

18 June 2010

Dr Richard Chadwick
General Manager – Adjudication Branch
Australian Competition & Consumer Commission
Canberra ACT
By email

Dear Dr Chadwick

Exclusive dealing notification N94674, lodged by FOXTEL Management Pty Limited

I refer to your correspondence of 1 June 2010, and provide by way of attachment to this letter a submission on behalf of Optus in relation to the proposed exclusive dealing notification lodged by FOXTEL Management Pty Limited on 4 May 2010.

In summary, Optus is strongly of the opinion that the proposed exclusive dealing arrangement, which amounts to Third Line Forcing under S47 (6) of the Trade Practices Act, should be rejected on the basis that it will deliver no public benefit but will in fact have significant adverse consequences for competition in a number of telecommunication markets.

Please do not hesitate to contact me on (02) 8082 8437 if you would like any further information concerning Optus' submission.

Yours faithfully



Andrew Sheridan
**General Manager,
Interconnect and Economic Regulation**

Optus submission on exclusive dealing notification by FOXTEL Management Pty Limited

Introduction

This submission provides comments on behalf of Optus in respect of the exclusive dealing notification lodged by FOXTEL Management Pty Limited on 4 May 2010.

Proposed arrangement

Optus understands that under the proposed arrangement FOXTEL customers with an IQ set top unit will be given access to additional content that will be delivered over a broadband connection. A condition of accessing this additional content is that the FOXTEL customers must acquire a broadband connection from Telstra Bigpond. The notification suggests that Telstra Bigpond has indicated that it will not charge any additional amounts in relation to the carriage of data for customers accessing the content.

Whilst the precise details of the content to be provided is masked as commercial in confidence, we understand that it will likely include movies and television programs.

Inadequacies of the Notice and insufficiency of material to assess public benefits and detriments

Under the current process the notified conduct has effectively been granted immunity from the Third Line Forcing prohibitions in the Trade Practices Act until such immunity is revoked by the ACCC. As will be outlined later in this submission Optus has grave concerns that the parties involved in the proposed conduct have the incentive to delay the ACCC's decision making process to enable them to benefit from the conduct.

With this in mind we draw the ACCC's attention to the significant deficiencies in the material presented to support the notification. Much of the material provided in answer to the ACCC's questions of 19 May has been masked as commercial in confidence and Optus is not, therefore, in a position to comment on the validity of the responses. Further, a number of issues which would be acutely relevant to an assessment of the public benefits and detriments arising from the proposed conduct do not appear to have been addressed. For example, it is not clear;

- What content is to be provided in connection with the service and where this content is to be sourced? It remains unclear whether the content will be packaged by FOXTEL, Bigpond or both;
 - Why access to this content cannot be provided over the existing FOXTEL Hybrid Fibre Coaxial (HFC) and satellite networks. That is to say, it is unclear why a separate broadband service is required to access the content;
 - Whether the Telstra Bigpond service will be provided over the Telstra copper or HFC networks or a combination of these; and
 - Whether there are any commercial arrangements between FOXTEL and Telstra Bigpond in respect of the arrangement. For example, it is not clear whether Telstra will receive a share of the revenue generated from customer's accessing the content to offset any data carriage costs Telstra may incur.
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The absence of the responses to the ACCC's questions and further information in relation to the issues raised above puts Optus at a distinct disadvantage in being able to provide comprehensive comments on the proposed arrangement. Our comments in this submission are necessarily based on the limited information provided to date.

Market overview

As the ACCC will be aware, the parties involved in the proposed conduct and exclusivity condition are the dominant supplier of pay-tv services in Australia and the dominant provider of fixed line telecommunication services.

FOXTEL is the dominant provider of pay-tv content services in the Australian market. Whilst Optus competes with FOXTEL at the retail level in the provision of pay-tv services in certain locations within Sydney, Melbourne and Brisbane, under the terms of a Content Sharing Agreement with FOXTEL Optus service essentially resupplies content supplied by FOXTEL. As at 30 June 2009 FOXTEL accounted for 70% of pay-tv subscribers on a retail and wholesale basis¹. Pay-tv remains a highly concentrated market. Optus does not accept, therefore, the assertion in FOXTEL's submission that it competes in a broad and highly competitive market for supply of audiovisual content.

Telstra continues to dominate the fixed line telecommunications market at both the retail and wholesale level. As the following tables of markets share data demonstrate, Telstra not only retains a very high share of both the retail fixed line voice and broadband markets, it has also been able to increase its share in both markets in recent years notwithstanding policy measures that have been introduced to support competition.

	2005-06	2006-07	2007-08
Telstra	69%	71%	72%
Optus	11%	11%	11%
AAPT	4%	3%	3%
Other	16%	14%	15%

Source: ACCC telecommunications reports 2007-08

	2005-06	2006-07	2007-08
Telstra	47%	56%	58%
Optus	20%	19%	16%
iiNet	6%	8%	7%
Other	28%	18%	19%

Source: ACCC telecommunications reports 2007-08

¹ ACMA Communications Report 2008-09, page 37. FOXTEL reported 1.63 million subscribers form an industry total of 2.3 million.

Telstra's dominance at the wholesale level is even more pronounced. Thirteen years after the fixed line market was opened to competition, Telstra continues to account for 85% of all fixed lines connections in Australia².

Telstra's dominance in the fixed line market is enhanced by its horizontal integration into related markets. For example, unlike incumbent operators in other jurisdictions, Telstra was not prevented from entering the pay-tv market. It holds a 50% stake in FOXTEL and has been the owner of a HFC network which is used to deliver FOXTEL pay-tv services to residential customers in Sydney, Melbourne and Brisbane. Telstra has used its access to pay-tv content to defend its dominant position in the fixed line voice and broadband markets.

Given Telstra's position in the fixed line telecommunications market, policy makers have long expressed concern about the nature of its relationship with FOXTEL, in particular its ability to leverage FOXTEL's position in pay-tv content to undermine competition in the downstream telecommunications markets.

In its Emerging Market structures report of 2003, the ACCC commented on the potential for Telstra to leverage its fifty per cent ownership stake in FOXTEL to the detriment of competition in the fixed line telecommunication markets. In particular, the ACCC noted that:

"Further, Telstra's interest in FOXTEL reduces the incentives for FOXTEL to supply channels to competing network providers, who pose the threat of facilities-based competition in the supply of broadband and telecommunications services".³

More recently, the ACCC's Chairman Mr Graeme Samuel warned of the ability for a telecommunications company to use access to content to stifle competition:

"a telecommunications network operator is able to acquire sufficient compelling content on an exclusive basis, such that it limits alternative network owners' ability to offer attractive packages to consumers".⁴

These concerns lead the ACCC, in Emerging Market Structure Report of 2003, to recommend the introduction of legislation to require Telstra to divest its fifty per cent interest in FOXTEL⁵.

The Government has also recognised the potential for Telstra to leverage its ownership stake in FOXTEL to the detriment of competition. In commenting upon these concerns in the Explanatory Memorandum to the Competition and Consumer Safeguards Bill the Government has noted that:

"In addition to Telstra's control of fixed line networks, Telstra's 50 per cent stake in FOXTEL has hindered competition in both the telecommunications and pay-TV markets. This is because Telstra has the incentive to base its decisions on its interests in both the telecommunications market and its pay-TV interests. As a result, new products that a pure

² page 30

³ ACCC "Emerging Market Structures for the communications sector", page XXVi

⁴ Mr Graeme Samuel, ATUG Regional Conference 21 May 2009

⁵ ACCC "Emerging Market Structures for the communications sector", page XX

media company or a pure telecommunication wholesaler might offer are potentially not being made available to consumers”⁶.

The Explanatory Memorandum elaborates further on these concerns in the following comment;

“Exclusive access to content creates an effective means of locking customers in. Further lock-in can be achieved through the bundling of services (i.e. selling two or more types of services together at a discount rate). Access to content on an exclusive basis limits the opportunities available to competitors, in both the carriage and content sectors”⁷.

In recognition of these significant concerns the Government included measures in the Telecommunications Competition and Safeguard Bill 2009 to require Telstra to divest its interest in FOXTEL.

As will be outlined further below, Optus submits that the proposed arrangement is a clear manifestation of the problems identified by both the ACCC and the Government as likely to arise from the Telstra/FOXTEL relationship. This conclusion on its own should lead the ACCC to decide to revoke the immunity that is currently in place in respect of the notification. However, as will be demonstrated below, the proposed arrangement is patently **not** in the public interest.

Public benefits of the proposal

FOXTEL submits that it is not necessary for FOXTEL to demonstrate more than minimal public benefits given there is no anti-competitive detriment arising from the proposed conduct. Optus submits that there are significant anti-competitive detriments arising from the proposed conduct (see below). The ACCC will need to conclude that the public benefits are considerable in order for it to be satisfied that those benefits outweigh the substantial detriments to the public that arise from the proposed conduct.

In paragraph 4.1 of its submission FOXTEL lists a number of potential benefits arising from the proposed service. A closer examination of these indicates that each of these claims is invalid and that in contrast to FOXTEL’s claims there are no public benefits arising from the proposed arrangement.

FOXTEL indicates that the proposed services will lead to an increase in consumer choice for the acquisition of content. Whilst it might be the case that the proposed service will extend the range of content available to certain FOXTEL customers only, this will clearly not rest on the proposed exclusive arrangement with Telstra Bigpond. There would appear to be no impediments to FOXTEL making the content available to its subscribers. Whilst it is claimed that those subscribers will need a broadband connection, this service could be provided by any number of existing internet service providers. Such alternate providers would have a strong commercial interest in agreeing terms for the carriage of the FOXTEL service which are equally favourable (to FOXTEL) as those offered by Telstra.

A further benefit identified for the service is that customers will face “no or minimal per-download data charges” to access the content since Bigpond would waive such carriage

⁶ Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 – Explanatory Memorandum, page 36

⁷ Telecommunications Legislation Amendment (Competition and Consumer Safe Consumer Safeguards) BILL 2009 – Explanatory Memorandum, page 37

charges. As with the point above, such an outcome cannot be said to be a unique characteristic of the proposed arrangement between FOXTEL and Telstra (that is, the exclusivity condition is not required in order for customers to face no "download data charges" to access the FOXTEL content). Optus notes that alternate internet service providers have retail plans in the market today that offer customers' very substantial data download allowances (up to 500 Gigabits)⁸. In effect, a customer using the broadband service of one of these retail service providers would effectively face no "download data charges" to access the FOXTEL content. Optus submits that there is likely to be keen interest from alternate internet service providers to provide access to the FOXTEL content. We note that a number of retail internet service providers already "free rate" specific broadband delivered content. As FOXTEL admits in its submission, service providers such as iiNet, Internode, iPrimus, Adam internet, Apex internet and Vivid wireless provide unmetered access to the Tivo/CASPA content. As a further example, iiNet has a broader 'freezone' offering which, in addition to Tivo content, also free rates content from ABC iView, Apple iTunes and Xbox.

Finally, in its submission FOXTEL makes the unsubstantiated claim that the proposed "service will enhance competition in all relevant markets". Optus strongly disputes this claim and, as will be demonstrated below, we consider that the proposed exclusive arrangement will substantially lessen competition in some important markets.

In summary, it is not at all clear that an "exclusive" arrangement with Telstra Bigpond is required to deliver the proposed service supplied by FOXTEL. This condition would largely appear to benefit Telstra which would suggest that Telstra might have exerted substantial influence upon FOXTEL in order to obtain this exclusivity condition, by leveraging its fifty per cent ownership stake in the company. This point is alluded to in a recent report by analysts Fat Prophets:

"Considering Telstra owns 50 per cent of FOXTEL, this move is commercially logical from Telstra's point of view, but not necessarily Foxtel's".⁹

Optus submits that if FOXTEL was an independent entity then it would have little or no incentive to enter into the proposed arrangement and offer the service exclusively to Telstra Bigpond customers. On the assumption that a broadband connection is a necessary condition of accessing the content¹⁰, then rather than build a closed access environment, as envisaged by this arrangement, FOXTEL would have a strong incentive to allow any broadband service provider to provide a carriage service for the content and to allow its subscribers to use a broadband service provider of their choice.

The arrangement will substantially lessen competition in a number of relevant markets

Optus submits that the "exclusive" nature of the proposed arrangement is a blatant attempt by Telstra to use its ownership interest in FOXTEL to tie up access to FOXTEL's content

⁸ Refer TPG plans - [/www.tpg.com.au/products_services/adsl2plus_pricing.php](http://www.tpg.com.au/products_services/adsl2plus_pricing.php) and AAPT plans - <http://aapt.com.au/services/personal-small-business/personal/cheap-broadband-plans>

⁹ Article by Colin Kruger "Content is King even if there is not yet a network to deliver it through" – Sydney Morning Herald 14 June 2010

¹⁰ As indicated earlier, this assumption has not been proven.

thereby foreclosing its competitors from accessing that content and increasing its dominance in both the fixed line broadband and voice markets.

Rather than promote competition as alleged in the FOXTEL submission, Optus submits that the proposed exclusivity arrangement will raise barriers to entry into the broadband market, undermine competition by reducing broadband competitors' addressable market and increase Telstra's market power in the broadband market (and/or the broader market for fixed line services). In this way it is likely to lead to significant adverse consequences for consumers. This will include:

- A clear reduction in customer choice. Customers who want to take the FOXTEL service will effectively be denied the right of access to competitive broadband and fixed line voice services in that they will be likely to acquire those services solely from Bigpond (see further below)
- Increased prices for customers accessing broadband and voice services. Whilst Telstra has indicated that it will not charge for carriage of the content, Telstra's broadband plans are without doubt the most expensive in the market. Recent press articles have highlighted the fact that Telstra's broadband plans are priced as a significant premium to the market.

"The move has left BigPond as the most expensive high-usage broadband provider - \$100 dearer than market leader TPG for 200 gigabyte-per-month plans".¹¹

"Analysts at industry watchers OVUM...view is that Telstra needs to make further reductions as it has been obvious for a long time that Telstra's fixed broadband pricing is way above the market".¹²

- A reduction in innovation, with less competitive tension in the market.

Telstra's strategy to leverage its relationship with FOXTEL to bolster its position in the fixed line broadband market has been commented upon by a number of investment analysts. For example, in a recent note to investors JP Morgan indicated that:

*"The key to Telstra's long term value is retaining customers at premium prices. Method number one, owning the local access network, is more difficult today and impossible post-NBN. Method number two appears to be exclusive content, from 50%-owned FOXTEL in this case. FOXTEL is seeking ACCC permission to provide its content exclusively to Telstra Bigpond broadband customers. If FOXTEL is successful, its content could help to retain and attract customers to Telstra's Bigpond internet service, **even at premium prices**, bolstering long term value."¹³ (Emphasis added).*

If immunity stands and, in effect, the "exclusivity" arrangement is approved, Optus forecasts that it will lose existing and future customers, since consumers who wish to purchase FOXTEL's proposed service will have no choice but to purchase broadband services from Telstra. The "exclusivity" arrangement in combination with customer switching costs will

¹¹ Lucy Battersby, The Age – 29 April 2010

¹² Dominic White, Financial Review – 28 April 2010

¹³ Morgan Stanley, 4 June 2010, *Telstra Corporation: Quick Comment: Content the New Battleground; Playing the FOXTEL Card*

make customers substantially more likely to purchase all of their fixed line telecommunications requirements from Telstra.

Telstra's strategy is all the more likely to be effective, and detrimental to competition, as a result of the prevalence of strong network externalities in broadband (as in the telecommunications more generally). Products and services characterised by network effects increase in value as the size of the network increases. This exacerbates the tendency towards natural monopoly. As consumers increasingly gravitate towards the largest network, competing, smaller networks increasingly lose value and become squeezed from the market.

Economic theory suggests that in network industries, anti-competitive tactics can be crucial, even outcome determinative, regardless of whether an industry's cost structure is conducive to competition, or an entrant is more cost efficient than the entrenched incumbent. In the present case, FOXTEL and Telstra's exclusive content offering is likely to act in combination with existing network effects to create a positive feedback loop (the more customers which shift to Telstra's network to obtain FOXTEL's exclusive content, the more attractive Telstra's network will become). This feedback effect will act to strengthen Telstra's market share and weaken Telstra's broadband competitors. Ultimately, if Telstra's strategy to reduce the sales of its competitors in the fixed line telecommunications market is effective, some players may become unprofitable and be forced to exit the market, thus further entrenching Telstra's dominance in the fixed line market.

It is well recognised that the impact of anti-competitive conduct is likely to be magnified in networked communication markets. As Shapiro has stated:

"...I believe that the magnitude of potential harm tends to be greater in network markets. In conventional markets, the key issue is whether an entrant can gain a sufficient scale of business to successfully cover its fixed (as well as variable) production costs... Compare this to the situation prevailing in network industries. In a network context, what matters is not the absolute size of the "defecting coalition" of buyers who are considering whether to sponsor an entrant. Rather, what matters are the network benefits they would have to forego to do so, given the exclusivity required by the incumbent.

...I conjecture that exclusivity can operate on a grander scale with network effects than with conventional scale economies."¹⁴

The economic theory of network industries suggests that the development of competition within the telecommunications market requires fostering and vigilant protection against the endeavours of incumbent operators to undermine competition through anti-competitive conduct. The proposed third line forcing by FOXTEL and Telstra is exactly the type of conduct which must be prevented if effective competition in broadband is to be achieved.

¹⁴ Shapiro, *Exclusivity in Networked Industries*

Others matters relevant to the ACCC's consideration of the notification

National Broadband Network

An issue which the ACCC should give specific regard to is the likely impact of this proposal on the development of competition on the National Broadband Network (NBN). There are two specific factors in this context.

Firstly, a decision to withdraw immunity from the proposed conduct is time critical. The date on which FOXTEL intends to commence the proposed service or commence to market that service has been marked as confidential in FOXTEL's correspondence with the ACCC. Optus is concerned that FOXTEL will commence the proposed service during the ACCC process, during which time the proposed arrangement has immunity from breach of the third line forcing prohibitions.

This is a very sensitive time for the industry as internet service providers seek to build their market position in the lead up to the roll-out of the NBN. There is a clear risk that Telstra's aims could be achieved by commencing the supply of the proposed service and simply delaying the ACCC's decision making process (and that of the Tribunal, in the event the ACCC issues a notice revoking immunity and FOXTEL applies for review of the giving of that notice). Whilst ever a decision is pending Telstra can benefit from the proposed conduct and win market share as customers take up the FOXTEL offer and in doing so are compelled to acquire Bigpond broadband services from Telstra. Even if the immunity is revoked and the conduct ceases in several months time, Telstra would retain the benefit of any market share gains.

Secondly, this proposal should be seen as a thin end of the wedge for Telstra's ability to use its control of content to establish a broadband monopoly. The NBN will significantly extend the prospective market for FOXTEL, with the ability to deliver IPTV services over a high-speed broadband connection. The tying of FOXTEL content to a Telstra broadband connection could be used to create a dominant position on the NBN for Telstra. Such an outcome would be contrary to the Government's policy objectives for the NBN and inconsistent with the public interest.

ACCC questions

In correspondence with FOXTEL, the ACCC has asked whether FOXTEL approached internet service providers other than Telstra to discuss the prospect of entering into unmetered download agreements for the proposed service. We note that the answer to this question is marked out as being confidential.

Optus can confirm that it was not approached by FOXTEL to discuss such an arrangement. We can, however, confirm that had we been approached by FOXTEL we would have a strong interest in agreeing appropriate terms to provide broadband access for the delivery of the proposed service. Optus anticipates that other internet service providers would similarly have an interest in agreeing terms for the carriage of the FOXTEL service.

Conclusion

In summary, Optus is strongly of the opinion that the proposed exclusive dealing arrangement, which amounts to Third Line Forcing under S47 (6) of the Trade Practices Act,

should be rejected on the basis that it will deliver no public benefit but will in fact have significant adverse consequences for competition in a number of telecommunication markets.

