

**Submission by Seven Network
Limited in relation to Foxtel's special
access undertaking in relation to
Digital Set Top Unit Service**

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1 Executive summary

Seven Network Limited (**Seven**) makes this submission in response to the Discussion Paper issued by the Commission¹ in relation to the special access undertaking (SAU) given by Foxtel Management Pty Ltd and Foxtel Cable Television Pty Ltd (together **Foxtel**) under section 152CBA of the *Trade Practices Act 1974* (Cth) (**TPA**).

Seven submits that the Commission should reject the SAU given by Foxtel in relation to access to its Digital Set Top Unit Service (the **Undertaking**) in its current form, because the terms and conditions in the Digital Access Agreement (**DAA**) that forms part of the Undertaking do not comply with the requirements of Part XIC of the TPA. In particular, the Undertaking:

- (a) is not consistent with the standard access obligations (**SAOs**), for the reasons explained in section 3 below;
- (b) is not reasonable and is not in the long term interests of end users (**LTIE**), since the tie of access to the Basic Package means that the access provided will not promote competition in the provision of carriage services or services provided by means of carriage services, specifically retail Pay TV services;
- (c) is priced unreasonably as it includes unverified (and inappropriate) costs and uses an inflated cost of capital; and
- (d) exposes the access seeker to multiple access regimes, particularly as the Undertaking does not provide for true interactivity, with resulting inefficiencies inherent in multiple access regimes.

Moreover, in respect of each of these last three items, the Undertaking fails to address the fundamental concerns identified by the Australian Competition Tribunal (the **Tribunal**) in its decision² in respect of Foxtel's previous Digital Access Agreement (**Previous DAA**), particularly:

- (1) the tie of access to the Basic Package;
- (2) the verification of the costs included;
- (3) the provision of access to allow for true interactivity.

Accordingly, the Commission should not accept the Undertaking.

Further, Foxtel has not provided sufficient evidence to allow the Commission to be satisfied that that the Undertaking meets the statutory test. In particular, the counterfactuals against which Foxtel purports to assess the LTIE assume that Foxtel submits alternative SAUs. This is not correct. If Foxtel is not gaming the regulatory process, then the Undertaking is what it has chosen as the appropriate form of access. The counterfactual against which the Undertaking must be assessed cannot be another, improved version of the SAU, but must be declaration of the service determined by the access seeker.

¹ Commission Discussion Paper *Foxtel's Special Access Undertaking in relation to the Digital Set Top Unit Service* November 2005

² *In Re: Seven Network Limited (No. 2)* (2004) 187 FLR 373.

This submission addresses the following points:

- section 2 sets out the regulatory framework and the factual and counterfactual scenarios to which the Commission must apply the statutory test in assessing the Undertaking;
- section 3 explains why Foxtel's attempt to limit the Undertaking to Foxtel subscribers is not consistent with the SAOs;
- section 4 addresses the issue of Foxtel's attempt to tie access to the provision of Foxtel's basic package and why this is not in the LTIE;
- section 5 addresses Foxtel's cost of capital calculation;
- section 6 addresses Foxtel's failure to provide a rigorous verification of its inputs and costs;
- section 7 explains the implications of declaration of only part of the Digital Pay TV service, particularly examining the failure of the DAA to allow for or provide true interactivity; and
- section 8 identifies other issues that weigh against accepting the Undertaking.

In support of its submission, Seven also submits reports by Mr Greg Houston of NERA and by Professor Bob Officer.

2 Regulatory framework

2.1 What are the legislative criteria that the Commission must apply in accepting or rejecting a SAU?

The Commission should not accept a SAU unless four criteria are satisfied, the two relevant criteria of which are:

- (1) The Commission must be satisfied that the SAU is consistent with the SAOs.
- (2) The Commission must be satisfied that the terms and conditions of access set out in the SAU are reasonable.³

In determining whether to accept or reject a SAU, the Commission must be satisfied that the terms and conditions of the SAU would be consistent with the SAOs. The meaning of "consistent with" is not necessarily synonymous with "not inconsistent with". Simply showing that the Undertaking is not inconsistent with the SAOs does not suffice.

Nevertheless, on any view, the Undertaking is inconsistent with the SAOs, and accordingly for the reasons in section 3 should be rejected.

Section 152AH(1) establishes six criteria to which the Commission must have regard, in assessing the reasonableness of a SAU. The first of these is whether the terms and conditions promote the LTIE of carriage services or of services supplied by means of carriage services.

³ Section 152CBD of the TPA

In determining whether the Undertaking is in the LTIE, the Commission must have regard to two relevant objectives:⁴

- First, the objective of promoting competition in markets for listed services.
- Second, the objective of encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which listed services are supplied.⁵

Consistent with the Commission's approach in respect of the Previous DAA, Seven submits that the Commission should not, and for present purposes does not need to, define the relevant market. As the Commission is aware, the relevant market definition is currently the subject of Federal Court proceedings.⁶

The Australian Competition Tribunal (**Tribunal**) has provided guidance as to how promoting competition in the market for listed services, and encouraging the economically efficient use of and economically efficient investment in the infrastructure by which listed services are supplied, are to be interpreted. In *Sydney Airports*⁷, the Tribunal stated that the notion of promoting competition in the context of section 44H(4)(a) under Part IIIA of the Act does not require there to be:

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

Further, in *Re Seven Network Limited*⁸ the Tribunal applied the same definition of promotion of competition that it had used in *Sydney Airports* with respect to the phrase in Part XIC and extended its application to the criteria of the efficient use of and investment in infrastructure. Relevantly quoting the above passage in *Sydney Airports*, the Tribunal stated:

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

The Tribunal has also described the proper approach that should be adopted when determining the LTIE. In *Re Seven Network Limited*, the Tribunal said that the “future with and without” approach provides helpful guidance in applying the LTIE test.⁹ That is, the Tribunal will compare the future with the SAU (the

⁴ Seven does not challenge Foxtel's assertion that this criteria of achieving any-to-any connectivity in relation to carriage services that involve communication between end users is not relevant in considering the SAU.

⁵ Section 152AB(3) of the TPA

⁶ If required, the Commission should adopt the working definition used by the Tribunal in *Re Seven Network Limited & Anor (No 2)* (2004) 187 FLR 373 at [126]. That was the market for the provision of subscription television services.

⁷ *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10

⁸ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at 123 and 124.

⁹ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [119]

“**factual**”) to the future without the SAU (the “**counterfactual**”) in determining whether or not the SAU is in the LTIE. In *Virgin Blue Airlines*,¹⁰ the Tribunal said that the comparison of the factual with the counterfactual “requires a forward-looking analysis which involves a comparison of the competitive conditions and environment likely to arise in the future with and without declaration.”¹¹ This future looking analysis, however, is not completely divorced from the present. The counterfactual also must pay regard to the “present conditions of access projected into the future” and the “current and past behaviour of the service provider projected into the future”.¹²

This two-fold enquiry where the factual is compared to the counterfactual, “is not the ultimate or final answer”¹³ to the question whether a SAU is in the LTIE. Rather, the “answer must be couched in terms of an appropriate degree of satisfaction that the [acceptance of the SAU] ... will promote the long-term interests of end-users...”.¹⁴

2.2 What is the appropriate point of comparison?

(a) What Foxtel is proposing: the Factual

In the Factual, the Commission accepts the Undertaking, which contains the DAA that governs access to the Digital Set Top Unit Service, under section 152CBC of the TPA. As a result:

- Foxtel must abide by the terms and conditions in the DAA in relation to the Digital Set Top Unit Service that is supplied to Foxtel subscribers.
- Foxtel need not abide by the SAOs (including the obligation to supply the service) in relation to the Digital Set Top Unit Service to non-Foxtel subscribers.
- Foxtel need not abide by the SAOs in relation to new services or those services that already exist but which are expressly excluded from the DAA. For example, Foxtel need not provide access to a cable return path even if Foxtel began using it.
- Access seekers have the opportunity to seek declaration of Foxtel’s “end-to-end” digital pay TV service, including interactive services, under section 152AL of the TPA.¹⁵
- It is not clear from Foxtel’s submission whether the Digital Set Top Unit Service covers the field of services provided by Foxtel that are capable of declaration. Seven submits that the Digital Set Top Unit Service does not cover the field, for at least three reasons:

¹⁰ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5

¹¹ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at [148]

¹² *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at [149] and [157]

¹³ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [119]

¹⁴ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [119]

¹⁵ In *Foxtel Management Pty Ltd v Seven Cable Television Pty Ltd* [2000] FCA 1161, the Full Court held that Foxtel’s end-to-end analogue pay TV service was a listed carriage service capable. It should be noted that there could be a lower likelihood that this service would be declared if the ACCC has accepted the special access undertaking: *Re: Seven Network Limited (No. 2)* (2004) 187 FLR 373 at [277]-[278]

1. Foxtel's submission states that the DAA excludes Digital Set Top Unit functionality including return path and interactive functionality, access to or use of flash memory, and access to play out services.¹⁶ These are all services that Seven submits are capable of declaration under the TPA.
 2. Foxtel's end-to-end Digital Pay TV service is capable of being declared in its entirety as was the case with its analogue pay TV service.¹⁷
 3. Pay television services are dynamic and the services specified in the DAA today will differ from those likely available in six to twelve months time. Seven submits that these new services, and developments to the existing services, are capable of being declared.
- If the end to end service, or any part of Foxtel's service is declared, access seekers have the ability to refer to arbitration before the Commission an access dispute over price and non-price terms and conditions of access. However, the terms and conditions of the Undertaking prevail over inconsistent terms and conditions determined by arbitration.¹⁸
 - If any part of Foxtel's service is declared, access seekers will face multiple access regimes to the extent that the declared service is not covered by the Undertaking. The Tribunal has previously said that multiple access regimes are not in the LTIE. This point is developed in this submission below. Importantly, the reports by Mr Ergas and Dr Williams submitted by Foxtel do not consider the impact of multiple access regimes when assessing the Factual's reasonableness.
 - In addition to there being multiple access regimes, there is scope for debate about the boundaries of the Undertaking and the boundaries of a declared service. This will inevitably increase the costs and inefficiencies associated with access to the whole system.

(b) The Foxtel Counterfactuals

Foxtel itself proposes two counterfactuals in the report by Mr Ergas¹⁹ (**Foxtel Counterfactuals**).²⁰ These are options D and E in the Ergas report.

Under Option D Foxtel would unbundle the supply of the Digital STU from its CA and SI services, and supply CA and SI services to non-Foxtel subscribers with the Digital STU²¹ supplied by the access seeker or its agent. Mr Ergas describes this scenario as follows:

¹⁶ Foxtel's submission at 51

¹⁷ *Foxtel Management Pty Limited v Seven Cable Television Pty Ltd* [2000] FCA 1161.

¹⁸ Section 152CGB of the TPA

¹⁹ "Reasonableness of limiting the supply of Foxtel's conditional access service", report prepared by Henry Ergas of CRA International.

²⁰ As noted above, the Foxtel Counterfactuals assume that Foxtel lodges a different SAU. This is incorrect. The Counterfactual must be declaration of a service sought by an access seeker.

²¹ To be effective, this would require minimum standards in respect of the STUs to be provided to ensure interoperability. Professor Ergas cites this standardisation as a negative impact of Counterfactual D, however, for

“The first alternative scenario is that Foxtel submits the same SAU but with the addition of an unbundled CA/SI service, and the licensing of its STU specifications and the “security keys” to its STU.

Such a service would enable an access seeker to offer subscription television services to non-Foxtel customers, by providing for its own STU and carriage, but using Foxtel’s CA/SI system (rather than providing its own CA/SI).

This would also obviate the need to buy two separate channels of carriage to offer the same channel of content over two different CA systems (Foxtel’s and its own).

As a result, in this counterfactual, an access seeker could (in addition to the options in the factual) offer its services to non-Foxtel customers who are reachable by the carriage infrastructure used by Foxtel (Telstra’s HFC and direct to home (DTH) satellite), by using Foxtel’s CA/SI and providing its own STU (option D).

In this case, the access seeker would not need to simulcast, irrespective of whether it supplies its subscription television by its own or Foxtel’s STUs, since its program will be encrypted by a single CA system (Foxtel’s) and would be broadcast to either Foxtel STUs or STUs with an identical ability to interpret the SI and decrypt the signal.”²²

Under Option E Foxtel could supply the Digital Set Top Unit Service to non-Foxtel subscribers (ie. completely unbundle the Digital Set Top Unit Service from Foxtel’s basic package). Foxtel describes this as the full service model, and in Henry Ergas’s report, Ergas describes this model as follows:

“The second counterfactual is that Foxtel offers a full service for STU access, including the provision, operation, maintenance and removal of STUs in homes reachable by the Telstra cable or a satellite and within Foxtel’s service footprint. This is known as the “full service model”, or “FSM”. In this scenario, the provision of Foxtel’s CA/SI and the STU are “together” unbundled from the provision of Foxtel’s subscription television service and provided in non-Foxtel homes service by the access seeker.”²³

Seven does not accept that the Foxtel Counterfactuals are the appropriate counterfactuals to consider. Nonetheless, for completeness Seven examines Foxtel Counterfactual D. Seven submits that, for the reasons in Mr Houston’s report, Foxtel has not provided sufficient evidence to allow the Commission to be satisfied that the Undertaking (and the Factual) will promote the LTIE as compared with even the Foxtel Counterfactual D²⁴. These reasons are set out in detail in section 4.

(c) The Counterfactual

the reasons stated in Mr Houston’s report such standardisation could well promote competition, particularly in the markets for listed carriage services (ie the relevant test in section 152AB(3)).

²² “Reasonableness of limiting the supply of Foxtel’s conditional access service”, report prepared by Henry Ergas of CRA International at 14.

²³ “Reasonableness of limiting the supply of Foxtel’s conditional access service”, report prepared by Henry Ergas of CRA International at 14.

²⁴ Seven does not examine Foxtel Counterfactual E, since it is only necessary to show that the Factual is not in the LTIE, which can be demonstrated by considering only Foxtel Counterfactual D.

In *Re Seven Network Limited (No. 2)* (2004) 187 FLR 373, the Tribunal reviewed the Commission's decision to grant anticipatory individual exemptions to Foxtel and Telstra under Part XIC of the TPA. In that case, in the Tribunal's view, the counterfactual was:²⁵

- Access available to access seekers on the terms offered by Foxtel and Telstra under the section 87B undertakings that were lodged by Foxtel and Telstra in 2002; and
- Access seekers have the opportunity to seek a declaration of the Foxtel and Telstra services by the Commission under section 152AL. If the services are declared, then the SAOs will apply.

Applying the Tribunal's logic, the Counterfactual in this case, in the context of an access provider giving a SAU under Part XIC of the TPA, would be:

- Access available to access seekers on the terms offered by the Foxtel section 87B undertaking as in force, until 2007, when the section 87B undertakings expire.
- Access seekers have the opportunity to seek declaration of Foxtel's "end-to-end" digital pay TV service or parts thereof, including interactive services, by the Commission under section 152AL. Regardless of the extent of the end to end digital pay TV service that the access seekers sought, it is highly unlikely that it would include a tie to Foxtel subscribers.
- Foxtel must abide by the SAOs under section 152AR of the TPA in relation to the Foxtel digital pay TV service that is declared.
- Access seekers have the ability to refer to arbitration an access dispute over the price and non-price terms and conditions of access to the declared service. The Commission determines the terms and conditions of access using criteria as to "reasonableness" identical to those used when determining whether to accept or reject a SAU: section 152CR of the TPA. One difference, however, in an arbitration, is that the Commission has power under section 152CP(2)(c) to require a party, including the access provider, to extend or enhance the capability of a facility.²⁶ Seven submits that this is important in an industry that is dynamic, such as Pay Television.

The relevant differences, therefore, between the Factual and the Counterfactual are four-fold. First, although the SAOs apply in both scenarios, in the Counterfactual access seekers have the ability to seek to have any or all of the price and non-price terms and conditions of access settled by the Commission in an arbitration. Second, in the Counterfactual the Commission has the power to require the extension or enhancement of the capability of the access provider's facilities. Third, in the Counterfactual the likelihood of multiple access regimes is

²⁵ *Re: Seven Network Limited (No. 2)* (2004) 187 FLR 373 at [235]

²⁶ Facility is defined in the *Telecommunications Act* 1991 as:

- (a) any part of the infrastructure of telecommunications network; or
- (b) any line, equipment, apparatus, tower, mast, antenna, duct, hole, pit, pole or other structure or thing used, or for use, in or in connection with a telecommunications network.

removed since the access seeker applies for declaration of all the services they require (and even if these were later increased by subsequent declarations, the same regime applies). Fourth, access in the counterfactual will not contain a tie to Foxtel Basic.

Having established the relevant framework in which the Commission must assess the Undertaking, Seven sets out in the remainder of this submission why the Commission should reject the Undertaking in its current form.

3 The Tie is not consistent with the SAOs

3.1 Attempt to limit access is inconsistent with the SAOs

Under the Undertaking, Foxtel undertakes to provide access to the Digital Set Top Unit Service only to Foxtel subscribers, and expressly excludes an access seeker's right to use the Digital Set Top Unit Service to non-Foxtel subscribers. This effectively ties the supply of Digital Set Top Unit Services to Foxtel's basic pay TV package.

Seven submits that this tie is not consistent with the SAOs. Accordingly, the Commission must reject the Undertaking in this form.²⁷

The Undertaking fails to satisfy and is not consistent with the SAOs because it seeks to exclude the obligation that section 152AR imposes on an access provider (i.e. Foxtel) to continue to provide access. On a proper construction of Part XIC, Foxtel must continue to supply Digital Set Top Unit Services, and a Foxtel STU, to access seekers who were supplying a Foxtel subscriber, and who continue to supply that customer when the customer ceases to acquire the Foxtel pay TV service.

The key limitation in the DAA

As the Commission acknowledges in its Discussion Paper, clause 11.1 of the DAA “means that Foxtel is not obliged to continue providing the Digital Set Top Unit Service to a person who ceases to be a Foxtel subscriber, even if the subscriber still wishes to receive an access seeker's service. If the subscriber wishes to continue to receive the access seeker's service once it ceases purchasing the Foxtel service, the access seeker will need to supply the subscriber with an STU.”

What do the SAOs mean for Foxtel giving access to Foxtel subscribers?

Once a service is a declared service, that declared service becomes an “active declared service” under section 152AR(2) if “a carrier or a carriage service provider supplies declared services, whether to itself or to other persons” (emphasis added).

Accordingly, if the Digital Set Top Unit Service were declared²⁸, and Foxtel supplied the Digital Set Top Unit Service either to itself or to other persons, the

²⁷ Pursuant to section 152CBD the Commission must not accept the Undertaking unless, amongst other things, the Commission is satisfied that the terms and conditions in the Undertaking would be consistent with the applicable SAOs.

Digital Set Top Unit Service would be an active declared service. **This means that if Foxtel supplied the declared Digital Set Top Unit Service *only to an access seeker*, the Digital Set Top Unit Service still would be an active declared service.**

Obligation to supply

Once Foxtel is supplying an active declared service by supplying its Digital Set Top Unit Service, Foxtel is under the obligations imposed by section 152AR. Where requested by an access seeker, Foxtel must supply the service. Sections 152AR(4) and (9) expressly set out the limits on the access provider's obligations to supply the service.

Section 152AR does not, at any stage, contemplate the ability of the access provider to refuse to provide access or to cease to provide access simply because the end user ceases to obtain a service from the access provider. In fact, section 152AR(2) expressly contemplates that the active declared service may be provided to a person other than the access provider.

Accordingly, Foxtel is under an obligation to supply the service, irrespective of whether the end user is a Foxtel subscriber or not. The attempt by Foxtel to limit the obligations to provide the service to Foxtel subscribers is not only inconsistent with the obligations imposed under section 152AR, it also is contrary to the regime imposed pursuant to Part X1C.

Further, section 152AR(8) states:

"If an access provider supplies an active declared service by means of conditional-access customer equipment, the access provider must, if requested to do so by a service provider who has made a request referred to in subsection (3), supply to the service provider any service that is necessary to enable the service provider to supply carriage services and/or content services by means of the active declared service and using the equipment."

Accordingly, section 152AR(8) also contemplates the need to provide CA and SI services to other persons, even where Foxtel no longer supplies the end user itself.

What do the SAOs mean for Foxtel giving access when a Foxtel subscriber switches off Foxtel?

Section 152AR also requires that, if a Foxtel customer decides to cease acquiring the Foxtel service, but wishes to continue receiving the access seeker's content only, Foxtel must continue to enable the access seeker to supply that content via Foxtel's Digital Set Top Unit Service and the Foxtel STU installed in that home.

Foxtel's attempt under the Undertaking to have the ability to cease supplying the Digital Set Top Unit Service, and to have the ability to remove the customer access equipment (ie. the STU), would be inconsistent with the SAOs, and accordingly the Undertaking should be rejected.²⁹

²⁸ Note that the Digital Set Top Unit Service, as defined in Schedule 1 of the DAA, is not limited to Foxtel subscribers only. The limitation is imposed via other provisions in the DAA, which Foxtel purports to include into the definition. The Digital Set Top Unit Service is the relevant service for the purposes of the obligations imposed under s152AR, and the purported limitation to Foxtel subscribers should be excluded on the basis that it is consistent with s152AR.

²⁹ If Foxtel's construction of Part X1C was correct, Telstra would be released from the SAO if a house ceased to be a Telstra retail customer. This is clearly incorrect.

3.2 Foxtel's assertion that Part XIC does not allow for supply to non-Foxtel subscribers

Foxtel, in support of its attempt to tie access to the provision of the basic package asserts, inter alia, that "*Part XIC does not give rights to an access seeker to require an access provider to alter fundamentally the nature and scope of the services it provides in its current business*".³⁰ This assertion underlies a number of subsequent statements by Foxtel, specifically that it cannot be required to supply the Digital Set Top Unit Services to non-Foxtel subscribers.

Seven rejects Foxtel's assertion. Part XIC, like any access regime, expressly contemplates that a carriage service provider will be required fundamentally to alter its business in that it will need to provide access as a wholesale service that it may not normally provide. Foxtel does not currently provide the Digital Set Top Unit Service to third parties, and but for Part XIC, would not do so in all likelihood. Accordingly, it is clear that Part XIC contemplates requiring the access provider to alter fundamentally its business. Moreover, Section 152AR expressly contemplates that Foxtel would be required to supply services (and to continue to provide services) where Foxtel does not obtain the service itself (for example, where Foxtel's customer has ceased obtaining Foxtel, but continues to obtain content from the access seeker).

4 The tie is not in the LTIE

4.1 Introduction

Even if the Commission disagreed with Seven's submission in section 3, the Commission must reject the Undertaking because Foxtel's attempt to limit access under the Undertaking to current Foxtel subscribers is not reasonable within the meaning of section 152CBD(2)(b) of the TPA, particularly as this tie is not in the LTIE.

Seven submits that Foxtel's tie subverts the purpose of Part XIC of the TPA. Access regimes are designed to prevent persons with upstream market power from using that power to leverage the downstream market. It is designed to promote competition at the retail level via provision of access at the wholesale level. Foxtel, however, is attempting to use Part XIC to consolidate and entrench its upstream market power by maintaining its monopoly over basic pay TV packages; i.e. forcing supply of its retail services with any wholesale service it provides. This is clearly contrary to the intention of Part XIC and not in the LTIE.

There are three key reasons why the tying condition is not in the LTIE. The tie does not create the conditions or environment for improving competition, or encouraging the efficient use of and investment in infrastructure but rather, is fundamentally anticompetitive and economically inefficient. In particular, the tie:

- (a) leads to allocative inefficiencies since end users who are prepared to pay a price in excess of the economic cost of the access seeker's content may face a price inflated above the level they are willing to pay and therefore will not make the purchase. Some customers will acquire both the Foxtel

³⁰ See section 6.4 of Foxtel's submissions, pp. 40-42.

basic package and the access seeker's content, although they would not have acquired the Foxtel basic package alone.

- (b) creates dynamic inefficiencies and deters innovation since it limits the supply of pay TV services to providing basic and premium services, which are a construct of Foxtel, and may not suit alternative providers and may not be in the LTIE. Because Foxtel faces no competition in respect to how it bundles or packages its services, it has continued with the provision of basic, which includes a number of channels which may or may not be wanted by the end-user, and then the provision of premium or tiered pay TV services which an end-user can elect to obtain for an additional sum. However, a large number of end-users may wish only to obtain one or several channels out of either the basic or premium tiers. These end-users are forced to obtain a number of other channels, which they do not value, in order to get the service they desire. By tying access to the provision of Foxtel basic package, the Undertaking effectively cements the requirement that an end-user obtain basic and therefore removes an important potential element of competition and customer choice from the market.
- (c) immunises Foxtel from competition in respect of retail Pay TV services, which is fundamentally contrary to the objects of Part XIC. It protects Foxtel and is anticompetitive as it:
 - (1) limits the contestable market. Since all users must take the Foxtel basic package, an access seeker cannot exert the same degree of competitive pressure that would force Foxtel to lower the price or improve the quality of its basic package as would be the case absent the tie.
 - (2) increases barriers to entry. In particular, it directly raises rivals costs and therefore the price of access to an access seeker's channels by an amount determined by Foxtel (at its sole discretion to set i.e. the cost of the basic package). Further, the need to buy the Foxtel basic package places the subsequent purchase of the access seekers' channels higher on the demand curve, where consumer demand is more elastic.
 - (3) enables Foxtel to readily eliminate competition for tiered channels or premium services. If an access seeker, for example, acquires the rights to a comparatively differentiated form of content, it can only be supplied as a tier channel. At the same time, Foxtel will have the opportunity to match, at least in a general way, that form of content with a channel in its basic package. That basic package will be available to end-users at a necessarily lower price than the effective price of the new entrant's channel (which will be the total of the charge for the tier channel plus the charge for the basic package). The creation of such a strategic responsive option for Foxtel is likely to deter entry such that Foxtel maintains its monopoly in the supply of premium or tiered channels. Additionally, the threat or possibility of such a strategic response significantly reduce the incentives for new entrants to acquire and develop fresh content. Any attempt to do so can readily be thwarted by Foxtel without any need for it to compete on the merits by providing a superior product. In this manner, Foxtel is able to

leverage its market power in one sector of the pay TV market (i.e. the basic package sector) into another sector (the premium service or tiered channel sector).

- (d) overcompensates Foxtel for its investment and creates a substantial free rider problem. Foxtel receives adequate compensation for the economic costs of its STUs by virtue of its access charges. In addition, however, because of the tie, access seekers will spend money advertising to promote their service, which can only be taken in conjunction with a Foxtel basic package. Foxtel gets the benefit of this advertising, since the access seeker in obtaining new customers has either obtained new customers for Foxtel or assisted in retaining existing customers. However, Foxtel does not incur any costs in respect of these customers, instead receiving at least the fee for the basic package from each of them. It also represents a further entry barrier.

For these reasons, Seven submits that Foxtel's tying condition is not reasonable, and therefore the Commission should reject the Undertaking. Seven develops below the reasoning in respect of allocative inefficiencies and the immunisation of Foxtel from competition.

4.2 Allocative inefficiency

The tie creates market inefficiency. In particular, consumers who are prepared to pay a price in excess of the economic cost of providing and distributing an access seeker's service but who are not willing to pay for Foxtel's basic package in order to receive the access seeker's channels may not subscribe at all thereby creating a dead weight loss.

These consumers will not purchase any Pay TV services and there is a loss of gains from trade as these consumers do not buy the new services even though their willingness-to-pay exceeds the cost of provision. Foxtel's ability to tie its downstream content to the use of the STUs thus hinders allocative efficiency.

These matters are addressed by Mr Greg Houston of NERA.³¹ They were also identified by Professor Stephen King, when he was a principal of CoRE Research.

In 2002, Professor Stephen King, as a principal of CoRE Research, identified the allocative inefficiency involved in respect of the previous DAA. Given Professor King's current role, Seven has not discussed with him the Undertaking or his previous report in the context of the Undertaking. Seven submits, however, that the economic principles and the analysis in respect of the tie set out in Professor King's previous report apply equally to the DAA.³²

Professor King considered a number of categories of potential consumers of pay TV. Amongst the categories, Professor King's observations about the following three categories are relevant.

"Some current Foxtel customers will continue to subscribe to just Foxtel even though they would prefer just to subscribe to the services provided by the new competitive entrants. These are customers who view Foxtel's

³¹ See pages 37-39 of Mr Houston's report where he sets out these inefficiencies.

³² See Report by Professor King *Competitive effects of the Foxtel undertakings* dated 3 October 2002, pages 2 to 13.

services and the product provided by the new entrants as substitutes. Because access to the STU is tied to the purchase of Foxtel basic services, these customers buy Foxtel basic services and are not willing to pay extra for the new services given that they are already required to buy Foxtel basic service. These customers would stop buying Foxtel if they had access to competitively provided STUs. In this situation, there is a deadweight loss created because these customers face economic disincentives to buy the new programmes even though they value those programmes at more than the price (and the cost) of those programmes and also value the new programmes more than the Foxtel services. But given that they must buy the Foxtel services to gain an STU, they are not willing to pay the extra amount to gain the competitive services given that they already receive Foxtel.

Some customers who are not current subscribers to Foxtel will start to subscribe to Foxtel in order to gain the STU and purchase products from new providers. These are customers who either (a) value the new programmes very highly and are willing to buy Foxtel to gain access to these programmes, even though they value the Foxtel services at less than the cost of supply of those programmes; or (b) value Foxtel programs at more than the cost of supply but at less than the Foxtel price, and who value the joint package of Foxtel and new programmes at more than the joint price. For these customers, Foxtel's sales (and profits) rise due to the ability to 'free ride' off the economic surplus created by the new entrant's. Part of this profit increase (for group (b) customers) may only represent a transfer from consumers and so does not represent a deadweight loss. However, some consumers (ie those in group (a)) may buy the package of Foxtel and the new services even though their individual value of the Foxtel services is below the true economic cost of providing those services. For such customers, there is an additional allocative deadweight loss.

Finally, some customers who value the new services above the cost of providing those services will not buy the new programmes because of the need to also purchase Foxtel. These consumers will not buy any pay-TV services and there is a loss of gains from trade as these consumers do not buy the new services even though their willingness-to-pay exceeds the cost of provision."

In his report, Professor King analysed other market inefficiencies caused under Foxtel's proposed access agreement, which was in all material respects similar to the DAA. He concluded his analysis of the inefficiencies imposed by Foxtel's proposed access agreement with the following:

"In summary, if customers must access an STU by purchasing Foxtel's basic service then this will lead to a variety of market inefficiencies. Some customers who view Foxtel and alternative providers as substitutes will purchase Foxtel alone even though they would gain greater surplus if they could buy the alternative channels alone. Some customers who value alternative channels relatively highly will purchase Foxtel in order to gain access to the alternative channels, even though they would not buy Foxtel alone. Some customers who value alternative channels at more than the cost of provision (including STU costs) will not purchase any pay-TV services. Further, the tying will tend to raise Foxtel's market power. In the

short-term it will create disincentives for innovative development of alternative programming as Foxtel can both copy that programming and receives 'first right' to sell to customers. In the longer term, if pay-TV competition develops, it may create incentives for Foxtel to downgrade its basic service and to simply exploit its position as monopoly gatekeeper."³³

The imposition of the tie is therefore contrary to the long term interests of end-users because it (a) does not promote competition in markets for listed services or (b) encourage the economically efficient use of and investment in infrastructure.

4.3 Immunising Foxtel from competition

The tying of STUs to Foxtel's Basic Package immunises Foxtel from competition. It is fundamentally anticompetitive because it significantly limits the contestable market for access seekers (i.e. in terms of the quantum of the market and in terms of the type of Pay TV content for which access seekers can compete) and allows Foxtel to control competition in that segment of the market.

This is for the following reasons:

- (a) Prior to receiving any content from access seekers, consumers must first pay to receive Foxtel's basic package. The channels in Foxtel's basic package are thus immune from competition from access seekers because the consumer is required to take those channels. Accordingly, Foxtel faces no competitive restraints from potential or actual access seekers in regard to the quality and price of its basic package offering.
- (b) The resultant competition is thus limited to competition between Foxtel's optional tiers and any access seeker's channels. However, the tie immunises Foxtel from competition in this area also. First, the access seeker is required to compete on a point on the demand curve which has a higher elasticity of demand. The discretionary consumer spend beyond Foxtel's basic package offering that is likely to be only a small portion of the basic package cost. It is not unreasonable to assume that the average consumer expenditure on pay TV beyond the basic package cost will be limited, say to \$5 to \$10 per month. Secondly, Foxtel can readily reduce or eliminate any additional consumer spend in favour of an access seeker (ie increase the elasticity of the demand curve further) by increasing the price of its basic package (which is immune from competition). Thirdly, Foxtel can alter its basic package at will, so if an access seeker introduces a channel with content that is similar to a Foxtel tiered channel, Foxtel could move that tiered channel into the basic package. This would have serious ramifications for the access seeker as it may deter subscribers from subscribing to the access seeker's service when similar content is already included in the basic package. Foxtel disputes that it would change the Basic and Premium mix.³⁴ However, its reasoning is spurious, as Greg Houston explains³⁵. In the event of competition, it would be normal commercial behaviour to introduce a rival channel to compete with a

³³ Report by Professor King *Competitive effects of the Foxtel undertakings* dated 3 October 2002, pages 12 to 13.

³⁴ See section 6.5 of Foxtel submission.

³⁵ See the report by Mr Houston, Foxtel's Special Access Undertaking in relation to Digital Set Top Unit Services, at pages 39-40.

successful channel. It is the tie that produces the anticompetitive effect of such conduct. Fourthly, the access seeker is disadvantaged because it does not have the basic revenue stream (ie \$50.95 from all persons wishing to receive pay TV) to develop its product or achieve the economies of scale necessary to compete against Foxtel in this limited segment of the market.

- (c) Therefore the channels in Foxtel's basic package are immune from competition with access seekers because the consumer is required to take those channels and access seekers compete solely for the remaining discretionary spend in an environment controlled by Foxtel and in respect of which significant "free rider" issues arise (i.e. Foxtel does not incur any of the cost of creating the demand for the channels offered by the access seeker but will benefit from the creation of such demand).
- (d) As a result of the anticompetitive effect of the tie, there is little incentive for an access seeker to incur the significant start up costs and risks in trying to develop new or alternative content if, at best, it can only compete for a limited remaining expenditure and, at worst, if it hits upon a successful formula, Foxtel could immediately replicate a similar genre and include it within the Foxtel basic package which is bundled with the Digital Set Top Unit Services.

The tying condition therefore raises rivals costs and constitutes a significant barrier to entry. As recognised by the Tribunal "*potential access seekers are likely to be deterred from commencing supply of subscription television services in competition with Foxtel for so long as access is tied in this manner*"³⁶. Such an outcome is directly and fundamentally at odds with the objective of Part XIC and access regimes.

The issue about stifling the incentive of access seekers to develop new genres³⁷ is important. In considering the LTIE, it is important not to put structural disincentives to those who wish to develop new content or even new ways of offering consumers choice.

Professor King, in his previous report in which similar issues arose, described this problem as follows:

"... there will be a dynamic disincentive effect for alternative pay-TV providers created by Foxtel tying STUs to its basic service. Suppose that an alternative provider creates a channel to exploit a particular niche of customers and works to grow that niche. If this alternative product is successful, Foxtel can copy that type of programming and include it in its basic service. While the Foxtel undertakings place a price cap on the basic service, they do not specify exactly which channels will be in the basic service. Thus, Foxtel can readily take a good idea for programming and include this programming in its own basic package. Ordinarily, such competition would merely lead to robust competitive results that benefit consumers. But for pay-TV, if Foxtel includes the programming in its basic package, then customers must buy the Foxtel programming before buying the programmes provided by the alternative provider. Rather than having robust competition between alternative providers, Foxtel automatically

³⁶ *Re Seven Network Limited (No 2)* (2004) 187 FLR 373 at [301].

³⁷ For example, a home renovation channel, exercise channel etc.

wins the customer by its first-mover advantage.³⁸ As a result, alternative programmers with innovative content may not find it worth their while to enter the pay-TV market in the first place.”³⁹

That analysis is equally applicable to the DAA, and potentially more so since the price cap on Foxtel’s Basic Package will not continue throughout the term of the Undertaking.

4.4 Foxtel’s has not established that the tie is reasonable

Further, Foxtel’s has failed to establish that the tie is reasonable and particularly that it is in the LTIE. As illustrated by Mr Houston’s report, even if Foxtel’s counterfactual D were the appropriate counterfactual,⁴⁰ Foxtel has not established that the SAU is reasonable and in the LTIE. This is because:

- In assessing the promotion of competition in the Factual, Mr Ergas and Dr Williams do not take sufficient account of the barrier to entry posed by incompatibility between competing STUs and FOXTEL’s established systems;
- CA/SI unbundling, as proposed in the Foxtel Counterfactual D, and the provisions of minimum standards for STUs would go some way to reducing FOXTEL’s market power by reducing this barrier, thereby promoting the conditions or environment for competition (as compared with the Factual);
- Mr Ergas and Dr Williams understate the prospect of new entry. Reducing the barrier to entry posed by incompatibility will provide greater opportunities for new entry by all forms of access seekers, irrespective of the number of channels they wish to offer; and
- Mr Ergas over-emphasises the potential detriment to competition from standardisation of CA/SI/STU technologies and understates the potential benefits that creating an industry standard may have for competition on the price and quality of subscription television content.

The Tribunal had concerns as to the impact of such a tie when it considered Foxtel’s previous DAA. On this specific issue, the Tribunal said:

“In the light of these factors, we consider that the tie of the basic package to access to Foxtel’s services as contained in the Digital Access Agreement is a significant deterrent to entry. This is exacerbated by what we regard as an unnecessary prevention of an access seeker using Foxtel’s infrastructure and services, other than its STUs, to deliver subscription television services. In our view, potential access seekers are likely to be deterred from commencing supply

³⁸ Foxtel’s dynamic incentives will probably depend on the extent of pay-TV competition. It could use a ‘copying’ strategy to undermine new entry and maintain an effective monopoly on the supply of pay-TV over the Telstra cable. Alternatively, if pay-TV competition were able to develop, Foxtel might have an incentive to downgrade its basic service over time. As customers must buy the basic service to gain an STU and buy competitors’ programming, Foxtel may decide to simply ‘free ride’ off these alternative suppliers, lowering the quality and cost of its basic service, knowing that customers will still buy this service in order to access the other suppliers.

³⁹ Report by Professor King *Competitive effects of the Foxtel undertakings* dated 3 October 2002, page 12.

⁴⁰ Seven does not accept that this is the appropriate counterfactual, as noted above in section 2. Nonetheless, even if it were, Foxtel does not establish that the Undertaking promotes competition as compared with this Counterfactual D.

*of subscription television services in competition with Foxtel for so long as access is tied in this manner.*⁴¹

If Foxtel is permitted to tie its content to the STU then, by analogy, there would be nothing to prevent the following scenarios from developing:

- Telstra, when it provides access to its local loop to another telecommunications company, could require that the other telecommunications company's customers acquire, say, \$45 worth of calls from Telstra per month, when average consumer telephony spend is only \$55 per month.
- AGL, which owns gas pipelines from gas fields to metropolitan areas, the pipes into consumers' homes and the gas metres installed in consumers' homes, could require that access seekers pay on a cost recovery basis for the infrastructure and also impose a condition that access seekers' customers must take \$50 gas from AGL's retail arm (in circumstances where the average consumer expenditure for gas is only \$55 per month).

In each of these cases such a condition would naturally be rejected as it would fundamentally undermine the purpose of the access regime. Such proposals would be wholly inconsistent with the legislative criteria in, and objectives of, Part XIC or Part IIIA.

Foxtel may seek to distinguish the above situations on the grounds that Foxtel could remove and relocate an STU. However, the same can be said for gas meters installed in consumers' homes. Theoretically AGL could move a gas meter to a new AGL customer's home in a new housing subdivision. The ability to remove a component of the infrastructure does not distinguish the fact that when a piece of infrastructure is subject to an access regime it is nonsensical to require the infrastructure owner's downstream product to be taken as a condition of access. However, this is what Foxtel seeks in its Undertaking.

Seven is not aware of any other access regime or access undertaking which limits an access seeker to providing its services to persons who already obtain downstream services from its competitor.

Nonetheless, in respect of the tie, Foxtel seeks to challenge the Tribunal's previous finding. Foxtel asserts⁴² that the Tribunal's finding was premised on five assumptions, although it provides no justification for its basis for arriving at these five assumptions.⁴³

The assumption that Foxtel asserts underpin the Tribunal's views are:⁴⁴

- (a) it is technically and commercially feasible for Foxtel to separate the supply of STU's and CA/SI services from the supply of its subscription television service;

⁴¹ *Re Seven Network Limited (No 2)* (2004) 187 FLR 373 at [301].

⁴² Section 6.5 of Foxtel's submissions

⁴³ It is certainly not clear that these were the assumptions upon which the Tribunal proceeded. It appears that Foxtel has ascribed assumptions to the Tribunal which it believes that it can then easily dismiss.

⁴⁴ See section 6.5 of the Foxtel submission.

- (b) if the Digital Set Top Unit Service were declared, Foxtel could be legally compelled to supply any or all of the STUs or the CA/SI services to non-Foxtel subscribers, and it would be reasonable to compel Foxtel to do so;
- (c) Foxtel has significant market power in respect of the supply of subscription television services;
- (d) Foxtel is able to change the pricing and/or content of its premium and basic packaging at will without impacting its revenue; and
- (e) there is a likelihood of new entry by a person who wishes to supply a 'basic' subscription television services in competition with Foxtel, rather than new entry by niche suppliers.

Whilst Foxtel purports to rebut each of these five presumptions, it does not succeed. In respect of (a), Seven sets out its submissions at 4.6 below. In respect of (b), section 3 explains why Foxtel can be compelled to supply services to non-Foxtel subscribers. In respect of (c)-(e), as noted in the report by Mr Houston:

- (1) Dr Williams' assertion that Foxtel does not have market power in the supply of digital subscription television services is unsubstantiated;
- (2) Foxtel can alter its basic tier "at will" to remove programs from premium tiers, and altering it would be a normal competitive reaction to the introduction of an attractive premium channel by a competitor. It is the tie to the basic package which creates the anti-competitive outcome of this action;
- (3) Dr Williams' assertion as to the low prospects of entry in the pay TV market understates the prospect of new entry. Reducing the barrier to entry posed by the tie or by incompatibility of the STUs under an unbundled service will provide greater opportunities for new entry by all forms of access seekers, irrespective of the number of channels they wish to offer and may also promote different offerings than the "basic" and "tiered" product offerings that currently exists.

Accordingly, Foxtel has not produced any substantial evidence to disturb the Tribunal's previous findings against the tie or to satisfy the Commission that the tie is in the LTIE. For these reasons the Commission should reject the Undertaking.

4.5 Foxtel recovers its costs under the Counterfactual

Foxtel seeks to dismiss the Foxtel Counterfactuals as unreasonable on the basis that, inter alia, it will not be able to recover its direct costs of providing access.⁴⁵

Foxtel misapplies this criterion. This criterion does not require a counterfactual consideration between the options. Rather, under all options, the same test applies. That is, Foxtel is entitled to recover direct costs of providing access and no more. The Explanatory Memorandum to the Bill introducing Part XIC to the TPA explains this:

"Consistent with Part IIIA of the TPA, the references here to "legitimate" business interests of the carrier or carriage service provider and to the "direct"

⁴⁵ Foxtel's submission at 35-36.

costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market”.

The consideration of legitimate business interests of the provider and the direct costs of providing access to the service are relevant to the manner in which, and the basis upon which, a charge for the Digital Set Top Unit Service should be constructed. They are not intended to be a basis for comparison between the factual and counterfactual or a necessary distinction. Under both options Foxtel will obtain its direct costs.

In fact under declaration, access will be granted only on reasonable terms, which if not agreed between the parties will be the subject of arbitration by the Commission.

4.6 The operational or technical requirements are not compromised under the counterfactuals

Foxtel has historically made assertions to the Commission as to technical and other difficulties with providing access (or making investment in new technology). These have been shown not to accurately reflect the position when tested. The Commission should take this into consideration and test the veracity of the assertions in the current case.

Further, Foxtel’s objections concerning the practical impact upon its business of supplying STU services are contrary to its assurances that it would build its digital pay TV platform in a manner which facilitated access.

In addition, Foxtel’s submission about:

- (a) the need to separate its subscriber management systems or the significant cost of modifying its systems seem to be contrary to clause 4.9 of Foxtel’s s87B undertaking; and
- (b) the need to obtain sub-licences in respect of third party IP seems to be contrary to clause 4.11 of Foxtel’s s87B undertaking.

As the ACCC observed on its website at the time it accepted Foxtel’s s87B undertakings:⁴⁶

- *Foxtel and Telstra are now undertaking to build their digital services infrastructure based on an ‘open access’ model, ie to support multiple access seekers without the requirement for significant additional enhancements. They have also undertaken that they will not enter into arrangements with suppliers of equipment, software and other rights if it means they will have to seek further consents from those suppliers for access seekers.*
- **Digital access:** *Foxtel undertakes to provide access to digital set top unit services in accordance with the terms contained in the undertaking once Foxtel commences supplying a commercial retail digital subscription cable television service. Specified levels of capacity are to be made available exclusively for third party use. Foxtel also undertakes that it will construct the infrastructure for its*

⁴⁶ Original website: www.accc.gov.au/telco/Foxtel_Optus.htm (now removed). Now reformatted at: <http://www.accc.gov.au/content/index.phtml/itemId/338042/fromItemId/269329>.

digital service as an 'open access' system, ie a system designed to accommodate multiple access seekers and without substantial delay or expense.

Similar comments were made in the public press release by Foxtel.⁴⁷

Relevantly, the s87B undertaking given by Foxtel and accepted by the Commission in November 2002 stipulated that:

- 4.9 *FOXTEL undertakes that the design and equipment of that part of the digital network used to provide any Commercial retail digital cable Subscription Television Service and any Commercial retail digital satellite Subscription Television Service (the STS network) will facilitate access to the STS Network by access seekers wishing to provide a Subscription Television Service by accommodating multiple access seekers without the need for significant additional network enhancements.*
- 4.10 *FOXTEL undertakes that from the date on which it commences to supply any Commercial retail digital cable Subscription Television Service and any Commercial retail digital satellite Subscription Television Service the STS Network will include an active customer smartcard database which is designed to support at least 25 access seekers.*
- 4.11 *FOXTEL undertakes that it will not enter into any arrangements or vary existing arrangements with suppliers for the supply of the equipment, software or other relevant rights for the STS Network if those arrangements will require FOXTEL to seek any further consents from those suppliers to permit access seekers wishing to gain access to the STS Network to provide a Subscription Television Service.*

In addition, Foxtel was aware that access seekers contended that Part XIC required Foxtel to supply STU services to end users who did not subscribe to the Foxtel basic package (in particular, to homes which had subscribed to Foxtel but wished to cease to take Foxtel's basic package). The Commission had also expressed its provisional view in its reasons accompanying its interim determination in the analogue pay TV access arbitrations that:

"226. Given that the purpose of the legislation is to allow access seekers to use the declared service and necessary ancillary services to deliver a pay television service to its customers, the Commission considers it is also appropriate to require the use of Foxtel's STUs in the premises of C7 customers who are not also Foxtel subscribers. Indeed, the Commission considers that s152AR operates so as to impose such an obligation."

⁴⁷ Foxtel Press Release, 13 November 2002, "FOXTEL WELCOMES ACCC APPROVAL OF LANDMARK UNDERTAKINGS PACKAGE TO IMPROVE TELEVISION SERVICES":

- *"Open digital network: FOXTEL has committed to build an open digital network which will facilitate access by accommodating multiple access seekers without the need for significant additional enhancements (undertaking 4.9). This will be achieved in part by including an active customer smartcard database in its network which is designed to support at least 25 access seekers from the time of digital access commencement (undertaking 4.10).*
- *FOXTEL has undertaken not to enter into any arrangements with suppliers for the supply of the equipment, software or other relevant rights for its digital network if those arrangements will require FOXTEL to seek any further consents from those suppliers to permit access seekers to gain access to the network (undertaking 4.11). "*

A copy of the press release is at www.foxtel.com.au/236_351.htm.

Therefore, the assertions by Foxtel as to the technical and operational difficulties in providing unbundled access or access without the tie should be dismissed.

5 Cost of Capital

Foxtel uses an inflated cost of capital in calculating the relevant return and therefore price of access. This increases the price of access above the reasonable level. Foxtel therefore seeks to obtain more than its direct costs of access, contrary to section 152AH(1)(d). Further, raising the price of access is not in the LTIE as it inhibits the environment for competition and discourages efficient use of infrastructure. For these reasons, the pricing proposed by the Undertaking is not reasonable and the Undertaking should be rejected in its current form.

Foxtel seeks to rely on the reports of Professor Gray in respect of the calculation of the cost of capital. Professor Gray states that:

- (a) franking credits do not affect the cost of capital of Australian listed firms;
- (b) Foxtel's cost of capital is less likely to be affected by franking credits since Foxtel has not paid Australian corporate tax and therefore has no franking credits to distribute to its shareholders. In addition, Foxtel does not intend to pay a cash dividend so there is no mechanism to distribute franking credits to shareholders even if they did exist.

Accordingly, Professor Gray attributes a zero value to the franking credits, which means that the cost of capital is not adjusted to take account of the franking credits.

Seven submits that Professor Gray's report and his conclusions suffer from several errors, including that his report and findings:

- (a) ignore relevant factors such as the valuation ascribed to franking credits by stock brokers, who are in the practice of valuing shares;
- (b) rely on irrelevant considerations such as 'foreign investors' inability to use the franking credits; and
- (c) misinterpret comments made by Professor Officer in previous work.

While there is substantial disagreement in the economic literature as to the true value of franking credits, ascribing a zero value to them is unreasonable. As Professor Officer shows in his report:

- 1 in calculating the cost of capital, one should adopt a forward looking approach;
- 2 franking credits have a value to investors, which are therefore included in the cost of capital calculations to reduce the return required by an investor in order to invest in a company or project;
- 3 the fact that investors value franking credits is supported by the following key factors:
 - Many equity analysts include franking credits in their company valuations.
 - Many companies pay a lot of attention to managing their capital by way of franking credits.

- Shareholders have redeemed in excess of \$200 billion in franking credits since 1987.

The only rationale consistent with these observations is that franking credits are valuable, and, moreover, that they affect the cost of capital of a company.

As a result of the errors, Professor Gray's conclusions as to the appropriate gamma and appropriate cost of capital for Foxtel are unreasonable. Accordingly, the Undertaking in its current form should be rejected since it is not reasonable with reference to the criteria in section 152AH(1)(a) or (d).

6 Verification of costs

In the *Re Seven Network Limited* case,⁴⁸ the Tribunal stated that it “*considered it important that the IBAC does not include Foxtel-specific marketing costs*” and “*that more rigorous verification of the inputs, including IBAC costs, and any recovery thereof would be appropriate*”.⁴⁹

Seven submits that Foxtel has failed to address either of these concerns expressed by the Tribunal. Seven has not had access to the underlying documents and accounts to allow it to test and challenge the relevant inputs that would allow it to identify all the errors and issues with the underlying cost base. The particular errors that Seven has been able to identify from the face of the documents include:

- the inclusion of Foxtel specific marketing costs in the IBAC; and
- the inclusion of Foxtel specific marketing costs in the on-going costs allocated to access providers.

The inclusion of these costs renders unreasonable the terms and conditions of access proposed under the Undertaking. As explained in Section 5 above, the inclusion of inappropriate costs fails both the criteria proposed under section 152AH(1)(a) and (d). For this reason the Undertaking should be rejected.

Seven also submits that the errors that it has been able to identify on the face of the review illustrate the failure of Foxtel and its purported verification exercise to address the Tribunal's concerns and call into question all of the costs that Foxtel seeks to claim.

Further, the extent to which the Commission or any other interested party could rely on the purported verification process is questionable. The Tribunal expressly stated that it “*would have been more comfortable if the IBAC costs had been supported by audited accounts*”. Foxtel has submitted reports from various personnel at PriceWaterhouseCoopers (PwC) in respect of the costs that it wishes to include in the access pricing. These reports, however, are of limited value. In respect of each report, a covering letter is provided that states that, *inter alia*:

- where a report relates to agreed upon procedures, the sufficiency of the procedures performed is solely the responsibility of FOXTEL and PwC makes no representation to FOXTEL, the ACCC or any other person*

⁴⁸ *Re: Seven Network Limited and Another (No 2)* (2004) 187 FLR 373.

⁴⁹ See paragraph 326.

regarding their sufficiency for the purpose of its engagement by FOXTEL or for any other purpose.

(d) *neither the ACCC nor any other party to whom PwC's report may be shown or given is entitled to rely on the report for any purpose or to claim to have done so."*

(a) ***The inclusion of marketing costs in the IBAC.***

Foxtel proposes to include 68% of sales and marketing acquisition costs and retention marketing costs in the costs per subscriber. In support of the inclusion of these costs, Foxtel relies on reports produced by PwC, particularly that of Maria Martin dated 19 January 2001. That report, however, provides insufficient verification of the underlying basis for the inclusion of 68% of the marketing costs. Although Ms Martin purports to have conducted an audit, Ms Martin does not actually verify the basis for the inclusion of 68% of these costs in the IBAC. Ms Martin sets out in Appendix 2 to her report the agreed upon procedures and her findings in relation to them. It is clear from what Ms Martin has done that she has not conducted a rigorous verification of the inputs. The same errors that concerned the Tribunal remain unaddressed.

At part I(2) of Appendix Two, Ms Martin states:

<i>Agreed Procedures</i>	<i>Findings</i>
<i>Document basis for percentage allocated to brand marketing and rationale for using consistent percentage for all periods</i>	<p><i>Foxtel has used information from the marketing department's 2000/01 marketing activity budget to determine the percentage of all marketing costs which are brand specific. It has been assumed that the remainder of the marketing spend relates to channel development. This amount has been included in as a cost of the STUs.</i></p> <p><i>This 2000/01 budget percentage has been used across all the years. Foxtel considers this to be conservative, because in early years consumers knew less about PAY TV and therefore a larger proportion of the marketing spend would have devoted to educating consumers about PAY TV.</i></p>

Three issues arise with respect to Ms Martin's findings.

First, as to the finding in respect of the basis for using 68% as the appropriate percentage in 2000/01, Ms Martin has not performed an actual verification, but has simply relied on the assertion by Foxtel. Further, that assertion is based on budgeted, rather than actual, costs.

Second, Ms Martin does not actually address the Tribunal's concerns. The Tribunal wished to exclude any Foxtel specific marketing. That is, it wished to

include only generic pay TV marketing. While the Tribunal did not expressly state the costs that it considered should be included or those that should be excluded as “Foxtel specific marketing”, Seven submits that the Tribunal did not mean that “Foxtel specific marketing” included only marketing in relation to a specific channel and excluded marketing by Foxtel in relation to multiple Foxtel channels or the Foxtel pay TV service generally. Such an approach, as proposed by PwC and Foxtel, would be inconsistent with approaches in other regulated industries in Australia and in respect of telecommunications in other jurisdictions around the world as explained in section 7(c) below.

Seven is not aware of any Foxtel advertisements in the 2000/01 period, or in fact in any prior or subsequent period, that did not bear the Foxtel brand. Any marketing that bears the Foxtel brand is “Foxtel branded marketing”. If Foxtel wishes to continue to assert that 68% of its marketing costs in the IBAC costs relate to “non-Foxtel marketing”, it should produce these advertisements and the precise costs of these non-Foxtel branded advertisements & marketing. Only then could a verification of the costs be possible. Simply relying on the assertion of Foxtel as to the budgeted, not actual, costs involved does not meet the standard required by the Tribunal.

Third, Ms Martin’s report was submitted to the Commission in 2002 and was before the Tribunal. The Tribunal has express reservations as to Foxtel’s costs. Foxtel has not attempted to correct this issue, but has simply re-filed the same material.

The logical result of the Tribunal’s reasoning is that these advertising costs must be excluded from the IBAC cost base. That will remove [CONFIDENTIAL] per subscriber from the IBAC costs. This has a dramatic impact upon the reasonableness of the Undertaking since including the IBAC costs increases the cost per consumer from approximately [CONFIDENTIAL] to approximately [CONFIDENTIAL] per customer, or an increase of approximately 60%. This clearly demonstrates the unreasonableness of the IBAC costs since it both purports to allow Foxtel to recover more than its direct costs and would discourage the efficient use of infrastructure and the promotion of competition.

(b) *Future Marketing costs*

The PwC reports also allocate future marketing costs into the pricing methodology. Mr Ridehalgh’s report of 13 July 2005 states at section 7.3.3 that:

[CONFIDENTIAL]

Once again Foxtel ignores the Tribunal’s requirements. The Tribunal was clear in that it required the exclusion of Foxtel branded marketing. The Tribunal did not define Foxtel branded marketing as marketing of a specific channel. Such a construction is too narrow and unwarranted.

The inclusion of these costs is inappropriate and unreasonable for precisely the reasons listed above.

The assertion by PwC and Foxtel that Foxtel [CONFIDENTIAL] is unsustainable. It appears to be based on an assumption that advertising of anything other than a specific channel is non-branded. This is clearly incorrect, and is inconsistent with the Tribunal’s previous decision. Two examples illustrate the flaws in this approach.

First, Foxtel has recently run extensive advertising campaigns celebrating the 10 year anniversary of FOXTEL. The advertising does not relate to the 10 year anniversary of PayTV specifically, but to Foxtel. It is disingenuous to seek to assert that because such advertising does not refer to a single, distinct channel on Foxtel that it is in some way non-branded. Branded marketing is marketing that carries the brand of either the specific channel or the specific provider, i.e. Foxtel.

Non-branded advertising is advertising that relates “to *wholesale activities* which are purely to promote the digital platform generally *and* which *do not refer to the offerings of any particular service provider . . .*”⁵⁰ (emphasis added).

Non-branded advertising should exclude any advertising that includes either the Foxtel brand or advertises any specific channel or combination of channels.

Second, the statement appears palpably false. Recently, Foxtel has been running advertisements for the Super 14 Rugby competition, which commenced in February 2006. The advertisements clearly refer to Fox Sports as the only place to see 90 Super 14 games live. This would appear to be brand marketing even under the contorted, narrow definition prescribed in the Undertaking.

(c) *General principles as to the inclusion of marketing costs*

Other access regimes in Australia impose strict conditions on the recovery of the costs of marketing undertaken during the access period. Similar conditions are imposed by OFTEL in its access arrangement for the supply of conditional access.

Decisions made under the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code) by both the Essential Services Commission of South Australia (ESCOSA)⁵¹ and the Queensland Competition Authority (QCA) prevent the recovery of any advertising that is not purely generic in nature.

In its access arrangement for Envestra, ESCOSA requires that only the costs of generic advertising can be recovered from access seekers. In order for advertising to be considered generic it must not favour any retailer:

*“On all advertising formats used, “all participating retailers” in the South Australian market are to be shown or “none at all”. No preference is to be implied or expressed for any one retailer.”*⁵²

The QCA imposes the same restriction in its access arrangement for Allgas and Envestra:

*“Further, the Authority remains concerned that allowing retailers’ names to be included on advertising material moves beyond the realm of generic advertising into retail promotion and particularly may be of benefit in promoting the name of the incumbent retailer and that this could create an unfair competitive advantage. Accordingly, the Authority is prepared to allow marketing expenditure of a generic nature only.”*⁵³

⁵⁰ OFTEL, *The pricing of conditional access and access control services: OfTel Guidelines*, May 1999, para 2.7.

⁵¹ Previously known as South Australian Independent Pricing & Access Regulator (SAIPAR).

⁵² SAIPAR, *Final Decision: Access Arrangement for Envestra Limited’s South Australian Natural Gas Distribution System*, dated December 2001, page 98.

⁵³ QCA, *Final Decision: Proposed Access Arrangements for Gas Distribution Networks: Allgas Energy Limited and Envestra Limited*, dated October 2001, page 258.

To accord with these decisions by ESCOSA and the QCA, Foxtel must be able to recover the costs of only marketing that is purely generic. Such advertising must not make reference to Foxtel's brand name, or to the extent that it does so, it must also make reference to all other retailers (including any access seeker) in a non-discriminatory manner. If Foxtel's advertising does not meet these requirements, then requiring digital access seekers to contribute to the costs of this marketing would favour Foxtel with an unfair competitive advantage.

Another approach consistent with the Gas Code is the exclusion from recovery of all retail marketing costs. This is the approach adopted by the Commission and the Independent Pricing and Regulatory Tribunal (IPART) in separate access decisions.

The Commission limits recoverable post-access marketing costs to wholesale marketing in its Central West Pipeline (CWP) decision. While much of the information motivating and explaining this decision is confidential,⁵⁴ it is clear from APT's (formally AGLP's) final and approved access arrangement information that the recoverable costs are wholesale. The recoverable costs are "in respect of general and administrative activities relating to the CWP and to market *its services*";⁵⁵ this suggests that only those costs relating to the marketing of the *wholesale* services of the CWP can be recovered. Costs relating to the marketing of gas in the retail market are to be excluded.

The Independent Pricing and Regulatory Tribunal (IPART) took the same approach in determining an access arrangement for AGC in Albury (although IPART discusses the broader category of non-capital costs). In its final decision, IPART requires the exclusion of post-access non-capital costs associated with the transportation of gas to the AGC distribution system and the operation of a distribution system by AGC. These costs are excluded on the basis that they result from retail market activities. Discussing this decision, IPART states that "these costs are not network costs and should be charged to retailers."⁵⁶

OFTEL, in its guidelines for the supply of conditional access and related services, adopts the same approach as the Commission and IPART in prohibiting the recovery of the costs of all retail marketing:

"OFTEL accepts that it is, in principle, legitimate to recover marketing expenditure from conditional access and access control charges where it can be clearly demonstrated that the expenditure:

- *relates to **wholesale activities** which are purely to promote the digital platform generally **and** which **do not refer to the offerings of any particular service provider** . . ."*⁵⁷

Applying these principles, Foxtel must be able to recover only the cost of marketing that promotes the digital platform and which does not refer to Foxtel's offerings. To the extent that Foxtel proposes to recover the cost of marketing that

⁵⁴ ACCC, *Final Decision Access Arrangement by AGL Pipelines (NSW) Pty Ltd for the Central West Pipeline* dated 30 June 2000, page 74.

⁵⁵ APT Pipelines, *Access Arrangement Information for Central West Pipeline* dated September 2000, page 12.

⁵⁶ IPART, *Draft Decision: Access Arrangement, Albury Gas Company Limited* dated June 1999, page 87.

⁵⁷ OFTEL, *The pricing of conditional access and access control services: OfTel Guidelines*, May 1999, para 2.7.

does refer to its offerings, Foxtel's proposal will provide Foxtel with an unfair competitive advantage over access seekers.

Seven submits that most, if not all, of Foxtel's marketing activities do not meet the criteria for recovery from access seekers. To the extent that access arrangements allow the recovery of any of Foxtel's marketing costs, the access arrangement must be amended so that marketing costs are recoverable only where the marketing falls into one of two categories:

- (1) marketing that is purely generic and refers to no retailer; or
- (2) marketing that refers to all retailers in a manner that is non-discriminatory.

Whether Foxtel's marketing falls into one of these two categories must be independently and objectively assessed.

(d) *Access seeker's advertising costs to be offset against access charges*

Seven further submits that, to the extent that Foxtel is permitted to recover marketing costs from access seekers, Foxtel must likewise contribute to the marketing efforts undertaken by access seekers, including Seven, from which it benefits. This would be even more so if the tie of access to the basic package remains, since any customer obtained by the access seeker would either:

- (a) have to install Foxtel in order to obtain the access seeker's pay TV service; or
- (b) have to keep Foxtel in order to obtain the access seeker's pay TV service.

Accordingly, every subscriber obtained by an access seeker acts to promote Foxtel by either adding to its subscriber base or maintaining its existing subscribers. As such, it simply cements Foxtel's market power. Foxtel obtains all the benefits from this advertising since it gains or retains customers, but does not contribute to the cost of the advertising. Should the tie of access to the basic package remain, then in order for the terms of access to be reasonable, all access seekers should be entitled to offset a proportion of their advertising costs as against the cost of access. An allocation of the costs of this advertising could be based upon a similar system of revenue or ratings allocation as suggested in the Undertaking.

(e) *Conclusion*

The errors identified above are sufficient to put in question the entire Foxtel costs structure. Seven has not been provided with sufficient information to test all assumptions and inputs, but the issues identified above clearly demonstrate that Foxtel has not performed a "rigorous verification of the inputs". The Tribunal has previously expressed its view that a review of the calculations was not sufficient. It required verification "*that the inputs to that calculation are accurate*"⁵⁸. Foxtel has failed to comply with the Tribunal's requirements and, accordingly, the Undertaking should be rejected until Foxtel meets these requirements. The errors are exacerbated by the fact that under the Undertaking an access seeker would not have the right to apply for arbitration of the terms of access, which would be the case if the relevant services were declared under Part XIC.

⁵⁸ paragraph 326.

The inclusion of these costs renders unreasonable the terms and conditions of access proposed under the Undertaking. As explained in Section 5 above, the inclusion of inappropriate costs fails both the criteria proposed under section 152AH(1)(a) and (d). For this reason the Undertaking should be rejected.

7 Multiple access regimes and access to interactive services

7.1 Introduction

In *Re Seven Network Limited*, the Tribunal expressly addressed the difficulties with an access agreement that covered only parts of the Pay TV network. Specifically, the Tribunal said:

*“We are of the view that the long-term interests of end-users would be best served if (both price and non-price) terms of access for the whole of pay television’s services are considered together at the same time.”*⁵⁹

That conclusion was based on two grounds. First, the Tribunal reasoned that if Foxtel’s proposed access agreements did not provide for sufficient access to interactive services, and if access to those interactive services could not be negotiated on a commercial basis, then access seekers would need to seek declaration of those interactive services. The Tribunal thought this was problematic for the following reason:

*“...as a matter of principle, we accept that separating interactive services from more general digital subscription television services may make it more difficult to satisfy the LTIE test required under s152AL than if those services were to be considered jointly.”*⁶⁰

That is, by exempting part of the whole pay TV service, it might be more difficult for access seekers to have only a part, namely interactive services, declared in the future.

Second, the Tribunal was concerned that if interactive services were declared, there would be multiple access regimes, as well as two pricing regimes, and that this would have the following effect:

*“There would be inefficiencies for both access providers and, more particularly, access seekers, in managing a business within the framework of multiple access regimes.”*⁶¹

In addition to this, the Tribunal said that if an access seeker has to arrange its own return path with Telstra, Foxtel and Telstra should price their services jointly.⁶²

The difficulties with multiple access regimes exist in the Factual but would not be likely to occur in the Counterfactual. This is because the access seeker would seek declaration of all elements they require. In this instance the issue with multiple access regimes is illustrated again by the interactive services.

⁵⁹ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [284].

⁶⁰ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [278].

⁶¹ *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [279].

⁶² *Re Seven Network Limited & Anor (No. 2)* (2004) 187 FLR 373 at [282].

7.2 Interactivity under the Undertaking

Foxtel contends that under the DAA Foxtel will offer access seekers access to interactive services. That access is said to be provided for by clause 6 of the DAA, which relates to Foxtel's supply of "modem services" to access seekers. No doubt, this is an attempt to address the Tribunal's concerns as to Foxtel's failure to provide interactive services under the previous DAA.

Seven submits that there are three problems with the terms and conditions on which Foxtel is proposing to supply modem services.

First, Foxtel is not obliged under the DAA to supply carriage services for the modem "return path". This allows Foxtel to supply itself with a higher quality return path than the one access seekers are able to obtain from a third party like Telstra.

Second, given Foxtel is not obliged under the DAA to amend, develop or upgrade its infrastructure to provide for interoperability with the Access seeker's service, the DAA does not permit an access seeker to undertake the necessary upgrades itself, or to provide its own upgraded infrastructure.

Third, Foxtel is not obliged under the DAA to provide access seekers with access to a "constant feed" forward path for content. This allows Foxtel to supply such a service to itself, leaving access seekers with a sub-standard forward path for their content.

Seven submits that these problems demonstrate that Foxtel's proposed terms and conditions of access to modem services (interactive services) are not consistent with the SAOs, and are not reasonable in that they are not in the LTIE.

7.3 What are interactive services?

Seven agrees with the distinction drawn by Foxtel in its submission between "interactive services" and "enhanced services".⁶³ Interactive services refer to the ability of end-users to "interact" with pay TV content that is provided by the access seeker by sending a response to the access seeker using a modem that is in the STU. It also refers to the ability of end-users to receive content that is unique to them. Examples of interactive services include wagering or voting in response to pay TV content. Enhanced services, such as multiple player angles, different news options, player statistics, the ability to pause programs (ie. receive dynamic content due to flash memory in the STU), and near video on demand, are not truly interactive, because those services transmit content using only a forward path from the access seeker (via the pay TV platform) to the end-user. Those services do not require the use of a modem to send back a response to the access seeker.

Put simply, interactive services work in the following manner. An access seeker sends its pay TV content to the end-user via the Foxtel playout centre, which is connected by cable to the end-user's STU (the **forward path**). Some Foxtel STUs contain a PSTN modem⁶⁴ that allows the end-user to send a return message via the Telstra PSTN network. End-users therefore are able to interact with the access seeker's (or Foxtel's) pay TV content by using their pay TV remote control to

⁶³ Foxtel's submission at 20.

⁶⁴ Those Foxtel STUs that do not contain a PSTN modem contain no modem at all.

send a message back to the access seeker (or Foxtel), using the STU modem, via a “return path” that is separate from the forward path.

In order to provide interactivity, the access seeker must also be able to update the content instantly and regularly. This dynamic content is at the heart of interactivity.

The manner in which these interactive services operate at present is limited in one fundamental respect; namely, that Foxtel’s STUs contain only PSTN modems. First, a PSTN modem requires a phone call to be made each time an end-user wishes to send a message back to the access seeker (or Foxtel) via the return path, which is expensive. Second, in addition to the fact that making a phone call necessarily limits the speed of the return path, PSTN modems are slow when compared to cable or ADSL modems. Such expense and delay will limit the ability of access seekers to provide a quality interactive service.

It is also necessary to bear in mind that interactive services (and enhanced services) are crucial to the future of the market for services offered via the digital STUs, and Foxtel partners agree that this is the case. As stated by the Managing Director of Sky Interactive:⁶⁵

“It’s difficult to imagine major sports events on TV without interactivity; Sky’s Ryder Cup coverage was the most recent example. Winning the rights to the Champions League gives us a chance to transform the way this competition is seen on TV. From next season, Sky will show 14 matches exclusively live each week. On a Wednesday night you’ll be able to use our interactive service to pick which of eight games you watch and switch between matches seamlessly.”

“If there is any channel controllers out there who still think interactivity is a superfluous gadget, my advice is to look at MTV Hits. Its audience increased by 30% after the launch of the “Your Chart” voting service.”⁶⁶

In the UK, Interactive TV revenues went from £93 million in June 2001 to £186 million in June 2002.⁶⁷

7.4 Proposed access to interactive services under the DAA

Under the DAA, Foxtel will supply access seekers with “modem services”.⁶⁸ “Modem services” are defined as “services using a modem integrated with conditional access customer equipment which enable a customer to send to the provider of the content, a reaction of the customer to that content.”⁶⁹

Although the DAA requires Foxtel to supply modem services to access seekers, Foxtel’s obligation is subject to five conditions. The relevant conditions for present purposes are:

⁶⁵ Sky Interactive is controlled by News Corp, a partner in Foxtel.

⁶⁶ Speech by John Florsheim, Managing Director of Sky Interactive, “Interactive TV: learning from the first three years,” Institute of Economic Affairs’ Interactive TV conference, 26 November 2002. The first paragraph refers to enhanced services, whereas the second paragraph refers to interactive services.

⁶⁷ BSKyB 2002 Results Presentation. Includes Sky Active, Betting, and third party interactive revenues.

⁶⁸ DAA, clause 6.1(b).

⁶⁹ Part D of Schedule 1 of the DAA.

- (1) while Foxtel *may* arrange for the return path to be connected, Foxtel is not responsible for providing or maintaining carriage services in relation to that return path;⁷⁰
- (2) Foxtel is not obliged to install a modem, or to provide a return path connection, or to amend or upgrade its STUs or modems to provide interoperability with the access seeker's modem content;⁷¹ and
- (3) Foxtel is not obliged to provide a continuous feed of the access seeker's content to the end-user when the end-user is not connected to, or not viewing, the services provided by the access seeker.⁷²

In addition to supplying modem services, the DAA requires Foxtel to publish a "modem services protocol".⁷³ The modem services protocol will contain the specifications and configuration of the modem and the STU, as well as the procedures and compliance rules in relation to using Foxtel's modem services.⁷⁴ Clause 11.2 of the DAA envisages that Foxtel may upgrade the modems in its STUs.

Accordingly, and by way of summary, the proposed terms and conditions relating to access to interactive services under the DAA have the following consequences for access seekers:

- (a) Foxtel will give access seekers access to existing STUs that contain a PSTN modem, and will connect that STU modem to a return path carriage service. Access seekers, however, will have to arrange for their own carriage service in respect of the return path. This will have to be done through Telstra's PSTN telephone network. The access seeker's interactive return path will be slow – first because it uses a PSTN modem, and second because the return path needs to dial into that telephone line each time the end-user wants to send an interactive response. The return path will also be expensive, because a phone call is used each time the end-user sends a response.
- (b) Access seekers are forced to use Foxtel's current technology, and cannot require Foxtel to upgrade its technology. Furthermore, access seekers cannot provide end-users with their own STU containing a better modem.
- (c) Access seekers do not have access to a constant feed forward path for their pay television content, and this limits the ability of access seekers to offer truly interactive services (whereby their content can be constantly updated). For example, a wagering operator needs to constantly update betting odds for its subscribers. Without a constant feed forward path to the end-user, the wagering operator is unable to provide a fully efficient and satisfactory interactive betting service in association with a racing vision channel.

⁷⁰ DAA, clause 6.1(c)(i); clause 6.3(a).

⁷¹ DAA, clause 6.1(c)(iv). However, Foxtel can notify the access seeker of "Required Network Enhancements" to facilitate access, the access seeker may have to pay for these enhancements, and Foxtel retains ownership of any enhancements: DAA, clause 9.1(a), (b), 9.3(b).

⁷² DAA, clause 5(a).

⁷³ DAA, clause 6.2(a).

⁷⁴ DAA, clause 11.2.

7.5 The problems with Foxtel's proposed DAA

(a) The return path

The first problem with the DAA is that the terms and conditions of access to "modem services" do not give access seekers access to Foxtel's return path. Instead, access seekers have to arrange for, and maintain, their own carriage service for the return path on their interactive service.⁷⁵ This is problematic, because if, for example, Foxtel inserted cable modems into its STUs, this would mean that Foxtel could use the cable forward path as the return path. This kind of return path would be superior to the current return path using Telstra's PSTN network, because there is no need to dial the line each time the end-user wants to send a response. Also, a cable is faster than a PSTN line.

In the Factual, where Foxtel places a cable modem in the STU, it is likely that access seekers will be unable to arrange for a separate cable return path, and that access seekers will be left with a return path on the Telstra PSTN network, which will be of lower quality than the return path that Foxtel could use. This is due to the fact that it may be too expensive or impractical for access seekers to arrange for a separate cable or ADSL return path.

Further, if an access seeker is unable to obtain access to Foxtel's cable return path through commercial negotiations with Foxtel, then the access seeker will have to seek declaration of that return path if it wishes to supply a comparable interactive service to Foxtel.

There are two problems, however, associated with seeking declaration in the Factual:

- (1) First, and as the Tribunal pointed out in *Re Seven Network Limited*, it may be difficult for access seekers to obtain declaration of a part only of the digital pay TV service if an undertaking has been given in respect of the rest.
- (2) Second, if Foxtel's return path were declared, this would lead to multiple access regimes, because an access seeker would have access to Foxtel's modem service under the DAA, but separately would have to negotiate (and potentially arbitrate) access to Foxtel's return path under Division 8 of Part XIC. The Tribunal has said that this is not acceptable, nor efficient, and accordingly, it is not in the LTIE.

In the Counterfactual, an access seeker can more easily obtain declaration (because it will seek declaration of the whole end-to-end pay TV service), and there will not be multiple access regimes. This is more efficient, and therefore, better promotes the LTIE.

(b) Interconnection of Foxtel's and an access seeker's equipment

The second problem with the DAA is that given Foxtel is not obliged to upgrade or amend its STU or modem to meet the requirements of an access seeker's modem content,⁷⁶ the DAA does not appear to allow access seekers to use their own STU with an upgraded modem, while still receiving Foxtel's modem services (or STU services for that matter).

⁷⁵ DAA, clause 6.1(c)(i); clause 6.3(a); clause 6.3(b).

⁷⁶ DAA, clause 6.1(c)(iv)(C).

Seven submits that this particular aspect of the DAA is not consistent with the SAOs under section 152AR(5) of the TPA. Section 152AR(5) of the TPA requires that access providers must permit interconnection of their facilities with the facilities of an access seeker for the purpose of enabling the access seeker to be supplied with active declared services in order that the access seeker can provide carriage services and/or content services. Given that some access seekers may need a better STU, or a better modem, if they are properly to provide their interactive service, then access seekers may want to provide their own modem. If Foxtel refuses to permit interconnection of its equipment (i.e., the playout centre and conditional access equipment) with the access seeker's equipment (by releasing specifications so that access seekers can make their equipment compatible) for the purpose of allowing the access seeker to provide an interactive content service, then Foxtel fails to comply with section 152AR(5). On that basis, this aspect of the DAA is not consistent with the SAO.

(c) The forward path

The third problem with the DAA is that Foxtel is not obliged to provide a constant feed forward path for sending the access seeker's content to the end-user. In Seven's view, this is problematic because Foxtel could supply such a constant feed forward path to itself. If access seekers are unable to obtain access to Foxtel's constant feed forward path, then Foxtel may be able to supply a higher quality interactive service to end-users than access seekers are able to supply. This would give Foxtel a competitive advantage over access seekers that is not in the LTIE.

Further, if an access seeker is unable to obtain access to Foxtel's constant feed forward path through commercial negotiation, the access seeker would have to seek declaration of that constant feed forward path if it wished to supply an interactive service of comparable quality to Foxtel's service. This also is problematic in the Factual for two reasons. First, and for the same reasons set out above, it may be difficult for an access seeker to obtain declaration of this part of the pay television service in the Factual, where Foxtel has given a special access undertaking in respect of the rest of the service. Second, if the constant feed forward path were declared in the Factual, there would be multiple access regimes, which in the Tribunal's view, is inefficient and not in the LTIE.

In the light of these problems it is clear that this aspect of the Undertaking is not reasonable since it does not promote the LTIE. Further, this aspect of the Undertaking is not consistent with the SAOs.

8 Other issues

8.1 Other failures to comply with the SAO

Further, key elements of Foxtel's STU are excluded from the Undertaking. For example, access seekers do not have access to flash memory in the STU. Seven understands that Foxtel is able to store on demand videos on the flash memory, which when requested by a subscriber, may be accessed immediately without

waiting for the usual broadcast slot.⁷⁷ This, when combined with no access to the constant feed forward path, means that Foxtel can offer a better enhanced service, because Foxtel is able to constantly update its content, and store its content on the STU whereas access seekers cannot. Foxtel subscribers will be able to view Foxtel content at the time of their choosing, whereas subscribers to access seeker content will not be able to do this as easily.

8.2 Pricing

The pricing methodology is not reasonable.

Firstly, access seekers are charged for access to the Digital STUs and yet not allowed to use all the facilities as explained above. Since they are being charged for access to the STU, they should be entitled to access to the entire STU.

Further, the costs allocation method based on imputed revenues and minimum ratings produces unreasonable results. Access seekers' revenue share is based on the higher of their actual revenue and an imputed revenue based on Foxtel's revenue. The imputed revenue is based on Foxtel's overall revenues and ratings, to each ratings percentage point. An access seeker's rating is deemed to be the higher of the minimum ratings figure specified by Foxtel.

The problem with imputed revenue is:

- (a) Foxtel receives high revenue from the compulsory basic package, which access seekers do not. This inflates access seekers imputed revenue.
- (b) The use of imputed revenue is one-sided as only access seekers' revenue share is the subject of a formula for the greater of the imputed revenue and actual revenue. In particular, Foxtel's share of costs is not allocated on the basis of the higher of its actual revenue and imputed revenue for channels not in the basic package.

This permits Foxtel to add additional tier channels to compete with an access seeker's channels but at a significantly lower cost base.

The use of a minimum ratings figure for access seekers has number of problems.

- (a) The minimum ratings figure is actually the average ratings figure on full digitisation ($0.25\% = 1/400^{\text{th}}$).
- (b) To the extent that ratings may be considered to be a measure of relative efficiency, that could only be the case as between channels on a tier. The channels in Foxtel's basic package are likely to have ratings in excess of the average ratings by reason of the fact that all viewers must receive those channels.
- (c) The minimum ratings figure only applies to calculating the access seeker's ratings and revenue not to Foxtel's ratings or revenue (for the purpose of the cost allocation revenue share). As a result, Foxtel's channels on a tier and access seekers channels are treated on a substantially different basis. The consequence is that Foxtel has a lower cost base if it wished to provide a competing niche channel on a tier.

⁷⁷ In addition, the DAA does not expressly allow access seekers to use any equipment such as a personal video recorder (PVR) and therefore it may not be included.

- (d) Applying a minimum ratings figure and imputed revenue to access seekers, but not Foxtel, will lead to significantly higher relative STU access charges for access seekers than for Foxtel for near video on demand (NVOD). NVOD channels will almost always have lower than average ratings for each of the time delayed channels (eg 2½ hour movie shown at 15 minute staggered intervals occupies 9 separate channels, each of which is likely to have low ratings).

If the Commission wishes, Seven will provide worked examples to illustrate these point further.