

# Pay TV in Australia

## Markets and Mergers

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CASE ASSOCIATES

Current Issues  
June 1999  
Published by the Institute of Public Affairs

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First published 1999 by  
Institute of Public Affairs Limited  
(Incorporated in the ACT) A.C.N. 008 627 727

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Veljanovski, Cento G.  
Pay TV in Australia: markets and mergers

Bibliography  
ISBN 0 909536 64 3

1. Competition—Australia. 2. Subscription television—  
Government policy—Australia. 3. Consolidation and merger  
of corporations—Government policy—Australia. 4. Trade  
regulation—Australia. I. Title. (Series: Current  
Issues (Institute of Public Affairs (Australia))).

384.5550994

Opinions expressed by the author are not necessarily endorsed  
by the Institute of Public Affairs.

Printed by *Impact Print*, 69–79 Fallon Street, Brunswick, Victoria 3056

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# Preface

This book examines in detail an important period in the early development of pay TV in Australia. The decision of the Australian Competition and Consumer Commission (ACCC) to block the proposed merger between FOXTEL and Australis in late 1997 is analyzed in detail, using the same framework as that employed by the ACCC itself. The conclusion is that the ACCC failed to demonstrate that the merger would substantially lessen competition, as it was legally required to do to justify its decision to block the merger.

The book is intended as a contribution to the understanding both of competition in the pay TV sector and of Australian merger policy in the communications sector. It is hoped that its adoption of a combative style to discuss such a controversial topic will stimulate public debate on communications and competition policies.

I am grateful for the helpful comments provided by three anonymous referees and Dr Ian McEwin of Case Associates (Australia) on earlier drafts, but remain responsible for any shortcomings in the final draft. I am grateful also to Dr Michael James for his editorial efforts, which have much improved the text. Although the book draws partly on research originally commissioned for FOXTEL Management Pty Limited, the views expressed are solely my own and not those of the IPA or of those mentioned above.

**Cento Veljanovski**  
**May 1999**

# The Author

Dr Cento Veljanovski is Managing Partner of CASE ASSOCIATES, an economics practice with offices in London and Sydney. He is also an Associate Research Fellow in the Institute of Advanced Legal Studies of the University of London. He was editorial and research director of the Institute of Economic Affairs (1988–91) and, until recently, a non-executive director of Flextech plc, the UK's second-largest pay TV operator.

Dr Veljanovski was an expert adviser to the UK government's influential inquiry on the financing of the BBC (the Peacock Committee). As a Director of the Institute of Economic Affairs, he was at the forefront of public debate on the future of broadcasting in the UK. He has served as an adviser to a large number of media and telecommunications companies on competitive and strategic issues, and in antitrust and regulatory proceedings in the UK, Italy, Ireland, Germany, Australia, and New Zealand, and before the European Commission. His recent clients include BSkyB, Flextech, Nethold, Telepiu, FOXTEL, News International, MCI Worldcom, Seagram, Cellnet, One2One, Telecom Eireann, Cable & Wireless and the Australian Radio Network.

Dr Veljanovski was educated in Australia and the UK, and holds several degrees in law and economics (B.Ec. (Hons), M.Ec., D.Phil.). At Monash University he was a student of distinguished trade practices regulators including Professors Bob Baxt (past Chairman of the Trade Practices Commission), Allan Fels (present Chairman of the ACCC) and Maureen Brunt, Australia's most distinguished trade practices economist and former member of the Trade Practices Tribunal. He has held academic posts at Oxford University and the University of London, visiting appointments at the University of Toronto (where he was Visiting Professor of Law and Economics), New York, Miami and Monash Universities, and fellowships with the Australian Law Reform Commission, the Centre for Socio-Legal Studies (Oxford University), and the Centre for Economic Policy Research (London). He was for a short time with the Australian Treasury.

He has written widely on the media, including *Choice by Cable: Economics of a New Era in Television* (1983), *Freedom in Broadcasting* (1989), *The Media in Britain Today: The Facts, The Figures* (1990), *Privatisation of Channel 4* (1996), and *The Economics of League Football* (1997).

# Glossary

**ABA:** The Australian Broadcasting Authority: the broadcasting regulator.

**ACCC:** The Australian Competition and Consumer Commission, responsible for enforcing the *Trade Practices Act 1974*.

**Analog transmission:** A method of broadcasting based on wave patterns.

**Asymmetric regulation:** Regulation which imposes heavier obligations on, or restricts or prohibits a sector or line of business of, the largest operator. This regulation is often defended as a necessary transitional requirement to foster competition with incumbent telecommunications operators.

**Basic cable:** The first tier of pay TV channels offered with the minimum subscription.

**Broadband network:** Communications network that operates over a wide frequency range and is able to deliver multiple signals.

**CAS:** Conditional Access System: the encryption system for pay TV.

**Communications satellite:** Any earth-orbiting spacecraft that provides communication over long distances by reflecting or relaying radio-frequency signals from earth. They receive signals from one ground station, amplify them, and then retransmit them at a different frequency to multiple reception sites such as parabolic dish antennas fixed to houses.

**Convergence:** Term frequently but loosely used to describe the process of merging computing, broadcasting and telecommunications to create one sector offering multimedia services.

**Digital transmission:** A transmission of data in encoded binary form as zeroes and ones. Digital signals have a number of advantages over analog signals. They are less prone to distortion and interference, are easily encrypted and compressed and therefore require less bandwidth than analog.

**Dish:** Colloquialism for a parabolic reflector dish antenna (solid or mesh) used to retrieve satellite messages.

**DTH:** Direct to home: the delivery of television services using a receiver dish mounted on the subscriber's property.

**Economies of scale:** These are present when unit costs fall as output increases.

**Economies of scope:** These are present if the costs associated with producing two products together are less than the combined costs associated with producing each product separately.

**Facilities-based competition:** Direct competition between network infrastructure operators.

**FCC:** Federal Communications Commission: the federal government regulator of the US communications industry.

**Fibre optics:** The transmission of light through fibres or thin rods of glass. Signals are digitally coded into pulses of light and transmitted over great dis-

tances by slender glass fibres. A fibre cable may contain up to 50 fibre pairs, each pair carrying up to 4000 voice circuits. This uses frequencies thousands of times higher than radio to carry much larger volumes of information.

**Fixed network:** Permanent communications path between two points. Usually refers to wire networks.

**FTA television:** Free-to-air television: broadcast channels which are intended to be received by viewers free of charge at the point of consumption. In Australia these include the three commercial networks (Channels 7, 9 and 10), and the government-owned ABC and SBS.

**HFC:** Hybrid fibre cable: combination of fibre optic and copper coaxial cables to deliver large amounts of data.

**Interconnection:** The connection of separate telecommunications networks.

**Market:** In trade practices law, a market is defined (under s 4E of the *Trade Practices Act 1974*) to include goods and services that are substitutable or otherwise competitive with one another in response to changes in their relative prices.

**Market power:** The ability to raise prices profitably above the competitive level without being constrained by the actions of competitors or potential competitors.

**MDS:** Multi-point distribution system: a radiocommunications system providing point-to-multipoint line-of-sight transmission using microwave transmitters. Operates on the frequencies 2.0–2.4 GHz.

**Microwave:** Wireless transmissions at very high frequency providing telecommunications links (including television distribution) between two places. Depends on line of sight.

**Natural monopoly:** Industries where the costs of production are minimized by using only one firm.

**Overbuild:** Direct competition between cable networks in the same geographical area.

**Pay TV:** Used generically to describe any channel offered for a monthly subscription.

**Platform:** The technical network for delivering pay TV.

**PPV:** Pay per view: payment made for individual programmes as opposed to a monthly subscription for a whole channel or group of channels.

**PTO:** Public telecommunications operator: a network operator with powers granted by the state to enable it to install its systems on public and private land, property, etc.

**Public good:** A public good is one of which the consumption by one consumer or viewer does not detract or diminish the consumption by another consumer or viewer.

**Sunk costs:** Those investment costs which have no value outside their existing use.

**Terrestrial television:** Television broadcasting using land-based transmitters broadcasting to conventional television aerials within the line of sight.

**TNC (Telstra News Corporation) Heads:** A programme-sharing agreement between Australis and FOXTEL giving the latter the Galaxy programme package of Australis.



# Chapter One

## Introduction

This book examines in detail the decision of the Australian Competition and Consumer Commission (ACCC) in 1997 to block the proposed merger between FOXTEL and Australis, two pay TV operators. It concludes that the ACCC did not make out its case that the proposed merger would lead to a substantial lessening of competition, as required under Australian trade practices law to justify the blocking of a merger. Since much of the discussion is based on technical legal and economic analysis covering a wide range of issues, a summary of the arguments underpinning this conclusion is set out here.

In May 1998, Australis, the pioneer of Australian pay TV, went into receivership after years of financial difficulties, and despite several financial restructures and two attempted mergers with FOXTEL. On both these occasions, the ACCC concluded that a merger between FOXTEL and Australis would breach trade practices law by substantially lessening competition.

The ACCC's decision in 1997 to block the FOXTEL/Australis merger followed a series of investigations by the ACCC into the pay TV sector. In 1995 the ACCC concluded that pay TV and free-to-air (FTA) television were in the same market and competed with one another. On this basis it approved a programme-sharing arrangement (the so-called TNC Heads) which gave FOXTEL access to Australis's core package of programmes, arguing that competition from FTA television channels would act as an effective competitive constraint on FOXTEL. In early 1996 it opposed the proposed merger between FOXTEL and Australis on the grounds that the merged entity would have given a monopoly of satellite television in view of the barrier to entry created by the government's moratorium on new satellite channels until 1 July 1997. When the government's satellite limit was removed, the parties believed that the impediments to a merger had been lifted. However, the ACCC then altered its position, arguing that the market was much narrower and consists of pay TV only, and that the reduction from three pay TV operators to two in the metropolitan areas would breach Australian competition law.

Even if the ACCC's about-face on market definition is ignored, its conclusion that pay TV was a separate, well-defined market was entirely hypothetical. The evidence that the ACCC relied on was weak, resting for the most part on legal decisions of regulatory bodies in Europe and the US which themselves had been criticized. Further, in defining the market the ACCC seized on only one area of competition—price competition—and ignored the fact that in the initial phase of a product's introduction non-price factors play a greater role in the competitive interaction between firms. This is certainly the case for pay TV, where the programme choice and diverse programme scheduling of different television operators represent the essence of the competitive pressures that firms exert on one another.

The proposed merger was unlikely to substantially lessen competition, for two further reasons related to the ACCC's prior approval of the TNC Heads. The ACCC had worked itself into an inconsistent position. Either it was right to approve the programming arrangement between FOXTEL and Australis, or it was wrong to do so. The ACCC's subsequent decision to block the merger implied that it believed that its earlier decision was wrong, even though the ACCC seemed to accept that without the agreement FOXTEL would not have entered the pay TV sector due to a lack of sufficiently attractive programming. But (and more important) if the ACCC regretted approving the TNC Heads it followed that the merger would not have substantially lessened competition because the damage had already been done. This is because, irrespective of market definition, the approval of the FOXTEL/Australis programming deal effectively gave FOXTEL access to core Australis programming and, as such, the merger would not have increased the programme offering of FOXTEL or Australis. Thus, the principal concern of the ACCC—that the merger would enable FOXTEL to have better programming—had already come about with ACCC approval.

The second reason why the proposed merger was unlikely to substantially lessen competition again relates to the ACCC's approval of the programme-sharing arrangement. By reversing its position, the ACCC could not then argue that three competitors were viable. This is because it approved the FOXTEL/Australis programming deal on the grounds that FOXTEL would not be able to enter as an effective competitor without access to Australis programming. If as a result of this Australis found it could not compete with FOXTEL (and Optus Vision), then this was a competitive, not an anti-competitive, outcome. The market had indicated that only two and not three pay TV operators competing for subscribers in the major cities of Australia were viable

(see Table 1.1). This was true irrespective of whether the market was defined narrowly (pay TV only) or widely (pay TV and FTA television).

For these reasons the merger of Australis with FOXTEL could not reasonably be said to substantially lessen competition. Reinforcing this conclusion was the fact that, prior to the merger, Australis had effectively withdrawn from competing head-to-head with the cable operators. It thus was not in the same geographic market as FOXTEL or Optus Vision, and therefore was not an effective competitor.

### **Summary of Main Points**

- There is clear evidence that government policy has encouraged unsustainable levels of competition in pay TV and telecommunications networks.
- The ACCC failed to establish that the FOXTEL/Australis merger in 1997 would substantially lessen competition, as is required under Australian trade practices law to justify blocking the merger.
- The ACCC's argument that the market consisted of pay TV only was not based on empirical evidence but on EC and US regulatory decisions. A wider assessment which looks at both price and non-price competition suggests that the market includes free-to-air TV during pay TV's formative years, and there is statistical evidence supporting this view.
- The ACCC's claim that the proposed merger would substantially lessen competition because it would eliminate a failing pay TV operator (Australis) ignored the fact that (a) the entry of FOXTEL was possible only because of an agreement approved by the ACCC that it could carry Australis programming, and as a result a merger would not have strengthened FOXTEL's position, and (b) as a result Australis was not an effective competitor to either FOXTEL or Optus. The inescapable conclusion is that the ACCC's endorsement of the Australis/FOXTEL agreement increased the number of competitors but also sowed the seeds of Australis's inability to compete. Hence, the presence of three pay TV operators in cabled areas was not and never could be a sustainable competitive outcome.
- The FOXTEL/Australis merger had no probable anti-competitive effects in the telecommunications sector unless it substantially lessened competition in the pay TV sector. The widening of the ACCC's case to the telecommunications sector was therefore unnecessary, irrelevant and based on factually incorrect arguments. It did, however, suggest that the ACCC's intervention was designed to protect a competitor (Optus Vision) from commercial harm caused by legitimate competition rather than to prevent a reduction in effective competition.
- The FOXTEL/Australis case highlights the need for a review by Australian policy-makers of the conflicting roles assigned to the ACCC in communications regulation.

**Table 1.1: The Main Participants**

**Australis Media Limited.** Australia's first pay TV operator and holder of Satellite Licence B. Australis was listed on the Australian Stock Exchange with Lenfest and TCI (US cable operators) as major shareholders but was eventually controlled by US bondholders. It broadcast the Galaxy programme package using satellite and MDS, and also licensed part of this programme package to FOXTEL and to regional pay TV operators Austar and ECTV. Australis went into receivership in May 1998.

**FOXTEL.** Australia's largest pay TV operator. FOXTEL is a partnership between Telstra (50 per cent), News Limited (25 per cent), and Publishing and Broadcasting Limited (25 per cent). FOXTEL provides a pay TV service over leased capacity on Telstra Multimedia's broadband network and in 1998 expanded to satellite delivery.

**Optus Vision.** Pay TV operator wholly owned by Cable & Wireless Optus. It provides pay TV over Cable & Wireless Optus's broadband cable network.

**Telstra Corporation.** Australia's largest communications company, which owns and operates the public switched telecommunications network, and a cable broadband network which delivers FOXTEL. Telstra was (until 1997) wholly owned by the Commonwealth of Australia. In 1997, 33 per cent was sold to the public, and the government plans to sell further tranches.

**Cable & Wireless Optus Limited.** Australia's second telecommunications operator, previously known as Optus Communications. Cable & Wireless Optus has built a broadband network designed to carry both pay TV and telecommunications services, and is Australia's second largest mobile telephone operator. Optus was a private company owned by Cable & Wireless (49 per cent), Mayne Nickless (25 per cent), and AMP (10.3 per cent). In 1998 it was floated as Cable & Wireless Optus, which increased Cable & Wireless Communication's stake to 53 per cent.

**News.** The Australian arm of News Corporation Limited, a listed media company controlled by the Murdoch family with extensive Australian and international media interests, including newspapers (*The Australian*, *The Times*, *The Sun*), television (Fox Network in the USA) and pay TV (25 per cent stake in FOXTEL, 40 per cent stake in BSkyB in the UK, and Star TV in Asia).

**Publishing and Broadcasting Limited (PBL).** A media company listed on the Australian Stock Exchange and controlled by the Packer family with interests in newspapers, magazines, Channel 9, and pay TV with a 25 per cent holding in FOXTEL. Until 1997 PBL held a minority shareholding in Optus Vision.

*continued ...*

**Austar.** An MDS and satellite pay TV operator serving non-metropolitan regions. Austar is controlled by UIH Asia/Pacific Communications, an international pay TV operator with interests in the US, Europe and Asia. Prior to the receivership of Australis it was an 'Australis franchisee' carrying Galaxy programming to its subscribers by satellite and MDS. It now also carries Optus Vision movie programming.

**East Coast TV (ECTV).** A regional MDS and satellite pay TV operator serving Newcastle, Gosford, Wollongong and Tasmania. Acquired by Austar after the receivership of Australis. ECTV held Satellite Licence A.

**Australian Competition and Consumer Commission (ACCC).** The federal government's competition and consumer protection regulator chaired by Professor Allan Fels. The ACCC has regulatory responsibilities for general competition law and telecommunications competition regulation under the *Trade Practices Act 1974*.

Subsequent events have confirmed that the acquisition of Australis's assets by FOXTEL would not have materially enhanced the competitive position of FOXTEL. The assets and subscribers of Australis had minimal value. Indeed, the ACCC approved FOXTEL's subsequent acquisition of Australis's satellite settop boxes, thus allowing it to secure most of Australis's satellite subscribers. And, paradoxically, the ACCC's intervention in the merger which forced Australis into receivership benefited FOXTEL by relieving it of the onerous costs of the programming deal with Australis which was extinguished when Australis collapsed. Thus, notwithstanding the high-profile intervention of the ACCC, much of what would have been achieved by the merger subsequently occurred with the ACCC's approval, and FOXTEL has continued to add subscribers, outgrowing Optus Vision by about two to one.

This underscores the belief amongst many informed commentators that the ACCC's intervention had little to do with pay TV, but stemmed predominantly from its concerns about the impact of the proposed merger on C&W Optus's telecommunications business. C&W Optus, which owns Optus Vision, built a broadband cable network designed to carry both pay TV and telecommunications services. It thus offered facilities-based competition to Telstra's local networks which the ACCC was intent on preserving. It was strenuously argued by the ACCC (and Optus) that any weakening of Optus Vision's pay TV business would adversely affect C&W Optus's ability to compete with Telstra, thus weakening competition in the telecommunications sector. This claim

rested on two factual propositions: that the merger between FOXTEL and Australis had anti-competitive consequences in the pay TV sector, and that there was a 'close link' between the take-up of pay TV and the take-up of local telephony services: specifically, that pay TV attracts or 'pulls through' telephone customers, so that a reduction in the growth in pay TV for Optus Vision would detrimentally affect C&W Optus's telephony business.

These arguments advanced by the ACCC fall at the first hurdle. As is shown in Chapter 5, there is no strong evidence of a cable TV-led 'pull-through' of telephony. Second, it was irrelevant. If the merger had substantial anti-competitive effects in the pay TV sector, then that should have been sufficient to block it. There was no need to expand the assessment to its alleged impact on local telephony. The proposition that a merger between two pay TV operators which do not provide telephony, and one (Australis) which was incapable of so doing, should be blocked because it would have an indirect effect on the telephony business of the parent company of a competitor to these pay TV operators appeared to many to stretch legal and economic analysis beyond credibility. The ACCC argued a strong link between the related markets of pay TV and telephony whilst at the same time concluding that pay TV and FTA television were not substitutable. Indeed, statements by the Chairman of the ACCC, Professor Allan Fels, a highly regarded economist and experienced regulator, that the merger would seriously jeopardize competition in telecommunications markets because the Australian shareholders of Optus said they 'would pull the plug' if the merger went ahead, seemed to many not only as uncharacteristically influenced by self-serving Optus threats but as confirming that the real focus of the ACCC was the protection of a competitor (Optus) rather than maintaining competition in pay TV.<sup>1</sup> It is therefore understandable that the ACCC was widely criticized at the time for being prepared to sacrifice pay TV to the interests of promoting telecommunications competition. As *The Bulletin* (1997) observed at the time:

Australia's pay TV industry is the free market system in free fall. Already, the players have flushed away some \$3 billion—a figure approaching the losses of the State Bank of South Australia. The expected entertainment-led bonanza has become a bloodbath ... but behind the scenes there is a much bigger game at stake—the emerging battle for the telephone dollar. To Fels, the public interest in terms of a healthily competitive phone system is worth a hell of a lot more than public amusement in the form of a few extra TV programs.

This passage from *The Bulletin* also highlights the way the pay TV and telecommunications sectors developed under the umbrella of government regulation. At the time of the proposed merger in 1997, Australia's pay TV sector had two unique features: two overlapping broadband networks owned by C&W Optus and Telstra (in addition to Telstra's copper wire telephone network) in metropolitan areas, and four major pay TV operators (FOXTEL, Optus Vision, Australis and Austar) using different methods of delivery (two new cable networks and satellite/MDS) on an exclusive basis. This level of competition between operators and platforms, particularly the existence of two overlapping broadband cable networks, was not found elsewhere. The government's policy of promoting such competition through asymmetric regulation was seen by many as the source of the pay TV sector's difficulties. In hard commercial terms, there was too much competition! In order for the industry to be viable, with shareholders able to see over the mountain of massive losses, some operators would have to go out of business or merge. It is therefore not surprising that, by 1998, many had called for the rationalization and re-organization of pay TV.

While the ACCC was ready to accept that competitive pressures and government policy were responsible for Australis's eventual collapse, it chose to ignore the implications of this for the assessment of the merger. The ACCC refused to consider the possibility that competition between four operators and four delivery platforms was not economically viable. It rather addressed a range of narrow demand-side competitive concerns even though it accepted that Australis was not a viable competitor and that there would be rationalization of the industry. It also adopted a highly bifurcated approach to the treatment of cost considerations (that is, economic efficiency): these were ignored where they pointed to industry rationalization but highlighted where they suggested a disadvantage to C&W Optus as a result of the merger. Yet the ACCC's own merger guidelines require that broader economic efficiency be taken into account when assessing a merger. For some reason, these were ignored despite the mounting concern that the industry had become overcapitalized.

Under Australian competition law, known as trade practices legislation, the ACCC is charged with ensuring that a merger does not lead to a substantial lessening of competition. The term 'competition' in economics and trade practices law is an effects-based test concerned with sustainable competitive pressures between products and firms which constrain the ability of one firm or group of firms unilaterally to raise prices above the competitive level. It is not understood as endorsing a

market structure where there are more rather than fewer firms, or where the number of firms cannot be reduced through merger. Rather, the ACCC is charged with ensuring that competitive pressures as defined above are not substantially weakened. The wider public policy concern is that the ACCC was engaged in some old-fashioned industrial re-engineering designed to assist a firm which was seen as crucial to developing competition in local telephony rather than pay TV. Although the regulator's tasks in today's fast-moving communications sector are not easily reconciled, the ACCC's decision to oppose the proposed merger between Australis and FOXTEL in 1997 nonetheless appears to have overstepped the mark and to take irrelevant considerations into account. While not all commentators will agree with these conclusions, this study seeks to set out rigorously a competitive analysis of the pay TV market using the same framework as Australian competition law so that the reader can evaluate the relative merits of the ACCC's and this study's conclusions.

The discussion is organized as follows. Chapters 2 and 3 provide an overview of the pay TV sector at the end of 1998, and its development. Chapter 4 outlines some economic concepts and provides an analysis of competitive pressures in pay TV and the way it is delivered, as a backdrop to the discussion of the ACCC's analysis. Chapter 5 examines in detail the question as to whether pay TV is a self-contained market, or competes in a wider market for video entertainment which includes FTA channels and (possibly) other means of delivering video programming. Chapter 6 closely and critically examines the grounds cited by the ACCC in rejecting the proposed merger between FOXTEL and Australis in 1997 under the *Trade Practices Act* 1974. The final chapter looks at some of the wider policy implications of the ACCC's interventions in the pay TV sector.

### *Endnote*

- 1 Professor Fels, interview with Michael Pascoe, Channel 9, *Sunday*, 24 May 1998.



# Chapter Two

## The Pay TV Picture

By the end of March 1999, pay TV had gained over 959 000 subscribers, representing nearly 15 per cent of all households. This chapter provides a brief overview of pay TV in Australia.

### *More Choice and Diversity*

Pay TV offers viewers more choice and variety. It is also progressively transforming television from a mass medium to one catering to the diversity of viewers' interests and tastes.

Prior to the introduction of pay TV, most Australians received five FTA channels—the three commercial networks (Channels 7, 9 and 10) and two government-owned channels (ABC and SBS). By early 1999, the number of channels and choice of programming had increased substantially, with nearly 50 additional channels—a ninefold increase in the number of channels.

Pay TV leads to more diversity because it has greater capacity to carry channels, thus removing the distribution bottleneck. Pay TV operators are able to offer a large number of channels and to package programmes into channels which cater for specific tastes and interests. Thus, instead of one general FTA channel offering a mix of sport, news, current affairs, movies and entertainment, specialist channels are offered dedicated to one type of programming such as movies, sport, children's, music, comedy, nature documentaries, news, lifestyle and many other genres (Table 2.1).

As the sector develops, other ways of packaging and pricing video entertainment will be introduced. Digital television, which has been introduced in Europe, will result in hundreds of channels offering services such as video on demand, individual programmes sold on a pay-per-view (PPV) basis, interactive television, and the bundling of video, telephone, Internet and information services. PPV, for example, exists in Australia but has so far been restricted to major events such as sports finals, major boxing championships, wrestling and other popular events such as concerts.

This increase in diversity and different formatting of channels is related to the funding of pay TV. As will be discussed in greater detail in Chapter 4, pay TV alters the nature of television by creating a market in programmes. The direct contractual link between viewers (subscribers) and broadcasters provides an incentive for the operators to cater for the diversity of viewers' tastes and preferences. This contrasts to the commercial FTA, whose primary commercial goal is to provide audiences to advertisers.

### *Packaging and Pricing*

Pay TV is usually packaged and priced in tiers or bundles of channels. In Australia, the basic tier or package consists of between 15 and 30 channels, depending on the operator, at monthly subscriptions ranging between \$14.95 and \$56.95 (Table 2.2). In addition, other tiers, add-ons and premium channels (mainly movie, sports and foreign language channels) are available for an additional charge.

**Table 2.1: Pay TV Channels by Operator as at May 1999**

Channel	Tiering of Channels		
	Austar (Satellite)	FOXTEL (Cable)	Optus Vision (Cable)
Adults only	Add on	Add on	Add on
Arena	Basic	Basic	
BBC World	Basic	Basic	
Bloomberg Television		Basic	
C7 Sports 1	Tier		Tier
C7 Sports 2	Tier		Tier
Cartoon Network	Basic	Basic	Basic
Christian TV			Basic
Channel [V]	Basic	Basic	
CMT	Basic	Basic	Basic
CNBC Asia	Basic	Basic	Basic
CNNI	Basic	Basic	Basic
Discovery Channel	Basic	Basic	
Disney Channel			Basic
Encore	Tier	Basic	
ESPN	Tier		Tier
FOX 8	Tier	Basic	
Fox News		Basic	

*continued ...*

Channel	Austar (Satellite)	FOXTEL (Cable)	Optus Vision (Cable)
Fox Sports	Basic	Basic	
Fox Sports 2	Basic	Basic	
FOXTEL Weather		Basic	
FX /FX Movies	Tier	Tier	
Hallmark	Tier	Tier	
Horizon			Basic
MainEvent (PPV)	Add on	Add on	Add on
Movie Extra	Tier		Tier
Movie Greats	Tier		Tier
Movie One	Tier		Tier
MTV			Basic
National Geographic	Basic	Basic	
Nickelodeon	Basic	Basic	
Odyssey			Basic
Ovation			Basic
Showtime	Tier	Basic	
Sky News Australia		Basic	Basic
Sky Racing	Basic	Basic	Basic
The Comedy Channel	Basic	Tier	
The History Channel/ FOX Kids Network		Tier	
The Lifestyle Channel	Basic	Basic	
TNT	Basic	Basic	Basic
TV1	Basic	Basic	
TVSN	Basic	Basic	Basic
UKTV	Tier	Basic	
Weather 21	Basic		
Weather Vision			Basic
World Movies	Add on	Add on	Add on
NHK (Japanese)			Add on
Antenna (Greek)		Add on	Add on
GATV (Greek)			Add on
Mega Australia (Greek)			Add on
RAI International (Italian)		Add on	Add on
ART (Arabic)			Add on
LBC (Lebanese)			Add on
CCTV & TVBJ (Cantonese & Mandarin)			Add on

**Table 2.2: Pay TV Packages and Prices, May 1999**

Delivery	Operator	Basic Package		Additional Tiers	No. of channels (whole package)	Add-ons
		Channels	Price \$ p.m.			
MDS and/or DTH	Austar	14	31.95	Movie Network (3 Channels) Showtime and Encore	19	World Movies \$6.95 Adults Only \$6.95 per night
	FOXTEL	21	56.95	Entertainment Plus (4 Channels)	25	World Movies \$6.95
DTH	Austar	18	35.95	Movie Network Showtime and Encore C7 Sports 1 & 2, ESPN Hallmark, UKTV Fox 8, FX	30	Adults only \$14.95
Cable	FOXTEL	30	42.95	Entertainment Plus	34	Antenna/RAI \$19.95 Adults Only \$14.95 World Movies \$6.95 PPV \$19.95-\$49.95
	Optus Vision	15	14.95	Deluxe (6 Movie and Sports Channels)	21	Adults Only \$13.95-\$19.95 Japanese \$25.00 Languages \$20.00 each PPV \$19.95-\$49.95 World Movies \$6.95

Source: Operators

### *Delivery*

Pay TV is delivered by different technologies or ‘platforms’, as they are often called. At present three platforms are used: terrestrial microwave transmitters (Multipoint Distribution System, MDS), Direct-to-Home (DTH) satellite, and broadband cable networks. The majority of subscribers (61 per cent) receive pay TV via the two broadband cable networks built by Telstra and C&W Optus respectively. This is double the share receiving satellite pay TV (about 28 per cent), with MDS much lower and losing share at 9 per cent (Table 2.3). Of the 594 000 cable subscribers at March 1999, 385 000 received the FOXTEL programme packages, representing a take-up of 15 per cent of homes passed by Telstra’s broadband network. Optus Vision programming is carried by C&W Optus’s broadband network which at March 1999 had a take-up of 10 per cent of homes passed. The aggregate cable pay TV penetration is about 20 per cent of all homes passed.

**Table 2.3: Pay TV Subscribers and Penetration by Operators,  
31 March 1999**

Delivery	Operator		Subscribers	Share	Homes passed	Penetration
MDS	Austar*		93 000			
		Total	93 000	9.6%	2 000 000	4.6%
DTH	Austar* FOXTEL		217 000			
		Total	272 000	28.0%	6 500 000	4.2%
Cable	FOXTEL Optus Vision		385 000			
		Total	594 000	61.3%	3 000 000**	19.8%
		<b>All</b>	<b>959 000</b>			<b>14.8%</b>

\* Industry estimate based on 30%/70% split between MDS and DTH.

\*\* Industry estimate based on 80% Telstra/Optus cable overlap.

In order to receive pay TV, subscribers require new reception equipment. This consists of a dish antenna in the case of satellite reception and, for all platforms, an integrated receiving decoder (IRD), often called a 'decoder' or 'settop box'. The decoder sits on or near the television set and receives the encrypted video channels. This requires a conditional access system (CAS), and a separate billing and subscriber management system (SMS). CAS is a system which operates in much the same way as an *electronic turnstile*, allowing those who have paid to view pay TV channels, and those who have not to see only a distorted picture. The key that unlocks the decoders currently takes the form of a *smartcard*. Authorized subscribers access programmes through a smartcard which contains algorithms enabling different bundles of programmes to be decoded and viewed, depending on the number of tiers which the subscriber has purchased. In the future, television sets may contain the necessary electronics to remove the need for decoders and smartcards, and will be directly addressable by the pay TV operator.

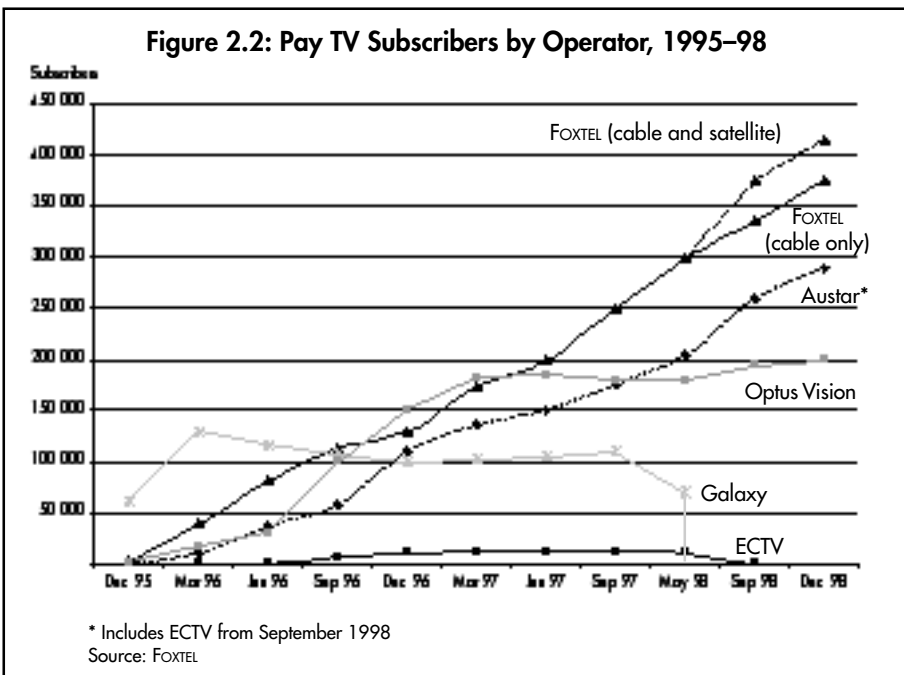
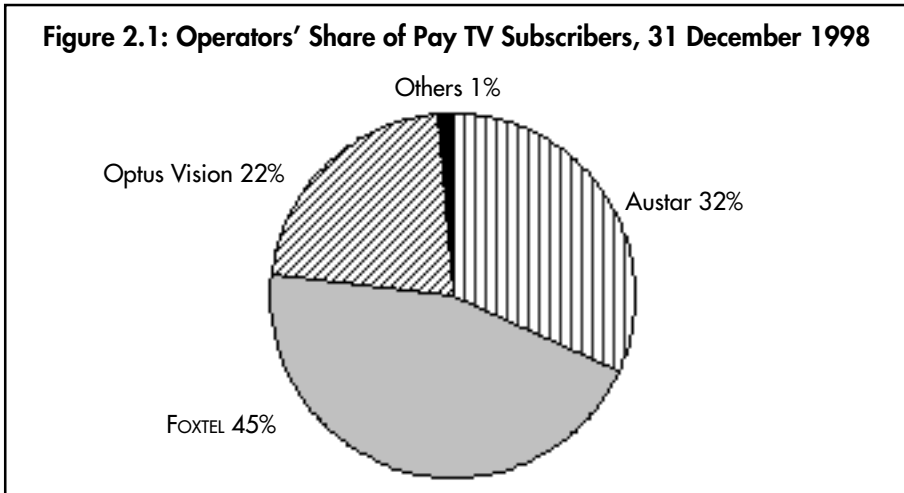
### *The Operators*

Pay TV is supplied by three main operators—FOXTEL and Optus Vision in metropolitan areas and Austar in regional centres—and several smaller regional operators. FOXTEL is a partnership between Telstra, News and PBL to supply pay TV on Telstra Multimedia's broadband network. Optus Vision is a wholly-owned subsidiary of C&W Optus providing pay TV on C&W Optus's broadband network.

FOXTEL is the largest operator with 45 per cent of all subscribers, followed by Austar (32 per cent) and Optus Vision (22 per cent) (Figure

2.1 and Figure 2.2). FOXTEL and Optus Vision are cable operators; recently the former has entered satellite pay TV delivery as well. Austar, on the other hand, uses a combination of satellite and MDS delivery, and cable in Darwin.

As can be seen from Figures 2.1 and 2.2, the industry has rationalized as some operators have floundered. Since 1995, Australis has gone into receivership and Austar has purchased ECTV. It is the declining fortunes of Australis that form the principal focus of this book.



# Chapter Three

## A Brief History

Pay TV in Australia has had a troubled and turbulent history. This chapter discusses some of the main episodes relating to industry structure, government policy and competition between the operators. Table 3.1 provides a brief chronology of events from 1992 to the beginning of 1999.

### *The Beginning*

Australia's first pay TV service began operating in 1995. By international standards this was a late start. Pay TV began in the US in 1948 and in the UK, widely recognized to have a more restrictive and less competitive television sector than Australia, in 1984. The primary reason for this delay was a political lack of will in the face of intense lobbying from the three commercial FTA networks, which regarded pay TV as a competitive threat. After considerable debate, lobbying for and against, and government inquiries in the early 1980s, the broadcasting regulator (ABT, 1982) recommended that pay TV be allowed. The government rejected this in September 1986, placing a moratorium on pay TV for a minimum of four years, subsequently extended to a fifth.<sup>1</sup> Deregulation was finally achieved when on 11 December 1992 Parliament enacted Part 7 of the *Broadcasting Services Act 1992 (BSA)*.<sup>2</sup>

Australis Media was the first to launch pay TV services in Australia in January 1995, with limited coverage of Sydney and Melbourne and a handful of channels. It initially used MDS, a line-of-sight microwave system using a network of ground transmitters. Prior to the liberalization of pay TV, Australis offered a restricted range of narrowcast foreign language pay TV services (Teleitalia, New World Television and ALB, offering Italian, Chinese, Arabic and Lebanese language programmes) in metropolitan areas, and an international news service to hotels.

**Table 3.1: Chronology of Pay TV in Australia**

**1992**

December *Broadcasting Services Act* amended permitting pay TV.

**1995**

January Australis launches *Galaxy*, the first pay TV service in Australia using MDS. Service initially free with installation costing \$299.

March Australis, FOXTEL, News and Telstra sign TNC Heads Agreement permitting FOXTEL to distribute *Galaxy* package.

April *Galaxy* package expanded to eight channels, for a monthly subscription of \$49.95.

June Australis cuts installation charge to \$99.

August Austar and ECTV commence broadcasting.

September Optus Vision launches on Optus broadband network, with an installation charge of \$29.95 and monthly subscription of \$25 for the basic Vision package.

October FOXTEL launches on the Telstra broadband network. Installation charge of \$19.95 and monthly subscription of \$39.95.

Australis announces agreement with News and Telstra to merge FOXTEL and Australis. Australis commences satellite DTH service.

November Australis cuts installation charge to \$19.95 and monthly subscription fee to \$39.95, matching FOXTEL.

**1996**

March Australis increases installation and monthly subscription charges to \$199 and \$49.95 respectively.

May ACCC opposes Australis/FOXTEL merger, which is then abandoned.

July Additional five-channel tier (*Entertainment Plus*) launched by FOXTEL for \$9.95 per month.

August Australis and Optus Vision announce agreement on terms of satellite joint venture. News, FOXTEL and Telstra bring legal actions.

October Restructuring of Australis to raise finance.

*continued ...*



**1997**

- January Optus Vision increases subscription charges on basic packages.
- March Financial restructuring of Optus Vision.
- April Pay-per-view services launched by FOXTEL (Event TV) and Optus Vision (Main Attraction).
- May New South Wales Supreme Court injunction prevents Australis from transferring assets to the satellite joint venture. Australis and Optus Vision subsequently appealed.
- July Deregulation of pay TV, ending ten-channel satellite limit and the exclusive rights of DTH satellite licence holders, and permitting advertising on subscription television.  
Australis and FOXTEL announce plans to merge.
- September FOXTEL increases basic monthly subscription fee to \$42.95.
- October ACCC begins Federal Court action to block FOXTEL/Australis merger.
- November Australis asks for shares to be suspended on Australian Stock Exchange.  
Australis sells settop boxes to raise funds.  
Moody's Investors Service expects Australis to be placed in receivership sooner rather than later and expresses concern at low penetration after more than three years of significant infrastructure investment.  
Australis launches legal action against Telstra and News Corporation, claiming damages of \$2.4 billion because Telstra had reduced its cable rollout from 4 million to 2.5 million homes allegedly affecting Australis's programme agreement with FOXTEL.  
News and Telstra abandon FOXTEL/Australis merger. Parliamentary Committee on Financial Institutions and Public Administration told that Optus Vision provided financial assistance to ACCC's legal action opposing the merger of its rival FOXTEL with Australis.
- December Australis announces US\$27 million short-term financing from its US bondholders.

**1998**

- January Australis retrenches 80 staff.  
The Hollywood studios which supply Australis take legal action to terminate their movie supply arrangements, alleging Australis to be insolvent.

*continued ...*

<b>1998</b>	
February	Publishing & Broadcasting Ltd launches legal action against Australis alleging that its US\$27million bond issue breached an agreement under which PBL had supported its previous refinancing.
March	<p>The federal government proposes to introduce laws giving FTA broadcasters the right to block retransmission of their channels or seek financial compensation from the pay TV operators.</p> <p>The federal government announces allocation of free spectrum for digital terrestrial television to FTA broadcasters allowing them to expand into datacasting and 'enhanced services'. They will not be allowed in the short term to use this spectrum for pay TV. The government also announces FTA broadcasters are to be protected for at least ten years by limiting Australia to three commercial terrestrial FTA TV networks.</p>
April	<p>FOXTEL announces it has 300 000 subscribers, making it Australia's largest pay TV operator.</p> <p>Optus Vision restructures its pay TV pricing, reducing the price of its cheapest package from \$29.95 a month to \$9.95 for ten channels and retransmission of the five FTA channels. Optus Vision says its strategy is to reduce the price entry point to pay TV to win more subscribers. FOXTEL retains its entry point at \$42.95 per month for 23 pay TV channels and the FTA channels.</p>
May	<p>Telstra applies to court to wind up Australis to protect its Australis bonds.</p> <p>Australis's bondholders appoint receiver to Australis.</p> <p>News and Telstra terminate the 25-year programme agreement with Australis.</p>
June	FOXTEL purchases from the Australis receiver 50 000 satellite settop boxes in homes served by Australis. Optus agrees to supply programming to Australis franchisees ECTV and Astar.
July	Austar pays \$50 million for ECTV thereby also raising its stake in pay TV programmer XYZ to 50 per cent, with 50 per cent owned by FOXTEL.
November	C&W Optus successfully floats giving CWC a controlling stake.
December	PBL purchases 25 per cent stake in FOXTEL, ACCC clears acquisition.
<b>1999</b>	
March	FOXTEL launches its satellite service.

Under the *BSA*, MDS licences were issued for all Australian capital cities and most regional centres. Each licence allowed one broadcast or narrowcast channel. Of the 566 licences issued, 136 were owned by Australis, 406 by the regional pay TV operators ECTV and Austar, and 24 by others. However, when MDS threatened to provide a viable alternative to satellite pay TV, the government stopped issuing further licences in order to prevent it undermining Australis's investment in satellite, and Optus's satellite subscription television distribution monopoly (*BSA*, s 96).

### *Satellite TV*

The government's pay TV policy was based on the view that satellite would be the primary means of pay TV delivery in the early years. This was conditioned in part by the existence of AUSSAT, a government-owned satellite system, which provided immediate national coverage. The government's stance was reinforced by several other components of its telecommunications and privatization programmes. In 1992, the Keating Labor Government created a satellite monopoly owned and operated by Optus. Under the *BSA*, Optus was given a five-year monopoly (ending 1 July 1997) on domestic subscription television broadcasting by satellite. Optus's satellite monopoly was tied to its purchase of AUSSAT. As well, the government restricted the number of satellite programme licences to three, allowing a total of ten channels until 1 July 1997. One of the licences was allocated to the ABC (which did not use it) while the other two were auctioned to the private sector.<sup>3</sup>

Under the procedure, Licences A and B were auctioned to the highest bidder. Applicants were required to make sealed bids, pay a nominal non-refundable fee of \$500, and provide a statement of their plans and proposed ownership and control structure. These bidding arrangements were flawed. The nominal application fee, along with the absence of a requirement that applicants establish that they had adequate financial resources, led to 'paper bids' which the applicants did not necessarily intend to honour. As a result, applicants made multiple bids for progressively lower sums in the hope that one of them would eventually be low enough to attract funding.

The outcome was an embarrassing round of rejected bids as applicants failed to come up with the money. UCOM was awarded Licence A with a bid of \$177 million, and Hi Vision Licence B at \$212 million. Both bidders were unable to raise these sums and withdrew. The government quickly enacted the *Broadcasting Services Amendment Act (No.*

2) 1993 in May, requiring a 5 per cent non-refundable deposit from successful bidders within three days of approval by the Australian Broadcasting Authority (ABA). The next four highest bids for each licence were voided because the applicants could not find the money. On 1 September, New World Telecommunications was declared the successful bidder for Licence B at \$117.001 million and also awarded Licence A which, under the licensing conditions, it could not hold. With New World's decision to take-up Licence B, UCOM was next in line for Licence A with a bid of \$97.001 million. It paid a deposit of \$4.85 million but, in November, when required to pay the balance, it defaulted, losing the deposit. Licence A was then awarded to, and voided by, UCOM (for failure to raise funds) for a second time, then to Payvision Australia, then to an unidentified bidder, and finally back to UCOM on 4 December 1993.

### *The Race to Cable*

To the surprise of most, and despite the preferential treatment given to satellite, Australia was cabled at breakneck speed. By May 1998, when they effectively stopped cabling, C&W Optus's and Telstra's broadband cable networks had passed over 2.1 million homes and 2.5 million homes respectively. As the ACCC (1996b, para. 5.21) observed:

At the outset intense competition between the two licensed telecommunications companies, Telstra and Optus Vision had the direct effect of accelerating duplicated broadband cable rollouts to residential homes, with the capability of delivering significantly more pay TV channels to subscribers in a quicker time frame than was originally envisaged when Part 7 of the BS [Broadcasting Services] Act was drafted.

Government regulation played a part in fostering the rapid growth of broadband cable. Under the *Telecommunications Act* 1991 the government liberalized telecommunications initially by establishing a fixed duopoly (Telstra and Optus). As a result, Telstra and Optus enjoyed exclusive rights to build and operate broadband cable networks exempt from planning laws. The key objective of the *Telecommunications Act* 1991 was 'to provide a framework for fostering genuine and sustainable network competition'. This was specifically designed to encourage rollout and construction of a fixed broadband infrastructure as the following review by the BTCE (1995, page 23) states:

First, the Government took the view that 'had unrestricted competition been introduced immediately, it is likely that the

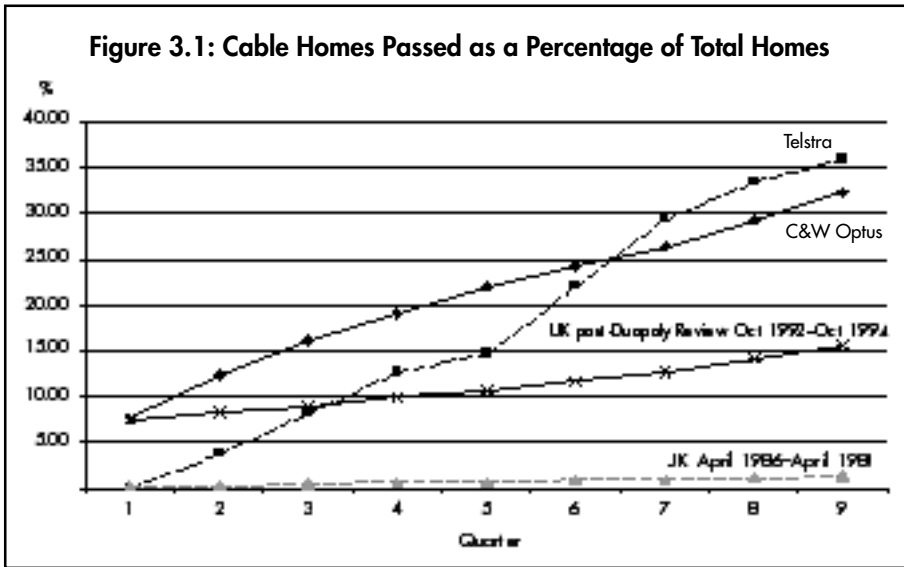
new carriers would have taken longer to provide “critical mass” of sufficient market share necessary to provide effective competition to AOTC’ (Holthuyzen, 1992). A second, short-term aim of the regulatory arrangements was ‘to assist the second carrier in overcoming the formidable advantages associated with Telecom-OTC’s control over the customer base, infrastructure and access to information so that the second carrier would be able to compete from as level a playing field as possible’ (Beazley, 1991).

Both Telstra and Optus took advantage of their privileged positions to roll out broadband networks across major cities of Australia. During the 18 months up to 1 July 1997, a cabling race ensued with Telstra reportedly following Optus’s cable layers down many of the densely populated streets of Australia’s capital cities.

Telstra, with the benefit of long-held easements (a legacy of its public telecommunications carrier status), initially rolled out its broadband network underground. Optus used cheaper ‘aerial cabling’, stringing its wires along the power poles of the local electricity authorities. Since this enabled the network to be constructed faster and more cheaply, Telstra soon followed suit. This produced a public reaction that resulted in the removal of the two operators’ exemption from the planning and development laws. However, by this time the bulk of Telstra’s and Optus’s networks had already been constructed.

The rapid pace of Australia’s cabling is evident from comparison with the UK, where the cable industry was deregulated in 1984. In the four years to April 1988, less than 3 per cent of UK television homes (about 600 000 homes) had been passed. Even during a much faster period of growth in the UK, the two years following the Duopoly Review of 1991–92, the share of UK television homes passed rose by only eight percentage points, from 8 per cent to 16 per cent. Two years after launch, Telstra’s and Optus’s broadband networks passed over 30 per cent of Australian TV homes.

Another remarkable feature is that the two cable systems are ‘overbuilt’—a term used when two wire networks are built in the same area offering potential subscribers a choice of different networks—by 80–85 per cent in the main metropolitan areas. This level of fixed facilities competition does not exist to any significant degree anywhere else in the world. It is, therefore, not surprising that the Bureau of Transport and Communications Economics concluded in its 1995 review that most of the government’s short-term objectives for telecommunications had been met (BTCE, 1995).



### Programming

In the development of pay TV, two programme categories—movies and sport—have been crucial in differentiating it from the established terrestrial channels. As a result, there has been a scramble to secure exclusive rights to such programming, often at prices which have proved both high and onerous to the pay TV operators, and generated public and political concern that such programming will be denied to the mass of television viewers. Australian pay TV has been no exception in this regard.

Australis and Optus Vision battled to secure exclusive rights to Hollywood movies. Australis had ‘output deals’ with Sony, Paramount and MCA (Universal) (later joined by Fox); Optus Vision with Disney, Warner and MGM. The competition between the two resulted in programming deals with Hollywood studios which were costly, involving as they did very high Minimum Subscriber Guarantees (MSGs). MSGs gave the studios a guaranteed sum irrespective of the number of subscribers watching their programmes. These burdened the industry with high costs and financial difficulties.

As the third entrant, FOXTEL did not have access to movies from the major Hollywood studios (other than Fox). This placed it not only at a disadvantage, but potentially blocked its entry to pay TV. Under the Telstra News (TNC) Heads Agreement, approved by the ACCC, Australis agreed to supply FOXTEL with part of the Galaxy package consisting of four channels, including movies and sports. The ACCC acknowledged that without

this programme arrangement it was highly unlikely that FOXTEL would have commenced a pay TV service (Fels, 1996). However, this was achieved at a high cost to FOXTEL shareholders: a reported \$4.5 billion guarantee over 25 years.

Sport is seen as important in attracting subscribers to pay TV. It has also proved to be a battleground. In the latter part of 1994 it was rumoured that News Limited was to establish a new rugby league competition—the Super League—to replace the national competition managed by the Australian Rugby League (ARL). The idea was to create an elite competition of ten or so teams, consisting of the ‘cream’ of rugby league players. In response, the ARL offered 20 clubs admission to the national competition for five seasons, on the condition that each club agreed to participate for those seasons, and not in any other competition unless conducted or approved by the ARL. Each club signed a Commitment Agreement to this effect.

Inevitably, the dispute ended up in the courts, with numerous actions brought by the ARL based on breaches of player contracts and of club contracts, and by News Limited based on breaches of the provisions of the *Australian Trade Practices Act*. The ARL successfully gained an injunction stopping the Super League, but this was overturned on appeal. The two leagues ran in parallel for a year in the face of mounting costs and dwindling public appeal, and have now merged to form the National Rugby League.

### *The Battle with FTA Television*

Pay TV operators have had running battles with the FTA networks. The BSA applies different levels of regulatory control according to degree of influence. In practice this means that the more influential a medium is, the more regulation it tends to attract. Hence, FTA, the most influential sector, should attract the ‘most regulation’. In practice, the FTA networks have gained many privileges in addition to the delay of pay TV. These include:

- a ban on advertising on pay TV until 1 July 1997 followed by limitations on the amount of advertising time;
- a ban on R-rated material on pay TV despite research by the ABA which indicates that a majority of those polled believed that R-rated material should be available, with appropriate restrictions; and
- anti-siphoning rules designed to ensure that major sports would not move from FTA to pay TV exclusively.

In addition, in 1998 the federal government announced that no additional commercial FTA licences would be issued before 2008, and that

the existing three FTA networks would receive valuable spectrum for digital terrestrial television free of charge. These two decisions caused considerable controversy within and outside government, being seen as an excessively generous gift to the highly profitable FTA commercial networks (Shanahan, 1998). The government justified the decision in terms of the expense that these networks would incur in moving from the present analog to digital transmission estimated at between \$500 million and \$700 million (Fairfax, 1998). The Australian government has also arbitrarily decided to mandate the introduction of High Definition Television despite the lack of clear evidence, from either Australia or the experience of other countries, that this is commercially viable and desired by consumers.

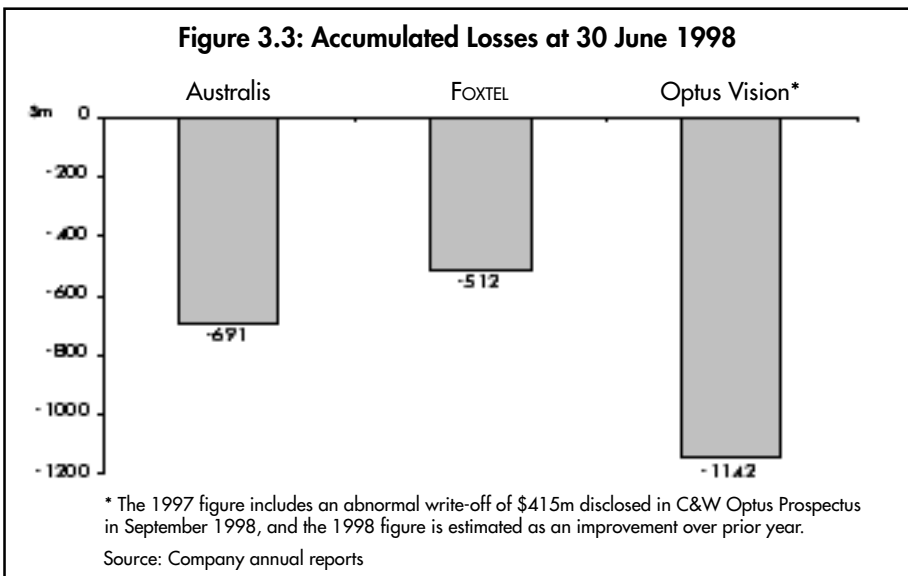
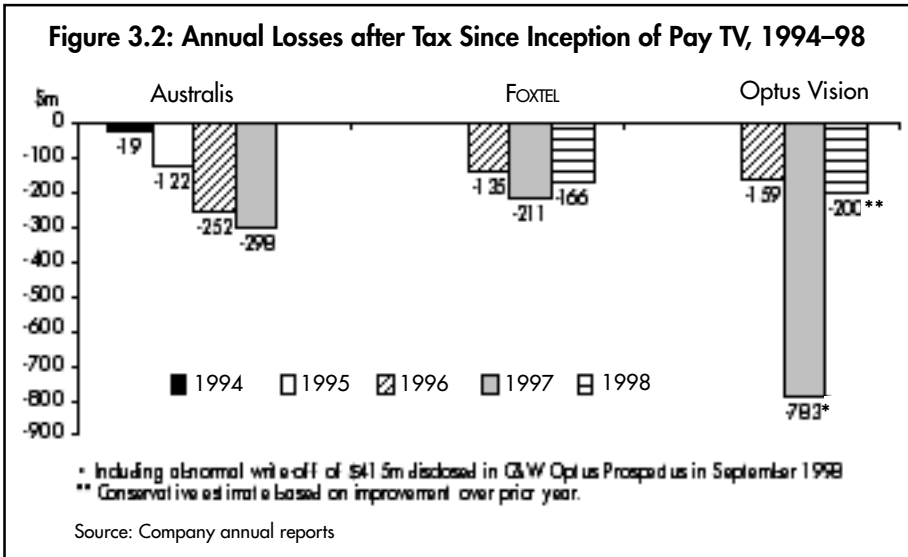
### *Pay TV Finances*

The plight of the pay TV sector can be readily seen from its financial position. All three current pay TV operators and two which no longer exist (Australis and ECTV) sustained substantial losses, and had done so since commencing transmission. Figures 3.2 and 3.3 show that net losses grew with each year of operation, amounting to over \$2.2 billion (at June 1998) in pay TV alone, quite apart from the investment in broadband networks. Telstra's network is estimated to have cost around \$3 billion while Optus is reported to have invested \$2 billion building its broadband network. Australis's losses were so large that at 30 June 1997 its balance sheet showed negative net assets of \$40 million. Australis went into receivership in May 1998, owing its US bondholders about \$700 million.

### *Endnotes*

- 1 See discussions in DTC (1989) and HR (1989).
- 2 *Broadcasting Services (Subscription Television Broadcasting) Amendment Act*, which inserted Part 7 into the *Broadcasting Services Act 1992*.
- 3 The procedure was laid down in the *Broadcasting Services (Subscription Television Broadcasting Licences A and B Price-based Allocation System) Determination*, 19 January 1993. Applications were invited on 22 January 1993, closed on 24 March and the results announced on 20 April.







# Chapter Four

## A Model of Dynamic Competition

Assessing competition in pay TV or a wider video or communications market is not a simple task. It involves the subtle, and sometimes not so subtle, interplay between the actions of pay TV and other video and telecommunications providers in the short run, together with longer-run structural issues.

This chapter sets out the rudiments of a framework for analysing the emerging tension between competition, regulation and market structure in pay TV and related communications networks. The discussion is designed to set the scene for the more detailed discussions of competitive issues raised by the pay TV industry under Australian trade practices law in Chapters 5 and 6.

### *The Basics*

There is no doubt that as an economic commodity, television is unusual.<sup>1</sup> A television programme is what economists call a public good in the sense that, once produced, it can be broadcast to an additional viewer at zero cost. Thus, for any given programme, the larger the audience of a channel, the lower is the cost per viewer of programming and of many other activities associated with the distribution and marketing of television.

These *economies of scale* explain much of the organization of television markets. They explain why television networks exist and why there is often a threshold below which it is not commercially sensible for pay TV channels to produce their own programmes. A large network can spread the fixed costs of programming over more viewers, and has the financial capacity to produce more expensive programmes. Networks also substantially reduce the transaction costs of scheduling, transmitting and selling airtime, and enable schedules to create and capture the value of 'adjacency effects' where a programme builds audiences for the next one. The fixed costs of programme production also explain the way rights are priced and 'windowed' across different formats and delivery systems.<sup>2</sup>

There are also *economies of scope*. Economies of scope arise when an increase in the production of one product leads to a reduction in the production costs of another. For example, a railway or an airline may find it less costly to supply both passenger and freight transport than to specialize in only one service. The bundling of pay channels will generate economies of scope, as will the bundling of pay TV and telephone services on broadband cable. The latter is particularly significant in Australia, where the Optus fixed network has been constructed to carry both services. This means that the additional cost of supplying telephony and pay TV is significantly lower than supplying each on a stand-alone basis.

The other relevant feature of television is that *audiences are relatively fixed*. If anything, people are watching less television, presumably because other forms of leisure and entertainment are competing with television. Furthermore, there is little evidence that increasing the number of channels or introducing pay TV channels increases average viewing hours, although pay TV subscribers may watch more hours on average than those who watch FTA television only. Therefore, as the number of channels or stations increases, the same audience is spread or fragmented among more channels. This means that, all things being equal, the introduction of pay TV takes audience share away from FTA broadcasters, and tends to reduce average audiences per station or per channel. The net effect is to increase the average costs of attracting viewers even if the greater costs of delivery/transmission, and the impact that increased competition has on rights fees and programme production costs, are ignored.

### *Competition and Programme Costs*

Increased competition in television has a two-way pull on programme costs. An increase in the number of bidders increases competition for programme rights and resources. This, in turn, drives up the fees that broadcasters must pay for attractive programming. However, increased competition also fragments audiences and reduces the share of audience and revenues of each broadcaster, who will respond by reducing overall programme costs in two ways. First, broadcasters and third-party programme producers will increase the production of television programmes. Second, broadcasters will alter their schedules to incorporate cheaper programming and more repeats. For example, drama may be replaced by game shows and fly-on-the-wall documentaries.

The introduction of pay TV increases programme costs for two further reasons. First, the value of a pay TV subscriber is several times the

value of the same viewer to an advertiser-supported FTA station. This is because subscribers are often willing to pay more for attractive programming than advertisers are prepared to pay for advertising airtime around those programmes. In the UK, the average revenue per subscriber hour generated by UK pay TV is twice the advertising revenue per hour for a FTA channel, although for premium programming, like movies and sport, it will be many times higher than the potential advertising revenue.

Second, the prices for pay TV rights tend to escalate rapidly where there is direct competition between two or more pay TV operators. In countries where pay TV has developed with several operators vying for programmes, a bidding war has broken out for Hollywood movies and major sports events. These are referred to as 'drivers' or 'killer applications' because of their importance in attracting new subscribers. Both attract mass audiences and both are highly valued by viewers. Also, the quantity of this programming is limited. Thus, competition in the programme rights market, particularly in the early phase of the development of pay TV, leads to a high-cost structure for the industry which, in retrospect, is seen to have been based on wildly optimistic projections and a 'winner-takes-all' strategy premised on the assumption that the competitor will not survive. For example, the costs of the Hollywood output deals were substantially renegotiated downward when the UK's pay TV sector was rationalized in the early 1990s.<sup>3</sup>

The impact of pay TV on programme costs, however, should not be exaggerated. In general, programme expenditure per channel and per hour for a pay TV operator is low compared with FTA channels. This can be seen using the programme budgets of UK FTA and pay TV operators. BSkyB spends a fraction on programming per channel compared with UK terrestrial broadcast channels, although on a per-viewer-hour basis it spends the largest amount, since it has many hours of programming but relatively few viewers.

Second, the dramatic escalation in programme costs is confined to specific types of programmes. BSkyB spends the bulk of its programme budget on acquiring the rights to premium programmes. In 1995–96 expenditure on movies accounted for 34 per cent and sports 32 per cent of its total programme budget. That is, 66 per cent of the total programme expenditure was devoted to these premium channels.

Third, pay TV operators rely heavily on acquired programmes. Pay TV's general entertainment programming generally consists of acquisition of secondary rights in television programmes which have already received their first transmission on FTA television overseas. In the early

phase of the development of pay TV, there is very little original production made specifically for pay channels. This is especially true of new pay TV channels where the economics of entry and the volume of programming required make it uneconomic for pay TV operators to engage in significant production of original programmes.

Pay channels also schedule their programmes in different ways which reduce costs. The number of repeats is considerably higher than on FTA. For example, six- or four-hour blocks of programming are repeated over the course of the day or week.

**Table 4.1: Programming Expenditure in the UK:  
Terrestrial vs Pay TV, 1996**

Channel	Programme expenditure £m	Number of channels	Expenditure per channel £m	Viewer hours	Expenditure per viewer hour (pence)
BBC	1 130	2	565	21 910	5.2
ITV	810	1	810	17 554	4.6
Channel 4	268	1	268	5 301	5.1
BSkyB	420	10	42	5 155	8.1

Sources: BBC, *Annual Report and Accounts, 95/96*, ITV, *Annual Report and Accounts 1996*, Channel 4, *Report and Financial Statements 1996*, BSkyB, *Annual Report 1996*, *Advertising Statistics Yearbook 1997*.

### *Programming Choice*

In order for pay TV to succeed it must offer viewers something significantly different from FTA television. Obviously, pay TV has greater channel capacity, thus enabling more and different programmes to be sold to subscribers. This greater channel capacity has led to the development of thematic channels devoted to one type or genre of programming. As shown in Chapter 2, pay TV led to a ninefold increase in channels devoted to specific types of programmes such as movies, documentaries, news, sport, children's, lifestyle and many others catering to specific viewer tastes and preferences.

Pay TV alters the relationship between broadcaster and viewer. It creates a genuine market for programmes, unlike commercial FTA television, which is best described as a market for audiences sold to advertisers. The direct contractual link between channel provider and viewer means that viewers' preferences backed by willingness to pay are con-

veyed to the pay TV operator. This, in turn, gives the operator a monetary incentive to satisfy those preferences.<sup>4</sup> As Professor Jora Minasian (1964, page 74) commented in an early analysis of the subject:

... a subscription system can be expected to yield a more diversified program menu than an advertising system because the former enables individuals, by concentrating their dollar votes, to overcome the 'unpopularity' of their tastes.

This is because pay TV can tap the willingness to pay of those with intense preferences for particular programmes or a different mix of programmes from that offered by the FTA broadcasters. A competitive pay TV system will offer more channels or programme types to viewers.

Commercial FTA television typically consists of a handful of general programme channels providing a broad mix of programming catering to all tastes over the schedule. Moreover, advertiser demand for mass audiences has an effect on programming. Advertiser-supported FTA broadcasters usually seek a mass audience. In a competitive setting, broadcasters with one FTA channel tend to duplicate programme schedules in an effort to maximize audience share. Thus, it is claimed that advertiser-financed FTA channels result in wasteful duplication, lowest-common-denominator programming, and too little diversity and variety.

In practice, while these effects exist for FTA television financed by advertising, the interactions are more complex. First, many FTA channels are heavily regulated to encourage greater diversity and 'public service' programming. Second, in Australia and many European countries state-owned (public-service) channels compete for audiences directly with commercial (advertiser-financed) FTA stations. The programming output of these channels often places a competitive constraint on the commercial FTA stations.

### *Competitive Pay TV Systems*

A number of commentators have drawn attention to the competitive dynamics in pay TV. Indeed, a recurring theme in recent discussions of pay TV, and a central feature of the ACCC's decision to block the proposed merger between pay TV operators, is so-called 'network effects' which generate positive feedback that result in a large operator becoming larger, and eventually dominating the industry. For example, the ACCC (1997) stated that the proposed merger between FOXTEL and Australis in 1997 would give FOXTEL more subscribers, and therefore enable FOXTEL to outbid Optus Vision for better programming, which in

turn would attract even more subscribers. This would generate a 'death spiral' for its competitors. Other commentators have gone further, contending that pay TV is a natural monopoly (Graham & Davies, 1997, page 17):

... we have a critical dilemma for public policy. High quality material can still be produced and yet cost very little *per unit* provided that it reaches a large number of people (exploiting economies of scale) and/or provided that it is used in a wide variety of different formats (exploiting economies of scope), but the exploitation of these economies of scale and scope imply concentration of ownership. Thus, even though the new technology has removed once [*sic*] source of monopoly, spectrum scarcity, it has replaced it with another, the natural monopoly of economies of scale.

These claims are exaggerated. The existence of scale economies does not imply monopoly provision. A high fixed-cost structure tends to limit the number of competitors but the optimal number of competitors will depend on the size of the market. Thus, there tend to be more radio stations than television stations, and more television operators than telecommunications networks. All these are more numerous in larger countries than smaller countries. The constraining influence of costs explains these differences. If these networks supply differentiated products, then more network competition may be profitable. The real question is whether, given the fixed costs, demand is able to generate sufficient revenues to permit two or more competitors to coexist profitably.

In television, competing stations and networks do profitably coexist. The same cost conditions as exist for pay TV exist for FTA television and mobile telephony, where there is active competition between three or four networks. For example, Channels 7, 9 and 10 compete aggressively for ratings in such a way that one channel's gain is another's loss. That is, in a small-numbers setting typical of network television, there is a recognized interdependence between the stations, which leads to a competitive reaction. It could be argued that were, say, Channel 9 able to break away and establish a larger audience (as it has done), then it may be able to lock into a virtuous circle of better ratings, more advertising revenue, greater ability to buy better programming, and still better ratings.<sup>5</sup> Yet what we see is the viable competitive coexistence between three commercial networks in Australia, not a 'death spiral'. The reason is that channels confronted with the prospect of decline and loss of audience share or revenues react. Channels 7 and 10 will go into the market and spend on programming to arrest their audience decline:



they invest, break the 'spiral', and re-establish the equilibrium. Furthermore, the profitability of these channels clearly shows that television is not a natural monopoly, and that there is probably room for additional channels—a fourth network such as the Fox Network in the US, and a fourth network in Australia (ABA, 1998; ABS, 1998; and Albon & Papandrea, 1998).

In addition, TV programmes are not homogeneous products. TV stations can differentiate their schedules to cater better to a specific part of the audience. The positioning of the three commercial FTA networks shows this. Channel 9 has the highest ratings with the highest revenue for those ratings largely because it dominates the early evening peak (6pm to 7pm). To achieve this, it has pursued a high-programming-cost strategy. Channel 7 attempts to follow Channel 9 with a high-cost/high-ratings strategy. On the other hand, Channel 10 has opted for lower-cost programming appealing to an audience under 35 years of age. If the costs of this strategy are significantly low it can afford to fall behind in the ratings, provided that this is not offset by a more than proportionate decline in advertising revenues. (The ACCC's arguments concerning these network effects are discussed more fully later in this chapter.)

### *Facilities-based Competition*

So far the discussion has been confined to the economic and competitive pressures between programming providers, ignoring their different ways of delivering their programming to viewers. However, competition between pay TV operators often involves competition between different delivery platforms or facilities. This is especially so in Australia, where pay TV platforms have been tied to one pay TV operator and are 'closed' in the sense that third-party pay TV operators do not have access to the platform. Thus, FOXTEL is the only provider of pay TV on Telstra's broadband network and Optus Vision on Optus's broadband network; and, before it went into receivership, Australis had exclusivity of DTH satellite pay TV. Australian pay TV is not strictly vertically integrated because the TNC Heads Agreement made Galaxy core programming available on two competing delivery systems in different territories—FOXTEL and Australis franchisees on satellite/MDS. In other countries pay TV is organized differently. In the UK, cable and satellite compete directly for viewers. The main programming provider, BSkyB, actively markets channel packages including the channels of other operators and also wholesales the Sky channels to cable networks, which com-

pete directly with B SkyB for subscribers. Nonetheless, cable networks are still closed unless access is negotiated with the cable operator.

In order to understand fully the impact of the vertically integrated structure of Australian pay TV it is necessary to stray into some basic telecommunications economics.

The extent and economic viability of competition between facilities are determined by supply-side factors (fixed and sunk costs of networks) and demand-side network effects.

Building telecommunications facilities, either fixed or wireless, involves a significant initial investment. Optus's broadband network cost \$2 billion to pass 2.1 million homes: a cost of nearly \$1 000 per home passed before any are connected. If there are two wires passing the same homes, the costs may be twice as large, and escalate substantially if calculated on the basis of homes connected. These costs are fixed and so, in a more graphic way than pay TV programming costs, influence the efficient number of networks. They are also *sunk costs* in the sense that the network's value in alternative uses is significantly lower than the invested sum or its value outside the pay TV sector. This feature is particularly strong for Australian broadband networks where there is significant 'overbuild'. Optus's and Telstra's broadband networks overlap by more than 80 per cent, so that if one decided to exit, the value of its network to potential buyers would be much lower than its capital costs. Sunk costs may also be deliberately incurred to signal a strong commitment to the market, a strategy of 'burning one's boat behind you' (Dixit, 1980). Both Optus and Telstra Multimedia have adopted this strategy in rolling out their networks, signalling their commitment to remain in the market. Finally, the investment is in the construction of networks which have lives of anything from ten to 25 or more years.

The cost structure of telecommunications networks has two other influences on competition and market structure. The first is the so-called 'integer problem'. This occurs when demand is sufficient for more than one network to operate at the minimum efficient scale (MES) but not all networks. For example, suppose MES is 150 units of output, but the competitive output is 220 units. This would support one network operating at MES with the other having average costs well above the first. It would therefore be hard for the second network to compete effectively. The result will either be monopoly, or duopoly of one strong and one weak operator (or two weak operators) which could easily be unstable. Second, the cost structure of networks exhibits high fixed but low and often negligible marginal costs. This is especially the case for broadband networks, where the addition of more traffic on a high-capacity network

which has already been built is virtually costless. This cost structure contains the recipe for destructive competition in which an emphasis on price may lead to severe financial difficulties as competition drives price down to zero marginal costs, and revenues do not cover costs.

These cost considerations differ considerably as between different delivery systems. Satellite has the lowest cost per subscriber, followed by MDS and then cable. The costs of cable will vary depending on the type of wires (coaxial or the more expensive optic fibre) and the civil engineering used (ducted cable is more expensive than aerial cable). On the other hand, these delivery systems have different functionality and capacity. Broadband cable has greatest bandwidth (that is, it can carry more traffic and channels), and is interactive like a telephone. Satellite and MDS are not fully interactive and often have more limited capacity. As a result, broadband cable has the ability to offer telephone and data services, which give rise to significant economies of scope in the provision of both pay TV and local telephony (joint provision is cheaper than separate provision).

### *Entry Assistance*

Telecommunications policy and regulation in Australia have been designed to overcome one major problem: the monopoly of one entrenched public network operator with access to all customers, namely Telstra. Telstra was therefore in a position to block others using this network or to extract onerous terms. Moreover, the competition issues become more acute when the owner of the facility also provides services (that is, when it is vertically integrated). It then has a conflict of interest since it provides an 'essential' input to enable other service providers to compete directly with its services. A policy of *laissez faire* was therefore regarded by policymakers as inadequate to generate sustainable competition within a reasonable timeframe. This led to regulatory affirmative action designed to assist entrants to overcome the ubiquity and entrenched position of Telstra.

Governments have used two approaches to open the telecommunications market to greater competition: service competition and facilities-based competition. This distinction is crucial to understanding regulatory policy in Australia. *Service competition* takes place between the content providers such as different pay TV operators, or between those providing telephone and value-added services on telecommunications networks. *Facilities-based competition* relates to the provision of carriage or delivery services by different operators (in other countries it is called

'network competition', 'alternative infrastructure' or 'infrastructure competition'). It can involve head-to-head competition using the same technology such as between broadband networks (called in the US 'overbuild'), or between networks using different technologies such as fixed and satellite networks.

Most countries have liberalized their telecommunications sector. In doing this they have focused on these two areas of competition, often giving one greater emphasis during the early phase of liberalization. Some regulatory regimes encourage service-based competition through open access and interconnection arrangements on fair, reasonable and non-discriminatory terms. Under this 'interconnection model', the difficulties involved in building a new fixed network to compete with an entrenched facilities operator are treated as sufficiently great to require perhaps a decade to remedy, and so competition is not introduced rapidly. Moreover, in the absence of an effective access regime, an entrant will be disadvantaged because it cannot offer potential customers universal connectivity (the ability to call anyone connected to a network). If there are no interconnection arrangements with other networks, then the value of any newly constructed network will be substantially reduced because (as discussed in greater detail below) the value of a network service increases with the number of other individuals using or interconnected to that network.

Australian telecommunications policy has gone down a different route. It is based on the premise that direct competition between facilities providers is essential for a fully competitive telecommunications market. It therefore encouraged entrants to build new networks to compete directly with Telstra's fixed network. By giving consumers a choice of network, large benefits may arise in the form of lower prices, better service, more innovation and generally a better deal for consumers.<sup>6</sup>

A facilities-based policy often involves an initial distortion of competition known as *entry assistance* or *asymmetric regulation*. Entry assistance is based on a simple proposition: special measures are needed to overcome the entrenched position of the incumbent network operator and to give the entrant the incentive to make the investment needed to build a network, much of which will be sunk and so irretrievable. The best way to foster effective competition is to allow only one new entrant, and to give it protection for a limited period while at the same time bearing down on any anti-competitive abuse by the incumbent: the so-called 'duopoly policy'. Australia operated such a policy, giving Optus five years of exclusivity as the only public telecommunications operator (PTO) in addition to Telstra.

Entry assistance can take a variety of forms, some of which appear contradictory. The incumbent PTOs can be prohibited from certain lines of new business, or entry into related activities such as pay TV. Access arrangements have often been 'rigged' to achieve entry assistance objectives by setting interconnection charges either too high (thereby encouraging entrants to build their own facilities) or too low (thus fostering service competition based on cheap carriage).

A facilities-based policy is frequently based on *closed* or *proprietary networks*. In order to encourage entrants to invest and take the risks to build a new network, they are often permitted to determine its uses and users. Thus, C&W Optus was allowed to build a new broadband network on which it exclusively provided pay TV. This approach is also usual for mobile telephone networks across the world with the result that upward of three networks compete. The facilities-based model employed in Australia has therefore created (quasi-) vertically integrated pay TV systems offering exclusive programming on incompatible networks. It is this structure that some see as the source of the pay TV industry's problems.

### *Closed Networks and Competition*

To understand fully the dynamics of competition between closed networks it is necessary to discuss another economic concept: *network effects* or *demand-side economies of scale*. Network effects exist when the number of other users affects the value of a product or service to a user.<sup>7</sup> It is therefore closely related to the economist's concept of an externality or third-party effect; however, it arises not from technological or cost factors but because the demand of consumers is interdependent.<sup>8</sup> Professor Jean Tirole (1989, page 405) offers a more detailed definition:

Positive network externalities arise when a good is more valuable to a user the more users adopt the same good or compatible ones. The externality can be direct (a telephone user benefits from others being connected to the same network; computer software, if compatible, can be shared). It can also be indirect; because of increasing returns to scale in production, a greater number of complementary products can be supplied—and at a lower price—when the network grows (more programs are written for a popular computer; there are more video-cassettes compatible with a dominant video system; a popular automobile is serviced by more dealers).

Thus the economic benefit or value of an additional subscriber exceeds the value of the transaction to individual subscribers. His or her connection confers an external benefit. The literature also refers (approvingly) to Metcalfe's law which states that the 'value' of a network increases geometrically with the number of people who use it. In telephone networks, positive network externalities provide the motivation for networks to interconnect.

It is argued that this demand interrelationship leads to reinforcing feedback that generates growth and economies for larger networks. In the computer industry, for example, users will pay more for a popular computer system, other things equal, or opt for a system with a larger installed base if the prices and other features of two competing systems are equivalent. This apparent advantage, it is argued, enables firms with a high market share to get larger, leading to monopolistic market outcomes. The implication is that a small network is at a disadvantage to a large network, and that there may be a critical size for a network to be viable.

How does this relate to Australian pay TV? We have seen that the ACCC attempted to invoke a type of network effect arising from the effect that more subscribers would have on the ability of FOXTEL to pay for more and better programming. This is, however, not in the same class as the network effects discussed above. The demand of individual subscribers for pay TV services is not interdependent. The impact and existence of an additional subscriber do not directly affect the value of pay TV to other subscribers. It is true that there are economies of density in cable networks as the average infrastructure costs and the costs of settop boxes decrease as total take-up increases. But this is a supply-side effect unique not to a specific cable operation but to the take-up of cable generally when unit costs fall with volume production.

However, where network effects do come into operation is when subscribers are required to choose between incompatible pay TV platforms.<sup>9</sup> In such cases, consumers will often be reluctant to commit to one platform, fearing that their up-front investment in receiving equipment will lock them into one pay TV operator.

This phenomenon leads to a variety of effects. First, the wrong technical standard may be selected. The literature refers to *excess inertia* arising from the fear of early adopters of a new technology that they risk losing their initial investment because the technology is not adopted by a sufficiently large portion of the market. In this case, the parties' fear of being 'stranded' with a low-value technology<sup>10</sup> may result in deferring its purchase. If many in the market take this stance, there is 'excess iner-

tia' resulting in an efficient standard not being adopted, even though buyers would be better off if it were. Others have questioned this conclusion, arguing that this literature offers a set of hypothetical market failures and misinterprets the limited evidence, and that market forces do in practice lead to better choices than governments.<sup>11</sup>

Nonetheless, the existence of technical incompatibilities has implications for competition in the pay TV industry. There are two effects: consumer *switching costs* and *lock-in* on the one hand, and reduced value of individual pay TV offerings on the other.

The costs to consumers of switching between products can limit competition and affect take-up. Prospective customers will recognize that if they purchase a satellite dish and settop decoder to receive the service from a pay TV operator, this cost may be sunk (unrecoverable) and they will be locked into the service. This is particularly the case with satellite or pay TV, where satellite dishes cannot receive the signals of two different satellites because of the line-of-sight requirement, or when different technical standards are used. In these cases, the ability of subscribers to switch between the services is limited by cost factors or simple technical incompatibility. In order to avoid being stranded, potential subscribers may delay their purchase decision. (Often this is accompanied by strategic manoeuvres by the competing operators to increase customer confusion and denigrate one another's service.) Platform incompatibility also may reduce take-up because attractive programming is usually split between two exclusive systems.

There is evidence of these effects. For example, in the UK, during the late 1980s, two pay TV operators—Sky Television and British Satellite Broadcasting (BSB)—rushed to establish two different satellite pay TV platforms. These used different satellites, required the subscriber to purchase different settop boxes, and offered different programming. The presence of two incompatible systems was not at the time commercially viable, and the companies merged to form BSkyB, which went on to become the success story of pay TV.<sup>12</sup> Australia was also affected by this concern given the reports of its impending collapse.

In Australia, this particular problem has been minimized because the pay TV operators do not require the subscribers to purchase the settop boxes or satellite dishes. Ownership of these is retained by the operator and they are retrieved by the operator on disconnection.

## *Broadband Entry Strategies*

Australia's duopoly policy led to the construction of two broadband networks which have heavily influenced the provision of pay TV. As noted, the speed with which facilities-based competition developed was not expected, even though government policy actively encouraged it. It was the more surprising because the UK's duopoly policy gave stronger protection to new entrant Mercury (also owned by CWC, the majority shareholder in C&W Optus) by banning British Telecom (BT) from providing pay TV on its network. This, however, had the opposite result, with poor cable rollout and weak competition. Viewed with British policymaker's eyes, the decision of the Australian government to permit the then state-owned Telstra to build a broadband cable network would have seemed the death knell for Optus. The EC Commission has also sought to divest national telecommunications operators from ownership of cable networks in order to foster more facilities-based competition.<sup>13</sup>

A number of explanations have been advanced for why duopolistic competition between Telstra and Optus led to such ferocious broadband construction. The government encouraged Optus to build its own network by protecting it from competition under the fixed duopoly policy, giving it relief from environmental laws so that it could use much aerial cabling, and blocking it from using Telstra's ducting. It has also been claimed that Optus found it difficult to negotiate commercially 'realistic' interconnection charges with Telstra and found Telstra's interconnection charges hard to calculate, that the interconnection charge set by the then telecommunications regulator was 'too high',<sup>14</sup> and that reliance on interconnection would have placed 30–40 per cent of Optus's revenues under the control of Telstra, its main rival. Further, it was federal government policy to continue untimed local calls using Telstra's network so that interconnection would have not been financially attractive to Optus.

There were also less parochial reasons for the strategy. Optus's entry into the Australian telecommunications market clearly drew on lessons from the experience of the UK cable industry. In the UK, the failure of broadband cable to become the dominant delivery platform for pay TV is widely regarded to have been the result of its fragmented structure (made up originally of over 130 regional franchises), slow and fitful construction, and absence of exclusive programming. Optus's strategy appears to have addressed each of these difficulties. It took advantage of the legal shield from competition by investing heavily in a rapid



and ambitious broadband cable rollout, and pre-emptively signed up exclusive programming, particularly movies. This gave Optus the coverage and exclusive programming not available to later entrants. If the absence of these factors was the reason for cable's failure in the UK, then the architects of Optus's strategy must have thought they were delivering a 'killer blow' to other entrants and pay TV operators in Australia. That is, a classic 'winner-takes-all' strategy was adopted.

Optus Vision's decision to enter pay TV using a broadband network with huge sunk costs and massive financial exposure was a daring one. If other potential entrants, including Telstra, adopted the same strategy or did not regard Optus's strategy as credible and/or viable, the outcome would be an escalation of infrastructure costs and excess broadband capacity with the consequence that two broadband competitors may not be commercially viable. The inefficient cost structure of the industry may nonetheless be justified if the resulting competition generates consumer benefits in terms of lower prices and/or better services in the medium to long run.

Looked at from Telstra's point of view, the picture is similar. Telstra was permitted to enter the video market and to build a network overlapping Optus's. This led to direct network competition in broadband services, including pay TV. Telstra's action did not prevent entry of Optus as an alternative telephony/pay TV operator, a concern which has led several countries to ban PTO entry into pay TV and cable networks. The result is a unique level of network competition. In assessing the competitiveness of the Australian pay TV sector and the alleged anti-competitive nature of Telstra's strategy, this central fact cannot be ignored.

Once pay TV operators have made huge initial investments, what might be their competitive actions? The situation is potentially unstable since the investment is for the most part sunk and the costs fixed. They can therefore price at any number of levels in a desire to build up subscribers or compete. Potential entrants, recognizing this outcome, will seek one of two solutions: avoid competition because it is unsustainable, or engage in 'cut-throat' competition designed to deliver a 'killer blow' to their competitors. Such intense competition can arise in what economists have modelled as a 'war of attrition', where intense competitive rivalry is followed by the exit of one of the two firms (Tirole, 1989, pages 311–14).

## *Overbuild and Economic Efficiency*

The discussion has arrived at one of the critical issues surrounding pay TV regulation: has past government policy and regulation, combined with the commercial strategies of Telstra and Optus, led to uneconomic duplication of facilities? The answer is 'yes'. As noted above, no other country has so extensively invested in one broadband network, let alone two overlapping networks.<sup>15</sup> Although the costs of technology are constantly falling and demand expanding, there is scepticism about the viability of interactive local broadband networks. For example, after detailed and exhaustive studies of the economics of multimedia, Bruce Egan (1996, page 160) concluded that:

Based on cost data ... even under heroic assumptions of quick mass market deployment, the additional per household monthly revenues required to pay for the original investment is staggering.... Overall, the current demand and revenue data from the telecommunications sector indicate that a competitive service provider of two-way residential broadband network services faces an uphill battle. New revenue growth is always going to be subject to the ability of households to afford to pay for fancy new services and the terminal devices that support them .... Even the telco's own financial simulations for public broadband networks are pessimistic.

To the extent that broadband overbuild has directly resulted from entry assistance policy, the government created an inefficiency, albeit a competitive one. This cost of regulation is well recognized. Mark Fowler (Fowler *et al.*, 1986, pp 193–4), past Chairman of the Federal Communications Commission (FCC), wrote on leaving office:

It can be argued that some of the Commission's regulatory actions ... in fact encouraged entry by uneconomic providers and uneconomic construction of excess capacity. If this is true, the gradualist approach to deregulation of interexchange markets will have resulted in substantial, unnecessary costs for society that never would have been incurred in a truly competitive marketplace. Moreover, this approach will have directly increased consumers' costs by requiring regulated firms to charge higher prices to protect competitors during the transition.

The subsidy inherent in entry assistance can only be justified in competitive terms if its effect is to generate more competition in the medium term than would otherwise have occurred and this competition yields benefits to consumers which outweigh the short- and long-term costs

and inefficiencies associated with entry assistance. Even if the cost penalty arising from the existence of two overlapping local networks were ignored, direct competition would have profound implications for their financial viability. This is especially so if they rely, as has been the case in Australia, on pay TV. Two pay TV operators dedicated to different broadband networks based on exclusive programming would fragment the audience, drive rates down and split take-up.

### *The Regulatory Game*

There is another consequence of entry assistance, which is becoming more prominent. In today's political and regulatory environment, regulators are increasingly co-opted by entrants, often going beyond the mix of regulation and intervention required to foster genuine competition. Regulation is not imposed from above but is the outcome of the competitive strategy of the main participants, albeit in the political marketplace or courtroom. Getting a favourable regulation or decision can be worth hundreds of millions of dollars and can significantly hamper one's competitors. As Baumol and Sidak (1994, page 128) observe, it takes the form of a Greek tragedy where each actor plays his or her pre-ordained part: the incumbent resists entry; the regulator moves to favour the weaker entrant; the entrant seeks to compete by using regulation to handicap the rival. The result is that the entrant co-opts the regulator who fears the accusation that it has failed to carry out its duties (Sappington & Weisman, 1996, Chapter 8). This problem is succinctly put by John Haring (1985), a former FCC staff member:

A firm does not have to possess a large market share to exercise economic power. The OCCs [other common carriers] do not possess large market shares, but they can certainly exercise power by threatening to make government officials who inflict huge costs on consumers to promote competition look bad. They can do this by threatening to fail. A small market share and low profits can be assets in such an extortion campaign. They make the threat of failure more compelling and thus make it more likely that government officials will yield to extortionate demands and as is always the case with extortionists, giving in merely encourages additional blackmail attempts.

Favourable regulation substitutes for competition, and generates an ethos among entrants of complaining to regulators rather than vigorously competing with the established facilities provider.

Entry assistance gives rise to a type of ‘moral hazard’ problem induced by regulation. In the US, it has been argued that mandatory disclosure requirements imposed on Regional Bell Operating Companies regarding network or service plans reduced innovation. These requirements enabled entrants to quickly copy and oppose proposals of the incumbent, with the result that the incumbent was inhibited from developing its business and the entrant was reduced to imitation. As one commentator stated: ‘Asymmetric regulation gives rise to an inferior breed of competition—more adept at imitation than innovation and more prone to battle in the hearing rooms than the marketplace’ (Egan, 1996, page 195). This, it has been claimed, leads competitors to ‘adopt a strategy of “optimal mediocrity”’ (Egan, 1996, page 197). In the UK, there have been recurring concerns that the government’s policy created a ‘cosy duopoly’ between BT and Mercury (then partly owned and now fully owned by Cable & Wireless), which made Mercury complacent in the market and overly reliant on regulatory assistance. It was seen as a weak competitor, targeting new business rather than competing head-on with BT. In return, BT adopted a live-and-let-live strategy designed to give Mercury sufficient slack so as to ensure its survival and/or to avoid more unfavourable regulation.

### *Conclusions*

This chapter has sought to set out the background and basic economics relevant to assessing the efficiency of Australia’s pay TV and telecommunications industries. It does not pretend to do more than scratch the surface. Nonetheless, a number of conclusions emerge.

- Economies of scale place a limit on the number of competitors, but their existence does not necessarily imply that the sector is a natural monopoly.
- Competition in the pay TV industry leads to excessive programming and other costs which may be unsustainable. This is because, during the initial phase with two or more pay TV operators, the entry strategy is ‘winner takes all’.
- In Australia this has been exacerbated by government regulation which has induced an excessive and unsustainable level of facilities-based competition in Australia.

The relevance of these factors to the ensuing discussion of the ACCC’s intervention is straightforward. The ACCC ignored the above efficiency concerns which suggested that three-operator or three-platform competition was not economically viable. Rather, it addressed a range of

narrow demand-side competitive concerns while implicitly accepting that the present structure of the industry required reform. It also adopted a highly bifurcated approach to the treatment of costs: these were ignored where they pointed to industry rationalization but highlighted where they suggested a disadvantage to C&W Optus as a result of the merger. It is also noteworthy that, unlike some other jurisdictions, the ACCC has acknowledged in its merger guidelines (ACCC, 1996a, paras 5.19–5.20 and 5.159–5.162) that it will take economic efficiency into account when assessing a merger. This it did not do!

### *Endnotes*

- 1 For economic analyses of broadcasting and television see Owen, Beebe & Manning (1979), Home Office (1986), Veljanovski (1989), Hughes & Vines (1989), Owen & Wildman (1992), Congdon (1992), and Beesley (1996).
- 2 ‘Windowing’ is the temporal and territorial release of licences or rights in video programming to maximize the value to the intellectual property owners. For Hollywood movies a new movie will be released first in the cinema, then on videocassettes, maybe on PPV, then on pay TV, and then on FTA. The release pattern will also vary geographically. The licences will usually be sold at prices which reflect the different market conditions and age of the movie. Windowing is a form of price discrimination.
- 3 An ‘output’ deal is an arrangement whereby the broadcaster gains exclusive rights or the right of first refusal to the entire catalogue or future output of a studio.
- 4 For Australian literature focusing on demand-side issues see Parish (1968), Brown (1986), BTCE (1991 and 1993), Brown & Cave (1992) and Albon & Papandrea (1998).
- 5 There are reasons to believe that this effect may be relatively more pronounced for commercial FTA channels because of non-linearities in pricing advertising airtime. Often, the cost per 1000 audience rises the larger the audience share of a channel such that the price for the same 1000 audience is greater than for a smaller channel providing a 1000 audience but with a smaller commercial share. This has been attributed to the reduced wastage when commercial share increases.
- 6 The OECD (1995) in a recent review of liberalized telecommunications markets (UK, USA, Sweden, Japan, Australia) found that network competition brings substantial benefits in the form of increased choice, greater innovation, better services, and greater investment in and modernization of the telecommunication infrastructure.

- 7 Shapiro & Varian (1998) and Case Associates (1997b).
- 8 An externality is said to exist if a transaction imposes a cost or a benefit on others not taken into account by the transacting parties. The classic case of an externality is pollution where the production of a good (for example, paint) gives rise to a third-party effect (polluted rivers) not priced in the market. As a result, the activity in question is over-expanded because society at large is effectively subsidizing its production.
- 9 Tirole (1989, Chapter 10), Owen & Wildman (1992, Chapter 7), and Besen & Saloner (1989).
- 10 Farrell & Saloner (1985) and Besen & Johnson (1986).
- 11 Liebowitz & Margolis (1990).
- 12 This destructive competition can occur quite easily in network industries. It occurs often in the newspaper industry when 'circulation wars' break out. Australia has had a recent experience with the FTA networks. During the late 1980s all but one of these channels changed hands at least once. These were sold at high prices to Alan Bond, Frank Lowy and Christopher Skase in 1987. To acquire the stations, all three incurred substantial debt that they could not repay; and by 1990 all three were effectively in receivership. Channels 10 and 7 were in the hands of the banks and Channel 9 reverted to Kerry Packer, the original owner.
- 13 EC Commission (1998) and *Draft Commission Directive amending Directive 90.388/EEC with regard to its effective application in a multimedia environment, by legally separating the provision of telecommunications and cable TV networks owned by a single operator* (1998). Also Veljanovski (1996).
- 14 King & Maddock (1996, page 142) suggest that AUSTEL's decision to increase the interconnection charge by more than 10 per cent was one of the motivating factors in Optus's decision to develop its own network.
- 15 Hazlett & Spitzer (1997) suggest, on the basis of a simple spreadsheet model, that an off-the-shelf cable entrant in the US could earn an 18 per cent rate of return at current cable subscription rates, assuming that the current penetration of 66 per cent is split between the two. The problem is that rates are unlikely to stay the same. The evidence indicates that, in the US, duopolistic competition would lead to rates for the full cable package falling by 20 per cent. Even with this adjustment, Hazlett suggests that entry of a second cable network would be financially viable. However, apart from difference in geography and demand (pay TV penetration of homes with access to cable in Australia is 19.8 per cent, split between two operators), the capital cost of Australia's cable networks will be higher because they are interactive.

# Chapter Five

## The Video Marketplace

Does pay TV compete with FTA television or other forms of delivering video entertainment? This question was one of the most contentious (and as yet unresolved) issues underpinning the ACCC's opposition to the proposed FOXTEL/Australis merger in late 1997. Under Australian merger law, in order to oppose a merger the ACCC must first define the relevant markets to establish that the merging parties are 'in competition' with one another and then demonstrate that the merger will substantially lessen competition in one of those markets. The ACCC did not accept that FTA and pay TV were in the same market, despite coming to a different view earlier in 1995. In this chapter, the interrelation between pay TV and other forms of delivering video entertainment is explored in detail.

### *A Common-sense Approach*

At a common sense level, it is obvious that pay TV competes with many other means of distributing often-identical video programming. As such, it competes with other forms of television, the cinema, video rentals and sales, and increasingly the Internet. Often these compete directly for the same audiences and advertisers at the same time, in the same home and on the same television set with similar programming.

Pay TV and FTA channels do regard each other as competitors. The pay TV operators see themselves in vigorous competition with the established, and in their view heavily 'subsidized', FTA channels. The FTA channels, meanwhile, see pay TV as a major threat, which led to their intense lobbying to block pay TV's introduction and subsequent successful efforts to ban and then limit its ability to sell advertising airtime and buy exclusive rights to major sports events. These actions are consistent with the FTA networks regarding pay TV as a competitor.

In key areas, pay TV operates in a wider market. The term 'pay TV' disguises a number of different types of video programming, which have different competitive relationships with other media. Pay TV competes with FTA television and the cinema for programme rights, and increasingly for advertising revenues. News and current affairs can easily be

seen as part of a wider market which includes other mass media such as FTA television, print and radio. A film channel is increasingly competitive with the cinema, parts of FTA television, and video rentals and sales. Music and youth channels compete with radio, videos and music recordings.<sup>1</sup>

These facts, and most importantly the observed behaviour of those in the video market, suggest that no sharp boundary exists between the various forms of video entertainment.

### *The ACCC's Analysis*

However, the ACCC concluded that pay TV is a separate market from FTA television. This is because the ACCC, in common with most competition authorities, defines markets in a technical way aimed at assessing the extent to which one form of video entertainment imposes a competitive constraint on another in setting its prices.

The details of the ACCC's approach to market definition are set out in the *Revised Merger Guidelines* (ACCC, 1996a).<sup>2</sup> The ACCC uses market definition as part of its analysis of whether a merger will or is likely to substantially lessen competition under section 50 of the *Trade Practices Act*. Crucial to defining the market is the intensity of demand- and supply-side substitution, both among products and among firms.

Under the *Merger Guidelines*, a 'market' is defined as the range of products, which if under the control of one supplier (a hypothetical monopolist) would enable it to raise price profitably 5–10 per cent above the prevailing level.<sup>3</sup> This means that if all pay TV operators merged they would be able to raise subscription charges above the pre-existing level if pay TV were a self-contained market. If, on the other hand, pay TV were substitutable in the viewers' eyes for FTA channels and other video entertainment, the hypothetical monopolist of pay TV would not be able to raise its price, since viewers would simply switch over to the FTA channels or other forms of video entertainment.

Using this demand-side analysis, the ACCC blocked the proposed 1997 merger because it found that 'there are no services which are substitutable or reasonably substitutable for, or in close competition with, pay TV services in Australia' (ACCC, 1997, para. 44(h)), and that as a result 'the pricing behaviour of the suppliers of pay TV services in Australia is not closely constrained otherwise than by the market behaviour of another supplier of pay TV services.' (ACCC, 1997, para. 44(k)). The ACCC offered three principal reasons for its assessment that pay TV has no reasonable substitutes:



1. Pay TV is priced, whereas FTA television is free to viewers and funded by advertisers. As a result, the competitive constraints which FTA television places on the ability of pay TV operators to raise prices is weak; moreover, recent evidence shows that the price of one operator's pay TV package responds more directly to the price of another pay TV operator's package than to FTA operators.
2. Pay TV operators offer many channels whereas FTA consists of a handful of separately owned general channels. FTA television thus leaves unsatisfied demand for video programming and hence does not constrain the actions of pay TV operators.
3. There are high barriers to entry and expansion in the supply of pay TV services (ACCC, 1997, para. 56). These are alleged to arise from sunk costs, programming costs, conditional access, and various exclusive arrangements.

### *Assessing the ACCC's Analysis*

The ACCC (1996b, para. 5.1) has acknowledged that defining media markets is a difficult task:

It is difficult to distinguish markets in media, not only because they will depend upon the circumstances of each particular case, but also because the rapid growth of alternative forms of service provision means that market boundaries may change and also that new markets may emerge in the near future.

Indeed, within Australian trade practices law, different approaches have been adopted. Competition enforcement agencies generally define markets very narrowly. The ACCC is no exception. For example, advertising markets are usually defined for each medium and sometimes each type of advertising within a medium is defined as a separate market. The Trade Practices Commission (the predecessor of the ACCC) concluded that radio advertising was a distinct market separate from press and TV advertising (TPC, 1994). On the other hand, the Trade Practices Tribunal (now the Australian Competition Tribunal), an appellate body, has tended to take a wider view of markets. In *Re Media Council of Australia* the advertising market was defined as the national market for advertising space and time in Australia.<sup>4</sup> The courts are less predictable and it is therefore less easy to generalize. In the rugby Super League case, which had a direct bearing on the development of pay TV in Australia, the court held that all major sports such as rugby league, rugby union, soccer, AFL and basketball, were in the same market.<sup>5</sup> In other countries, competition authorities have held that individual sports con-

stitute separate markets, and that even the major events or senior leagues of a specific sport are separate from the rest of their sport.

The difficulty of market definition is reflected in the way the ACCC altered its position over the relationship between FTA and pay TV. In April 1995 the ACCC cleared the programming alliance (the TNC Heads Agreement) between Australis and the FOXTEL shareholders on the grounds that FTA television and pay TV were in the same market. The Chairman of the ACCC stated that 'a central issue before the Commission was whether the free-to-air broadcasters would materially constrain the exercise of any market power arising from the alliance' (Fels, 1996, page 7). The ACCC concluded that they would, although this was said to be based on 'speculative rather than empirical' analysis (Fels, 1996, page 7). Yet in February 1996 the ACCC alleged that the proposed merger between Australis and FOXTEL would substantially lessen competition, and therefore breach trade practices law on the grounds that new evidence suggested that pay TV and FTA television did not compete. In less than nine months the ACCC had redefined the market!<sup>6</sup>

The ACCC reversal in 1997 was alleged to be the result of 'new market evidence'. However, apart from one piece of price analysis, this 'market evidence' consisted of legal decisions drawn from other countries, in particular the European Commission merger decision blocking the digital pay TV alliance between Kirch, Bertelsmann and Deutsche Telekom known as *MSG Media Services*.<sup>7</sup> The reasons, which the EC Commission gave, were, with several exceptions, repeated by the ACCC together with reference to statutory standards/findings of the FCC.

The applicability and relevance of these decisions to Australian pay TV are questionable. In *MSG Media Services* the EC Commission's Merger Taskforce examined the proposed digital joint venture between several television companies and Deutsche Telekom, which owned most of Germany's cable networks. It concluded that pay TV and FTA television did not compete directly, and the premium pay channels did not compete with advertiser-financed TV and public TV. It based its decision on the fact that the customers differed—FTA television involves a commercial relationship between network and advertisers, whereas for pay TV the relationship is between operator and subscribers—and the 'conditions of competition' differed—for FTA television it was audience share and advertising rates, whereas pay TV caters to the interests of target groups and subscriber prices. This approach has also been followed by UK regulators.<sup>8</sup>

Market definitions drawn from cases or regulatory determinations in other jurisdictions cannot be used to define Australian media mar-

kets. In the first place, the market structure and competitive issues considered in these cases are often radically different from those in Australia (Fels, 1996, pages 12–13). Second, as a purely legal matter, it is a central tenet of the application of trade practices law that market definition must be based on the facts as they exist in Australia in the sectors affected at the time of the merger, and not on market facts as they exist in some foreign country. Third, the legal standards used to define markets differ as between the countries relied on by the ACCC. In EC law, the courts use a very focused demand-side substitution test to define a market which effectively excludes supply-side substitutability, whereas supply-side substitutability plays a more significant role in US and Australian tests. Foreign statutory tests, such as effective competition standards used by the FCC, are based on administrative criteria, which have no bearing on Australian trade practices tests.

Take the first of the above factors. Table 5.1 shows the vast disparities in pay TV markets in the countries covered by the legal decisions referred to by the ACCC—the US, Germany and the UK. As can be seen, the US is a mature market served predominantly by cable networks, with very little direct competition between different pay TV delivery systems. The UK has more direct competition between cable and satellite with about 30 per cent of homes receiving pay TV, but no direct competition by overlapping cable networks. Germany has negligible pay TV and a very weak digital satellite platform.

**Table 5.1: Pay TV Penetration: International Comparisons 1998**

	Penetration rate	Delivered by			Total number of subscribers
		Cable	DTH	Other	
US	(Jun. 98) 78.2%	65 400 000	9 228 200	*2 006 000	76 634 200
UK	(Oct. 98) 30.1%	2 666 783	4 384 000		7 050 783
Australia	(Dec. 98) 13.9%	575 000	243 000	**87 000	905 000
Italy	(Dec. 98) 6.0%	100 000	1 100 000		1 200 000
Germany	(Oct. 98) 5.9%		1 650 000		1 650 000

\* MMDS, SMATV and OVS

\*\* MDS

Sources: FCC (1998); New Media Markets; FOXTEL and relevant European pay TV companies' annual reports.

Furthermore, a close analysis of the reasoning employed in the cases or decisions used by the ACCC, together with the facts as they existed at the time of the 1997 merger proposal, would have probably resulted in its clearance by EU and US authorities. There are several reasons for this claim.

### **MSG Media Services**

First, the issue before the EC Commission was an alliance to fund a digital pay TV platform that brought together the monopoly provider of cable which also owned the public telecommunications network (Deutsche Telekom), and the two large media conglomerates which dominate Germany's media (Kirch and Bertelsmann). The EC Commission held that in the formative stages such a 'grand' alliance was not required, and that the risks of the three foreclosing the market to other entrants were substantial. The EC Commission may or may not have been correct; yet, three years after the decision, Germany still has no significant analog or digital pay TV sector. Recently, the EC Commission blocked on competition grounds another attempt by the same parties to resurrect their 'digital alliance'.<sup>9</sup>

Second, while the EC Commission in *MSG Media Services* concluded that pay TV was a separate market, it also found that cable and satellite pay TV were separate markets. The EC Commission expressly rejected the view of the parties that cable, satellite and terrestrial frequencies were regarded by consumers as interchangeable because there were differences between the three means of transmission 'as far as the technical conditions and financing are concerned'. The EC Commission was clear that cable and satellite do not form part of the same 'relevant market':

While terrestrial transmission and satellite television only require the viewer to install an aerial or a satellite dish at his own expense, cable television presupposes the maintenance of a cable network financed by the viewer through cable fees. It makes a difference to the final consumer whether he has to incur a large amount of expenditure on a one-off basis for one form of transmission (for example, for the satellite receiver) or whether he prefers to incur low-level, regular payments in the form of cable fees. (*MSG Media Services*, para. 41)

The ACCC ignored this distinction, even though Australis directly operated pay TV only through MDS and satellite. Indeed, the Chairman of the ACCC noted that there were significant switching costs which made it difficult for subscribers to substitute between pay TV platforms, and that these incompatibilities were partly responsible for the industry's problems:

Fels told the *Bulletin* 'The Commission acknowledges that the industry has got significant problems: very heavy losses, customers unable to easily switch between the different offerings of pay TV companies. There is massive churning, consumers don't get full coverage, only half of the Hollywood movies are available and sport is divided between them, so that Optus offers AFL, FOXTEL rugby league'.<sup>10</sup>

The EC Commission further decided that cable and satellite were not interchangeable from the programme supplier's point of view given the differences in the costs involved (*MSG Media Services*, para 42). If this demand-side 'evidence' were used and carried through to its logical conclusion, the proposed merger between FOXTEL (cable) and Australis (satellite and MDS) would not have been blocked because it brought together two companies in separate markets. (Despite Professor Fels's emphasis of switching costs, these are substantially lower in Australia because viewers do not purchase settop boxes.)

### **FCC's Effective Competition Standard**

The ACCC cited FCC decisions or findings that FTA television does not constrain pay TV, and that cable networks have market power. The claim that because US cable operators have market power Australian pay TV operators therefore also have market power does not follow, because the market conditions in the two countries differ substantially. In the US, cable operators have local monopoly franchises of cable delivery and are the sole suppliers of pay TV (and often FTA channels), passing over 90 per cent of all homes.<sup>11</sup> As cable has grown, the principal regulatory issue has been the power of monopoly cable operators to control programming and to raise the price of cable programming. There has been limited competition from other delivery systems such as Satellite Master Antenna TV (SMATV), Multichannel Microwave Distribution Systems (MMDS), and satellite DTH, which in aggregate serve less than 4 per cent of US television households. DTH satellite delivery, the new entrant, is now making inroads. However, to date, most households with satellite dishes have been in areas not served by cable. Overbuild is limited to only about 180 out of approximately 10 000 cable systems. This does not describe the Australian pay TV sector in either structure or maturity.

There is little doubt that if the Australian pay TV sector were transposed to the US the FCC would, on current regulatory criteria, find it effectively competitive. A pay TV operator with an audience share of less than 30 per cent or facing direct competition from other multichannel

video providers is deemed competitive. In Australia, at the time of the proposed 1997 merger, pay TV operators had shares below 10 per cent, and FOXTEL faced significant head-to-head competition from Optus in a substantial part of its service area. Also, in the early phase of the development of pay TV, the FCC did regard FTA channels as constraining pay TV. Finally, the FCC's standard of effective competition is not an antitrust market test but one devised by the US Congress with price regulation as the goal. The application of this test to a legal finding under the Australian *Trade Practices Act* is irrelevant.

### *Pricing*

The ACCC regards price as a key factor placing FTA television and pay TV in separate markets. Because pay TV has a price and FTA television does not, it is alleged that they do not compete. Specifically, it is claimed that pay TV operators react more to the actions of other pay TV operators, and that the ability of viewers to react to changes in the price of pay TV by switching to FTA does not provide a sufficient constraint on pay TV operators.

Defining and delineating markets on this basis of absolute price differences is simple-minded. FTA television and pay TV represent an extreme in terms of absolute price differences, and therefore somewhat of a challenge to conventional antitrust analysis. However, FTA television has a price—zero—and there is a price differential between it and pay TV which can be widened and narrowed. If FTA television offers more desirable programming at zero price, the effective price differential between it and pay TV will narrow and people will substitute away from pay TV to FTA television. This in turn will cause pay TV either to lower its price and/or to increase the quality of its programming so as to give viewers value for money. Levy and Pitsch (1985, pages 64–65) tackle this head on:

In order to derive a 'price' proxy for broadcast television, quality considerations must be introduced. When product prices are compared, it is necessary to specify the quality as well as the quantity of product available at a given price. For example, if two television receivers each cost \$400, and were identical except for the fact that one of them had a remote control and the other did not, it would not make economic sense to say that their prices were the same. By analogy, the quality-adjusted price of broadcast television services becomes lower as the number of stations available increases.

The way pay TV is priced further indicates that the differences between FTA television and pay TV have been exaggerated. Pay TV is sold as a bundle of channels for a fixed monthly subscription. The entry or basic tier consists of 15–28 channels. The basic subscription is as much a charge for these channels as it is an access fee. Once the basic tier has been purchased, there are no charges based on hours of viewing or channels watched. That is, watching the package is ‘free’ and can occur for as long a time as the viewer desires. Since the viewer will also have access to FTA channels, his or her viewing choice will be based on the same non-price factor—programme appeal. It is for this reason that the distinction based on price is misleading. The decision the viewer faces is whether the bundle of channels provides sufficient value for money in order to justify the fixed access charge. Once this has been paid, the consumption decision is based on non-price factors for both FTA television and pay TV. Thus, FTA television competes on two levels: in the setting of the initial quality benchmark, and hourly in attracting audience share which for both delivery methods is ‘unpriced’. Obviously this analysis would not apply for PPV formats, which price each programme. However, PPV has generally been used in Australia only for wrestling and boxing events and concerts, and is not yet a significant aspect of pricing.

A more systematic consideration of the nature of FTA television and pay TV paradoxically shows that FTA television actually has an implicit usage charge whereas pay TV (as opposed to PPV) does not. FTA television is not costless to viewers at the point of consumption. Viewers of commercial FTA television have to put up with advertisements, which many dislike, and would be prepared to pay to avoid. They diminish the value and detract from the enjoyment of a programme. This is a cost, not in money, but one factored into the viewers’ decisions. Professors Owen and Wildman (1992, page 126) note that FTA television has a ‘price’:

If viewers do not like commercials, then commercial time may be treated as a nonmonetary price that viewers pay to see programs supported by advertising. As with monetary prices, we can draw demand curves relating the size of a program’s audience to the price viewers pay in terms of the amount of advertising time inserted into the program.

The ‘price’ of FTA television can also be varied. If the number and crassness of advertisements increase in any hour, the disutility to FTA television viewers will increase.<sup>12</sup> This is particularly the case in Australia, where advertisements are both greater in number and are more

intrusive since, unlike in the UK, they do not occur in natural breaks in a programme. FTA television is therefore 'priced' and the actions of FTA broadcasters can influence this price by changing the volume, scheduling and quality of advertising.

The reliance of antitrust analysis on observed prices is unreliable. Consumers do not make purchase decisions solely on the basis of observed prices. They use the full cost of products or services which incorporate other elements, such as transport and transaction costs, and (most important) the quality of the product. In many economic transactions involving highly differentiated goods and services, the 'full' or 'quality adjusted price' which influences consumer decisions is not registered in the market. The quality-adjusted price is the observed price adjusted for perceived quality differences. For example, designer jeans sell at a higher price than usual brands of jeans because consumers perceive these to be of a higher quality. But this does not mean that there is no competitive constraint between designer jeans and other brands. Indeed, it is more likely that an increase in the relative price of designer jeans, whether due to an increase in the actual price or a reduction in perceived quality, will cause consumers to switch away from designer jeans to other standard brands. It is important to note that, for an effective competitive constraint between these two products to exist, it is not necessary for all consumers to switch, but only that sufficient numbers do so.

As indicated a number of times, crucial to assessing the competitive relationship between FTA television and pay TV is the degree of supply-side substitution between the two, especially in the early phases of development of pay TV. If FTA channels provide high-quality programming attractive to viewers, then the take-up and pricing of pay TV will, other things being equal, be lower. In more technical parlance, the residual demand curve facing pay TV operators alters as a result of the actions not only of other pay TV operators but also of FTA television channels. Their actions can reduce or increase demand, and twist the demand curve facing an individual pay operator.

The strength of supply-side responses depends on programme scheduling and regulatory factors. If FTA channels feel that pay TV operators are making sufficient inroads into their audiences, affecting advertising revenues, then they will induce counter-scheduling against pay TV programming. Moreover, they compete for high-rating material, such as sport and other mass appeal programming. By acquiring such premium programming and scheduling it against, say, a pay sport channel, FTA broadcasters can affect not only the price of a sports chan-



nel but the pay TV operator's total subscriber numbers and penetration rate.

The ACCC has accepted that there is a relationship and possible competitive constraint between FTA television and pay TV:

... suppliers of pay TV services must supply programming content of sufficient high quality to attract subscribers prepared to pay monthly subscription fees to view such programming.  
(ACCC, 1997, para. 44 (i))

The EC Commission in *MSG Media Services* similarly noted that pay TV would have greater difficulties in Germany because the FTA services there broadcast more imported US material and films than in other countries in Europe. In *Bertelsmann/Kirch/Premiere* the EC Commission spent considerable time examining the relationship between FTA television and pay TV, reaffirming its previous conclusion that they were in separate markets but acknowledging that the wide availability and quality of FTA television (on average 30 channels in Germany) would affect the demand for pay TV. Interestingly, the EC Commission expressed concern that Bertelsmann and Kirch, which had significant interests in FTA television, might co-ordinate to switch programming over to pay TV.

Within the strict confines of antitrust analysis, then, the enquiry must extend beyond price analyses.<sup>13</sup> Tests such as the price elevation test must take into account changes or prospective changes in product quality (that is, supply-side substitutability). This is especially so in the video entertainment markets, where quality differentiation is the essence of competition. In an extensive analysis of US cable rate regulation, Hazlett and Spitzer (1997) showed that when basic cable rates were regulated, viewer ratings fell substantially, indicating that quality had fallen in subscribers' eyes. When they were unregulated, price increases were driven by quality upgrades. This meant that quality changes are routinely made by pay TV operators to adjust the real price facing the subscriber. If one is regulated, the other is adjusted to the detriment of the viewer.

### *A Radical View of the ACCC's Merger Test*

The use of price competition as the sole basis for determining market definition in technologically dynamic industries such as pay TV can and has been questioned (FTC, 1997). The so-called 5 per cent test used by the ACCC (and indeed other competition regulators) results in an excessively narrow market definition, and in identification of market power where

none may genuinely exist. This is often a deliberate enforcement tactic that gives regulators latitude, and has often been the grounds for complaints that merger decisions are arbitrary and often not supported by adequate reasoning. Notwithstanding this, in the hi-tech, fast developing communications sector the focus on instantaneous price adjustments as the competitive weapon is misdirected. New products are 'experience goods' which must be used in order for consumers to evaluate properly their price-performance characteristics. It follows that the boundaries of the markets are unknown and certainly fuzzy. As consumers (viewers) are trialling a new product, a price increase of 5 per cent or even 25 per cent may not immediately induce substitution. Since these markets are also buffeted by a constant flow of new products with changing specifications and quality characteristics, the static (point-in-time) approach of the ACCC to market definition is rendered obsolete.

In the light of these concerns, some commentators have argued for a radical revision of market definition tests to give them greater practical relevance and to reflect commercial reality. Professors Jorde and Tece (1992, page 8) have advocated that the market definition tests used in merger analysis be recast solely in terms of non-price competition:

the pertinent question to ask is whether a change in the performance attributes of one commodity would induce substitution to or from another. If the answer is affirmative, then the differentiated products, even if based on alternative technologies, should be included in the relevant product market.

Such a test might ask whether consumers would shift to other products to defeat a 25 per cent lowering of quality in any key performance attribute or whether a new product exhibiting a 25 per cent improvement in a key performance attribute would draw sufficient customers from the old product. If so, the substitute products would be included in the relevant market. Advocates of attribute-based market definition also propose a longer time-period within which to evaluate consumer and supplier reaction. The ACCC's test for market definition and indeed for assessing the competitive constraints that operate on firms is unduly narrow. Often the market is defined in terms of price reactions which occur instantaneously or within a year, and the assessment of the merger takes a limited timeframe. Again, Professors Jorde and Tece (1992) propose four years, as compared with the one or two years used by the *US Merger Guidelines*.

## *The Number of Channels*

The ACCC also stated that a significant factor in distinguishing FTA television and pay TV markets was the number of channels. It argued that, because FTA television had fewer channels, it did not compete and, therefore, did not effectively constrain the ability of pay TV operators to raise prices above the competitive level.

The ACCC's argument was illustrated by the following example. Assume that the government decides to give away a limited number of pencils with the balance sold by a private-sector monopolist. Would the fact that a limited number of pencils are given away free constrain the monopolist's ability to charge above competitive prices for his private-sector pencils? The ACCC answer was 'no' and that therefore, in antitrust terms, there were two separate markets: one for free pencils, and one for paid-for pencils.

This example is misleading and erroneous for several reasons.

First, it wrongly characterizes the nature of television as an economic product. Once a limited number of pencils are given away, they are unavailable to other potential consumers unless a secondary market develops. The same is not true of FTA television. As discussed in Chapter 4, FTA television is a public good. Once a FTA television channel is broadcast it is available to all. Those who want to watch it can do so without any supply constraint. Unlike the pencil example, where there is a separate market for pay pencils, there is no separate market for pay TV. Rather, there is only one television market with differentiated products at varying prices. People commit themselves to additional pay TV charges because they want greater variety in programming. Pay TV substitutes for FTA television because people replace their FTA viewing (or other activities) with watching pay TV.

The pencil example also exaggerates the difference between pay TV and FTA television in terms of their respective capacity to satisfy the viewers' demand for video programming.<sup>14</sup> This is best illustrated by data from the UK, since ratings for pay TV channels are not yet available in Australia. In the UK, over a decade of experience with pay TV led in 1997 to five FTA television channels supplying 35 000 hours of programming, with an 88 per cent viewing share and (apart from the new Channel 5) a 100 per cent reach, compared with over 60 pay TV channels broadcasting nearly 300 000 hours to 25 per cent of TV homes attracting less than 12 per cent of total viewing. These statistics show that despite the existence of only five FTA television channels, the take-up and audience of pay TV was relatively small. They show that

approximately 75 per cent of TV homes in the UK do not regard pay TV as sufficiently attractive to satisfy their demand for video programming, and also that the 'punching power' of FTA television far exceeds the number of channels. On the last point, note that 60 pay TV channels attract only 12 per cent of the viewing—substantially less than the average FTA channel, and only slightly larger than Channel 4 which, under the *Broadcasting Act 1990*, is constrained to be a minority channel. Put another way, one minority FTA channel satisfies far more demand for video programming than the entire UK pay TV sector with its 60 channels and massive volume of programming.

FTA television is not the minnow among the sharks of pay channels, as the ACCC argued. The audience size and impact of FTA television is large compared with pay TV, and is therefore a major force in satisfying the demand for video programming. Simply put, viewers do not demand channels—they demand and watch programmes. As a working assumption, the unit of analysis should be viewer hours or audience share.

There are other reasons to be suspicious of the ACCC's focus on the number of channels. As already noted in Chapter 3, the competitive interaction between FTA television and pay TV audiences is conditioned by several features peculiar to television, namely:

1. viewers can watch only one programme at a time;
2. an expansion in the number of and variety of programmes/channels does not increase aggregate television viewing, but serves to fragment existing audiences;<sup>15</sup> and
3. the competitive impact between channels varies around the clock, e.g., peak and off-peak.

So viewers have a limited amount of time to watch programmes, and can watch only one programme at any one time. These physical constraints make television different from other markets. The audience for a specific channel at any one time depends on the type of programming available at that time from all channels. The fact that the viewer has a choice of two or 60 programmes in a given hour still does not enable him or her to watch more than one programme.<sup>16</sup> FTA television can compete effectively at a point in time because it addresses the same audience. Moreover, competition which takes place in peak hours has more impact overall because that is where pay TV and FTA channels seek to maximize their audiences and generate most of their revenues. These factors mean that competition takes place hour by hour, is more pronounced during peak viewing hours,<sup>17</sup> and one channel's gain in audience (and hence revenue) is another's loss.

The attempt to analyse the market in terms of number of channels is highly suspect for another reason. In a newly developing pay TV industry, the battleground between different video delivery formats tends to be confined to a few specific and identifiable categories of programming—the ‘drivers’ or ‘killer applications’ (movies and sport). Both FTA and pay TV compete intensely for the high-rating programming critical to financial success. In Australia, among the highest rated programmes on FTA channels are football programmes (Rugby League and AFL) and movies (ABA, 1996). These are the programmes which are considered the main reason why subscribers take pay TV. In the UK, sport is the single most important type of programming responsible for increasing pay TV take-up and its financial success. It has greatly assisted in transforming BSkyB from a company losing £2 million a day to a highly profitable venture and one of the UK’s largest listed companies.

### *The Empirical Evidence*

As noted, the ACCC’s case rested essentially on legal decisions drawn from other jurisdictions. There is little hard statistical evidence directly on the way FTA television constrains the pricing decisions of pay TV operators, apart from several US studies.

#### **US Studies**

In proceedings prior to the enactment of the US *Cable Act* 1992, attention focused on whether broadcast television was a source of competition to cable TV. This was part of the review of the previous effective competition standard administered by the FCC, which required four FTA channels for a cable pay TV franchise to be regarded as competitive. Two studies undertaken in 1990 provide interesting evidence of the competitive relationship between broadcast and pay TV in the US. Dertouzos and Wildman (1990) and Crandall (1990) found that cable networks in the US facing competition from five or more FTA channels had fewer subscribers, carried more channels in the basic tier, and had a lower price per basic channel than cable networks facing fewer channels.<sup>18</sup> A more recent study by Crandall and Furchtgott-Roth (1996, pages 96–97) using panel data for 1992 confirmed this finding but with one modification:

Our model revealed that the demand for cable services is sensitive to the number of broadcast channels available to households without cable service.... As the number of competing channels increases, demand for each type of cable service de-

creases. We found that the competitive effect of broadcast signals continues for all number of signals.

No doubt these studies have problems and can be criticized. Nonetheless, where the issue has been examined empirically, evidence has been found that pay TV and FTA television compete, and that the effect is significant.<sup>19</sup>

### **Australian Evidence**

The ACCC claimed that the way Australis's prices altered in 1995 when faced with competition from FOXTEL and Optus Vision was evidence that pay TV was a self-contained market. The evidence does not support this interpretation.

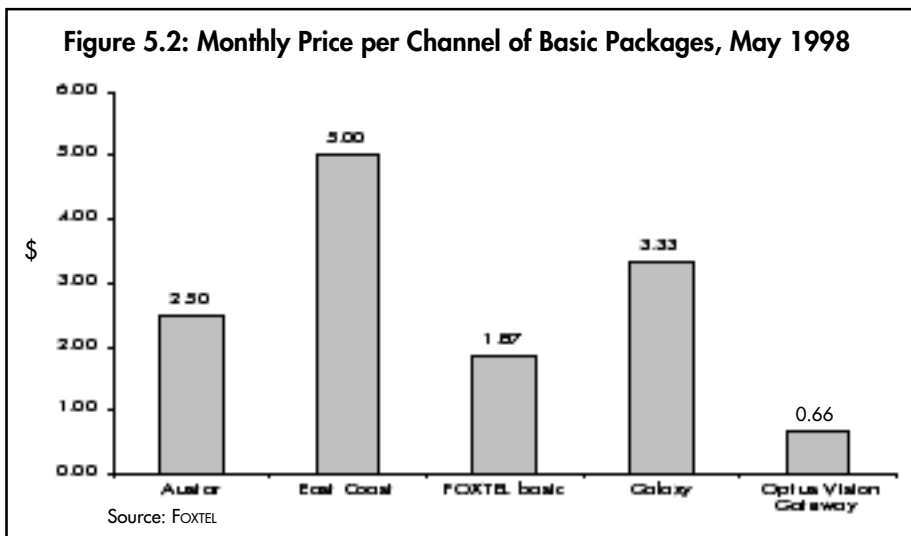
When Australis launched Galaxy in 1995 it charged a monthly subscription of \$49.95 and an installation charge of \$299. In June, with FOXTEL and Optus Vision launches several months off, Australis reduced its installation charge to \$99.00. When Optus Vision launched in September, it undercut Australis's installation (\$29.95) and monthly subscription, as did FOXTEL, which offered Galaxy core programming as part of its package (installation charge of \$19.95) when it launched in October 1995. Australis matched FOXTEL's charges in November. Thus, within a six-month period Australis, in the face of increased competition, reduced its installation charge by 93 per cent and its monthly subscription by 20 per cent.

While this is evidence that pay TV operators react to one another's prices, it does not support the claim that pay TV operators can unilaterally set prices without competitive constraint. First, the scale of the reduction suggests that Australis got its initial pricing grotesquely wrong. Indeed, its take-up was 81 per cent below its forecast figure for October 1995. When prices were lowered in November, take-up accelerated significantly. Second, within three months Australis had increased its installation charge, and monthly subscriptions were significantly higher than those of FOXTEL or Optus Vision on a like-for-like basis. Australis's installation charge at May 1997 was \$49.95 for both MDS and DTH, Austar \$49.95 for MDS and \$199 for satellite DTH, and East Coast \$199 for MDS. Cable installation charges were considerably lower at \$29.95 for both FOXTEL and Optus Vision. Thus, around the time of the proposed merger between Australis and FOXTEL in 1997, Australis's installation charges were 67 per cent higher than either FOXTEL or Optus Vision.

A similar picture emerges from an analysis of subscription charges. At the time of the proposed 1997 merger, the price of the basic package

varied within the range \$29.95–\$49.95. However, the number of channels offered varied considerably. FOXTEL offered 28 channels, including Galaxy core programming, in its basic package for \$42.95 per month, compared with Australis’s 15 channels at \$49.95. Such a wide disparity in price structure between the different pay TV operators would not be easy to explain if they were operating in the same market. The implicit price per channel in each operator’s basic (entry-level) package can be used as a proxy for the quality-adjusted price. On this basis, the cheapest package was Optus’s Gateway, which cost subscribers 66 cents per channel, compared with \$1.87 for FOXTEL and \$3.33 for Galaxy. If, on the other hand, Optus Vision’s Super Deluxe package is used, which at 27 channels had one fewer than FOXTEL’s basic tier, the price of each cable-delivered channel was almost identical at \$1.88. Thus Galaxy was priced at least 80 per cent higher than FOXTEL’s basic tier and more than 400 per cent higher than Optus Vision’s Gateway.

These data appear to tell a different story from that presented by the ACCC. First, while Australis did react to competition from FOXTEL and Optus Vision, this was short-lived, and in the end Australis’s position was rendered commercially unviable. Second, the larger differences between the pay TV operators in terms of price and the quantity and quality of programming appear to indicate that at the time they operated in regional markets. Australis’s high price/fewer channels service was not competitive with the larger and cheaper packages offered by the cable operators, and explains its strategy to withdraw from cabled areas. Finally, the price differentials provide some evidence that FTA channels may have an influence on pay TV charges. The regional operators Austar



and ECTV were able to levy considerably higher charges than Optus and FOXTEL. These operators faced less competition from FTA channels. As the managing director of Austar commented at the time of the proposed merger:

‘We do well in markets where there are less than three commercial TV channels’, says Austar managing director, John Porter... ‘That is a demonstration of the fact we are competing with the free-to-air channels, we are in the same market for entertainment. We’re competing against free-to-air, against video’. (quoted in Brewster, 1997)

### *Concluding Observations*

The ACCC failed to make any rigorous case that the market did not include other forms of video entertainment. It prevaricated as to the relevant market, holding first that FTA television and pay TV were in the same market and then that they were not. This was so even within the narrow confines of merger analysis under Australian trade practices law. Furthermore, its analysis of market definition was entirely hypothetical, based as it was on legal judgments and regulatory decisions from other countries. The hard evidence relied on by the ACCC was weak, and insufficient to indicate that FOXTEL even reacted over the period under consideration to Australis’s pricing. It was increasingly apparent that Australis was an ‘ineffective competitor’ progressively retreating to a separate geographic market where cable was not present due to its inability to compete with the greater programme offering of cable operators. Further, in terms of defining the relevant market for trade practices purposes, the ACCC seized on only one area of competition—price competition—ignoring the fact that in the initial phase of product introduction non-price factors are of critical importance and play a greater role in the competitive interaction between communications companies.

### *Endnotes*

- 1 The impact of television extends beyond video programming. As live television coverage of sport increases, television competes directly with attendance at the match. Recent empirical studies in the UK indicate that this effect can be significant, with live television coverage, whether on pay TV or FTA television, of UK league football depressing attendances by 5–10 per cent (Case Associates, 1997a, and Baimbridge, Cameron & Dawson,



1995). Of course, the critical question is whether gate prices affect pay TV prices for televised matches. Clearly, as the sector moves to PPV there will be a direct relationship between gate prices and PPV prices.

- 2 These mirror the influential US Department of Justice/Federal Trade Commission, *Horizontal Merger Guidelines 1997*. Also see EC Commission (1998).
- 3 ACCC (1996a, paras 5.46 and 5.47). This is sometimes called the 'hypothetical monopolist test'. Ideally market definition should be examined by statistical analysis to find whether the quantity demanded of a product is price elastic in the sense that an increase in price leads to more than a proportionate fall in the quantity demanded, thus lowering the supplier's profits. This finding would establish that consumers had choice of substitutable products to which they could turn to defeat any unilateral attempt to increase price.
- 4 *Re Media Council of Australia* (1996) ATPR 41–497.
- 5 Burchett J, *News Ltd v Australian Rugby League Ltd* (1996) ATPR 41–466.
- 6 In October 1998 with the proposed acquisition of 25 per cent share of FOXTEL by PBL (the controlling owner of FTA Channel 9) the ACCC was actively reconsidering its position:

Acting ACCC Chairman Mr Allan Asher confirmed yesterday that the Commission was particularly interested in whether there were any 'identifiable market overlaps that may raise issues under section 50 of the Trade Practices Act or section 45'. 'We have been getting some more information from them,' he said. 'We are waiting to understand the way that the commercial transactions operate in this sector.' Section 50 of the Act outlaws mergers which 'substantially lessen competition' while section 45 prohibits agreements between businesses that have 'the purpose or effect of substantially lessening competition in a particular market'. The ACCC last year opposed the merger of FOXTEL and Australis Media on the basis that the merger would substantially lessen competition and, at that time, eschewed FOXTEL's argument that the pay-TV sector was part of the wider television market. 'The point there was in the past we had seen them as separate markets,' Mr Asher said. However, he pointed out that 'the notion of convergence' in technology had raised the need for the ACCC to take a fresh look at the television market. 'Digital is highly relevant,' he said. (Burke, 1998)

The ACCC cleared the acquisition in December 1998, reaffirming its view that pay and FTA television were in separate markets.

- 7 *MSG Media Services Case IV/M.469*. This was an alliance between Bertelsmann, Taurus (owned by the Kirch Gruppe) and Deutsche Telekom

(called *MSG Media Service Gesellschaft für Abwicklung von Pay-TV und verbundenen Diensreo*) to develop 'technical and administrative services' (conditional access, subscriber management, decoder boxes) for a new digital pay TV service for Germany. See also *Nordic Satellite Distribution Case IV/M.490 1996* which follows this line of reasoning.

- 8 The UK Office of Fair Trading (OFT, 1996) mirrored the EC Commission's finding that pay TV is a separate market, and that premium channels may constitute a distinct market. The OFT found that BSkyB had a dominant position in the supply of the key movies and premium sport channels. The OFT regarded the degree of substitution between pay TV and FTA television channels as insufficient to constrain the *wholesale* price of BSkyB's premium channels. It concluded that there was evidence that BSkyB had exercised its market power, based largely on the finding that BSkyB had earned 'excess profits' consistent with the OFT's observation that there were barriers to entry caused by limited analog satellite transponder capacity. Note that the OFT was effectively attributing its finding of market power to barriers to entry in the satellite transponder market, and suggested that the practices of the satellite operator (SES of Luxembourg) be investigated by the European Commission. See also the uncompromising views of the UK Office of Telecommunications concerning the impact of BSkyB channel pricing and bundling practice on UK cable networks, and its submission to the broadcast regulator that the participation of BSkyB as a shareholder in the successful bidding consortium for the new digital terrestrial licences be blocked (OfTel, 1996 & 1997). Under pressure from OfTel and Brussels, the Independent Television Commission forced BSkyB to withdraw from the consortium and to modify its programme supply arrangements. See also MMC (1999).
- 9 *Bertelsmann/Kirch/Premiere Case No. IV/M.993 (1998)* and *Deutsche Telekom/Betaresearch Case No. IV/M.1027 (1998)*. Also see discussion in Veljanovski (1999b) and McCallum (1999).
- 10 *The Bulletin* (1997, page 23).
- 11 For recent analysis of US pay TV and its regulation see Johnson (1994), Crandall & Furchtgott-Roth (1996) and Hazlett & Spitzer (1997).
- 12 AGB McNair conducted face-to-face interviews with 1000 respondents in October 1992 on the subject of FTA television and pay TV. The strongest response on FTA television was from the statement 'There is too much advertising on existing commercial television', with strong agreement from 67 per cent of respondents. When asked if they would be happy to pay to view without advertising, a total of 36 per cent of respondents were in either mild or strong agreement.

- 13 This is recognized in the ACCC's *Merger Guidelines*:

5.50 The price elevation test does not require that all products included in the market should have the same price. Within a market, there can be product differentiation. The relevant question is the degree of constraint imposed on the price and output decisions of the merged firm. As Wilcox J. stated in *Australian Meat Holdings*:

the existence of price differentials between different products, reflecting differences in quality or other characteristics of the products, does not by itself place the products in different markets. The test of whether or not there are different markets is based on what happens (or would happen) on either the demand or the supply side in response to a change in relative price. [AMH (1988) ATPR 40-876, at 49,480.]

- 14 FTA television will always create excess demand for identical programming because programmes are free. This follows from the economist's principle of a negatively sloped demand curve. The cheaper something is, the more people want it. Thus, it is not surprising that people should be dissatisfied with the FTA television service and possibly be attracted to pay TV when it becomes available. But on this point it should be noted that (a) only a small fraction of viewers subscribe to pay TV when it is made available, and (b) the level of churn (annual gross disconnection) is often very high for new cable operators. In the UK, churn figures of 40 per cent are common and sometimes exceed 60 per cent. So while there may be unsatisfied demand in a FTA television system, there is a high degree of dissatisfied demand when people pay.
- 15 The evidence shows that this is also the case for Australia, although viewing increases. It is also the case that viewing in general has remained stable with regional variations, with some cities in Australia experiencing decline and others a modest increase; see ABA (1996) and BTCE (1991).
- 16 Ignoring time shifting using VCRs and 'channel surfing'.
- 17 There will also be competition between television programmes at different times. But this can be expected to be more limited given the viewers' other commitments and limited flexibility.
- 18 A study by the US Federal Trade Commission (1992) looked at the competitive relationship in the other direction—the impact of cable on broadcast TV audiences. The study found that for each percentage point increase in the number of homes passed by cable, there was a decrease of one half of a percentage point in audience share to local broadcast stations.
- 19 US studies of the price sensitivity of basic pay TV (defined as the retransmission of FTA channels) range widely from 0.8 to 3.75, i.e., anything from

no sensitivity to highly elastic demand implying considerable substitution. The upper range of the estimates suggests pay TV competes with other products, although these studies usually do not identify which products. It is also the case that premium channels are treated in the US as part of a wider market competing with video sales, rentals and, to some extent, cinema. Studies from the US show that duopolistic competition between cable systems leads to basic cable rates 20 per cent lower than monopoly markets (Hazlett & Spitzer, 1997, pages 27–33). The ACCC also noted that pay TV operators face competition from other industries (e.g., cinema, video and FTA) in movies since movie studios sell rights on a staggered or windowed basis.

# Chapter Six

## The FOXTEL / Australis Merger

In this chapter I examine in detail the ACCC's 1997 decision to block the proposed merger between FOXTEL and Australis. The discussion examines each argument in detail using market information and data at the end of 1997.

As stated above, the ACCC blocked the first merger between FOXTEL and Australis in February 1996 on grounds that there were barriers to entry in parts of the pay TV sector:

The fact that Optus Vision could not deliver via satellite until July 1997 meant that a merged Australis/FOXTEL would have a considerable head-start and 'first mover' advantage, such that it would substantially lessen competition in the pay TV market (among other markets). (Fels, 1996, page 8)

This government-created barrier to entry was lifted on 1 July 1997. With the removal of this barrier Australis and FOXTEL anticipated no objection from the ACCC to their renewed attempt to merge in late 1997. However, the ACCC again opposed the proposed Australis/ FOXTEL merger in October 1997, on two grounds. First, it would substantially lessen competition in pay TV, even though there was now free entry into satellite delivery. Second, and more controversially, it would also substantially lessen competition in local telephony if Optus's pay TV activities declined. Indeed, the telecommunications issue quickly became central in the debate and prospective arguments of the ACCC. Many regarded telecommunications as the real reason why the merger was blocked, even though Australis was not in the telecommunications business and, ironically, used C&W Optus's satellite to distribute its programming.

Telecommunications took on importance for two reasons. The first was that Australia's two main telecommunications operators were shareholders in the two cable pay TV services—Telstra owned 50 per cent of FOXTEL and Optus owned 100 per cent of Optus Vision at the end of 1997. Second, the ACCC attached, and continues to attach, considerable importance to promoting facilities-based competition in telecommunications markets. It took the position that the merger would put at

risk facilities-based competition in the telecommunications sector by weakening Optus's ability to continue investing in its broadband network, which would provide direct competition to Telstra's former monopoly of the telephone wire into each Australian's home.

### *The Legal Framework*

Mergers are regulated in Australia under the *Trade Practices Act 1974* (as amended). The object of the Act is 'to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection' (s 2). Section 50 of the Act prohibits acquisitions that would have the effect of substantially lessening competition in any substantial market for goods or services in Australia.

In addressing this provision, it is now standard trade-practice analysis to proceed in a series of steps. This begins by defining a 'relevant' product and geographic market in the terms discussed in Chapter 5, and then calculating each firm's shares in the market as an initial indicator of market power. When this factual inquiry has been completed, a detailed analysis of the merger is required to determine whether the merged entity has improved its ability to raise prices unilaterally (that is, free from effective competitive constraints) or otherwise to profitably influence the *prevailing* terms of trade. A merger inquiry requires the ACCC to focus on a specific question: in this case, would the merger of FOXTEL and Australis have enhanced market power to an extent that a substantial lessening of competition would be likely?

There is a presumption that a merger in a market with a small number of firms is more likely to lead to the merged firm being able to impose a profitable price rise, or decrease output/quality, than one where there are a large number of firms. It will, however, not have this effect if (a) the merging firms do not effectively compete with one another or, if they do, (b) competition in the market in which they operate remains effective after the merger.

There are two reasons to doubt that the proposed merger would have reduced competitive pressures in pay TV depending on whether FOXTEL was present or not in Australis's broadcast areas:

1. where only Australis was present, then pay TV services were already priced at their profit-maximizing level. Hence, post-merger, these prices would not have increased; and
2. where Australis faced competition from Optus and FOXTEL, continued competition between the two pay TV services was likely to hold prices at their current levels.

If these conclusions are accepted, then it is unlikely that any difficulties created for Optus as a result of the proposed merger would have been the result of anti-competitive abuse. Indeed, even if this was not the case, the alleged link between pay TV and the success or otherwise of Optus's local telephony is weak, as will be shown below.

### *The Impact of the Merger on the Pay TV Sector*

To examine the ACCC's principal arguments, it will be assumed, purely for the purposes of illustration, that pay TV is the relevant product market. Obviously, if under this assumption the ACCC's case is weak, then it will be considerably weaker in a broader market which includes FTA television and potentially other forms of video entertainment.

#### **From Three to Two**

The proposed merger would have reduced the number of pay TV operators from three to two in some areas. The ACCC appeared to regard this as sufficient to establish that the proposed 1997 merger would have substantially lessened competition. The ACCC contended that the merger would result in an entity with about 73 per cent of all subscribers, nearly three times that of Optus, and would have enabled FOXTEL to launch a national satellite service. Table 6.1 shows subscriber shares before and after the proposed merger using September 1997 figures.

**Table 6.1: Subscriber Shares of Pay TV Operators, September 1997**

Operator	Subscribers	Subscriber shares	
		Pre-merger	Post-merger
Optus Vision	180 000	25%	25%
FOXTEL	250 000	34%	} 49%
Australis	110 000	15%	
Austar	176 000	24%	24%
ECTV	12 000	2%	2%
<b>Total</b>	<b>728 000</b>		

Source: Acocia Press Pty Limited

The ACCC's calculations exaggerated the impact of the merger. A merged FOXTEL–Australis would not have had 73 per cent 'market' share since this included Australis franchisees who were free to carry Optus programming if they could have negotiated a mutually satisfactory ar-

rangement.<sup>1</sup> In fact, ECTV and Austar did agree in 1998 to carry Optus programming. Excluding the Australis franchisees, the merged entity would have had 360 000 subscribers—or 49 per cent of all subscribers.

It is also necessary to distinguish clearly the geographic market in which the different pay TV operators carried on business. The Australis franchisees did not compete in the same geographic market as Optus Vision or FOXTEL.

### **Australis Was Not an Effective Competitor**

In assessing a proposed merger, the ACCC is required under Section 50(3)(h) of the *TPA* to consider ‘the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor’. Clearly this was not the case given the financial state of Australis and the fact that it was losing subscribers and subscriber share.

Australis was an ineffective competitor, for a number of reasons. First, it offered viewers less value for money, higher installation charges, and fewer channels than either Optus or FOXTEL. In the face of the poor take-up of its pay TV offering, Australis withdrew from head-on competition with FOXTEL and Optus Vision in cabled areas. Its total number of subscribers was declining, and it was progressively becoming insolvent and was forced to sell assets to stay afloat.

The second reason has to do with a previous decision of the ACCC affecting FOXTEL and Australis. The programme arrangements between FOXTEL and Australis, which were approved by the ACCC, made the competitive impact of the merger *de minimis*. It meant that FOXTEL already carried Australis’s core movies and sports programming, and so the impact of the merger in altering the strength of competition to Optus through enhanced programming was minor. Also, and critically, as the ACCC itself concluded when it approved the TNC Heads Agreement, without access to core movies and sports programming, FOXTEL would not have been commercially viable. The Chairman of the ACCC had stated ‘to be a commercially viable pay TV service, FOXTEL wanted the movies of the Hollywood studios (Columbia, Universal and Paramount) that Australis had exclusively tied-up’ (Fels, 1996, page 6). The proposed merger would then not have altered FOXTEL’s position in terms of programming. The effect of the merger would have been to increase the number of channels on FOXTEL by only two.

Thus the ACCC was left with a situation of which it was the principal party supporting two-firm rather than three-firm competition. Either there was competition between Australis and Optus without the TNC Heads Agreement because FOXTEL would not have entered, or, with



the agreement, there was competition between only FOXTEL and Optus, because the consequence was that Australis was not able to compete effectively with cable-delivered pay TV and was commercially unviable. Either way, the market could sustain only two operators.<sup>2</sup> If three-firm competition was not viable, then the merger of a failing operator with one of the surviving operators would not have been likely to substantially lessen competition. That is, one could not sustain the argument key to the ACCC's submission that 'but for' the merger there would be three, not two, pay TV operators.

### **Merger Would Not Reduce Competition in Cabled or Non-cabled Areas**

The conclusion that the proposed 1997 merger did not substantially lessen competition is supported by a more detailed appraisal of its impact by reference to individual geographic markets. Depending on where they lived, Australians in late 1997 had a choice between one of three pay TV packages delivered in one of three ways:

1. *Australis and its franchisees* delivered programming by satellite or MDS;
2. *FOXTEL* distributed by Telstra's broadband cable which included core Australis programming; and
3. *Optus Vision* distributed by Optus's broadband cable also offering telephony.

To assess the impact of the proposed merger, the incremental impact on market power needs to be examined separately in those areas where Telstra's broadband network had been built, and those areas where it had not been and where the FOXTEL TV package was not available.

### **Impact of the Proposed Merger Where FOXTEL's Pay TV Package Was Not Offered**

In those areas where FOXTEL was not available, the proposed merger would not have lessened competition since it did not reduce the number of pay TV operators. Optus would have faced the same level of competition post-merger as pre-merger. Nor would the proposed merger have adversely affected the prospects of Optus in the DTH satellite business. Optus owned the satellite and had reserved transponder capacity for its own use. The proposed merger would not have affected the type of programming offered by Australis or its franchisees. Under the terms of the TNC Heads Agreement, FOXTEL assigned to Australis the exclusive MDS and DTH distribution rights for all FOXTEL programming, to

which FOXTEL had obtained MDS and DTH rights. For these reasons, the proposed merger could not have lessened competition in those areas where Australis and FOXTEL did not overlap.

### **Impact of the Proposed Merger in Areas Where FOXTEL Was Offered**

In those areas where Telstra's broadband network had been built, the FOXTEL programming package was in direct competition with the programming packages offered by one or both of:

- Programming via DTH or MDS, marketed by Australis and to a lesser extent one of its franchisees; and
- Optus Vision on broadband cable.

While the proposed merger would have reduced the number of competing programme packages, this is unlikely to have had a material impact on competition. It was generally recognized that Australis was unable to compete against cable operators with a bigger package, whether FOXTEL or Optus Vision. Australis lost subscribers in cabled areas. As a result, Australis refocused its marketing in non-cabled areas.

### **Competition in the Programme Rights Market**

It was also suggested by the ACCC that the merger would eliminate one bidder for programming, thus reducing competitive pressures in the programme rights market. It is not, however, clear what follows from this theoretical observation, given that most informed commentators agree that the prices paid for Hollywood movies as a result of earlier competitive pressures were excessive, and placed a crippling financial burden on the industry. As the demise of Australis showed, when the programme contracts come up for renegotiation, programme rights fees decline significantly to more 'realistic' levels. Optus has also signalled a renegotiation of its studio agreements.

The disappearance of one bidder from a more stable pay TV market does not imply that that market will be less competitive. The driving force for the ferocity of bidding was the entrants' strategy to knock out other competitors by securing exclusive rights to the 'killer applications'. When the parties realized that this strategy had created an unsustainable cost structure, a more realistic competitive relationship began to develop between the parties. Without this consideration, the demand for programming, or rather its terms, would not have altered significantly because of the merger. This is because FOXTEL already took Australis's programming. If Australis was viable, then by virtue of its 25-year deal with FOXTEL it would enter the programme rights market

bidding, on the basis of the revenue potential of its own subscribers, those of Australis's franchisees and FOXTEL. Post-merger, the new entity would have been bidding on exactly the same basis. Since Australis proved not to be a viable competitor, the merger on a forward-looking basis would not have substantially lessened competition.

The ACCC argued that FOXTEL/Australis would, because of the increase in its installed subscriber base, be able to bid programming away from Optus Vision. This would result in the virtuous circle discussed in Chapter 4, with the result that Optus Vision would have been thrown into a vicious cycle of low subscriber numbers, reduced finances and poor programming. When Optus was sufficiently weak, FOXTEL/Australis would move to raise pay TV charges.

The ACCC's assessment of the impact of size was exaggerated, for a number of other reasons. First, the addition of 110 000 Australis subscribers using satellite and MDS (the latter regarded as an obsolete delivery method) was not likely to cause a dynamic implosion of Optus Vision of the type put forward. As noted in Chapter 4, network effects are not strong in pay TV. Second, different programme packages may imply that consumer demand is willing to support more than one package. Third, the willingness and ability of pay TV operators to acquire programming do not depend on the number or their share of existing subscribers but *expected future subscribers* and *expected future profitability* ('expected' in the forecasting or probabilistic sense). All pay TV operators have their eye on increasing penetration rates from their present levels (about 15 per cent of all Australian homes) to somewhere between the 'worst case' projection of 30 per cent and the 'best case' of 70 per cent (the penetration rate in the US). That is, they are playing for anything up to three to six times the number of subscribers currently watching pay TV. It is therefore not realistic or credible to claim that a pay TV operator with, say, 5 per cent take-up who could boost potential subscriptions by as much as twelvefold would not bid a sum much higher than the current number of subscribers justifies. The willingness to pay for exclusive programming by pay TV operators is based on future, not present, subscriber numbers. That is why pay TV operators pay large amounts for the exclusive TV rights to live sports. This in turn means that they would be willing to invest in programming and infrastructure expansion well beyond that justified by current profitability in order to build the business and attract subscribers to the service. In all developing pay TV industries, it is investment in programming which has priority, not profits from a small but growing base of subscribers.

In short, this analysis was simply not credible given the modest gain in subscribers involved and Optus Vision's strong line-up of exclusive programming. The ACCC needed to go beyond establishing that Optus would have been harmed in arguing that FOXTEL would have gained increased market power sufficient to substantially lessen competition. These are not the same, since firms in competitive markets overtly seek to harm their competitors by offering better and cheaper products.

### **The Merger Will Not 'Give Less and Charge More'**

Pay TV prices can be increased by firms with market power only if, to quote the Australian courts, they 'give less and charge more'.<sup>3</sup> Evidence of an abuse or exercise of market power requires that any profitable price be shown to be accompanied by *output-reducing actions* by the merged entity.<sup>4</sup> The ACCC must show how the merged FOXTEL/Australis would have reduced the number of channels or the quality of its programming. Given that the ACCC argued the opposite—that as a direct result of the merger, FOXTEL/Australis would outbid Optus Vision and give FOXTEL/Australis's viewers better programming—any price increase would have been accompanied by an increase in 'output' in terms of better and/or more channels. That is, the merger would harm a competitor by giving a better deal to the FOXTEL/Australis viewer! Even if the ACCC did establish that the merger would have raised pay TV prices, this need not have been in itself evidence of enhanced market power, but merely evidence that the merged entity was offering its subscribers more for their money. Thus, the ACCC's position appeared to boil down to the vague claim that the merged entity would have been able to corner the market in exclusive programme rights, undisturbed by the prospect of future competition law investigation.

## *Telecommunications Competition*

The second plank of the ACCC's claim was that the merger would substantially lessen competition in the market for the supply of facilities-based local telephony services and broadband services.

### **Pay TV Pull-through**

The ACCC case rested on the claim that there was a 'close link' between the take-up of pay TV and the take-up of local telephony services: specifically, that pay TV subscribers attracted or 'pulled through' telephone customers, so that a reduction or low growth of pay TV for Optus would detrimentally affect its prospects and ability to compete with Telstra in

the provision of local telephony. In support of this claim, the ACCC relied on evidence from the UK which purported to show that 50 per cent of cable pay TV subscribers take local telephony from the same supplier, and that these subscribers are less likely to 'churn'. In short, the ACCC (1997) claimed that as a result of the proposed merger, Optus would not be able to provide an effective competing pay TV service, and hence was unlikely to be an effective competitor in providing a local telephony service.

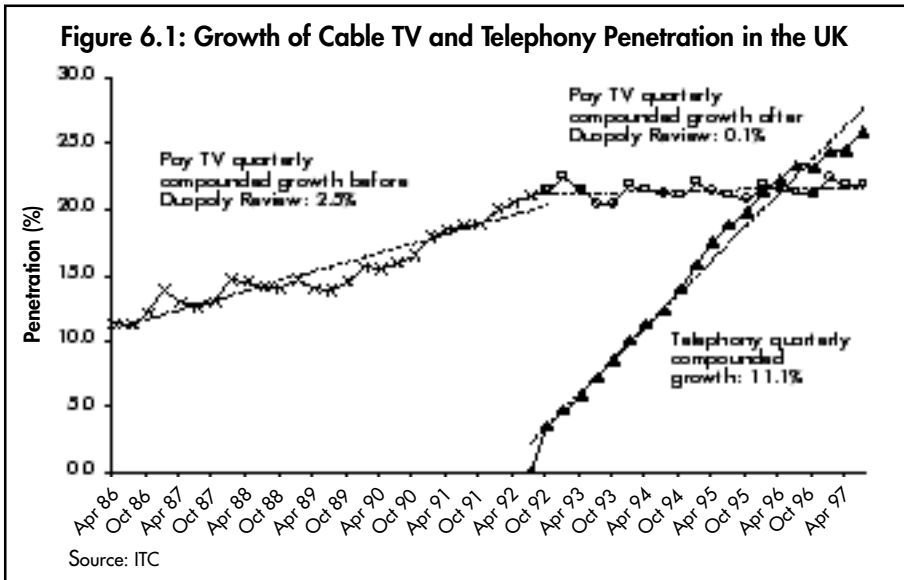
However, the various descriptions of the UK cable sector offered by or on behalf of the ACCC were inaccurate. The evidence shows that, to the contrary, telephony pulls through pay TV.

The UK pay TV sector differs considerably from that in Australia. It consists of DTH satellite pay TV, supplied by BSkyB, and regional cable operators. BSkyB has most subscribers (although cable is catching up), and supplies most of the premium channels to cable networks. For over a decade the UK's cable pay TV sector has been in a parlous state, with penetration languishing at 22 per cent of homes passed. This has led to consolidation of the industry and pushed share prices for those operators listed on the London Stock Exchange well below their issue price. In short, as a pay TV business, UK cable has failed. At the time the ACCC was blocking the merger in Australia, CWC and other cable operators in the UK were publicly discussing pulling out of pay TV or handing over the sales and marketing to BSkyB, Mirror Newspaper Group and/or Flextech. Such discussions do not support the ACCC's belief that pay TV is critical because it 'pulls through' telephony.

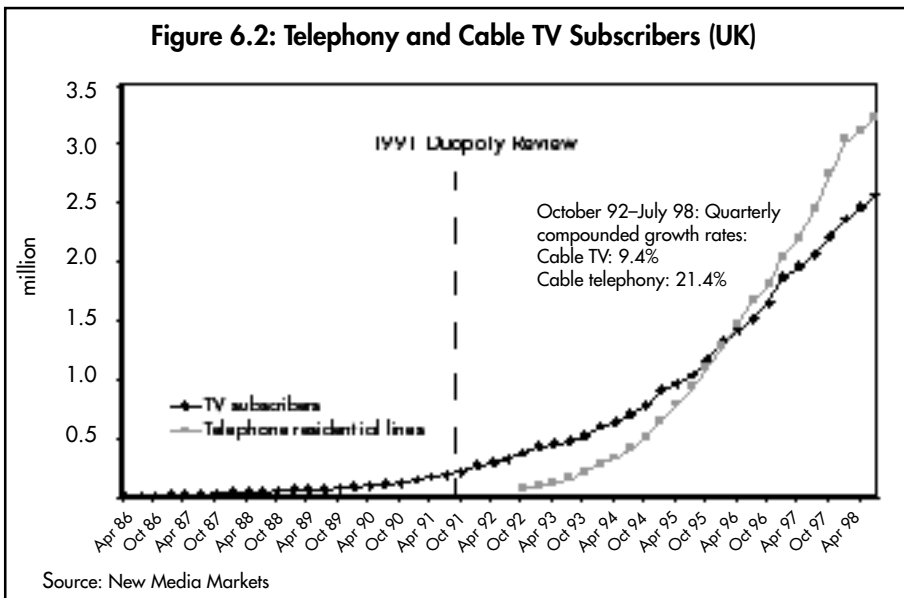
It is, therefore, an extraordinary and counterfactual claim to infer from the evidence that the weak performance of pay TV explains the strong performance of the emerging telephony business of UK cable operators.

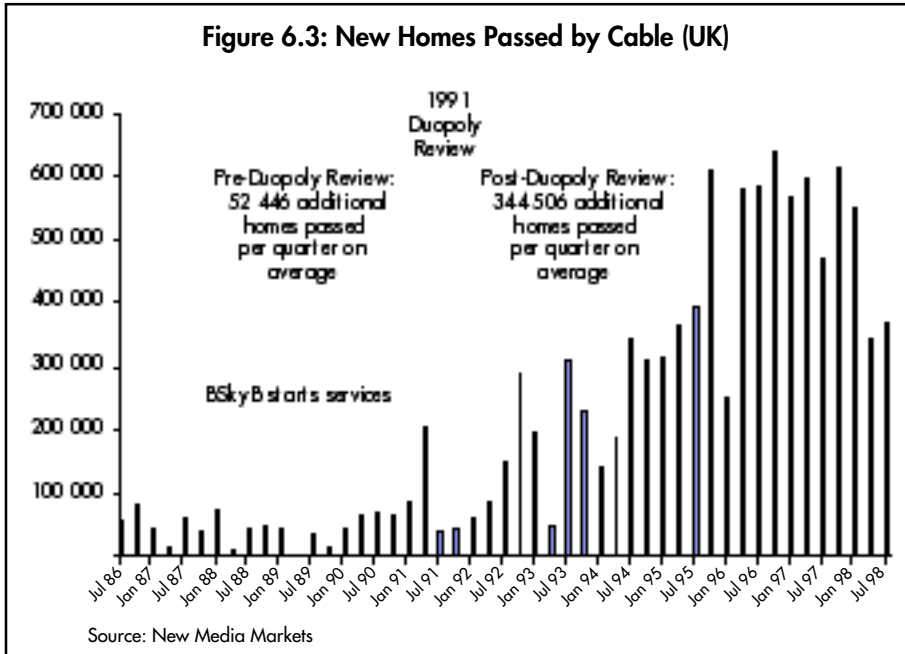
A careful examination of the UK data establishes the reverse of that claimed by the ACCC. In the UK, telephony now drives cable take-up, and pay TV is regarded as an add-on. Telephony provided by cable operators has higher take-up than pay TV and is estimated to generate two-thirds of cable operator revenues (in the case of Cable & Wireless Communications the figure is 90 per cent). UK cable operators are transforming themselves into telephone companies with the add-on of pay TV.

Figure 6.1 traces the growth of cable TV and telephony in the UK from 1986 to April 1998. The period is divided into two: before the duopoly review in October 1991 and after, when cable operators were allowed for the first time to offer cable telephony to their subscribers in



their own right. There are two trends: the rate of growth of pay TV penetration was greater before the duopoly review than after, and pay TV penetration rates stagnated at the same time the penetration of telephony increased. The outcome is that telephony penetration exceeds that of pay TV.<sup>5</sup> Figure 6.2 uses aggregate data to reinforce this point. It is direct evidence that UK cable operators are moving away from pay TV to telephony, and the increasingly subsidiary role being played by pay TV in 'pulling' the UK broadband cable sector.



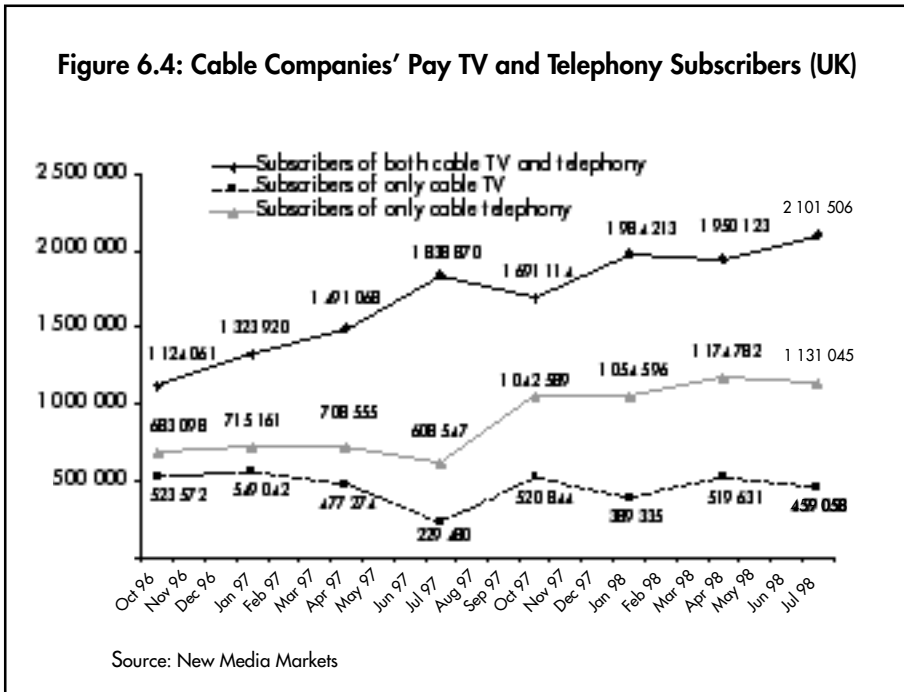


The changes in the investment in cable rollout support this interpretation. Figure 6.3 shows the number of new homes passed by cable networks in the UK each quarter. After the relaxation of restrictions, following the duopoly review in 1991, cable roll-out accelerated dramatically. Prior to 1991 an average of 52 446 new homes per quarter were passed, compared with 344 506 in the period after 1991. The renewed impetus to invest in cable networks was due entirely to telephony.

Further evidence that telephony is the driving force in the cable companies' expansion is offered by Figure 6.4. By October 1992, when cable companies started to offer telephony, they had a combined pay TV subscriber base of 377 000. By July 1998 the number of those subscribing to pay TV only was at a similar level, just over 450 000. Since October 1996, pay TV-only subscribers steadily declined, while telephony-only subscribers doubled to over 1 million in the same period.

The ACCC has even acknowledged in a different context that pay TV plays only a minor role in the economic and competitive position of cable networks, even in Australia. For example, David Lieberman (1997, page 10), a former ACCC Commissioner, has stated publicly that:

While pay TV has a critical short to medium term role in funding the investment required to roll-out the competing cable networks, the roll-out is largely about telephony and broadband services of which Internet services are a prime example.



### Are Multiple Revenue Streams Essential?

The ACCC (1997) argued that multiple revenue streams were crucial for the economic viability of broadband cable systems. To be sure, if a broadband system was built at large expense capable of carrying video, voice and data services in large quantities, it would be foolish to deny that it is useful to have revenue from all sources. But this is not the issue. The issue is whether the merger breaches competition law in the sense that any decline in Optus's fortunes can be traced back to FOXTEL gaining enhanced market power as a result of the merger. The oft-cited dire consequences to, and the threat of withdrawal by, Optus are not necessarily evidence supporting the monopoly claims without first demonstrating that the merger is anti-competitive. Reference to scenarios from Optus business plans are also not evidence of anti-competitive harm. Low returns and losses from reduction in forecast lower market shares are entirely consistent with competitive markets: poor performance results in low profits.

The pull-through argument is essentially a demand-side issue. On the supply side, there are economies of scope in providing pay TV, telephony and Internet services on the same broadband cable network. It was suggested that the merger would diminish the economies of scope



from Optus's network, thereby raising Optus's costs and decreasing competition. The economies of scope between pay TV and telephony arise from the common costs which result from the investment in constructing and maintaining broadband cable networks, and, to a lesser extent, in operating and marketing costs.<sup>6</sup> However, the inability to reap economies of scope can be regarded as anti-competitive only if the reduced take-up of Optus Vision pay TV resulted from the exercise of enhanced market power by the merged entity.

The ACCC also ignored a counteracting consideration, namely, that because of the addition of telephony revenues a pay TV subscriber is worth more to Optus than Australis. Optus's ability to bundle pay TV and telephony, together with the ACCC's claim that pay TV was critical to attracting telephony customers, would have given Optus a tremendous advantage. Optus could have reduced pay TV subscription charges and/or bid higher for pay TV programme rights than its subscriber numbers would justify, as they have.

The ACCC's treatment of cost factors is selective and bifurcated. The argument that FOXTEL would gain efficiencies from a larger number of subscribers was implicitly dismissed as irrelevant. On the other hand, the prospect of a decline in Optus's competitive position, which would reduce the realization of economies of scope, was seen as critical.

Further, Optus stated that if the merger went ahead, it would not invest in a satellite delivery platform to expand its coverage to meet that of Australis, and (more dramatically) that it would withdraw from Australia completely. The latter threat was not credible. Moreover, if Optus had decided to sell its business, presumably at a knockdown price, others would have willingly taken over. While the claim that Optus would not invest in satellite delivery to compete in the non-cabled market may have been commercially justified, it was not credible. Optus owns the satellite, has immediate access to programming, and can point to no capital market constraints which would limit its access to funds. This 'threat' has no competitive implications *per se*, and the commercial viability of Optus's satellite business would therefore have been unchanged by the merger. At the time of writing, Optus was still questioning whether it will launch a satellite business.

### *Concluding Remarks*

A number of reasons have been offered as to why the proposed merger was unlikely to have substantially lessened competition in either the pay TV or telecommunications sectors. Simply put, Australis was not

an effective competitor in the provision of pay TV. This was because the Galaxy purchase package of core programming was already broadcast on FOXTEL and, as such, the merger would not have increased the programme offering of FOXTEL or Australis. As well, because Australis found it could not compete in cabled areas, it withdrew from them. The outcome was, in some sense, ironic: Australis could not compete because of government policy, which favoured telephony, and was not allowed to merge because it was viewed as a threat to the viability of the telephony service it did not supply. The ACCC appears to have protected competitors from competition, rather than competition from monopoly.

The ACCC's approach also raised a more significant question about the benchmark for facilities-based competition and the economic efficiency of the Australian communications sector. The ACCC's line of analysis pointed to a potentially significant problem about the sustainability of the facilities-based competition between FOXTEL and Optus. They suggested or implied that there was a strong natural monopoly element in the provision of broadband infrastructure of the type examined in Chapter 4. If there were major economies of scale and scope, as Optus was alleging, this would point to an uneconomic structure for Australia's broadband cable sector.

### *Endnotes*

- 1 Astar and ECTV were at the time 'Australis franchisees'. Each delivered Australis's programming to subscribers within its region. Australis provided a conditional access system and transmission facilities to the franchisees. In return, the franchisees paid Australis a fixed percentage of their net revenue for the Galaxy package, and a proportionate share of the costs of the Australis conditional access system.
- 2 The ACCC's analysis proceeded on the basis that there were only three operators (Australis, FOXTEL and Optus Vision) and dismissed Astar as a competitor, grouping it with Australis.
- 3 *QCMA (1976) ATPR 40-012* and then *Queensland Wire Industries Pty Ltd v BHP (1989) 167 CLR 177*
- 4 This follows from the economist's standard assumption that demand curves are negatively sloped.
- 5 This growth of telephony is unremarkable since it picks up an existing installed subscriber base of pay TV customers rather than new pay TV customers. Once this effect has worked through, the growth rate of telephony should slow, as has occurred.

- 6 In the UK, CWC's new pay-TV access tier costs £9.99 a month and includes telephone line rental, the five FTA channels plus ITV2, UK Horizons, Sky News, BBC News 24, a local channel and a 'bonus' channel. This compares with the £8.87 BT charges for line rental alone (*New Media Markets*, 1 October 1998).



# Chapter Seven

## Policy Implications

This episode in trade practices law has at least two wider policy implications concerning the ACCC's enforcement procedures which warrant debate and possible reform.

First, the framework used by the ACCC to assess mergers and competition in the communications sector is flawed. This was touched on in Chapter 5 above. The ACCC's single-minded focus on the hypothetical impact of a merger on price competition is misplaced and ignores the key features of the competitive process in hi-tech communications sectors. These features comprise mainly innovation, product quality and gaining consumer acceptance. The analysis must therefore take into account the evolving nature of the market and the fact that product-market definition and industry boundaries are fuzzy, indeterminate and constantly changing. While this book is not the place to discuss the reform of Australian trade practices law or to develop a new framework for assessing dynamic competition, there is a need for a competitive framework which places more emphasis on non-price competition over a longer timeframe, and which incorporates supply-side factors such as economic efficiency and investment incentives in a systematic manner that better balances short- and long-term competition concerns.

Second, the intervention of the ACCC raises questions about its role and enforcement policy. It is received wisdom that the ACCC has become more interventionist than its predecessor, the Trade Practices Commission, and has deployed the media more systematically to publicize its activities. As a result it is reviled by segments of industry and finance. If this is because it has become more effective, then there is no policy issue. But behind the criticism lies a genuine concern that trade practices law has moved beyond its traditional role of preventing anti-competitive behaviour to a more interventionist and proactive stance. Allan Fels, Chairman of the ACCC, has denied the latter: 'The Commission [ACCC] is not a social engineer, and it doesn't have a positive role in bringing about the most competitive solutions. Its only role is a backstop, if something is going to worsen competition' (Davidson, 1998, page 18).

Professor Fels's statement ignores the new regulatory role of the ACCC following the reform of Australian trade practices regulation. The Hilmer Committee recommended the integration of telecommunications regulation into trade practices law, and the enforcement of both by the ACCC.<sup>1</sup> Unlike traditional trade practices law, telecommunications regulation seeks to bring about competitive solutions through active intervention. In the ACCC's pay TV merger decisions, the trade practices goal to prevent lessening of competition and the proactive approach of telecommunications regulation clashed, with the clear sacrifice of the interests of pay TV. The concern is that, in its desire to promote competition in telecommunications, the ACCC was offering preferential treatment to Optus under the guise of promoting facilities-based competition at the expense of the more narrow interpretation of its role in blocking mergers which substantially lessened competition. At a minimum, the tensions between competition and communications regulatory approaches have not been adequately resolved, nor have they led to a coherent enforcement policy.

### *Endnote*

- 1 Hilmer *et al.* (1993) recommended one regulator covering competition and utility regulation and a new legal regime which could give a right of access to specified 'essential facilities' on fair and reasonable terms. While the government did not accept the essential facilities doctrine, an open-access regime administered by the ACCC using an administrative 'declaration process' followed by negotiated interconnection terms is now in operation.

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