 NECG report**). FOXTEL relies on the 2002 NECG report in support of the SAU and has provided the NECG reports to the Commission as Attachment 7 to its Submission in support of the 2005 Undertaking.

In section 3.1 of its report, NECG describes the capital costs which were included in its calculation of the cable and satellite IBAC. One of these costs is generic platform marketing costs. At page 21 of the NECG report describes the source of these costs as follows:

Generic marketing costs are calculated as 68% of total marketing costs allocated to cable STUs. The 68% is based on the assumption used in the PwC analogue model.

The PwC analogue report to which NECG refers was provided to the Commission as Attachment 11 to its Submission in support of the 2005 Undertaking. In Schedule I of the report, PwC sets out the basis for this percentage. PwC obtained data from FOXTEL's accounts in order to determine the total amount of spending on marketing. PwC then 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, 32% of the total marketing spend budgeted for that financial year was to be spent on FOXTEL-specific marketing. This percentage figure was applied to FOXTEL's marketing costs throughout the period.

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<sup>9</sup> Attachment 11 to FOXTEL's Submission in support of the 2005 Undertaking

The Commission has expressed concern that the percentage figure derived by PwC for FOXTEL-specific marketing "*lacks a firm basis*". The Commission's concerns are that this figure is based on budgeted, not actual, figures and is assumed throughout the period.

FOXTEL does not agree with the Commission's view and submits that the Commission should be satisfied that the percentage figure derived by PwC is an acceptable proxy by which to split FOXTEL-specific and non-specific marketing costs. FOXTEL submits that it is reasonable to apply the percentage projected to be spent by FOXTEL on brand marketing in the 2000/01 budget to the entire period covered by the IBAC calculation, particularly in circumstances where FOXTEL's total expenditure on marketing was broadly similar throughout the period. FOXTEL also 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.<sup>10</sup>

In response to the Commission's concern, however, FOXTEL has examined whether it is possible to reconcile the budgeted amounts used by PwC with actual expenditure in the relevant period. FOXTEL has been able to verify its total costs on marketing in the relevant period. Its actual expenditure on marketing in the period 2000/2001 is set out at point 1 of Confidential Appendix B, which is similar to the budgeted amount for the period used by PwC, which is set out at point 2 of Confidential Appendix B.<sup>11</sup> However, FOXTEL has not been able to verify the percentage of expenditure on "brand marketing" in the period. This is principally because the concept of "brand marketing" is one that is only of relevance to FOXTEL in the context of regulated retail access and is not a concept which is used by FOXTEL in the context of its normal business operations. Thus, FOXTEL's financial records do not readily reveal the split. Deducing any split involves a substantial amount of estimation and judgement, based on the categories of expenditure actually recorded in FOXTEL's financial records. The difficulties in estimation are compounded because of the time that has elapsed since the relevant budget was expended, creating problems in locating all relevant documents and personnel (some of whom are no longer with FOXTEL).

The Commission has previously accepted FOXTEL's IBAC as reasonable. In support of FOXTEL's application to the Commission for an anticipatory 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 for cable and \$115m for satellite. FOXTEL offered a reduction of the cable IBAC amount to \$278m. The Commission conducted its own calculation and accepted this amount as reasonable on the basis that it was broadly consistent with its own calculation.<sup>12</sup> The spreadsheet that FOXTEL understands the Commission used to

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<sup>10</sup> 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.

<sup>11</sup> See page entitled "Sales & Marketing – Schedule 1" of the PwC Report dated 19 January 2001 which is Attachment 11 to FOXTEL's Submission

<sup>12</sup> ACCC, *Section 152ATA Digital Pay TV Anticipatory Individual Exemption Application lodged by Foxtel Management Pty Limited – Final Decision*, p 54, which refers to a cable IBAC calculated by the Commission of "*around \$270 million*"



undertake its calculation was provided by FOXTEL to the Commission on 11 April 2006 as part of FOXTEL's response to the Commission's information request dated 23 March 2006. This spreadsheet, and any material the Commission used in undertaking its calculation of a reasonable cable IBAC in the context of FOXTEL's anticipatory individual exemption application (even if not made available to FOXTEL), is material before the Commission in relation to its consideration of the Undertaking<sup>13</sup> and its assessment of the reasonableness of the IBAC in the context of the Undertaking. In any event, the concern raised by the Commission in relation to the Undertaking must be considered in circumstances where the Commission has previously accepted the IBAC and FOXTEL offered a significant concession from its own calculation of a reasonable estimate for the IBAC.

In addition, FOXTEL submits that the percentage of marketing costs allocated to the IBAC are relatively immaterial to the final access price.

The model the Commission used to calculate its estimate of FOXTEL's cable IBAC is not particularly sensitive to changes in the percentage of FOXTEL-specific marketing. The following table illustrates the changes to the IBAC which occurs if the percentage of FOXTEL-specific marketing is adjusted:<sup>14</sup>

<b>Percentage of brand marketing</b>	<b>Cable IBAC</b>
32%	\$267m
40%	\$262m
50%	\$255m
60%	\$248m

In addition, the FOXTEL IBAC model which is the one used to produce the rate cards is not particularly sensitive to these changes. Since preparing its report in 2002, NECG has been acquired by CRA International. FOXTEL has retained CRA International to update the NECG model with the inputs from the PwC reports of 2005 and calculate the value of the cable and satellite IBAC that results from different assumptions about brand marketing. CRA have produced a report setting out the results of this work and FOXTEL attaches this report in support of these submissions.

As described in its report, CRA has updated the inputs into the NECG model from the cable and satellite IBAC costs schedules which were the subject of PwC's agreed upon procedures reports dated 13 July 2005, and which were Attachments 8 and 9 to FOXTEL's Submission. Using a brand marketing assumption of 32%, CRA calculated FOXTEL's IBAC as at 30 June 2004 as \$287,607,000 for cable and \$105,576,000 for satellite. FOXTEL has amended Schedule 3 of the DAA to reflect these updated figures.

<sup>13</sup> Alternatively, it is material that FOXTEL is putting before the Commission and asking it to consider in making its decision in relation to the Undertaking.

<sup>14</sup> These figures were derived from adjusting the percentage figure in cell C8 on the 'Assumptions' tab of the file 'FOXTEL TSLRIC v07.09.01E-adjust', which FOXTEL understands is the Commission's model, and which was provided to the Commission by FOXTEL in the context of this Undertaking on 11 April 2006.

CRA was also instructed to vary the assumed brand marketing percentage. The following table sets out the results of the analysis conducted.

	Brand	Non brand	Cable IBAC	Satellite IBAC
<b>Estimate in NECG's 2002 report</b>	32%	68%	271,394,000	114,660,000
<b>Estimate in CRA's 2006 report</b>	32%	68%	287,607,000	105,576,000
<b>Sensitivity Test 1</b>	15%	85%	301,273,000	107,802,000
<b>Sensitivity Test 2</b>	40%	60%	281,062,000	104,528,000
<b>Sensitivity Test 3</b>	50%	50%	272,838,000	103,218,000
<b>Sensitivity Test 4</b>	60%	40%	264,567,000	101,908,000

FOXTEL also attaches a statement of Michelle Kvello of FOXTEL. As set out in her statement, Ms Kvello has inputted the various values for the cable and satellite IBAC into the FOXTEL Digital Access Pricing Model and produced various ratecards, which are attached to her statement, which show the prices which would be charged under the different scenarios. These prices show that changes to the percentage of marketing costs do not have a material affect on the access price.

In circumstances where the percentage does not have a very substantial effect, the Commission has previously accepted the overall amount of the cable IBAC as reasonable and the difficulty in attempting to find material to support a percentage split for marketing costs incurred as long ago as 10 years, FOXTEL submits that the Commission should accept the figure of 68% as a satisfactory basis on which to split FOXTEL-specific and non-specific marketing costs in the context of the cable IBAC.

**(b) Future marketing costs**

The Commission has also expressed a concern that the calculation of non-specific marketing for future periods is dependent on FOXTEL, non-transparent and not subject to independent review. It has also expressed concern that the percentage of non-specific marketing determined for the 2003-2004 period of 90.29% *"appears to be unreasonably high"*.<sup>15</sup>

FOXTEL reiterates that it is appropriate to include 'acquisition' and 'retention' marketing costs in its cost base going forward (in addition to its inclusion in the IBAC). This is because such marketing is directed to acquiring and retaining subscribers who install FOXTEL STUs in their homes. Access seekers directly benefit from the size of FOXTEL's installed subscriber base and the Undertaking gives access seekers access to a ready-made customer base. Given this benefit, it is reasonable to expect access seekers to contribute to the costs of maintaining and growing the subscriber base.

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<sup>15</sup> ACCC Draft Decision, p 58

Consistently with the Tribunal's decision in *Seven Network Limited (No 4)*,<sup>16</sup> FOXTEL accepts that marketing that is directed to a specific FOXTEL channel (which may compete with an access seeker's channel), and is not directed to the FOXTEL service generally, should be excluded from the marketing costs. This distinction is appropriately reflected in the division of FOXTEL's marketing costs into "branded" and "non-branded" marketing (as defined in Schedule 3 of DAA). FOXTEL also observes that it does not conduct a wholesale business and accordingly does not engage in any "pure" wholesale advertising whereby it markets the Digital Set Top Unit Service to potential access seekers.

FOXTEL asked PwC to review the marketing costs included in the T1 rate card. However, in order to perform a review, PwC required that FOXTEL locate and provide to it about 2500 invoices and allow them to conduct interviews with marketing staff in relation to the majority of the invoices, a process that would have proven very difficult, time consuming and expensive.

Instead, in order to support the figure it has put forward, FOXTEL has provided the Commission with a detailed statement from Mr Antony Warne, FOXTEL's General Manager of Brand Marketing, which analyses actual marketing expenditure by campaign and removes campaigns which are solely or partly devoted to a single channel in FOXTEL's basic service (consistent with the definition of "Defined Capital Expenditure" in Schedule 3 of the DAA). Having performed this task, the percentage figure of 90.29% was calculated.

FOXTEL submits that this procedure is transparent and has been conducted fairly. However, FOXTEL has addressed the Commission's concerns by doing, or undertaking to do, the following:

- Amending the definition of marketing costs in "Defined Capital Expenditure" to exclude marketing of single channels wherever they appear in FOXTEL's service (in basic *and* in tiers). FOXTEL submits that the costs of marketing packages of tiers (eg. the sports tier and the movie tiers) should be included in the definition because these tiers are significant acquisition drivers. This is supported by the fact that only around the percentage set out at point 3 of Confidential Appendix B of FOXTEL's subscribers subscribe only to the basic package. The ability of tiers to attract new subscribers is something that access seekers benefit from, because each new FOXTEL subscriber is an additional potential customer for an access seeker. Accordingly, the cost of marketing these tiers to create awareness and enhance their pulling power is a cost that access seekers should contribute to. Clause 3.5(c) of Schedule 3 to the DAA has also been amended to exclude marketing solely devoted to a single Subscription Television Service on FOXTEL on a tier from the marketing costs to be depreciated over 3 years.
- From FY 2005/2006, in conjunction with the review of the rate card, PwC performing an independent review of the process undertaken by FOXTEL management to identify and separate general marketing costs from channel specific and other specific marketing costs. PwC's work will include discussions with FOXTEL management and, where available, external marketing suppliers, as well as observation of relevant documentation. PwC will provide a report on the process undertaken by FOXTEL and the factual findings from its work.

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<sup>16</sup> [2004] ACompT 11 (23 December 2004)

FOXTEL has therefore amended clause 7.3.3 of the Regulatory Accounting Procedures Manual (*RAPM*) so that the second paragraph reads:

Line 15 will record the percentage of Marketing which should be included for each year as determined in accordance with Schedule 3 of the DAA.

## **2.6 Gamma**

FOXTEL notes that the Commission has formed the view that it would be difficult to justify a departure from the gamma used in the digital exemption application in 2003 (0.5)<sup>17</sup>. FOXTEL continues to rely on the expert reports of Professor Stephen Gray in support of its submission that the appropriate gamma is 0.

## **3. Reasonableness of Tie and Bundle**

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### **3.1 Tying of Basic Package to Access**

In its Draft Decision, the Commission ultimately found that in its view the tie of the basic package to access is reasonable and that FOXTEL should not be required to supply STUs to non-FOXTEL homes.<sup>18</sup> FOXTEL supports and welcomes this conclusion.

However, in the course of arriving at its decision, the Commission made a number of comments that FOXTEL wishes to address.

#### **(a) FOXTEL's market power**

The Commission has stated that "the tying condition may serve to consolidate FOXTEL's market power in the provision of digital subscription television services more generally."<sup>19</sup> FOXTEL denies that it has market power in any relevant market and refers to its previous submissions on this point.<sup>20</sup> It also notes that the Commission has not referred to any evidence about market power nor has any evidence of market power been submitted by anyone. FOXTEL does not see how the Commission can express any view about FOXTEL's "market power" when it has indicated that it does not believe it is necessary for it to define the appropriate market and there is no evidence about market power.

#### **(b) Barriers to entry**

The Commission has stated that, while the Undertaking may promote competition in terms of facilitating the entry of access seekers at the tier level, it does not promote competition in the provision of basic package services.<sup>21</sup>

FOXTEL submits that, in relation to the promotion of competition for the basic package, the Undertaking potentially does promote competition even for the basic package because it provides one means by which an operator seeking to offer a basic package can supply that basic package to a subscriber who also wants to take FOXTEL's service. In any event, it certainly does not discourage basic package competition. With or without the Undertaking, access seekers have the ability and the option of rolling out their own STUs in order to

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<sup>17</sup> ACCC Draft Decision p 78

<sup>18</sup> ACCC Draft Decision p 89

<sup>19</sup> ACCC Draft Decision p 86

<sup>20</sup> Section 2 of FOXTEL's Supplementary Submission in support of the 2005 Undertaking, pp 3 – 8

<sup>21</sup> ACCC Draft Decision p 86

compete with FOXTEL in the provision of basic package services. As the Commission has recognised,<sup>22</sup> digital STUs are freely available to purchase and range from relatively low cost, low feature STUs to high-cost, full feature STUs (like the FOXTEL STUs).<sup>23</sup> Different STUs may suit different access seekers depending on their needs, business model and budget. Access seekers can also set up their own conditional access system or license one from a third party, again ranging from a basic system to a full feature system.<sup>24</sup> A bundled carriage, CA and SI service may also be available to acquire from some third parties (eg Globecast on satellite and Telstra on cable).<sup>25</sup>

The Commission has stated in the Draft Decision that:<sup>26</sup>

More generally, the Commission considers that STUs (i.e. the hardware), in and of themselves, do not constitute a bottleneck element in the supply of subscription services. While there may be some economies of scale involved in provision, the Commission notes that the functional life of FOXTEL's STUs, for example, are 5-7 years, while the average subscription terms are 2 years. Therefore STUs can be readily redeployed and the costs of the STUs are not necessarily sunk. As such it is not apparent that access seekers pursuing self supply options with respect to STUs would necessarily deter competitive entry or lead to inefficient outcomes.

The Commission has stated that the real factor that prevents there being competition for FOXTEL's basic package is not the Undertaking but sufficient access to carriage and premium content.<sup>27</sup> FOXTEL submits that there is clearly no impediment to access to carriage. Access seekers can source carriage from Telstra under the Telstra Multimedia Access Agreement, or from another carriage provider, independently of seeking access under FOXTEL's DAA. The Telstra Access Agreement allows for a subscriber to use either FOXTEL STUs or the access seeker's own STUs.<sup>28</sup> Schedule 2 to the Telstra Multimedia s87B undertaking provides that Telstra Multimedia will allocate to access seekers:

- (i) at least 15% of the total number of digital channels allocated by it to subscription television broadcast carriage services during the dual analogue / digital simulcast period; and
- (ii) at least 35% of the total number of digital channels allocated by it to subscription television broadcast carriage services after the simulcast period.

The simulcast period is currently due to end in March 2007 when FOXTEL ceases supplying an analogue service. Therefore from that time 35% of subscription television carriage capacity will be available to allow services over the Telstra Multimedia cable.

In addition, there is also significant satellite capacity available for access seekers to license as set out in the expert report of Mr Bill McDonald.<sup>29</sup>

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<sup>22</sup> ACCC Draft Decision, pp 88 - 89

<sup>23</sup> Engineering Report, Section 6.1.2(c).

<sup>24</sup> Engineering Report, Section 6.1.2(d).

<sup>25</sup> Engineering Report, Section 6.1.2(a) and (b).

<sup>26</sup> ACCC Draft Decision pp 88 – 89

<sup>27</sup> ACCC Draft Decision pp 5, 103 and 136

<sup>28</sup> Telstra Multimedia Access Agreement, Clause 6 .

<sup>29</sup> Attachment 2 to FOXTEL's Submission in support of the 2005 Undertaking

The Commission has accepted that, if an access seeker had access to "a compelling suite of channels and carriage", there would appear to be no impediments to deployment of STUs and related CA/SI functionality for provision of subscription television services to end-users.<sup>30</sup>

The primary issue is therefore access to sufficient compelling content to create a new competitive basic service. The Commission has indicated in its draft determination that, given this, the real "bottleneck" that the Undertaking is trying to address, and that the Commission is concerned with, is the provision of niche, tiered services to subscribers. The Undertaking allows for real competition at the niche, tiered level without preventing competition at the basic level in the event that a service provider emerged that could provide real competition for the basic package.

### 3.2 Provision of Unbundled CA/SI Services

Again, the Commission has ultimately concluded that it "would not be inclined to place great weight on the value of access to unbundled CA/SI services"<sup>31</sup> and that on balance the Undertaking is reasonable. FOXTEL supports this conclusion. However, the Commission has made a number of comments in reaching this conclusion that FOXTEL wishes to address.

The Commission has indicated that acceptance of the Undertaking would foreclose the possibility of the Commission making an arbitral determination that mandates access to FOXTEL's unbundled CA/SI services.<sup>32</sup> In this context, the Commission has stated that its assessment of the 'reasonableness' of the Undertaking will involve a comparison of the "definite provisions for access provided under the terms and conditions of the Undertaking" with a counterfactual that includes the *possibility* of broader access.

FOXTEL agrees with the Commission's approach to the assessment of the LTIE in this regard but submits that there are a number of other factors that must be taken into account in assessing the reasonableness of the Undertaking, including:

- the legitimate business interests of the carriage service provider;
- the interests of persons who have a right to use the service;
- the direct costs of providing access to the service;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service; and
- the economically efficient operation of a carriage service.<sup>33</sup>

#### (a) Reduction in barriers to entry

The Commission has again stated that "the prospect of unbundling CA/SI may be viewed as a means of promoting competition at the level of basic package offerings in the absence of compelling FOXTEL to provide access to STU equipment in non-FOXTEL homes"<sup>34</sup> and

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<sup>30</sup> ACCC Draft Decision, p 103

<sup>31</sup> ACCC Draft Decision, p 104

<sup>32</sup> ACCC Draft Decision, p 100

<sup>33</sup> Section 152AH of the Act

<sup>34</sup> ACCC Draft Decision, p 100

may reduce barriers to entry.<sup>35</sup> FOXTEL repeats its submissions above that even given the bundling provision there is nothing preventing access seekers from supplying their own STUs, CA and SI and competing with FOXTEL for the provision of the basic package.

The Commission itself notes that third party hosting of CA/SI and bundled satellite carriage/CA/SI services are available and reduces these barriers<sup>36</sup> and concludes that CA/SI services appear to be contestable inputs. In particular, the Commission states that, like provision of STUs, provision of CA/SI services by full-scale subscription television providers is not a bottleneck.<sup>37</sup>

The Commission states that, if access seekers choose to use the FOXTEL DAA for STUs in FOXTEL homes *and* provide their own STUs, CA and SI in non-FOXTEL homes, access seekers will need to purchase capacity equivalent to two channels for each channel they wish to distribute.<sup>38</sup> However, the Commission notes that this requirement does not *per se* make it a bottleneck input. In FOXTEL's view the cost of purchasing additional channel capacity is reasonable as the access seeker is still receiving a large benefit from using FOXTEL STUs in FOXTEL homes, rather than installing its own STUs. The access seeker would be utilising two different networks – FOXTEL's and its own – in the same way that FOXTEL uses two different networks and pays for capacity on each (ie. cable and satellite).

Furthermore, FOXTEL submits that it is highly unlikely that this dual cost will arise. The two realistic scenarios for future new entry by a subscription television provider are *either*:

- (i) a full service provider in which case, as the Commission has recognised, it will roll out its own STU network rather than seek access to FOXTEL's; or
- (ii) a niche provider competing only with FOXTEL's tiers and not wanting access to non-FOXTEL homes.

**(b) Efficiency issues**

The Commission notes that the provision of unbundled CA/SI may have positive efficiency outcomes in that the access seeker avoids the cost of establishing its own CA/SI and also the cost of simulcasting channels. The Commission also states that an access seeker's ability to service customers on a stand-alone basis may increase with access to unbundled CA/SI and this may lead to higher demand.<sup>39</sup>

On the other hand, the Commission refers to the inefficiencies that may result from unbundling CA/SI services. In response, CRA concludes that compelling FOXTEL to supply CA and SI services to non-FOXTEL homes is unreasonable as it is likely that:

- entry barriers would not be reduced or reduced only slightly;
- significant costs would be incurred by FOXTEL with no assurance they will be recovered;
- unbundling CA/SI may reduce and distort competition;

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<sup>35</sup> ACCC Draft Decision, p 101

<sup>36</sup> ACCC Draft Decision, p 101

<sup>37</sup> ACCC Draft Decision, p 103

<sup>38</sup> ACCC Draft Decision, p 101; FOXTEL Engineering Report, Section 6.1.2.

<sup>39</sup> ACCC Draft Decision, p 102

- there would be no clear efficiency gains and, in particular, innovation and service upgrading would become substantially more difficult; and
- FOXTEL's ability to recover and gain a return on its investments would be compromised.<sup>40</sup>

The FOXTEL Engineering Report outlines the technical and operational issues that would be involved if FOXTEL was to 'unbundle' CA and SI and supply those services to access seekers in non-FOXTEL homes.<sup>41</sup> These issues include the following:

- an access seeker's STU would need to be compatible with the FOXTEL STU at all times (which in essence would require it to be identical in all material respects with the FOXTEL STU) otherwise the access seeker's STU would become unstable and eventually fail to decode FOXTEL signals;
- access seekers' STUs would need to be managed as if they were FOXTEL STUs, and would need to be tested and upgraded at the same time as the FOXTEL STUs;
- a high level of cooperation between FOXTEL and the access seeker would be necessary, which may be difficult given that they are competitors;
- management of different versions/variants of compatible STUs would become very expensive, complex and time-consuming;
- increased bandwidth would be needed for management and support; and
- any conflicts may lead to one or both platforms stalling in their development which would impact on all users (and subscribers).

In addition to these technical and operational issues, providing CA and SI services to access seekers in non-FOXTEL homes would require several significant modifications to FOXTEL's systems, including:

- redesigning the ACSD;
- changing FOXTEL's STU tracing and field installation/maintenance databases;
- the establishment by FOXTEL of smartcard purchase management; and
- changes to FOXTEL's testing facilities.<sup>42</sup>

This would essentially require establishment of a wholesale division with dedicated personnel who would have responsibility for managing provision of services to access seekers. The costs of this division would have to be borne by access seekers.

While recognising some of these issues, the Commission has nonetheless stated, without providing evidence or reasons, that they "may be able to be mitigated through implementation of contractual terms and conditions of supply that protect FOXTEL's legitimate interest in being able to improve and upgrade its platform."<sup>43</sup> However, neither the Commission nor other third parties have provided any evidence that undermines

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<sup>40</sup> Henry Ergas, Charles River & Associates: Reasonableness of Limiting the Supply of FOXTEL's Conditional Access Service, p25

<sup>41</sup> Engineering Report, Section 6.1.3.

<sup>42</sup> Engineering Report, Section 6.1.3.1.

<sup>43</sup> ACCC Draft Decision, p 102



FOXTEL's contentions about the technical impacts of unbundling the CA/SI. FOXTEL submits that, in the absence of any evidence to the contrary, these technical and operational limitations should be accepted.

## 4. Interactive Service

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While FOXTEL agrees with the conclusion the Commission ultimately expresses in its Draft Decision that the Undertaking is reasonable, even though it does not grant existing or potential FOXTEL channel providers access to modem services, it does not agree with certain aspects of the Commission's reasoning. FOXTEL wishes to address these aspects.

### 4.1 Importance of modem services

The Commission states that it:

...considers that the ability for access seekers to obtain an equivalent quality and functionality of modem services is a critical factor in enabling access seekers to compete with FOXTEL in the provision of interactive content as part of channel offerings.<sup>44</sup>

The Commission refers to the fact that as at 23 March 2006 there were 17 channels out of 77 that comprised a constant feed forward path interactivity and 14 channels that included return path interactivity. However, it is important to note that the 17 forward path channels **do not use the modem** and so access to modem services is not necessary in order to provide these services. All of the return path interactivity included in these 14 channels relates to a combination of voting, quizzes, i-ads and FOXTEL Box Office. As FOXTEL has previously submitted,<sup>45</sup> access to the modem is not necessary for channel providers or subscription television providers to compete. This type of functionality is available through many mechanisms, including SMS, the internet and telephone.

The Commission has nonetheless concluded that provision of interactive services will be critical to competition between rival providers of pay TV services and competition **between individual channels** as adding interactive features increases the basis upon which channels compete and also opens the possibility of additional revenue streams directly to the channel provider.

### 4.2 Channel provider as access seeker

The Commission goes on to say that:<sup>46</sup>

...even those firms that sell their feed directly to FOXTEL can be regarded as access seekers, since they are asking FOXTEL to carry their channel in order to allow them to earn a separate stream of revenue from the interactive services...

and further that:<sup>47</sup>

interactive offerings are likely to change the relationship between FOXTEL and third party channel providers to a relationship more closely akin to access provider and access seeker, since the channel provider will wish for FOXTEL to carry the channels to the end customers so that the channel provider can earn revenue from interactive features...

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<sup>44</sup> ACCC Draft Decision, p 110

<sup>45</sup> Section 8.1 of FOXTEL's Supplementary Submission in support of the 2005 Undertaking, pp 26 - 27

<sup>46</sup> ACCC Draft Decision, p 111

<sup>47</sup> ACCC Draft Decision, p 112

On this basis, and on the basis that *some* of FOXTEL's existing contracts are silent on the issue of the provision of interactive services, the Commission rejects FOXTEL's argument that the Commission cannot consider the issue.<sup>48</sup>

FOXTEL submits that the Commission's characterisation of FOXTEL's own channel providers as "access seekers" that potentially compete with each other in this way is misconceived. If a person has a channel they wish to be seen by the public they have two means by which to do so:

- by supplying the channel to FOXTEL (or another subscription television operator); or
- by supplying the channel directly to subscribers.

This second objective could be achieved by three possible means:

- by obtaining carriage from Telstra and negotiating with FOXTEL to have access to its infrastructure;
- by seeking access as an access seeker under FOXTEL's s87B undertaking; or
- if accepted by the Commission, by seeking access under the Undertaking.

The Undertaking promotes competition by creating another option for channel owners to commercially exploit their product.

If a channel provider who is supplying the channel to FOXTEL wishes to add interactive services to the channel, it has three options to do so:

- it can commercially negotiate with FOXTEL to include the interactive services into the FOXTEL-provided channel;
- subject to its contract with FOXTEL, it can choose to supply the channel and its interactive services directly to subscribers by simulcasting the channel as an access seeker and including the interactive services into the simulcast channel; or
- subject to the contract with FOXTEL, it can terminate its arrangement with FOXTEL and supply the channel and its interactive services directly to subscribers as an access seeker.

Again, the Undertaking promotes competition by creating other options for channel owners to commercially exploit their product.

The only thing that the Undertaking does not facilitate is the ability of a channel provider, who is supplying the channel to FOXTEL under contractual terms by which FOXTEL acquires the right to broadcast the channel as part of its television service, to force FOXTEL to broadcast the channel in an altered form, namely with the addition of interactive services

The purpose of Part XIC is the promotion of competition for the provision of retail services, not interfering with the type of content that a retail provider chooses to include in its own service. In FOXTEL's submission, the provisions of Part XIC of the Act do not and should not be construed in a manner that would interfere with a retail service provider's control over its own retail content. FOXTEL has made substantial submissions to the Commission on this point previously and again refers to and relies on those submissions.<sup>49</sup> It does not propose to repeat them here.

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<sup>48</sup> ACCC Draft Decision, p 112 and 113

<sup>49</sup> Letter from Allens Arthur Robinson to the Commission dated 31 May 2006; Letter from Allens Arthur Robinson to the Commission dated 14 June 2006; FOXTEL's Further Supplementary Submission in support of the 2005 Undertaking; Supplementary Confidential Statement of P W Campbell dated 26 June 2006

FOXTEL submits that the Commission's suggestion that the providers of its existing channels should have the ability to access modem services through the Undertaking ***in order to compete with FOXTEL*** and each other is entirely misconceived.<sup>50</sup> FOXTEL accepts that channel providers may choose to compete with FOXTEL and supply their channels directly to subscribers. The Undertaking promotes that competition. But the Commission appears to imagine a different form of competition whereby the channel provider will supply its channel to FOXTEL for inclusion in FOXTEL's service (and for supply to FOXTEL's subscribers), and at the same time supply the channel in an altered form (with interactive content) also to FOXTEL's subscribers. It is difficult to understand how the form of competition that the Commission envisages would ever occur in practice, or be commercially sustainable. The effect is to force FOXTEL to acquire a particular kind of content for its own television service; FOXTEL believes that competition demands that it is free to choose the content that it wishes to acquire and supply as part of its television service.

While FOXTEL agrees with the Commission that it is in its legitimate business interests to control its own content<sup>51</sup> and agrees with the Commission's ultimate conclusion that the Undertaking with the interactivity provisions is reasonable,<sup>52</sup> FOXTEL adheres to its previous submissions that the issue is not relevant to the Commission's consideration as it is about access to the content of a subscription television provider not access to services to enable a person to provide its own subscription television service.

## 5. Other Non-Price Terms and Conditions

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### 5.1 Changes to the DAA

FOXTEL refers to the Commission's Draft Decision at page 122.

To address the Commission's concerns in relation to notice periods, FOXTEL has:

- amended clause 4.4(b) of the DAA to extend the required notice periods before a Change can be enacted (from 1 month to 2 months and from 3 months to 6 months in sub-clauses (b)(ii) and (iii) respectively); and
- amended clause 11.2(b) of the DAA to provide that reasonable notice of a Modification is not less than 1 month's notice.

FOXTEL does not agree that clauses 4.4(b) and 11.2(b) of the DAA are not consistent with section 2.5 of the SAU. Clause 4.4(b) relates to changes to the Digital Set Top Unit Service and clause 11.2 relates to changes to the Interface Specifications, Operational Procedures, Modem Protocol and/or Channel Kit. The subject matter of these changes is different to that of section 2.5 of the SAU, which relates to changes to the DAA itself.

As noted in FOXTEL's Supplementary Submission, the effect of the Undertaking is that FOXTEL will not vary the DAA other than in accordance with section 2.5 of the SAU. Notably, this includes a requirement that the Digital Set-Top Unit Service supplied to an access seeker remains supplied to the equivalent quality as FOXTEL supplies to itself.

FOXTEL contends that these provisions are reasonable as:

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<sup>50</sup> ACCC Draft Decision, pp 115 – 116

<sup>51</sup> ACCC Draft Decision, pp 115 and 118

<sup>52</sup> ACCC Draft Decision, pp 118 – 119

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

Without these limited rights to vary the DAA, FOXTEL contends that it would be impossible to obtain the unanimous approval of all access seekers to undertake any changes to its pay TV platform: this is not in the LTIE and clearly against the legitimate business interests of FOXTEL who wishes to provide a world class pay TV service.

In addition, clauses 4.4(b) and 11.2(b) relate to different changes – clause 4.4(b) relates to changes to the Digital Set Top Unit Service itself whereas clause 11.2(b) relates to operational changes. FOXTEL has amended the DAA to provide access seekers with 2 months' notice in relation to changes to the Digital Set Top Unit Service itself. However, in relation to operational changes, FOXTEL currently has a 3 week cycle to implement operational changes and has amended the DAA to provide access seekers with at least 1 month's notice of these changes. If FOXTEL was also forced to provide access seekers with 2 months' notice of operational changes, this would impact significantly on FOXTEL's business. FOXTEL submits it is not inconsistent for the notice periods in clauses 4.4(b) and 11.2(b) to be different and that this is in fact appropriate.

## **5.2 Charges for faults**

FOXTEL refers to the Commission's Draft Decision at page 124.

As stated in FOXTEL's Supplementary Submission, FOXTEL agrees to amend the DAA to provide that in Schedule 2, clause 6, where a Fault is notified by the access seeker and it is not caused nor contributed to by FOXTEL or the access seeker, then the costs in paragraph (b) will be shared equally between FOXTEL and the access seeker.

## **5.3 Warranties, indemnities and assignment rights**

FOXTEL refers to the Commission's Draft Decision at page 126.

As stated in FOXTEL's Supplementary Submission, FOXTEL contends that the warranties, indemnities and assignment rights in the DAA are commercial and reasonable, given the arrangements that FOXTEL has in place with other third parties in relation to its platform and the technical and operational risks to FOXTEL of an access seeker's presence on its pay TV platform.

However, to address the Commission's concerns in relation to consequential loss, FOXTEL is prepared to amend clause 23.3 of the DAA to make the exclusions apply to both parties.

## **5.4 Additional amendments to the SAU and DAA**

In addition to the amendments to the SAU and DAA outlined above, FOXTEL has also made the following additional amendments:

- a Confidentiality Deed between FOXTEL Management Pty Limited and the Access Seeker has been inserted as Appendix 3 to the SAU; and
- clause 5.2(e) of the DAA has been deleted.

## 6. Consistency with Standard Access Obligations

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### 6.1 What does 'consistent with the standard access obligations' mean?

Under s152BV(2)(b) of the Act, the Commission must not accept the SAU unless it is satisfied that it is "consistent" with the standard access obligations (**SAOs**) that are applicable to FOXTEL. The Act does not stipulate the way in which this is to be ascertained.

As FOXTEL noted in its Submissions in Reply, in its Final Decision on Optus' undertaking with respect to the supply of its Domestic GSM Terminating Access Service released in February 2006 (the **Optus Decision**), the Commission stated that it adopts the following method to determining whether an undertaking is "consistent" with the SAOs.<sup>53</sup>

- identify those SAOs that are applicable to a particular access provider; and
- assess whether the proposed undertaking is consistent with the applicable SAOs.

The Commission reiterated this approach in its Final Decision on Hutchison's undertakings with respect to the supply of its Mobile Terminating Access Service released in June 2006 (the **Hutchison Decision**).<sup>54</sup> The Commission has stated on several previous occasions that this assessment of "consistency" involves a consideration of whether the terms and conditions of an undertaking "raise any *inconsistencies* with the SAOs."<sup>55</sup> Furthermore, it has stated that:<sup>56</sup>

If the terms and conditions are not found to be inconsistent with the SAOs, the Commission is likely to regard the undertaking as being consistent with the applicable SAOs.

The Commission has also elaborated that its view is that the meaning of the word "consistent" in section 152BV(2)(b) is "its ordinary and natural meaning",<sup>57</sup> and to be "consistent with" implies that

there be some uniformity and adherence to the thing in question but that *there is no requirement for exact or complete correspondence*.

In outlining how it would apply this view of the meaning of "consistency" to the question whether an undertaking met the requirements of the Act, the Commission has stated that it does not require that the terms of an undertaking "be precisely in accordance with the applicable SAOs". Instead, there must be "at least a *reasonable* level of conformity" with them.<sup>58</sup>

This reasonableness with respect to conformity with the SAOs is distinct from the question of whether the terms of the SAU are reasonable. This was explicitly recognised by the Commission in its Final Decision on the Assessment of Telstra's ULLS Monthly Charge Undertaking released in August 2006 and its Draft Decision on the Assessment of Telstra's PSTN and LCS Undertakings released in September 2006, where it stated that the Commission's assessment of "consistency" is

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<sup>53</sup> Optus Decision, p 182

<sup>54</sup> Hutchison Decision, p 95.

<sup>55</sup> Hutchison Decision, p 95; Final Decision on the Assessment of Telstra's ULLS Monthly Charge Undertaking, released in August 2006 (the **Telstra ULLS Decision**), p 28; Draft Decision on the Assessment of Telstra's PSTN and LCS Undertakings, released in September 2006 (the **Draft Telstra PSTN Decision**), p 28; Optus Decision, p 182.

<sup>56</sup> Hutchison Decision, p 95. Statements to the same effect can be found in the Telstra ULLS Decision, p 28 and the Draft Telstra PSTN Decision, p 28.

<sup>57</sup> Hutchison Decision, p 95.

<sup>58</sup> Optus Decision, p 182; Hutchison Decision, pp 95 – 96

not "concerned with the *reasonableness* of the terms and conditions" of an undertaking and that this "is assessed separately".<sup>59</sup>

The Commission also accepts that a number of terms and conditions in any SAU are likely to intrude upon or limit, at least to some extent, the obligation to supply that would otherwise be established by the SAU. It identifies its task as assessing the extent to which the terms and conditions limit FOXTEL's obligation to supply in order to determine whether those terms and conditions "are so limiting as to be not consistent with the obligation set out in s152AR(3)(a)." The Commission says that this is "a question of degree".<sup>60</sup>

However, FOXTEL is concerned that in assessing whether its Undertaking is consistent with the SAOs, the Commission has in looked at factors that are more relevant in determining the *reasonableness* of the Undertaking under s152AH than whether it is consistent with the SAOs. In particular, the Commission is of the view that the following (non-exhaustive) factors may be relevant in determining whether a clause is consistent with the SAOs:

- whether the specific term/condition is a well accepted commercial term of supply; and
- whether the terms and conditions have the effect that the SAU is consistent with the purpose of Part XIC of the Act as is set out in s152AB.<sup>61</sup>

## 6.2 The Bundling Clause

### (a) The Commission's view

The Commission has assumed, for the purpose of assessing whether the bundling clause satisfies the SAOs, that FOXTEL has in effect not only lodged an undertaking in relation to the bundled DSTUS but has also lodged an undertaking in relation to each component service that makes up the DSTUS. This is because in its letter of 24 April 2006, FOXTEL stated that:

FOXTEL intends for the SAU to constitute an undertaking pursuant to s152CBA in respect of each and all of the services forming part of the DSTUS as defined. Accordingly, in any arbitration under Division 8 of Part XIC of the Act concerning the terms and conditions on which FOXTEL is to comply with the standard access obligations in respect of any of the services within the DSTUS, FOXTEL submits that s152CQ(5) will apply.<sup>62</sup>

The Commission has stated that there is some doubt as to whether the definition of the DSTUS operates as FOXTEL intended, but has nonetheless assessed the Undertaking on that basis.<sup>63</sup>

The Commission then goes on to state that the "effect" of the bundling clause is that if an access seeker requests access to any one of the component services alone, FOXTEL would only be required to provide access if the access seeker also acquired all of the other services that comprise the DSTUS.<sup>64</sup>

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<sup>59</sup> Telstra ULLS Decision, p 28; Draft Telstra PSTN Decision, p 28.

<sup>60</sup> ACCC Draft Decision, p 145

<sup>61</sup> ACCC Draft Decision, p 145

<sup>62</sup> ACCC Draft Decision, pp 30 – 31

<sup>63</sup> ACCC Draft Decision, p 32

<sup>64</sup> ACCC Draft Decision, pp 100 and 146

In particular, the Commission refers to the Tribunal's statement that "...the ability of an access seeker to provide subscription television services using its own STUs but without having to completely to duplicate FOXTEL's delivery infrastructure would appear to be a potentially attractive and valuable option..."<sup>65</sup> The Commission also states that it:

...believes that the price of acquiring all of the component services would be significantly higher than the price of acquiring the CA/SI services alone. In large part, the Commission believes that this difference would be attributable to the capex and opex cost pools. This additional cost is, in the Commission's view, a very significant limitation upon the obligation to supply CA/SI services as it would be likely to increase the price of obtaining these services far above their cost (even allowing for a commercially reasonable mark-up).<sup>66</sup>

The Commission says that "as a result" it considers "the effect of the bundling clause is to allow FOXTEL, under the Undertaking, to **constructively refuse to supply individual component services** to access seekers" and a term that allows this is "unlikely to be consistent with the obligation set out in s152AR(3)(a) to supply declared services." [emphasis added]

**(b) FOXTEL's primary view**

In FOXTEL's view, the Commission is wrong in its conclusion that FOXTEL is "constructively refusing" to supply component services. FOXTEL submits that the Commission has, in this instance, incorrectly applied the "consistency with the SAOs" test to its Undertaking.

The Commission's letter to FOXTEL of 13 April 2006 asked FOXTEL the following question:

Clause 2.2 of the SAU relevantly provides that 'FOXTEL undertakes to supply the Digital Set Top Unit Service on the terms and conditions specified in the Digital Access Agreement'. 'Digital Set Top Unit Service' ('DSTUS') has the meaning set out in Appendix 1 to the SAU. In the event that:

- (a) the ACCC, under section 152AL of the Act, declared a service that is a component of the DSTUS (such as a service consisting of Conditional Access Services and Service Information Services) to be a declared service;
- (b) one or more standard access obligations apply to FOXTEL in relation to that service;
- (c) the ACCC is required under section 152CP to make a determination on access by an access seeker to the service where FOXTEL is the carrier or provider,

does FOXTEL consider that the SAU would, for the purposes of section 152CQ(5), restrict the terms of the determination?

Note: the purpose of this information request is to clarify whether FOXTEL considers that the SAU:

- (a) is with respect to the DSTUS, and not a component service (and therefore imposes no restriction upon any arbitration with respect to that component service; or
- (b) covers the field (ie the DSTUS and all permutations of that service).

The ACCC appreciates that FOXTEL's response to this request would be without prejudice to FOXTEL's submission that such a component service could not be declared under Part XIC.

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<sup>65</sup> *Seven Network Limited (No 4)* [2004] ACompT 11 at [298]

<sup>66</sup> ACCC Draft Decision, p 146

FOXTEL's response in its 24 April 2006 letter was, essentially, "yes" and was expanded on as follows:

1. The Digital Set Top Unit Service (**DSTUS**) that FOXTEL has undertaken to supply pursuant to the SAU is expressed to be a single service. However, the DSTUS could be broken down or redefined into more narrow components and therefore said to encompass a range of services. This is not unusual. Many of the services to which Part XIC of the Act applies can be subdivided into more narrow components.
2. Although s 152CBA refers to a singular service, it must be permissible to give an SAU under s 152CBA in respect of a range of services. Otherwise, the section would be unworkable because it would require separate undertakings for each service. The section has to be applied in a practical manner.
3. Even if the Commission accepts the SAU, it may still declare the DSTUS or any service that forms part of the DSTUS and otherwise satisfies the criteria in s 152AL (see s 152AL(8)). This is the case for all SAUs and, as noted above, an SAU will usually encompass a range of services or services that could be redefined into more narrow components.
4. Section 152CM refers to a dispute about a singular service, but must also encompass disputes about a range of services.
5. Section 152CQ(5) should apply in the circumstances postulated by the Commission. Otherwise, in respect of any SAU which encompasses a range of services or services that could be redefined into more narrow components (which, as noted above, would be almost any SAU), the Commission could avoid the effect of the SAU by declaring each of the components separately. Such an outcome would undermine the legislative purpose, and the principal benefit to access providers and access seekers, of SAUs; that is, certainty about the terms and conditions of access.

FOXTEL notes that the question posed by the Commission is a matter of law and is hypothetical. It is difficult for FOXTEL to answer the question in a factual vacuum and FOXTEL's view on the question is qualified to that extent.

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

FOXTEL holds to these views. The reason why FOXTEL indicated to the Commission that its Undertaking was intended to be an undertaking in relation to each of the component services is because otherwise the Commission was suggesting that it would have the ability to declare separately each of the component parts of the DSTUS and that FOXTEL would be forced to supply each of those component parts. That could completely undermine FOXTEL's Undertaking and the whole rationale behind the provision of undertakings in Part XIC of the Act.

Every service potentially has component parts. For example, even if FOXTEL's undertaking was limited to access to Digital Set Top Units (and did not include CA/SI, EPG and Modem), arguably it could be separated further into access to STUs and fly cables as separate services, with each potentially able to be declared. FOXTEL does not believe that the Commission is suggesting it would go this far, but this is the logical conclusion of the Commission's reasoning. If it were the case that each service the subject of an



Undertaking could be broken down into components parts and each part separately declared, then an access provider may face the situation where, rather than its SAU governing the terms of access to the service, an access seeker may seek access to each separately declared part and seek arbitration and determination by the Commission.

Further, not all such component services will be declarable or likely to be declared. The Commission has indicated that it is unlikely that the component services would be individually declared as they are contestable services. However, it has still rejected FOXTEL's SAU on the basis that if the component services were individually declared, in its view FOXTEL would not be complying with the SAOs in relation to each of them as it requires that the services be taken as a bundle and that the costs of acquiring the bundle would be higher. FOXTEL submits that this question goes more to the 'reasonableness' of the Undertaking than consistency with the SAOs.

FOXTEL submits that the bundling provision is therefore more appropriately tested under the 'reasonableness' and LTIE criteria rather than consistency with the SAOs. Under the 'reasonableness' test, the Commission would conduct a 'with and without' analysis to see if the component services are likely to be declared and whether it is in the LTIE for the *possibility* of access to those individual services to be retained.

The Commission has already determined that the Undertaking is reasonable, on the basis that it is not likely those services would be declared and that the benefits of access to the bundled service outweigh the possibility of access to the component services. FOXTEL therefore submits that the bundling clause should not be seen as a constructive refusal to supply but, in effect, a bona fide and reasonable regulation of that supply.

**(c) FOXTEL's alternative proposal**

However, to address the Commission's concerns, FOXTEL will acknowledge in the Undertaking that the Undertaking is an undertaking only in relation to the DSTUS and not in relation to any possible part of the DSTUS.

Under s152AL(7) it is only the service that the SAU is *in relation to* that is a declared service. Under s152CBA(3)(a), the undertaking must state that the person agrees to be bound by the SAOs to the extent that those obligations would apply to the person *in relation to the service if the service were treated as an active declared service*. Under s152CBD(2)(a) the Commission must be satisfied that the terms and conditions of the undertaking would be consistent with the obligations referred to in paragraph 152CBA(3)(a). Therefore, as the component parts are not declared, the Commission only needs to be satisfied whether the DSTUS as a whole complies with the SAOs, not any potential component parts.

FOXTEL would still include clause 4.1(c)(ii). However, as the condition does not relate to any component service, the ACCC would not need to be satisfied that each component service is consistent with the SAOs. Rather, the condition would only be assessed as to whether it is reasonable, including whether it is in the LTIE.

The Commission has adequate opportunity to consider, when assessing the Undertaking, whether a provision like the bundling clause is reasonable. If it considers it is reasonable, even though it prevents the supply by that access provider of another service, then the undertaking should prevail. Otherwise the rationale and incentive for providing undertakings is completely undermined.

FOXTEL therefore submits that if the Commission does not accept FOXTEL's primary argument, it should accept FOXTEL's alternative approach and find FOXTEL's Undertaking is consistent with the SAOs.

### 6.3 Tie of basic package to access

Clause 4.1 of FOXTEL's DAA provides that:

- (c) FOXTEL is only obliged to supply and continue to supply Digital Set Top Unit Services to the Access Seeker:
  - (i) ...where the Digital Set Top Unit to which the Digital Set Top Unit Services are to be supplied is actually in use by a Subscriber for reception of FOXTEL's digital Subscription Television Services
- ...
- (f) FOXTEL has no obligation to supply any of the Digital Set Top Unit Services to a location where the Digital Set Top Unit to which the Digital Set Top Unit Services are to be supplied is not in use by a Subscriber for reception of FOXTEL's digital Subscription Television Services...

#### (a) Geographic condition

The Commission has indicated that if this so-called 'tying clause' was to be regarded as a 'limitation' on the undertaking (pursuant to s152CBA(5)) and therefore defined what was deemed to be declared under s152AL(7), it would accept that the tying clause was consistent with the SAOs.<sup>67</sup> However, the Commission correctly goes on to say that it understands that FOXTEL does not intend that the Undertaking is to be limited in this way; rather, the Undertaking is given in respect of services not only in relation to end users who are FOXTEL subscribers, but also in relation to end users who are not FOXTEL subscribers.<sup>68</sup>

FOXTEL submits that the so-called 'tying clause' is simply a bona fide **term of supply** of the 'active declared service' and is consistent with the standard access obligations.

The relevant standard access obligation imposed on FOXTEL under s152AR(3)(a) is to "*supply an active declared service to the service provider in order that the service provider can provide carriage services and/or content services*". The "active declared service" is the DSTUS by virtue of s152AL(7). The Undertaking and DAA provide for the supply of this service to access seekers. The so-called "tying clause" is simply a term of supply of this service – it provides that the service will only be supplied in relation to certain homes (that is, FOXTEL homes). This is not a *limitation* on the supply of the service in the Undertaking but simply a term of supply in the DAA. An access provider must be able to impose terms of supply over and above those in s152AR(3)(a) so long as they are not inconsistent. Here, there is no inconsistency – FOXTEL is supplying the DSTUS. The terms of supply (including the "tying clause") are then only assessed as to whether they are reasonable. As the Commission has already determined that the clause is reasonable, FOXTEL submits that it should accept the Undertaking.

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<sup>67</sup> ACCC Draft Decision, pp 146 to 147

<sup>68</sup> ACCC Draft Decision, p 31

**(b) 'Active declared service'**

FOXTEL also submits that this geographic term of supply is consistent with the SAOs because the SAOs cannot contemplate that FOXTEL should be forced to supply a service where it is not in fact supplying a service to itself.

The Commission says that this is an "additional argument" raised by FOXTEL in support of its Undertaking being consistent with the SAOs.<sup>69</sup> FOXTEL submits that this is not an additional argument, but rather supports FOXTEL's primary argument as FOXTEL could not be required to supply the service to non-FOXTEL homes even if the service was declared. The Commission has rejected FOXTEL's argument and states that in its view the use of the word 'active' does not require that the service actually be provided to a particular location but simply requires that the service is being provided at all.

FOXTEL disagrees with the Commission's interpretation and refers to its previous submissions that in its view the Act does not require that service providers provide services that they are not in fact supplying (including in fact to different locations).<sup>70</sup> FOXTEL submits that the ability for the Commission to "require a party to extend or enhance the capability of a facility" in an arbitral determination under s152CP(2)(e) does not affect this interpretation. First, the use by the Commission of this power comes only after a service is properly characterised as an 'active declared service' and is made subject to the SAOs under s152AR(3) and can be the subject of an arbitration and ACCC determination. An 'active declared service' is a declared service which is being supplied by an access provider (whether to itself or other persons).<sup>71</sup> FOXTEL submits that, in the context of the supply of the DSTUS, FOXTEL only supplies that service to itself in FOXTEL homes so that this is the only service that could be considered to be an 'active declared service' in relation to which FOXTEL is a 'service provider' under s152AR(2). Second, FOXTEL submits that a facility is not being "extended" or "enhanced" when it is being placed in an entirely new location; rather, a new service is being created.

Finally, FOXTEL also repeats its submissions that FOXTEL was found to be a 'carriage service provider' only in relation to the supply of the service to FOXTEL homes as further support for the submission that it cannot be required to supply the service to non-FOXTEL homes.<sup>72</sup> FOXTEL notes that the Commission has not addressed its submissions in this regard.

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<sup>69</sup> ACCC Draft Decision, p 147

<sup>70</sup> Sections 6.2 and 6.4 of FOXTEL's Submission in support of the 2005 Undertaking, pp 33 – 38 and 40 – 42; Section 5 of FOXTEL's Supplementary Submission in support of the 2005 Undertaking, pp 13 – 16

<sup>71</sup> Section 152AR(2)

<sup>72</sup> Section 6.4 of FOXTEL's Submission in support of the 2005 Undertaking, pp 41 – 42; Section 5 of FOXTEL's Supplementary Submission in support of the 2005 Undertaking, p14 – 15

## Appendix A

### List of materials to which FOXTEL wishes the Commission to have regard

Author	Title	Date
FOXTEL	Submission to Australian Competition and Consumer Commission	6 Oc
CRA International	<i>Attachment 1 to Submission:</i> Adjusted access pricing model for digital STUs	6 Oc
Bill McDonald	<i>Attachment 2 to Submission:</i> Independent expert report for submission to the Australian Competition and Consumer Commission	6 Oc
Peter Campbell	<i>Attachment 3 to Submission:</i> Confidential statement regarding the terms of FOXTEL's digital content agreements	6 Oc
CRA International	<i>Attachment 4 to Submission:</i> Reasonableness of limiting the supply of FOXTEL's conditional access service	6 Oc
Peter Smart and Ron Higgins	<i>Attachment 5 to Submission:</i> Engineering Report	6 Oc
Frontier Economics	<i>Attachment 6 to Submission:</i> Report by Dr Philip Williams on Market Definition and Promotion of Competition	6 Oc
NECG	<i>Attachment 7 to Submission:</i> FOXTEL explanatory material in relation to STU pricing	6 Oc
PriceWaterhouseCoopers	<i>Attachment 8 to Submission:</i> Agreed upon procedures report on cable IBAC cost schedules	6 Oc
PriceWaterhouseCoopers	<i>Attachment 9 to Submission:</i> Agreed upon procedures report on satellite IBAC cost schedules	6 Oc
PriceWaterhouseCoopers	<i>Attachment 10 to Submission:</i> Independent audit report on the schedule of gross capital purchase costs of satellite set-top-units	6 Oc
PriceWaterhouseCoopers	<i>Attachment 11 to Submission:</i> Report on gross purchase cost of cable set-top-units	6 Oc
PriceWaterhouseCoopers	<i>Attachment 12 to Submission:</i> Independent review report on FOXTEL's Digital Regulatory Accounting Procedures Manual	6 Oc
PriceWaterhouseCoopers	<i>Attachment 13 to Submission:</i> Independent audit report on FOXTEL's Digital Access Pricing Model, version 6, for the T1 period	6 Oc
Strategic Finance Group	<i>Attachment 14 to Submission:</i> The effect of franking credits on FOXTEL's cost of capital	6 Oc
Strategic Finance Group	<i>Attachment 15 to Submission:</i> A beta estimate for FOXTEL	6 Oc
Market Ridge	<i>Attachment 16 to Submission:</i> Consultancy report to the Australian Competition and Consumer Commission: subscriber management and conditional access systems	6 Oc
VPG Consulting	<i>Attachment 17 to Submission:</i> Response to consultancy report to the	6 Oc

<b>Author</b>	<b>Title</b>	<b>Date</b>
	Australian Competition and Consumer Commission regarding subscriber management and conditional access systems	
ACPG	<i>Attachment 18 to Submission:</i> Identification of media distribution mechanisms and models in Australia	6 Oc
FOXTEL	<i>Attachment 19 to Submission:</i> Folder of statements in relation to market definition	6 Oc
Allens Arthur Robinson	Letter to the Commission regarding interaction of SAU and s 87B undertaking	22 Nov
Allens Arthur Robinson	Letter to the Commission regarding use of Professor King's report by Seven	21 M
FOXTEL	Supplementary submission to Australian Competition & Consumer Commission: FOXTEL Special Access Undertaking	29 M
FOXTEL	<i>Attachment 1 to Supplementary Submission:</i> Table showing subscription television viewing - 2002 to 2006	29 M
FOXTEL	<i>Attachment 2 to Supplementary Submission:</i> Graph showing subscription television viewing - 2002 to 2006	29 M
FOXTEL	<i>Attachment 3 to Supplementary Submission:</i> FOXTEL's May 2006 re-packaging	29 M
FOXTEL	<i>Attachment 4 to Supplementary Submission:</i> Subscriber acquisition costs	29 M
FOXTEL	<i>Attachment 5 to Supplementary Submission:</i> Response to examples used by Mr Houston to support standardisation	29 M
NECG	<i>Attachment 6 to Supplementary Submission:</i> Supplementary report	29 M
Strategic Finance Group	<i>Attachment 7 to Supplementary Submission:</i> Supplementary report responding to report of Professor Officer	29 M
Peter Smart and Ron Higgins	<i>Attachment 8 to Supplementary Submission:</i> Supplementary Engineering Report	29 M
Allens Arthur Robinson	Letter to the Commission responding to information request	11 /
FOXTEL	<i>Annexure 1 to letter to the Commission:</i> Appendix 3 to the Special Access Undertaking	11 /
FOXTEL	<i>Annexure 2 to letter to the Commission:</i> Modem Services Protocol	11 /
FOXTEL	<i>Annexure 3 to letter to the Commission:</i> Extract 1 from spreadsheet entitled "FOXTEL TSLRIC v07.09.01E-adjust.xls"	11 /
FOXTEL	<i>Annexure 4 to letter to the Commission:</i> Extract 2 from spreadsheet entitled "FOXTEL TSLRIC v07.09.01E-adjust.xls"	11 /
FOXTEL	<i>Annexure 5 to letter to the Commission:</i> Extract 3 from spreadsheet entitled "FOXTEL TSLRIC v07.09.01E-adjust.xls"	11 /
Microsoft	<i>Annexure 6 to letter to the Commission:</i> Microsoft Excel Help on PMT function	11 /

<b>Author</b>	<b>Title</b>	<b>Date</b>
FOXTEL	Spreadsheet entitled "Cable and satellite IBAC.xls"	11 /
ACCC	Spreadsheet entitled "FOXTEL TSLRIC v07.09.01E-adjust.xls"	11 /
Allens Arthur Robinson	Letter to the Commission regarding whether SAU covers component services	24 /
Allens Arthur Robinson	Letter to the Commission regarding Regulatory Accounting Procedures Manual	9 M
Allens Arthur Robinson	Letter to the Commission regarding proposed deletion of clause 5.2(e)	29 I
Allens Arthur Robinson	Letter to the Commission regarding Terms of Reference provide to Convergent Consulting	31 I
Allens Arthur Robinson	Letter to the Commission regarding the Commission's request for further information	14 J
CRA International	Response to October 2002 Report by Stephen King	23 J
FOXTEL	Further Supplementary Submission	27 J
Peter Campbell	Supplementary confidential statement	27 J
Allens Arthur Robinson	Letter to the Commission regarding modem services	21 J
Allens Arthur Robinson	Letter to the Commission regarding error in letter of 29 May 2006	21 J
Allens Arthur Robinson	Letter to the Commission regarding marketing costs	28 J
Allens Arthur Robinson	Letter to the Commission regarding marketing costs	24 A
Antony Warne	Confidential statement	24 A