14 August 2001

Mr Ross Wilson
Productivity Commission
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Nature Conservation House
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By facsimile: 02 6240 3399

Dear Mr Wilson

Pay TV Content Access

Thank you for meeting with Adrian, Derek and myself on Monday 16 July, 2001. We were very grateful for the opportunity to discuss this issue further with you, and were encouraged by the interest shown by the Productivity Commission in this critical issue.

During the meeting you requested further clarification on the following issues:

1. The importance of focusing on pay tv operators being denied access to premium content, and the harmful effects of content exclusivity on innovation and economic welfare;
2. Why Optus does not sell its retail Pay TV service over other platforms;
3. Austar distribution of The Movie Network; and
4. What the ACCC proposal allows Optus to access.

We now respond as follows:

1. The importance of focusing on non-discriminatory access to premium content, and the harmful effects of content exclusivity on innovation and economic welfare.

(a) ***Competition***

Ex-ante competition regulation is critical to open up otherwise monopolistic markets to contestability and competitive entry. Such ex-ante regulation is generally targeted at reducing unnatural barriers to entry, caused by, for example, content exclusivity.

Competition has always been a principal driving force for increasing consumer welfare. With competition, competitors strive to give consumers more for less in order to win customer patronage. The incumbent supplier, in turn, must similarly offer something of value in order to retain consumers. As a result, consumers benefit from the increase in inter-firm rivalry that accompanies new firm entry and competition. Moreover, with competition, the gains reaped by consumers can be shown to exceed the losses realised by the former monopolist. Consequently, total net benefits are positive. Competition is a positive-sum game.

(b) *Need for Regulatory Intervention*

It has been recognised that there may already exist an undue concentration in the pay television market caused by Foxtel and related companies having a monopoly over premium content through exclusive agreements. This effectively cushions Foxtel against domestic competition.

Ex-ante regulatory intervention to ensure access to premium pay television content will:

- provide safeguards to prevent market foreclosure for current and prospective competitors;
- promote and maintain competition in the market by driving subscriber take-up;
- greatly benefit current and prospective consumers by providing *choice* of pay television providers in both regional and metropolitan areas;
- promote investment in technical innovation;
- provide incentives for new players to invest in digital television and the wider broadband market.

Access to premium content should be provided to all pay television broadcasters, regional and metropolitan alike, on a fair, reasonable and non-discriminatory basis.

The purchase by Foxtel and its related companies of the rights to both the NRL and AFL should, in our view, attract close regulatory scrutiny. There is a good case for ex-ante regulation here.

(c) Overseas Experience

The approach followed in both the United States and United Kingdom recognises the critical importance of access to premium content in driving investment in broadband delivery mechanisms. Both the US and UK regulate access to content: the U.S through the Program Access Regime, and the UK through rate-card regulation applying to BSkyB.

These foreign government micro-economic reforms have spurred increased investment and technical innovation in broadband delivery mechanisms. In the UK, cable systems pass over 50% of homes, achieve up to 60% penetration in serving areas, and provide a comprehensive array of interactive digital services to consumers, including internet access and email. In the U.S cable networks pass 95% of homes, cable TV penetration is 68%, and broadband penetration to the home is already 10%. By contrast, Australia's cable networks pass 40% of homes, pay TV penetration is less than 25%, broadband penetration is less than 1%, and the cable networks are not yet fully digitised.

(d) Unsuccessful Negotiations

As you are aware, Optus has been involved in negotiations with Foxtel and FoxSports for access to premium movie and sports content for several years. We have had little success, to the detriment of not only current Optus subscribers, but potential consumers in the metropolitan pay television market. The viability of our pay television service has also suffered as a result. This illustrates a situation where commercial negotiations have failed and regulatory intervention is required.

(e) Welfare-Inferior

The Pay TV environment is welfare-inferior because subscribers are being denied access to content that they wish to view, providers wish to supply, and content owners wish to deliver. Such outcomes are the antithesis of the three core goals of economic efficiency:

- allocative efficiency is reduced, because content of value is denied to subscribers;
- productive efficiency is undermined. Competitive delivery mechanisms are being denied access to content causing an uneconomic reduction in the economies of scope realizable on alternative distribution networks;
- dynamic efficiency is damaged. The Marginal Revenue Product attainable on alternative delivery mechanisms is unnaturally lowered by content exclusivity practices. This causes a reduction in prospective economic investment in broadband networks, and reduced technical innovation on current networks.

(f) Viability of Innovation

We understand that TransAct and Neighbourhood Cable have had similar experiences to Optus, and to date have access to little premium content from Foxtel or FoxSports, to the detriment of not only consumers in the regional pay television market, but further investment in broadband in Australia.

The global television and telecommunications industries are moving towards sophisticated systems offering consumers a choice of service provider. Under such systems, consumers access premium programming from as many alternative sources of supply as possible. By contrast, artificially erected barriers to entry such as the locking-up of key content under exclusive arrangements, precludes consumer choice. Such barriers also reduce investment, innovation and competition. Content exclusivity should therefore be prohibited by government policy unless shown to be in the public interest.

2. *Why Optus Does Not Sell Optus' Pay TV Service on Regional Platforms*

Optus has conducted negotiations with Neighborhood Cable and TransAct for some months on the basis of a model whereby they license content from us to distribute on their respective platforms. As advised in our meeting of 16 July, 2001, we have suggested to both TransAct and Neighborhood Cable that as our rights to license channels from channel providers are non-exclusive, we recommend that they negotiate directly with the channel providers themselves.

In relation to Optus compiled channels such as Oh!, Ovation and MTV, as also advised in our meeting, these channels are comprised of up to 50 separate program license agreements. As Adrian Chamberlain indicated in our meeting, we are certainly looking at renegotiating these individual program license agreements if the commercial terms of sub-licensing such content to TransAct and Neighborhood Cable for distribution on their own networks are commercially viable for Optus.

Whilst both TransAct and Neighborhood Cable previously expressed a preference for licensing content from Optus (for a number of reasons including maximising their own branding), both operators have recently suggested an alternative model whereby Optus licenses its pay TV service for distribution on the regional operator's platform.

Although we continue to recommend the regional operators negotiate directly with the channel providers themselves, we are simultaneously reviewing the alternative model of providing our pay TV service over other platforms. There are however, three significant reasons why such a model is unlikely to be economically viable or commercially attractive:

- duplication of channels;
- inability to exploit economies of scope; and
- customer relationships.

(a) Duplication of Channels

There would be a significant duplication of channels on regional pay TV operators' platforms if we were to distribute Optus' full pay tv offering on their platforms.

We note that Neighbourhood Cable and TransAct are already advertising the following channels which, separately, form part of the Optus Television line up. We understand that these channels are available predominantly through arrangements directly with the channel providers themselves.

Neighborhood Cable:

C7 Sport
Sky Racing
Cartoon Network
Animal Planet
BBC World
CNBC Australia
TVSN
TCM Classic Movies
ESPN Sports
The Disney Channel
National Geographic
CNN International
Sky News Australia
MC Music Country
Antenna – Greek Channel
RAI – Italian Channel

TransAct:

BBC World
CNBC Australia
TVSN
The Disney Channel*

* TransAct confirmed that they have licensed the channel from Disney in a meeting with Optus in February this year.

As it can be seen from the above list, a substantial amount of Optus' current premium product offering is already available to subscribers to the Neighborhood Cable and TransAct platforms. Not only would duplication of channels be unattractive to subscribers, but it would be an inefficient distribution of channels and would dilute the value of both Optus' and the regional pay TV operators' product offering.

We do not at this stage believe it would be a commercially viable model for the regional pay TV operator to supply some of the channels to the customer, whilst Optus supplied other channels to the customer. This would involve the customer having multiple commercial relationships with different pay TV channel providers. We doubt that this would be attractive to the customer. The viability of such a model, where multiple channel providers supply directly at the retail level to the customer, has also been rejected by the ACCC in its various Part XIC access inquiries.

If Optus were to supply its full suite pay TV offering to the customer, commercial viability would require the regional pay TV operator to discontinue its current retail supply of Pay TV services to the customer. This may be unattractive to the regional operator.

Of additional concern to Optus is the fact that, as we understand it, TransAct offers the channels listed above to subscribers 'free' in order to drive subscriptions. This raises the question - why would a consumer subscribe to and pay for Optus' pay TV service if they can get at least half of the same channels as Optus' basic package from TransAct at no additional charge?

(b) Inability to exploit economies of scope

A pay TV delivery model, where Optus rents infrastructure from a cable provider such as TransAct, and supplies retail pay TV services to the customer, is on its own, unlikely to be viable. The reason is that the retail provider cannot fully exploit economies of scope.

As has been previously discussed, the connection of residential homes to broadband infrastructure involves large fixed costs. To viably fund such costs, multiple products revenue streams are required: including pay TV, telephony, internet and data services. If Optus were restricted to simply supplying pay TV services over its own network, this would not be a commercially viable model. If Optus were similarly restricted to supply pay TV services over someone else's network, this would similarly not be a viable model. The pay TV revenue streams Optus could earn would not be sufficient to fund the fixed costs for renting the cable provider's network. To be commercially viable, multiple products would need to be supplied over the cable network, including telephony and internet services. There would also be scope economies from having a single retail provider of these multiple services to the consumer. This type of model has not yet been explored between Optus and TransAct.

Going forward, with products such as IDTV, there are likely to be significant economies of vertical integration between the retail and network stages of production. This is because the performance characteristics of two-way interactivity for the customer will be determined at the network level by the cable provider. This suggests vertical integration between the cable operator and retail supplier may become more important.

(c) Customer Relationship

In addition to the duplication of channels issue, a model in which Optus-branded pay TV services were distributed on another network would involve substantial investment in resources for localised sales and marketing, in addition to the back-end processes of separate billing, call centres and maintenance. Such investment would have to be passed onto the network distributing Optus services. We doubt that bearing such investment would be feasible for a regional start-up.

As mentioned, to date the regional pay TV operators have not proposed such arrangements as their preferred model. Even if they were to do so, the three issues discussed above mean that it is unlikely, in Optus' view, that such arrangements could be made to work in practice.

3. *The Austar distribution of The Movie Network*

Optus' arrangements regarding The Movie Network (TMN) are largely historical, and as such there may be some misunderstanding as to the nature of the arrangement. A brief explanation of the history of our current Austar arrangements should assist.

The output of the three major Hollywood movie studios and Village were licensed to a wholly owned subsidiary of Optus, MovieVision Pty Ltd. Under these arrangements, Optus had Australian marketplace exclusivity and sublicensing rights. The arrangements were renegotiated in 1999. As a result, the studios set up their own channel provider, TMN. Prior to the 1999 renegotiations, Optus had sub-licensed the content from these three studios and Village to Austar.

We stress that our agreement with TMN is non-exclusive and as such, we encourage pay TV operators to deal directly with the channel itself.

4. *What the ACCC Proposal Allows Optus to Access*

Under the proposals put forward by the ACCC to the Besley inquiry (recommending a US style program access regime), Optus' understanding is this would prevent pay TV operators entering exclusive arrangements with channel providers, unless shown to be in the public interest. Hence pay TV operators would be able to get access to fully compiled channels on non-discriminatory terms pursuant to such arrangements.

Typically, raw content, such as an AFL football game, is aggregated into a channel by a content provider. For example, Channel 7 currently supplies two sports channels, which aggregate Australian and international sport within the channels. FoxSports undertakes a similar production of sports channels. The Movie Network compiles three channels of Hollywood studio output as does the Premium Movie Partnership (PMP).

Under the ACCC proposals, pay TV operators would obtain access to these aggregated channels of content on non-discriminatory terms — unless it could be shown channel exclusivity on a particular operator's platform was in the public interest. Optus agrees with this proposal.

However, in contrast to a focus on the potential alternative models for delivery of premium Pay TV content to consumers, Optus would encourage the Productivity Commission to focus on the principal and threshold question: *whether premium content can be delivered to consumers?* If exclusivity prevents such delivery, government micro-economic reform should be initiated to increase access to content for consumers and prospective delivery platforms.

Furthermore, such mechanisms to provide access to premium content on reasonable terms should be framed in terms which enable the regulator, the

ACCC, to intervene in the event that commercial negotiations fail to arrive at an outcome which is fair, reasonable and non-discriminatory.

If you have any questions please do not hesitate to call.

Yours sincerely,

Paul Fletcher
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