Australian Competition and Consumer Commission

Supplementary Submission
to the Productivity Commission
Review of Telecommunications Specific Competition Regulation

Pay TV and Regional Telecommunications

August 2001

EXECUTIVE SUMMARY

This paper sets out the ACCC's response to Chapter 16 of the Productivity Commission's Draft Report, which considered the issue of access to pay TV content raised in the ACCC's submission to the Telecommunications Service Inquiry. The Productivity Commission's Draft Report also considered a series of program access rules proposed by the ACCC.

This paper is divided into three parts:

Part A - The problem and the proposed solution

The problem identified by the ACCC is the impact that a lack of access to pay TV programming has on competition for the supply of broadband telecommunications services. The principal objective of the ACCC's submission is to encourage the elimination of such barriers to competition. Attachment A to this submission sets out a preliminary analysis of the potential losses from content foreclosure if it leads to reduced investment in regional and other areas. The results of this analysis suggest that the costs of foreclosure of content in this market could be substantial, with an estimated welfare loss of $56 million if service provision was delayed for 2 years, and up to $750 million for a delay of 10 years.

While this problem is particularly acute in rural and regional areas it is not confined to these areas. Any solution must address this problem in metropolitan areas as well. In addition, the ACCC submits that foreclosure of access to pay TV content is primarily a problem where program suppliers, pay TV operators, and/or network operators are characterised by vertical (and in some cases horizontal) integration. That said, it is important that any program access rules should not be susceptible to avoidance by the adoption of different structures or arrangements that generate incentives to withhold content without involving vertical integration in terms of ownership. Having regard to this, the ACCC submits that the proposed program access rules should not be confined to entities which are vertically related.

Part B - The program access rules

Part B expands on the description of the four proposed rules suggested by the ACCC in its submission to the Telecommunications Service Inquiry. These rules are drawn from the U.S. program access regime but do not seek to replicate it. Rather, the ACCC recommends that four of the U.S. rules would, with some adjustment, be suitable for adoption in Australia. In several instances, these proposed rules have been modified in light of observations made by the Productivity Commission in its Draft Report and further consideration by the ACCC.

Part C - An access regime for pay TV programming

Part C examines the case for an access regime in relation to pay TV programming and the suitability of Part XIC for this purpose. The ACCC submits that there may be a case for regulating access to pay TV programming by imposing a positive obligation on program suppliers or pay TV operators to license other pay TV operators to broadcast pay TV content. Part XIC could be amended to regulate access to pay TV programming, although there is no reason why such an obligation could not be imposed under other legislation. This submission briefly canvasses how such an obligation might be imposed.

BACKGROUND

1. In its submission to the Telecommunications Service Inquiry, the ACCC proposed the adoption of four 'program access rules' to facilitate access to pay TV programming and, by doing so, remove a major hurdle to competition in the supply of broadband telecommunications services, particularly in rural and regional Australia.

2. Following the Telecommunications Service Inquiry, the Productivity Commission's terms of reference for its current inquiry were expanded to include consideration of the implications of existing pay TV programming arrangements for the development of telecommunications competition in regional Australia and whether any additional regulatory arrangements are necessary.

3. Chapter 16 of the Productivity Commission's Draft Report considered these issues and the ACCC's submission to the Telecommunications Service Inquiry. At p 16.31 of the Draft Report, the Productivity Commission concluded that:

   > "In the Commission's view, there is a possible case for intervention to stem foreclosure of pay TV content. Moreover, with new services, the problem may expand beyond the pay TV industry. For example, the problem of controlling content could also appear in other areas such as video on demand and web TV.
   >
   > That said, the Commission is cautious about recommending action at this stage. The industry is new and developing, alternative platforms for broadband services are emerging and the effect on competition is unclear. In addition, this part of the inquiry is at an early stage, and further investigation is needed.
   >
   > However, some things are clear. First, Part IV of the TPA would probably not suffice as an instrument to tackle the impact of the control of pay TV content on the development of telecommunications in regional Australia, although not necessarily for the reasons given by the ACCC. Second, the ACCC's proposal to remedy the problem would not be appropriate as it is currently structured, but with some modifications would provide more open access to content by pay TV operators, including those in regional Australia.
   >
   > *The Commission seeks views on these matters, and on how any of the options discussed might best be implemented*."

4. The purpose of this paper is to provide the ACCC's response to the issues raised by the Productivity Commission, as well as explaining in more detail the proposed solutions identified by the ACCC in its submission to the Telecommunications Service Inquiry.

5. This submission is divided into three parts:

   A. The problem and the proposed solution;

   B. The program access rules; and

   C. An access regime for pay TV programming.

   Attachment A to this paper contains the ACCC's assessment of potential losses from foreclosure of access to pay TV content.

PART A - THE PROBLEM AND THE PROPOSED SOLUTION

The nature of the problem

6. The problem identified by the ACCC was summarised in the ACCC's submission to the Telecommunications Service Inquiry as follows:

> "Through digitalisation and technical convergence, broadband cable networks are capable of providing a range of voice, data and video services such as telephony, high-speed Internet connections, e-commerce and pay TV.
>
> Accordingly, these facilities-based competitors have the potential to greatly enhance the delivery of telecommunications services in the regional areas where their cable roll-outs are occurring or are planned.
>
> Because of technical convergence, a regional operator's competitive position in telecommunications can also be promoted by quality pay TV programming through the following links:
>
> - the range of services that can be carried over broadband networks can be offered as bundled services;
> - pay TV programming quality is a key factor in attracting customers to a bundle of services and, thus, increasing the overall up-take of services; and
> - higher revenues per subscriber and economies of scope from bundling can be critical to funding the costs of network roll-out.
>
> Without access to quality programming, the necessary revenues may not be available to fund cable investment. Without this investment, an important source of facilities-based competition may be foreclosed from both telecommunications and pay TV markets."[1]

Facilities-based competition

7. The ACCC's primary objective is to encourage the removal of barriers that are hindering competition in the supply of broadband telecommunications services by preventing potential suppliers in this market from acquiring pay TV programming. While the ACCC notes the Productivity Commission's observation at p 16.17 that "competition is not a goal in itself", the elimination of barriers which have the potential to hinder the development of competitive conditions in telecommunications markets remains a critical outcome if the telecommunications regulatory regime is to promote economic efficiency in the ways identified by the Productivity Commission at p 5.2 of its Draft Report.

8. There is potential for broadband services and pay TV to be supplied to customers via several existing and emerging platforms, including HFC cable, ADSL, satellite and MDS. However, factors which hinder the roll out of cable will significantly lessen or remove altogether the pressure on competitors to develop the technology to supply broadband services via these other methods. The ACCC submits that access to pay TV programming is essential for potential new entrants to attract a sufficient number of subscribers to make the roll out and continued operation of a cable network viable. While

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[1] ACCC submission to the Telecommunications Service Inquiry (Part 2 - Promotion of regional cable competition through access to pay TV programming), p 2.

a number of companies have commenced, or are proposing to commence, the roll out of cable infrastructure,[2] several companies have also indicated to the ACCC (and to the Productivity Commission) that without access to pay TV programming, their roll out will either be delayed or will not happen at all.

9. The ACCC acknowledges that there are additional regulatory constraints that may be hindering facilities-based competition in the supply of broadband services. For example, a removal of the current restrictions on datacasting could potentially encourage the use of other forms of technology (such as ADSL) to deliver both pay TV and broadband services to consumers. However, the elimination of such barriers will not, by themselves, rectify the problem that is created where 'premium' content is licensed for broadcast under exclusive arrangements.

Economies of scope

10. The economies of scope and the importance of the connection between pay TV and broadband telecommunications services were discussed in detail in Part 2 of the ACCC's submission to the Telecommunications Service Inquiry and the supporting papers.[3] There are of course some cases where, even without prior access to pay TV programming, cable infrastructure is being rolled out in some areas and the ACCC is aware that some carriers in regional areas do have arrangements for acquiring pay TV programming. However, even if the lack of access to pay TV programming does not operate as a complete barrier to the roll out of cable infrastructure, the ACCC submits that it has, at the very least, the potential to significantly delay this roll out and may have the potential to undermine the on-going viability of networks.

11. It is important that the Productivity Commission's conclusion that "it seems likely that the major consequence of content foreclosure is the *delayed* availability of high bandwidth facilities in regional Australia"[4] is not seen as understating the impact of such delay or denial. The concern identified by the ACCC is not simply confined to the lack of availability of pay TV. Consumer benefits are being lost from an absence of competition in the supply of telecommunications services that could be provided using cable and through the use of other new and emerging forms of technology.

12. The ACCC agrees that it is important to establish not only that a problem exists, but also that the problem creates significant costs, which might support a case for regulatory intervention. In Attachment A, the ACCC sets out a preliminary analysis to identify and quantify the potential losses from content foreclosure if it leads to reduced investment in regional (and other) areas. In particular, the analysis looks at the impact in the market (or markets) for broadband internet services. The results of this analysis suggest that the costs of foreclosure of content in this market could be substantial, with an estimated welfare loss of $56 million if service provision was delayed for 2 years, and up to $750

[2] ACCC submission to the Telecommunications Service Inquiry (Part 2 - Promotion of regional cable competition through access to pay TV programming), p 1 and Attachment 2 - "Telecommunications and the pay TV connection", p 4. Also see Chapter 7 of the Report of the Telecommunications Service Inquiry and the Consultant's Report for the Inquiry prepared by NECG.

[3] While these arguments are not reproduced here, they are adopted for the purpose of this response.

[4] Draft Report, p 16.17

million for a delay of 10 years. In addition, it is necessary to factor in welfare losses from the lower level of competition in the provision of other telecommunications services, although the ACCC agrees that these benefits may not be substantial. While these estimates are preliminary, the ACCC believes that this analysis supports the view that denial of pay TV content can have substantial consequences in telecommunications markets, particularly if it results in the delay of infrastructure provision for a number of years.

Factors preventing access to pay TV programming

13. The principal factor identified by the ACCC as hindering the ability of new entrants to obtain pay TV programming is that much of this content (and almost all ‘premium’ content) is currently licensed to pay TV operators on an exclusive basis. The ACCC acknowledges that other factors, such as legitimate commercial or technical factors, can also play a role in hindering access to programming. There are also other regulatory factors that may prevent pay TV operators from obtaining pay TV programming, in particular anti-siphoning and anti-hoarding rules. The relaxation of such constraints may have the effect of making more content available for new entrants in the pay TV market. However such measures would not, by themselves, address the problem of premium content being tied up under exclusive licensing arrangements.

14. In a competitive market that is not characterised by high levels of vertical integration, the ACCC believes that participants would ordinarily have an incentive to deal with each other. For example, a producer of pay TV programming would ordinarily have an incentive to maximise its subscription and/or advertising revenue by licensing its content for broadcast to as many subscribers as possible.

15. In markets that are not characterised by vertical integration, the ACCC expects that foreclosure of competition would not be a relevant factor in the exclusive licensing of pay TV programming. Exclusive licensing is not, in every case, undertaken for the purpose of foreclosing competition in upstream or downstream markets. An exclusive licence might be granted in exchange for the payment of a sufficiently large premium. However, where there is vertical integration between program suppliers, pay TV operators and the owners or operators of the infrastructure over which the programming is broadcast, the potential exists for exclusive licensing to be used to lessen competition in one or more of these markets. The ACCC’s objective is to eliminate the incentive to deny access to pay TV programming by restricting the exclusive licensing of pay TV content by program suppliers.

Convergence

16. The importance of this proposal to convergence should not be underestimated. Technical convergence has opened the way for pay TV to be supplied to customers alongside other broadband telecommunications products such as telephony and high speed internet access. There is a clear and significant link between pay TV and the viability of these broadband services. The ACCC’s proposed rules should be seen as a measure aimed at addressing one of the challenges presented by technical convergence in the communications industry.

Is this problem confined to rural and regional areas?

17. The ACCC's submission to the Telecommunications Service Inquiry paid particular attention to the problem of competition in rural and regional areas. This reflects the fact that a lack of access to quality pay TV programming is likely to have a more serious impact on competition in the supply of broadband services in these areas because of a reduced likelihood of broadband services being delivered via other platforms. Cable infrastructure takes on increased significance in areas where there is less likelihood of broadband services being supplied to customers using different technology, such as ADSL.

18. While the consequences of a lack of access to pay TV programming may be more acute in rural and regional areas, further consideration of this issue suggests that it has the potential to hinder competition for the supply of broadband services in metropolitan areas as well (particularly suburban and outer metropolitan areas). The economies of scope between pay TV and broadband telecommunications services are not confined to cable infrastructure and broadband services in rural and regional areas. If a lack of access to pay TV content will hinder the roll out of cable infrastructure in metropolitan areas, it has the potential to stand in the way of competition for the supply of broadband telecommunications services in these areas, not only because the roll out of cable infrastructure will be hindered, but because this hindrance will lessen competitive pressure to supply broadband services using other forms of technology. It should be noted that, in opposing the proposed merger between Australis and Foxtel in 1997, the ACCC's concerns in relation to local telephony and broadband infrastructure were not confined to rural and regional areas.[5]

19. There is also a danger that distinctions between outer metropolitan areas on the one hand and rural and regional areas on the other will involve arbitrary judgments based purely on geography rather than an analysis of competition in those areas. Having regard to these factors, the ACCC submits that consideration should be given to a regime of program access rules applying in both metropolitan and non-metropolitan areas.

The proposed solution

20. The ACCC proposed the adoption of four program access rules that are based on (although not identical to) four of the rules in the U.S. program access regime. The purpose of the proposed rules is to remove exclusive licensing as a factor preventing the acquisition of pay TV programming, thus removing a barrier to competition in the supply of broadband services.

21. It is essential to recognise that the purpose of this paper is to outline a policy proposal. Further consultation and consideration will be an inevitable and essential part of the formulation of policy in this area, and a critical component of this process will be a discussion of the implementation of this proposal and the manner in which it will achieve its stated objectives. It is equally important that, at this relatively early stage, discussion

[5] ACCC submission to the Telecommunications Service Inquiry, Attachment 2 - "Telecommunications and the Pay TV connection", p 3. Also see "Pay TV, Cabling and Service Bundling: Challenges for Regulators" (speech to the Australian Cable and Satellite Television Conference by Commissioner David Lieberman, 6 February 1997, reproduced at www.accc.gov.au).

of this proposal is not side-tracked by focussing solely on questions of implementation, while ignoring the principles and objectives underpinning this proposal.

Differences between the objectives of the U.S. rules and the ACCC proposals

22. It must be emphasised that the ACCC does not propose the wholesale adoption in Australia of the U.S. program access regime. Rather, the ACCC has suggested that some of the rules in that regime would, with changes, be appropriate for adoption in Australia as measures to remove barriers to competition in the supply of broadband services. The U.S. regime consists of a more extensive set of rules designed to address different issues than the program access rules suggested by the ACCC. It must also be remembered that the structure of the Australian pay TV market is different to that which exists in the U.S. As a result, a comparison of the U.S. regime with the ACCC's proposals, while perhaps providing useful background, is likely to be of only limited benefit in understanding and assessing the merits of the proposed rules.

23. The U.S. rules, which are discussed in Part B of this submission, target exclusive arrangements between "satellite cable programming vendors" and "cable operators"[6] (ie. between a person who supplies pay TV programming via satellite for re-distribution and the operators of the cables over which the programming is distributed to customers). The cable operators can be, but need not be, the person who actually supplies the pay TV service to the customer. The rules proposed by the ACCC are different, in that they target exclusive arrangements between program suppliers and pay TV operators, rather than cable operators.

"Program suppliers"

24. The rules proposed by the ACCC refer to "program suppliers" rather than the U.S. concept of "satellite cable programming vendors". This is because the ACCC is not concerned with targeting satellite transmission to pay TV operators as such, rather its concern is to remove barriers which prevent new entrants from acquiring pay TV programming. The ACCC has therefore proposed rules to apply to licensing by "program suppliers". While no attempt is made to comprehensively define this term in this paper, the ACCC envisages that this would encompass entities which have the right to licence pay TV programming to pay TV operators. Some flexibility is essential in this area, since pay TV programming may be supplied by programming houses as a bundle or 'channel' of programs (eg. Movie Vision, Premium Movie Partnership, Fox Sports), but could also be supplied directly for distribution by the person who produces the program.

"Pay TV operators"

25. The distinction between "pay TV operators" and "cable operators" is less significant. In Australia there is a high degree of integration between 'cable operators' and 'pay TV operators' (eg. Telstra/Foxtel, Optus). Pay TV programming that is broadcast in Australia on an exclusive basis is generally broadcast by pay TV operators over a cable network that is owned or operated either by a related entity or partner. Targeting the 'pay TV operator' rather than the 'cable operator' is therefore less relevant. If the program

[6] These terms are defined in paragraph 35 below.

access rules proposed by the ACCC are to have any effect, it is necessary to focus on the exclusive arrangement between the person who can license a pay TV operator to broadcast a program over cable on an exclusive basis (ie. the program supplier) and the licensee (ie. the pay TV operator).

"Pay TV programs"

26. Again, while no detailed definition is attempted in this paper, the ACCC's intention is for the proposed rules to capture arrangements for the licensing of any program or package of programs to a pay TV operator. This concept is intended to be sufficiently broad to encompass both a single program and a bundled or branded product that is supplied to a pay TV operator for broadcast by a program supplier. It is not proposed that the rules be applied to specific pay TV programs or categories of programs, whether identified in legislation or by subsequent regulatory instrument. While it is possible that a specific program may not be particularly important to the viability of a broadband network, such a program is less likely to be licensed on an exclusive basis in the first place, and therefore less likely to be affected by the proposed rules. If the program is sufficiently valuable or sought after to be licensed on an exclusive basis, then the regulatory regime would be deficient if an exclusive licence was not subject to the rules due to an omission in the identification of the pay TV programming to which the rules apply.

Vertical integration

27. At p 16.26 of the Draft Report, the Productivity Commission questioned whether the proposed rules should be confined to vertically integrated pay TV operators and program suppliers. The Productivity Commission noted that an exclusive agreement between a pay TV operator and an unrelated program supplier could be just as anti-competitive as an exclusive agreement between vertically integrated parties. For this reason the Productivity Commission suggested that the confinement of this prohibition to vertically integrated parties may not be justified.

28. Denial of access to pay TV content is principally a concern where program suppliers, pay TV operators and/or the operators of cable networks are vertically integrated. As discussed above, in a competitive market that is not characterised by vertical integration, suppliers would ordinarily have an incentive to deal with other participants. The objectionable incentive for program suppliers to withhold content arises where they are related to pay TV operators.

29. This problem is even more acute in the presence of horizontal integration, which can provide an incentive for a vertically integrated program supplier to refuse to license other pay TV operators to broadcast its programming, eg. where a pay TV operator and/or program supplier is integrated with the owner of the cable network, which is itself characterised by horizontal integration in that it operates other infrastructure by which broadband services can be supplied. This situation highlights the possibility that a vertically integrated pay TV operator may have an incentive to prevent the licensing of programming to competing pay TV operators in order to protect the horizontally integrated entity from competition. The OECD recently noted that several European

countries (The Netherlands, Germany and Switzerland) have actually required their dominant telecommunications operators to divest their activities in pay TV.[7]

30. That said, it is important that any program access rules which are confined to entities that are vertically integrated by way of ownership should not be susceptible to avoidance by the adoption of different structures or arrangements. For example, it is possible that a pay TV operator and a program supplier could enter into an agreement or understanding which would leave the program supplier with the same incentive to foreclose access to pay TV content that it would have if it was related to the pay TV operator by ownership. Having regard to this, the ACCC submits that the proposed program access rules should not be confined to entities which are vertically related.

Access to cable infrastructure

31. It should be noted that the ACCC's proposal is not aimed at access to cable infrastructure by pay TV operators. While competition in the delivery of both pay TV and broadband services can be hindered by the refusal of the owner of a cable network to provide access to a third party, this is (to some degree at least) already subject to regulatory intervention under Part XIC. The ACCC's primary objective is to remove barriers that prevent potential entrants in the telecommunications market acquiring the pay TV programming that is crucial to the roll out of cable networks.

[7] OECD Committee on Competition Law and Policy, "Summary record of the 19th meeting of Working Party No. 2 on Competition and Regulation - executive summary of the discussion on telecommunications" (DAFFE/CLP/WP2/M(2001)2/ANN3) 25 July 2001, p 3.

PART B - THE PROGRAM ACCESS RULES

Background

32. In its submission to the Telecommunications Service Inquiry, the ACCC proposed the adoption of four 'program access rules' to facilitate access to pay TV programming, and by doing so remove a major hurdle to the supply of broadband services, particularly in rural and regional Australia.

33. The rules proposed by the ACCC are broadly based on four of the rules in the program access regime in force in the U.S..[8] The proposed rules are:

    (a) a partial prohibition on exclusive contracts in area served by the pay TV operator;

    (b) an absolute prohibition on exclusive contracts in areas not served by the pay TV operator;

    (c) a prohibition on exclusive sublicensing in unserved areas; and

    (d) a prohibition on discrimination by a program supplier between competing pay TV operators on terms and condition of supply.

34. The Productivity Commission made a range of comments in relation to these proposed rules. The ACCC has also given further consideration to the content and application of these proposed rules which has prompted a more detailed discussion and, in some cases, modification of the proposed rules.

<u>1. A partial prohibition on exclusive contracts in areas served by the pay TV operator</u>

A. Summary of the U.S. rule

35. Rule 76.1002(c)(2) provides that a cable operator[9] is prohibited from entering into an exclusive arrangement to acquire satellite cable programming from a satellite cable programming vendor[10] in which the cable operator has an attributable interest, with respect to any area served by a cable operator, unless the FCC determines that the arrangement is in the public interest.

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[8] These Rules are made under s 628 of the *Communications Act* (47 U.S.C. 548) and are set out at 47 C.F.R. 76. The rules sunset on 5 October 2002 (ie. ten years after their commencement).

[9] A "*cable operator*" is defined as "*any person or group of persons (A) who provides cable service over a cable system and directly or through one or more affiliates owns a significant interest in such a cable system, or (B) who otherwise controls or is responsible for, through any arrangement, the management and operation of such a cable system*" (47 U.S.C. 522(5)).

[10] A "*satellite cable programming vendor*" is a person engaged in the production, creation, or wholesale distribution of video programming which is transmitted via satellite to cable operators for re-distribution to customers (rule 76.1000(h), (i)).

36. The public interest test[11] provides that in deciding whether an exclusive arrangement is in the public interest, the FCC will consider the effect of the arrangement on the distribution of video programming in the served area in light of the following factors:

    (a) the effect of the exclusive arrangement on the development of competition in local and national programming distribution markets;

    (b) the effect of the exclusive arrangement on competition from programming distribution technologies other than cable;

    (c) the effect of the exclusive arrangement on capital investment in the production and distribution of new programming;

    (d) the effect of the exclusive arrangement on diversity of programming in the distribution market; and

    (e) the length of the exclusive arrangement.

37. A cable operator who wishes to enter into an exclusive arrangement of this type must first obtain the approval of the FCC. The approval process allows for submissions by the cable operator as well as its competitors.

B. ACCC submission to the Telecommunications Service Inquiry

38. The ACCC recommended the introduction of a prohibition on exclusive program supply contracts in the pay TV operator's service area, unless it could be demonstrated that the exclusive contract is in the public interest (eg. the promotion of competition or efficient investment in infrastructure). This proposed rule would apply to programs supplied by a program supplier to a pay TV operator by any means, not just satellite (as in the U.S.).

C. Issues

Served v. unserved areas

39. The ACCC suggested a partial prohibition on exclusive arrangements for the licensing of programs for broadcast in areas served by the licensee, and a per se prohibition on exclusive licensing arrangements for the broadcast of programs in areas *not* served by the licensee. The significance of the distinction between served and unserved areas is that in a served area, it would be possible to authorise exclusive licenses on public interest grounds. To this end, a "served area" means an area in which the licensed pay TV operator supplies a pay TV service. Exclusive arrangements will be prohibited per se in areas not served by the licensee, even if the area is served by another pay TV operator.[12]

40. This distinction reflects the ACCC's objective of removing barriers to pay TV programming in order to encourage competition in the supply of broadband services. If a

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[11] Rule 76.1002(c)(4).

[12] This means the per se prohibition would apply more widely in Australia than it applies in the U.S.. In the U.S., if an area is served by *any* cable operator, the partial prohibition applies, regardless of whether the relevant licensee serves that area.

new entrant wishes to roll out infrastructure in an area not served by a pay TV operator, there is no legitimate justification for that pay TV operator to deny access to its programming.[13] A per se prohibition is proposed in this situation. However, even once a new entrant has rolled out infrastructure, it is important that a competing pay TV operator cannot jeopardise the survival of the new entrant by denying access to pay TV programming that it does not broadcast itself in that area. As a result, the area is still deemed to be 'unserved' by the pay TV operator and a per se prohibition applies. If a pay TV operator does supply a pay TV service in an area, the area will be a 'served' area and the prohibition on exclusive licensing will be subject to public interest exemption.

Future service areas

41. It may be desirable to add an exception to the per se prohibition to permit the authorisation of exclusive licensing arrangements in areas that are not served by a pay TV operator, but which will be served in the near future. This is intended to address the possibility that a pay TV operator may have plans for a phased roll out of pay TV infrastructure that will only be viable if it can secure, in advance, the exclusive right to broadcast pay TV programming in each of those areas. Yet, even if such an arrangement merits authorisation on public interest grounds it would be impossible, under the current proposal, to authorise an exclusive licence for those areas where the pay TV operator merely plans to roll out its infrastructure, but has not done so. At the same time, the ACCC does not believe it is in the public interest to permit a pay TV operator to secure exclusive access to pay TV programming in the mere hope or expectation that it will expand its network into unserved areas. This could be used as a pretext for unfairly denying competitors access to pay TV programming. A pay TV operator in this position should be required to demonstrate that its plans for expansion into unserved areas are sufficiently firm to justify an exclusive licence to broadcast content into those areas on public interest grounds for a limited period.[14] Accordingly, the ACCC proposes that the concept of a 'served' area be effectively expanded to include an area which is about to be served by the pay TV operator.

Authorisation process

42. It is submitted that an authorisation process similar to the process under Division 1 of Part VII of the TPA would be suitable for determining whether an exclusive licence would be in the public interest. This is a transparent, well understood process that provides for substantial public and stakeholder input and has been used extensively by the ACCC over the life of the TPA for balancing public interests against anti-competitive detriments.

D. Revised proposed rule

43. In light of the above, the ACCC submits that the proposed rule should prohibit:

    (a) any contract, arrangement or understanding between a program supplier and pay TV operator;

[13] With one exception ('future service areas'), which is discussed in the next paragraph.

[14] The exclusive licence would become prohibited if the pay TV operator had not commenced service within the permitted time.

(b) under which the pay TV operator has an exclusive right:

(i) to broadcast a program via a pay TV service; or

(ii) to license another person to broadcast a pay TV program via a pay TV service;[15]

(c) in an area that is:

(i) served by the pay TV operator by cable; or

(ii) about to be served by the pay TV operator by cable;

(d) unless is it has been authorised on the basis that is justified in the public interest.[16]

2. An absolute prohibition of exclusive contracts in areas not served by the pay TV operator

A. Summary of the U.S. rule

44. Rule 76.1002(c)(1) provides that a cable operator is prohibited from engaging in any conduct or entering into any exclusive arrangement that prevents a multichannel video programming distributor[17] from acquiring satellite cable programming from a satellite cable programming vendor in which the cable operator has an attributable interest, for distribution in any area not served by a cable operator. There is no public interest exception to this prohibition.

B. ACCC submission to the Telecommunications Service Inquiry

45. The ACCC recommended an absolute prohibition on exclusive program supply contracts that cover areas which are not in the pay TV operator's service area.

C. Issues

46. See paragraphs 39 to 42 above.

D. Revised proposed rule

47. In light of the above, the ACCC submits that the proposed rule should prohibit:

(a) any contract, arrangement or understanding between a program supplier and pay TV operator;

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[15] This is intended to cover sublicensing in 'served' areas (see paragraph 55 below).

[16] In determining whether authorisation is justified in the public interest, it is suggested that relevant public interest factors should not be specified, reflecting the approach under Part VII of the TPA.

[17] A "multichannel video programming distributor" is a person who supplies a cable service to customers or subscribers and can include a cable operator (47 U.S.C. 522(13)).

(b) under which the pay TV operator has an exclusive right to broadcast a program via a pay TV service;

(c) in an area that is:

(i) not served by the pay TV operator by cable; or

(ii) not about to be served by the pay TV operator by cable.

3. A prohibition on exclusive sublicensing in unserved areas

A. Summary of the U.S. rule

48. Rule 76.1002(c)(3)(i) originally provided that a cable operator was prohibited from entering into any subdistribution agreement for satellite cable programming with a satellite cable programming vendor in which the cable operator had an attributable interest, for distribution in an area not served by a cable operator.[18] The effect of this rule was to prevent a programming vendor from ever giving a cable operator the right to sublicense another operator to distribute the vendor's programming in any area not served by a cable operator.

49. In 1994 the FCC revised this rule to provide that a subdistribution agreement in relation to an unserved area is prohibited only if it gives the cable operator an *exclusive* right to sublicense another operator to distribute the vendor's content in an area not served by a cable operator.[19]

50. Subdistribution arrangements in relation to areas that *are* served by a cable operator are permitted under the U.S. rules provided that:

(a) the cable operator cannot require a competing operator to purchase additional content when acquiring a licence to distribute the programming covered by the subdistribution arrangement, or require the operator to provide access to private property in exchange for the sublicence;

(b) the cable operator cannot charge more for the sublicence than the vendor would be permitted to charge; and

(c) the cable operator must respond to any request for a sublicence from a competing operator within 15 days. If the request is denied, the competing operator must be permitted to negotiate directly with the vendor for a licence to distribute the programming in the area.[20]

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[18] A "subdistribution agreement" is an arrangement between the programming vendor and the cable operator under which the cable operator is given the right to distribute the programming to competing multichannel video programming distributors (ie. competing pay TV operators).

[19] *Memorandum Opinion and Order on Reconsideration of the First Report and Order*, FCC 94-287, paragraphs 89-92.

[20] Rule 76.1002(c)(3)(ii), (iii).

B. ACCC submission to the Telecommunications Service Inquiry

51. The ACCC recommended the introduction of an absolute prohibition on the pay TV operator sublicensing in unserved areas. The ACCC made no recommendation on the adoption of any rule relating to sublicensing in areas that are served by the pay TV operator.

C. Issues

52. See paragraphs 39 to 43 above. The Productivity Commission also noted that the ACCC's proposal is not intended to prevent a pay TV operator from supplying feeds of its content to other pay TV operators outside of its service area. This is correct.

Permitting non-exclusive rights to sublicense

53. The objective of the proposed rule is to prohibit any arrangement under which a program supplier assigns exclusively to a pay TV operator its right to license a third person to broadcast pay TV programming in an area not served by the pay TV operator. This is because the assignment effectively empowers the pay TV operator to deny access to the content for re-supply in an area not served by the pay TV operator.

54. Consistent with the FCC's 1994 decision, it is appropriate to clarify the ACCC's proposal to confirm that sublicensing arrangements would only be prohibited where they gave the pay TV operator an *exclusive* right to license other pay TV operators to broadcast the content. There is no obvious detriment in a program supplier giving a pay TV operator a non-exclusive right to sublicense the broadcast of pay TV programming, since a new entrant which is denied a license by the pay TV operator can still seek such a licence from the program supplier (and vice versa).

Sublicensing in served areas

55. The FCC permits agreements assigning an exclusive right to sublicense in served areas subject to certain conditions (see paragraph 50 above). The ACCC instead proposes that sublicensing in served areas be covered under the first proposed rule set out in paragraph 43 above, ie. an exclusive sublicensing arrangement in relation to a served area would be prohibited unless it was found to be in the public interest.

D. Revised proposed rule

56. In light of the above, the ACCC submits that the proposed rule should prohibit:

    (a) any contract, arrangement or understanding between a program supplier and pay TV operator;

    (b) under which the pay TV operator has an exclusive right to license another person to broadcast a pay TV program via a pay TV service;

    (c) in an area not served by the pay TV operator by cable.

4. A prohibition on discrimination by a program supplier between competing pay TV operators on terms and conditions of supply

A. Summary of the U.S. Rule

57. Rule 76.1002(b) provides that a satellite cable programming vendor in which a cable operator has an attributable interest is prohibited from discriminating in the price and terms and conditions of sale for satellite cable programming between competing cable operators and multichannel video programming distributors. This does not prohibit:

(a) reasonable requirements of creditworthiness, offering of service, financial stability and standards relating to character and technical quality;

(b) different prices, terms and conditions to take into account actual and reasonable differences in cost;

(c) different prices, terms and conditions to take into account economies of scale; and

(d) exclusive contracts that are permitted under the rules discussed above.

B. ACCC submission to the Telecommunications Service Inquiry

58. The ACCC recommended that program suppliers be prohibited from discriminating between pay TV operators on the price and terms and conditions of program supply.

C. Issues

59. The Productivity Commission observed that this provision would effectively impose an access regime for pay TV programming, since a program supplier would be obliged to supply to a pay TV operator on non-discriminatory terms and conditions. This would require a process to resolve disputes relating to terms and conditions of supply. The Productivity Commission suggested that such an obligation could be imposed under Part XIC of the TPA.

60. This fourth rule was not intended to effectively impose an access regime. A rule that prevents a person discriminating between customers does not necessarily equate to a positive obligation to supply on demand. The former s 49 of the TPA, which prohibited price discrimination, was not regarded as imposing an access regime, rather its effect was to prohibit discrimination by a supplier where the supplier elected to supply.

61. In relation to whether a refusal to supply would amount to a breach of the U.S. non-discrimination rule, the FCC has stated that:

> "we believe that one form of non-price discrimination could occur through a vendor's "unreasonable refusal to sell", including refusing to sell programming to a class of distributors, or refusing to initiate discussions with a particular distributor when the vendor has sold its programming to that distributor's competitor. We believe that the Commission should distinguish "unreasonable" refusals to sell from certain legitimate reasons that could prevent a contract between a vendor and a particular distributor, including (i) the possibility of parties reaching an impasse on particular terms, (ii) the distributor's history of defaulting on other programming contracts, or (iii) the vendor's preference not to sell a program package in a

> particular area for reasons unrelated to an existing exclusive arrangement of a specific distributor."[21]

62. While the ACCC did not intend to introduce an access regime, it accepts that there may be some situations where a refusal to supply could amount to an act of discrimination. However, this alone does not elevate the non-discrimination rule to the status of an 'access regime'. The enforcement of this rule does not involve the determination of access or access pricing via an arbitration or regulatory process. Take, for example, the case of an entrant who complains that a program supplier has violated this rule because it offered to supply a program only at a price far in excess of the price at which it supplies the program to an incumbent pay TV operator. The task of the dispute resolution body in this case is not to determine the price at which the program should be supplied by any reference to cost or rate of return (as might be the case under an access regime). Rather, the sole function of the dispute resolution body is to ensure that the price is not discriminatory. Similarly, if a refusal to negotiate amounted to an act of discrimination, the role of the dispute resolution body is to prevent the discrimination by ordering the program supplier to negotiate. These functions are narrower than the functions that would ordinarily be conferred under an access regime.

63. It should also be emphasised that the prohibition on discrimination in relation to terms that include price does not mean that an identical price must be charged to each pay TV operator to whom a program is supplied. Both the U.S. rule and former s 49 of the TPA permit differing prices to take account of genuine differences in such matters as cost, economies of scale and quantity.

D. Proposed rule

64. In light of the above, the ACCC submits that the proposed rule should prohibit program suppliers from discriminating between competing pay TV operators on the price and non-price terms and conditions for the supply of pay TV programs for broadcast via a pay TV service. Differential treatment would not be prohibited if confined to the matters identified in paragraph 57 above.

Other issues

Enforcement

65. Under the U.S. program access regime, a pay TV operator who is a victim of a breach of the program access rules can commence proceedings before the FCC. The process is a typical 'judicial' process, including such steps as pleadings and discovery (at the discretion of the FCC). The FCC has the power to set terms and conditions for the sale of programming as well as the power to award damages. In Australia, the appropriate forum for the resolution of disputes in such a manner is the Federal Court. While the ACCC can conduct arbitrations to determine terms and conditions to apply between parties, remedies such as damages and injunctions can only be granted by a court.

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[21] *First Report and Order*, FCC 93-178, paragraph 116.

Existing contracts

66. The U.S. program access rules were not applied retrospectively, but were applied to existing contracts from the date the rules commenced (with a 120 day grace period), ie. existing contracts were not grandfathered. The ACCC does not advocate retrospective operation of the program access rules discussed above (ie. it is not proposed that they take effect from a date prior to their commencement). The objective of the proposed rules is to invalidate conditions which have the potential to prevent new entrants obtaining access to pay TV programming. The achievement of this objective does not require that the rules take effect retrospectively.

67. However, the question of retrospectivity is different from the question of whether existing contracts should be grandfathered. A law which renders a pre-existing licence condition invalid from the date of the law's commencement is not a retrospective law, but it leaves open the question of whether the pre-existing right should be grandfathered, ie. allowed to continue with immunity from the rules until its expiry or termination. Further consideration must be given to this issue, including whether a party to an existing exclusive licence would be entitled to compensation if a program access regime rendered a term of that licence invalid.

Summary

68. The program access rules proposed by the ACCC reflect a prohibitive approach to the removal of barriers to competition in the supply of broadband services, ie. they proscribe things that may not be done. The Productivity Commission has questioned whether there is a case for the introduction of a positive obligation to supply access on demand, ie. an access regime. While the ACCC did not propose this in its initial submission to the Telecommunications Service Inquiry, it accepts that there may be merit in such a proposal. This issue is discussed in Part C below. In the absence of an access regime, the ACCC believes that the introduction of program access rules is a necessary and desirable measure to facilitate competition in the supply of broadband telecommunications services.

PART C - AN ACCESS REGIME FOR PAY TV PROGRAMMING

Background

69. The Productivity Commission has suggested that the ACCC's proposal to introduce a rule prohibiting discrimination by a program supplier in relation to the price and terms and conditions upon which it supplies programming, effectively amounts to an obligation to supply access on demand, ie. it is effectively an access regime.[22] The Productivity Commission went on to suggest that if an access obligation is to be introduced, there are advantages in imposing such an obligation under Part XIC of the TPA as:

    (a) it will introduce the discipline associated with a formal declaration procedure and related procedures, which would in turn:

        (i) enable key areas of content to be declared rather than an effective blanket declaration;

        (ii) ensure that clear criteria are used in deciding whether to declare content and provide reasonable appeal rights; and

        (iii) enable declarations to be limited to cases where access would have an impact on competition in a telecommunications market; and

    (b) it will ensure that intervention in pay TV is contained in a regulatory system that is seen as transitional, and whose continued operation depends on the development of competition.

70. The Productivity Commission referred to a submission by AAPT which suggested coverage of pay TV programming under Part XIC by amending ss 152AF and 152AL of the TPA.[23] The Productivity Commission also noted that the ACCC had indicated that it has no difficulties in principle with the coverage of pay TV programming under Part XIC.

Is an access regime justified?

71. The first question that falls for consideration is whether an access regime for pay TV programming is justified. The need for access regimes has been linked to the problem of 'essential facilities'. This problem was described in the Hilmer Report as follows:

    > "Some economic activities exhibit natural monopoly characteristics, in the sense that they cannot be duplicated economically. While it is difficult to define precisely the term "natural monopoly", electricity transmission grids, telecommunication networks, rail tracks, major pipelines, ports and airports are often given as examples. Some facilities that exhibit these characteristics occupy strategic positions in an industry, and are thus "essential facilities" in the sense that access to the facility is required if a business is to be able to compete effectively in upstream or downstream markets. For example, competition in electricity generation and in the provision of rail services requires access to transmission grids and rail tracks respectively.

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[22] Draft Report, p 16.27.

[23] s 152AF defines "access" for the purposes of Part XIC, while s 152AL defines declared services.

...

> Where the owner of the "essential facility" is vertically integrated with potentially competitive activities in upstream or downstream markets - as is commonly the case with traditional public monopolies such as telecommunications, electricity and rail - the potential to charge monopoly prices may be combined with an incentive to inhibit competitors' access to that facility. For example, a business that owned an electricity transmission grid and was also participating in the electricity generation market could restrict access to the grid to prevent or limit competition in the generation market. Even the prospect of such behaviour may be sufficient to deter entry to, or limit vigorous competition in, markets that are dependant on access to an essential facility."[24]

72. Pay TV programming is not usually thought of as an essential facility in the same way as an electricity transmission grid or rail network. Yet it does exhibit some of the same characteristics. Like a major infrastructure facility, it is often difficult, if not impossible, to duplicate. There is, for example, only one major Australian rules football competition to broadcast. There are only so many premium movies to show. If one person has the rights to broadcast a package of premium movies, it is extremely difficult to economically duplicate this product by, for example, making more premium movies.

73. Similarly, access to such programming is crucial to competition in downstream markets. As the ACCC argued in its submission to the Telecommunications Service Inquiry and in this paper, quality pay TV programming is critical to attracting a sufficient number of customers to justify the roll out of cable networks which are, in turn, essential to promoting competition in markets for broadband telecommunications services.

74. Finally, where the holder of the rights to the pay TV programming (ie. the 'essential facility') is vertically integrated with a participant in a downstream market, there is an incentive to withhold access to this content in order to prevent or hinder competition in that downstream market by a potential competitor.

75. It can therefore be argued that there is a case for regulating access to pay TV programming by imposing some form of access obligation. The chief advantage of such a measure is that it would impose a positive obligation to make pay TV content available on demand. It could be argued that, even if a program access regime prohibited exclusive licensing, a program supplier might still be able to refuse to license a pay TV operator to broadcast its programming. While this is not considered by the ACCC to be a high risk, it would eliminated entirely if instead, program suppliers were under a positive obligation to license another pay TV operator to broadcast their programming on demand.

Is Part XIC suitable?

76. An obligation to license pay TV programming could be imposed under separate legislation or by amending existing legislation (eg. the *Telecommunications Act 1997* or the TPA). There are several reasons why Part XIC of the TPA might be suitable:

    (a) access to pay TV programming is necessary to promote competition in telecommunications markets. It may therefore be appropriate to address this issue under the telecommunications access regime; and

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[24] *National Competition Policy*, Report by the Independent Committee of Inquiry, August 1993, p 240.

(b) there may be some cases where an entrant will require not only access to pay TV programming, but also access to transmission services to enable the programming to be delivered to its head end. This may require access to services under Part XIC.[25] It arguably makes sense for both access issues to be dealt under a single access regime.

77. However, regulating access to pay TV programming under Part XIC could not be achieved through minor amendments. It will not, for example, be possible to achieve this outcome simply by amending ss 152AF and 152AL of the TPA.

78. Part XIC only provides for access to "eligible services" that have been declared by the ACCC. An "eligible service" is defined in s 152AL as a "listed carriage service" within the meaning of the *Telecommunications Act 1997* or a service that facilitates the supply of a listed carriage service, that is supplied, or capable of being supplied, by a carrier or carriage service provider.[26]

79. A "listed carriage service" is defined in s 16(1) of the *Telecommunications Act 1997* as a carriage service between two or more points, at least one of which is in Australia. A "carriage service" is defined in s 7 of the *Telecommunications Act 1997* as:

> "a service for carrying communications by means of guided and/or unguided electromagnetic energy".

80. Pay TV programming does not appear to fall within the range of services that are currently eligible for regulation under Part XIC. Allowing the regulation of pay TV programming under Part XIC would involve extending the coverage of the legislation. That said, there appears to be no reason why this could not be done. Ultimately, Part XIC is a set of rules and procedures governing access to certain telecommunications services. As discussed above, there are advantages in expanding the operation of Part XIC to apply to pay TV programming rather than creating an entirely new pay TV access regime or applying Part IIIA. In light of this, the ACCC believes that, with appropriate amendments, Part XIC could provide for access to pay TV programming where this is necessary to facilitate competition in the supply of broadband services.

What amendments to Part XIC would be required?

81. It is not proposed to attempt to set out exactly how Part XIC should be amended to provide for the regulation of access to pay TV programming or on what terms. This is a matter that would obviously be the subject of further consideration and consultation. It is noted that most of the obligations to provide access under Part XIC apply to carriers or carriage service providers. In relation to pay TV programming, it may be necessary to impose such obligations on persons who are not carriers or carriage service providers (eg. a pay TV program supplier, as opposed to the pay TV operator who holds a licence to broadcast the programming). For example, the standard access obligations under s 152AR apply to "access providers". For the purposes of s 152AR, an access provider is a

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[25] This is discussed in more detail in paragraphs 89 and 90 below.

[26] The reference to "a service that facilitates the supply of a listed carriage service" is intended to allow for access obligations to apply to blocks of functionality, or other inputs, which, while not carriage services themselves, may be used to produce a carriage service. It is not clear that this is intended to apply to pay TV content.

carrier or carriage service provider which supplies declared services to itself or other persons. The concept of an access provider may need to be expanded to include the program supplier and a licensee of declared pay TV programming.

An alternative approach to access

82. The ACCC acknowledges that there may be complexities in attempting to designate pay TV programming or particular types of pay TV programming. For example, would the regulator declare all sports programming, a particular channel or particular events? This problem can be avoided if, instead of designating particular content, an access regime focussed on designating specific pay TV operators and imposing an obligation to license on such operators.

83. As discussed in Part A of this Supplementary Submission, the ACCC is principally concerned with situations where pay TV operators are vertically integrated with program suppliers and/or network operators. This situation could be specifically targeted if an access regime permitted designation of pay TV operators in these circumstances.

84. An access regime could provide that the ACCC may designate a pay TV operator as a declared pay TV operator where:

    (a) the pay TV operator is related to a carrier or program supplier or subject to the control or direction of a carrier or program supplier; and

    (b) it is in the long term interest of end users to do so.

85. Once designated, a declared pay TV operator would be under an obligation to license another carrier to broadcast its content in areas not already served by the declared pay TV operator by cable. The ACCC could be given the power to arbitrate where the declared pay TV operator and the access seeker are unable to agree on terms and conditions.

86. The obligation to license another carrier to broadcast pay TV content is aimed at eliminating the barrier identified by carriers who are proposing or undertaking the roll out of cable networks, namely, that they are unable to obtain pay TV content for broadcast over cable. It is intended that, rather than having to re-package individual programs, this regime would simply enable a new entrant to obtain the right to re-broadcast an existing pay TV channel over their network.

87. While such a regime could be provided for under separate legislation, there is advantage in inserting it into Part XIC of the TPA as this legislation sets out the requirements of the LTIE test and contains an established set of rules and procedures for the resolution of access disputes.

Existing agreements in relation pay TV programming

88. See the discussion in paragraphs 66 and 67 above.

Transmission of pay TV programming to a pay TV operator's head end

89. At p 16.17 of its Draft Report, the Productivity Commission identified a problem that a pay TV operator might confront in arranging for the transmission of content to its head end on reasonable terms. The Productivity Commission noted that in many areas the most effective transportation system may be via satellite. The ACCC agrees that it is not enough for pay TV operators to be able to acquire the right to broadcast pay TV programming. They also need to be able to arrange for transmission of the programming to their head end.

90. The ACCC notes that existing legislation should be sufficient to provide for such transmission services to be made available on reasonable terms. The transmission of pay TV programming via satellite is an "eligible service" for the purposes of Part XIC of the TPA. Once an eligible service is declared, the provider of such a service is subject to the standard access obligations in Part XIC, including an obligation to provide the service to an access seeker. The ACCC can resolve disputes between an access seeker and the provider relating to terms and conditions of access (by arbitration if necessary).

ATTACHMENT A - ESTIMATING THE COSTS OF CONTENT FORECLOSURE

The ACCC notes the Productivity Commission's concern with identifying the magnitude of the problem that exists as a result of content foreclosure in the pay TV market. The ACCC agrees that it is important to establish not only that a problem exists, but also that the problem creates significant costs, which then might support a case for regulatory intervention.

The ACCC agrees with the Productivity Commission's view that the primary impact of content foreclosure is likely to be the delayed availability of high bandwidth services in regional areas. However, the ACCC also believes it is important to recognise that there are metropolitan and outer-metropolitan areas that will also be subject to this delay.[27] In addition, the ACCC considers that the effect of reduced competition (compared to competition that would have existed with facilities-based entry) in telecommunications and pay TV markets may be more significant than the Productivity Commission suggests.

Identifying and measuring the efficiency consequences of content restrictions, and their effect on broadband infrastructure entry, is difficult. This is because there is a great deal of uncertainty about the "latent" demand that may exist for services able to be provided by broadband cable.[28] In addition, and as the Productivity Commission notes, many of the services provided by broadband cable may also be deliverable by other means (albeit at different levels of price and quality).

Nevertheless, the ACCC considers it important to estimate the magnitude of costs caused by content foreclosure. The ACCC has undertaken some preliminary analysis that shows the costs of delays, directly in pay TV markets and indirectly in telecommunications markets, could be significant. The ACCC cautions, however, that this analysis will be influenced by assumptions made about the length of any delay and future demand.

Direct impact on pay TV market

The direct impact of content foreclosure in the regional pay TV market is that it allows for a monopolist provider of regional pay TV services (Austar). It is unknown to what extent this provides Austar with market power, because, as the Productivity Commission notes, prices charged in pay TV markets will be at least influenced by prices for other "entertainment" services (including free-to-air TV).[29] This said, the Productivity Commission's Draft Report comments that empirical studies in the United States have shown that cable TV prices are up to 20 per cent higher in markets serviced by a single provider.

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[27] For example, the Telstra and Cable & Wireless Optus HFC networks do not operate in any major regional centres, or in Hobart or Darwin, and it is not clear that ADSL services will provide sufficient bandwidth for many new and innovative services.

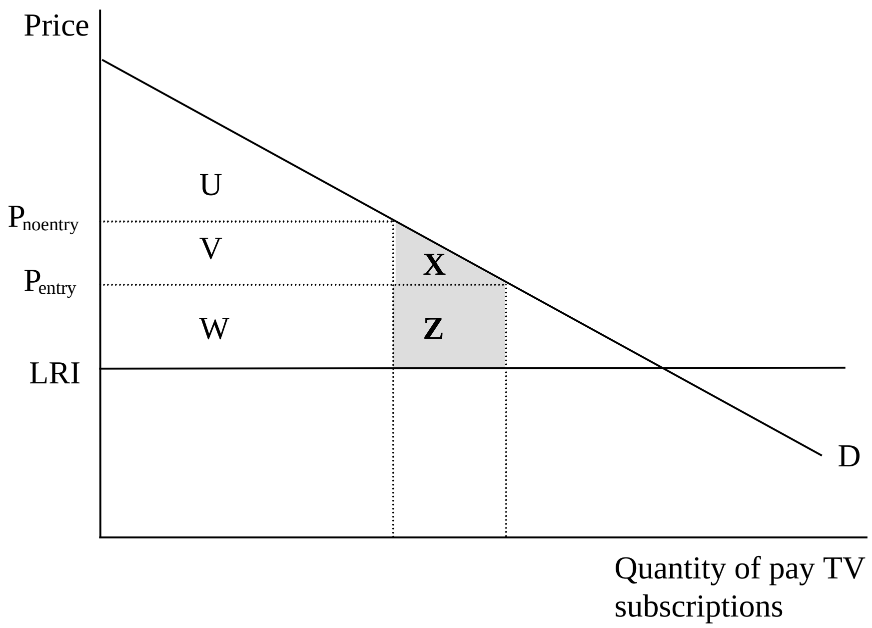
[28] This attachment primarily refers to "broadband cable" infrastructure, as the ACCC understands that most entrants have been interested in providing some form of cabled fibre-optic or hybrid fibre-coaxial (HFC) infrastructure.

[29] Austar does not appear to be highly profitable, although this may reflect that it is in a start-up phase of its business and has a wide variety of investments aside from its pay TV business. See "Fighting talk from Austar's Chief", *Australian Financial Review*, 6 August 2001.

The ACCC has noted in this and in previous submissions that infrastructure operators are interested in providing a bundle of telecommunications and other services (such as local calls and a broadband internet service). This arises from economies of scope in the provision of services over the infrastructure. The costs of establishing infrastructure are considerable and are largely fixed. For example, most of the capital costs and many operating costs (eg. maintenance, billing system) are independent of carrying capacity. Because of these fixed common costs (at least up until the infrastructure's capacity limit) the marginal cost of adding an additional service to the bundle is relatively low. By carrying more services, the common costs can be more widely spread and the amount chargeable to any single service is reduced. The pricing of the bundled elements of the various services is therefore likely to reflect a component to recover the long-run incremental costs of providing that service, plus a contribution to common costs which comprise the supply of the cable, plus a contribution towards profit (to cover the firm's cost of capital).

The direct impact of content foreclosure may therefore be illustrated as in Figure 1. Entry would likely cause the incumbent pay TV operator to reduce prices, meaning that the lack of entry entails a forgoing of potential efficiency gains X + Z.[30] It is difficult to estimate the size of these forgone gains without cost and demand information.[31] However, as the Productivity Commission points out, there is a limit to the extent to which the monopoly pay TV provider can exercise market power to raise prices in regional pay TV markets, and this might suggest that the gains are quite small.

Figure 1 Impact of denial of content on pay TV market in regional areas



Where:

[30] X is a gain in consumer surplus while Z accrues to producers.

[31] Strictly, the measurement of gains would also have to take into account the fixed costs of entry. However these fixed costs would not all have to be recovered in this market.

- $P_{noentry}$ is the price charged if no broadband entry occurs (with no pay TV service therefore provided);

- LRIC is the long-run incremental cost of providing the pay TV service; and

- P_{entry} – LRIC is the contribution to common costs and to profit from the supply of the pay TV service.

Indirect impact on telecommunications markets

Without a contribution to common costs from the provision of pay TV services, it seems likely that charges for other services delivered using broadband cable will correspondingly be higher. That is, each of the other components (including telecommunications services) must recover a higher proportion of common costs and contributions to profit than if these services were bundled with a pay TV service. This may cause an infrastructure builder to reduce investment or, as appears more likely given the discrete nature of the investment decision for many entrants, the elimination of new investment. This appears to be what many potential entrants have claimed to the ACCC and to the Productivity Commission.[32]

This impact may be shown with reference to a particular product that is likely to be highly prized by rural and regional consumers – broadband cable internet services. For simplicity, it is initially assumed that this is a separate market from other "broadband" internet services (equivalently, that ADSL technology is not an effective substitute).

To illustrate the argument with a numerical example, assume that a (profit-maximising) infrastructure provider wants to supply a bundle of two services – a pay TV service and a broadband cable internet service. Table 1 shows the (example) bundled and unbundled costs of providing these services.

Table 1 Costs of providing bundled and unbundled pay TV and broadband cable internet services

	Service provided				
Costs	Pay TV only	Broadband only	Pay TV plus Broadband bundle	Pay TV as part of bundle	Broadband as part of bundle
LRIC	20	30	50	20	30
Common	80	80	80	30	50
Profit	10	10	20	10	10
Total	110	120	150	60	90

Assume that the (efficient) provider incurs costs in providing the bundle of pay TV and broadband internet services of $150. The market price of each service is $60 for pay TV plus $90 for Broadband, which means the provider just covers all the costs identified in column

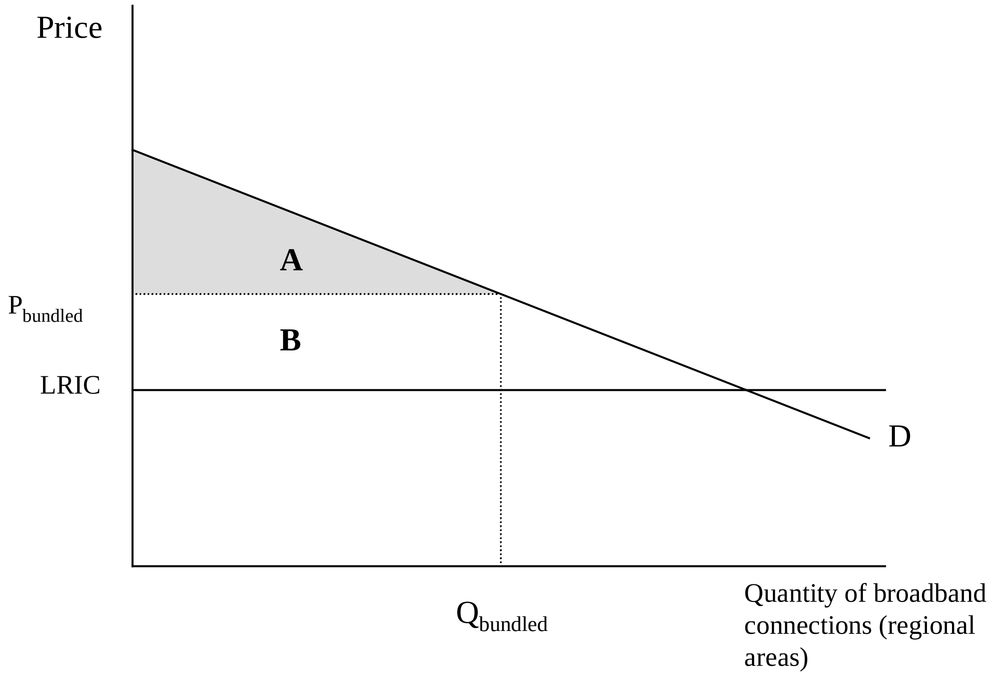
[32] See, for example, the ACCC's previous submission to the Productivity Commission, and the Draft Report at 16.13-16.14.

three – long-run incremental and common costs ($50 + $80), plus a contribution to profit to cover the firm's cost of capital ($20).[33]

The impact of content foreclosure can now be shown. The market prices for broadband ($90) and pay TV ($60) allow for the recovery of $80 of common costs when provided as a bundle, but now the provider must recover the full $80 from the broadband internet service alone. However, as shown in column two, providing the broadband service alone will cost the provider $120. This is above the market price and consequently infrastructure investment for the supply of broadband cable internet service alone would not be feasible.

This can also be shown diagrammatically. Figure 2 shows the impact of content foreclosure if it leads to the forgoing of broadband cable internet services in regional areas. With broadband cable entry and the delivery of both pay TV and broadband cable internet services, the internet service would be priced at $P_{bundled}$ and a contribution to profit and common costs of ($P_{bundled}$ – LRIC) per connection would be made.

Figure 2 Impact on broadband internet market in regional areas



Where:

- $P_{bundled}$ is the profit-maximising price charged for the internet service if all services are delivered as a bundle.

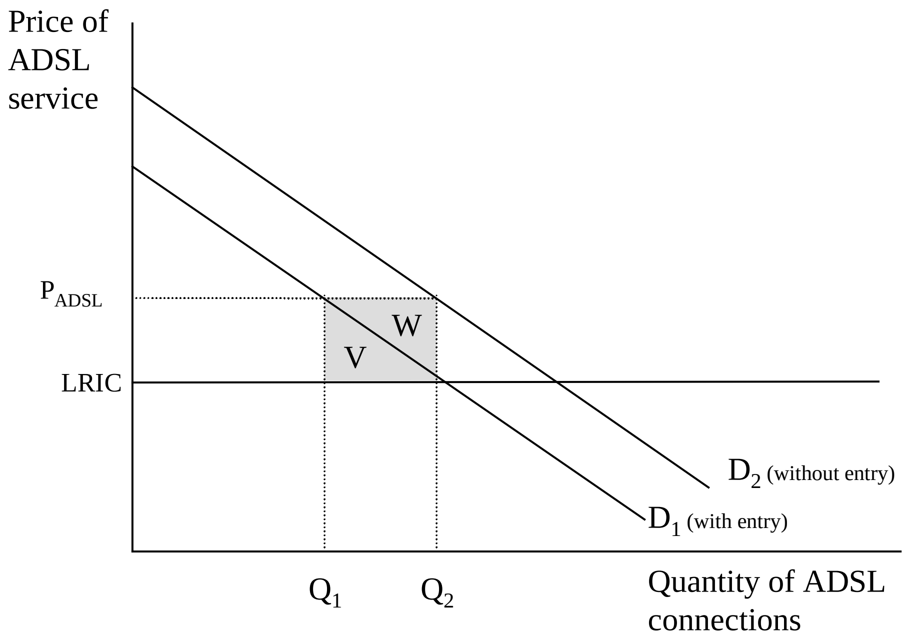
In the situation where the investment does not proceed, consumers lose surplus that they would otherwise have obtained from the existence of this market. That is, they lose an area A, which represents the surplus that they would have derived from the consumption of the

[33] If the investment is not marginal, the infrastructure provider may be able to recover a sufficient amount of the contribution in the internet market alone. However, if this was the case, then we may have expected the entry to have already occurred.

service. The infrastructure provider also loses area B, representing a contribution to its fixed costs and to profit.

If we extend the analysis to allow for some substitutability between ADSL and broadband cable internet services, and where ADSL is priced above its long-run incremental cost, it is apparent that the losses identified will be mitigated by an increase (shift) in demand for ADSL services. That is, in areas where consumers are able to switch to the substitute (even if less preferred), there will be an efficiency gain. This is illustrated in Figure 3.

Figure 3 Impact of substitutability between broadband cable and ADSL internet services



Where:

- D_1 is the demand curve for ADSL services if broadband infrastructure investment occurs and cable internet services are offered; and
- D_2 is the demand curve if content foreclosure prevents investment in broadband infrastructure.

Using Harberger's general-equilibrium efficiency analysis[34], consumers value the additional units at P_{ADSL}, but the cost to the economy of producing those units is only LRIC, resulting in an efficiency gain of the rectangular area, V + W.

The ACCC believes there are good reasons for suspecting the efficiency gains (V+W) from the demand shift as a result of content foreclosure will not completely offset the loss (B) identified above:

[34] This analysis is based on Harberger, A.C. (1964) "Taxation, Resource Allocation and Welfare", in NBER, *The Role of Direct and Indirect Taxes in the Federal Reserve System*, Princeton University Press, pp. 25-70.

- there are likely to be areas, particularly in regional Australia, where ADSL services will not be delivered in the short to medium term, but which may be subject to broadband cable entry.[35] This limits substitutability and hence the size of the demand shift; and

- broadband cable offers a superior internet service to ADSL-based technology, which is relatively limited in download speeds and is seen as a second-best alternative in most areas where broadband cable is available.[36]

Quantification

The difficulty with estimating welfare changes with this approach is that it is hard to estimate the parameters of price, quantity, cost and elasticity because the service does not actually exist. However, some variables might be inferred from other existing broadband cable services (on the price side) and the potential for expansion of cable infrastructure (on the quantity side). The ACCC is also aware of a limited number of studies estimating the elasticity for broadband internet access and for bandwidth. Cost information, needed to estimate producer surplus, is perhaps the most problematic, and for convenience it is assumed that producer surplus lost in Figure 2 (B) is at least as great as is gained in Figure 3 (V + W).[37]

Given this assumption, the welfare loss is likely to be reasonably estimated by the losses in consumer surplus identified in Figure 2 (ie. the area A). The following table identifies the necessary inputs for quantification of the losses in consumer surplus, assuming a simple linear form of demand.

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[35] Perhaps against this, Telstra has claimed that 90 per cent of households will have access to ADSL or broadband cable internet services within two years. See www.bigpond.com/broadband (accessed 8 August 2001).

[36] See the Federal Trade Commission's analysis of the Time Warner / AOL merger, *In the matter of America Online, Inc and Time Warner Inc,* Decision and Order, FTC Docket No. C-3989, 14 December 2000.

[37] This removes the need for cost estimation to identify efficiency changes.

Table 2 Inputs into estimation of consumer surplus loss

Input	Estimate	Source
Quantity of potential regional broadband cable internet consumers	25,000	Potential entry passing 500,000 households and businesses multiplied by 5 per cent take up rate. Rollout based on business plans of potential carriers. Take up rate Goolsbee (2000).[38]
Price of broadband internet service	Approx. $1000 per annum	Approximate annual price charged by Optus@Home (www.optus@home.com.au) for bundled broadband cable internet, telephone and pay TV service. Telstra's service is similarly priced (see www.bigpond.com/broadband).
	$1400 per annum [$1200 used as base]	Madden and Simpson's estimate of consumer spending on broadband services quoted to the Australian Communications Authority (1998).[39]
Elasticity of demand for broadband internet service	-1.3 to -2.5 [-1.5 used as base]	The ACCC is not aware of any studies that estimate demand for broadband services and/or bandwidth in an Australian context.[40] Goolsbee (2000) estimates broadband cable internet service elasticities in US cities, using sample data cross-checked with actual data.[41] Kridel, Rappaport, and Taylor (2000) estimate elasticity for broadband access ranging from –1.07 to –1.79.[42] Crandall and Jackson (2001) estimate the benefits of broadband internet access and use elasticities of -1.0 to –1.5.[43] Varian (1999) estimates elasticities for bandwidth using US sample data.[44]

[38] Goolsbee, A. (2000) "The Value of Broadband and the Deadweight Loss of Taxing New Technology", Mimeo, University of Chicago, November. The ACCC cross-checked this estimate with the take-up rate of @home, the biggest supplier of broadband cable internet services in the United States. @home currently reports over 1.1 million subscribers with access to about 33 million households (3.3 per cent), but some homes with access may subscribe to other services. See www.home.net/news.

[39] Madden, G.G. and Simpson, M.J. (1998), quoted in ACA, *Digital Data Inquiry,* 15 August 1998.

[40] The *National Bandwidth Inquiry* (1999) did not report a figure for elasticity of demand for either broadband services or bandwidth, and concluded that estimates were "equivocal". See *National Bandwidth Inquiry: Report of the Australian Information Economy Advisory Council* (1999), p. 97, available at www.onlineaustralia.net.au/projects/information_economy/bandwidth (accessed 8 August 2001).

[41] Goolsbee, A. (2000), *op.cit.*

[42] Kridel, D., Rappaport, P. and Taylor, L (2000), "The Demand for High Speed Access to the Internet: The Case of Cable Modems", paper presented at the 13th Biennial Conference of the International Telecommunications Society, Buenos Aires, Argentina, July 1-5.

[43] Crandall, R. and Jackson, C. (2001) "The $500 Billion Opportunity: The Potential Economic Benefit of Widespread Diffusion of Broadband Internet Access", Criterion Economics, Washington D.C.

[44] Varian, H. (1999) "Estimating the Demand for Bandwidth", Mimeo, University of California, August.

The likely key variable in these figures is the take-up rate of broadband internet services by consumers. Hence, the estimates are presented with different take-up rates.

Using these inputs, it is estimated that foreclosure of content causes losses to consumers of between $13 and $90 million per annum, with this amount being linear in the take-up rate by consumers for the broadband cable internet service.

Table 3 Estimated losses in consumer surplus in the broadband cable internet market from content foreclosure

Service take-up rate	3%	7%	20%
Broadband cable internet connections	10,000	35,000	100,000
Loss of consumer surplus per annum	$13,500,000	$31,500,000	$90,000,000

While these losses on an annual basis may not appear that large unless the take-up rate is quite high,[45] if content foreclosure results in delayed access to high bandwidth services for a number of years, then these losses will be greatly magnified.

As an example, consider the losses identified above if content foreclosure meant that infrastructure was not built for 2, 5 or even 10 years. Further, assume that the take-up rate of the broadband service started at 5 per cent and then grew at a rate of 20 per cent per year for five years, and then grew at 10 per cent for the next five years (that is, the take-up rate changed from 5 per cent in year 1 to 12 per cent in year 5, and to 20 per cent by year 10).[46] The net present value of consumer surplus lost can then be approximated.

Table 4 Estimate of losses in consumer surplus from content foreclosure over time

		Loss in consumer surplus(1)
Services delayed for…	2 years	$56.5 m
	5 years	$221.4 m
	10 years	$756.6 m

Note: (1) Assumes a net present value discount rate of 5 per cent.

These estimates suggest that the costs of content foreclosure, if leading to a delay in provision of broadband infrastructure, are potentially very high – close to three-quarters of a billion dollars if delay meant no access to this one service (or a substitute service) for 10 years. As noted above, however, these losses will be offset, to some extent, by gains if consumers

[45] A take-up rate of 20 per cent could be expected to be consistent with a more mature service.

[46] It might be expected that take-up rates would increase in the early years of a new service, and then decrease as the market becomes more mature.

perceive ADSL internet services as an acceptable substitute for broadband cable internet services.

While this exercise has illustrated the losses in one market, it is also likely that there will be potential gains for consumers and for society from broadband cable entry in other telecommunications markets (e.g. local calls, long-distance calls, interactive services). The scale of these, though, is likely to be smaller or less certain than the effects identified above:

- in the local call market, in which a regional infrastructure-based competitor could carry an entire call on its network, the current price for local call access (line rental and local calls) is capped by virtue of the retail price controls on Telstra. The Commission has previously noted that these controls keep prices for line rental and local calls close to (and possibly below) cost in many non-metropolitan areas.[47] This is likely to prevent the new competitor from significantly lowering prices;

- in long-distance markets, in which a regional infrastructure-based competitor would carry only an origination or termination part of a call, there is likely to be limited scope to reduce retail prices; and

- it would be unwise to attempt to forecast the success or otherwise of “interactive” services that can be provided over broadband cable infrastructure, and hence the magnitude of any efficiency losses or gains are highly uncertain.

This said, the ACCC believes that the Productivity Commission should not underestimate the importance of facilities-based entry in increasing competition (through service innovation) and in lowering prices in the longer term. While the notion of facilities-based competition may be difficult where one form of facility (ie. broadband cable) can provide significantly higher bandwidth (and hence more services) than the existing copper-wire facility, the important feature is that the facilities are both able to be used for the carriage of telephony services. This is likely, in the longer term, to reduce the current emphasis on regulation to deliver benefits to consumers in the form of lower prices.

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[47] See the Australian Competition and Consumer Commission, *Review of Price Control Arrangements: An ACCC Report*, February 2001.