Competition Down Under
Seven Network Limited & Anor v News Limited & Ors

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I. Introduction

In September 2006, the Federal Court of Australia concluded the longest and most expensive Competition-related trial in Australian history, *Seven Network Limited & Anor v News Limited & Ors*. The trial itself lasted for over a year and produced nearly 10,000 pages of transcript. If the Applicants (Plaintiffs) are successful, they may be awarded hundreds of millions of dollars in damages[1] and force a complete restructuring of the pay television industry in Australia. If the Applicants fail, they may be required to pay the legal costs of at least 20 of the 22 parties that they sued.[2] Total costs to date are estimated to exceed AUS $200 million. This case provides an example of how allegations of anticompetitive conduct can be used as a means of redressing business disappointments and attempting to gain business advantage, *ex post*.

II. Background and Summary of the Applicants' Allegations

In order to understand the Applicants' allegations (and to provide some context for the economic analysis), it is useful to begin by providing some background on the relevant parties

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[*] We oversaw CRA International's ("CRA") work in support of Professor Franklin Fisher, News Limited's liability expert economist in this matter. Fisher (MIT and CRA) was among five economists to testify at trial regarding the liability issues. In addition to Fisher, Professor George Hay (Cornell University and CRA) and Dr. Philip Williams (University of Melbourne and Frontier Economics) also testified on behalf of the Respondents (Defendants). Professor Roger Noll (Stanford University) and Dr. Rhonda Smith (University of Melbourne) testified on behalf of the Applicants (Plaintiffs).

The opinions herein are our own and not necessarily those of CRA or any of the parties in this matter.

[1] The Applicants originally claimed damages in excess of one billion Australian dollars (approximately 600 million euros), although damage claims were reduced in the course of the trial.

[2] The Applicants have already settled with two parties.

and the industries in which they compete. At the most basic level, inasmuch as this matter involves the television industry, it is useful to make a distinction between the two types of broadcast television in Australia: free-to-air (or "FTA") television and pay (or "subscription") television.[3] The former is funded by advertising revenues (or in the case of public broadcasting – by the government); the latter is funded predominantly by subscription fees (as the name suggests).

As depicted in Figure 1, the relevant supply chain in Australia involves many levels and many players:

- Telecast rights and program providers. These provide the fundamental inputs for broadcast television. Examples include programs such as 60 Minutes and Australian Idol and rights to televised sporting events – e.g., Australian Football League ("AFL") games and National Rugby League ("NRL") games (both of which are of particular relevance to this case).
- Channel providers. A channel is comprised of a collection of programming.
- Pay television operators. Pay television operators assemble a line-up of channels to sell to viewers, predominantly via subscriptions. Channel providers negotiate with pay television operators for inclusion in their respective service packages. It is also the case that pay television operators can (and do) assemble their own channels by acquiring content – i.e., rights and programming – directly. As noted in Figure 1, pay television can be delivered over several different platforms (e.g., coaxial cable and satellite).
- Free-to-air television. Telecast rights providers also sell programming inputs directly to free-to-air television networks, which are channels in and of themselves that are telecast over free-to-air.

As we noted above, the AFL and NRL telecast rights are particularly relevant: this case centers around the sale of these rights in late 2000 and the ensuing effects. Up to and through the 2001 season, the AFL licensed to Seven Network the telecast rights to all AFL matches. All of the premier matches were shown on free-to-air channel Seven. Seven Network televised the less popular matches on C7, its pay television sports channel. C7 was included in channel line-ups

[3] In Australia, the term broadcast television applies to both free-to-air television and pay television.

offered by pay television providers Optus and Austar; it was not included in the line-ups offered by rival Foxtel, a pay television operator jointly owned by News, Publishing and Broadcasting Limited ("PBL"), and Telstra.

Through separate auctions in late 2000, Foxtel acquired the 2002 through 2006 AFL pay television rights, and Fox Sports, a pay television channel jointly owned by News and PBL, won the NRL pay television rights for 2001 through 2006. In early 2002, when it no longer had pay television rights to what the Applicants called a "premium" sport (i.e., the AFL or the NRL), C7 ceased operating as a sports channel provider and went out of business (18 months after losing the rights to telecast the AFL matches). Also in early 2002, Optus – Foxtel's largest pay television rival (and a provider that had carried C7 in its line-up) – entered into a "Content Supply Agreement" with Foxtel, whereby it obtained content from Foxtel including Fox Footy (the Foxtel channel with AFL matches) and Fox Sports (the channel with NRL matches).

In brief, the Applicants (Seven Network and C7) alleged that Respondent (Defendant) News Limited[4] led a "Master Plan" to "kill" Seven Network's pay television sports channel, C7. Specific allegations of improper conduct, which the Applicants alleged were in breach of *Trade Practices Act 1974*, included but were not limited to:

- The refusal of Foxtel to carry C7 in its channel line-up when C7 had the AFL rights;
- Foxtel's (alleged) predatory buy of the 2002-2006 AFL pay television rights;
- The decision for many separate entities, including entities that were in competition with one another, to form a coalition and bid jointly for the 2002-2006 package of AFL rights;
- The simple fact that, beginning in 2002, C7 failed to acquire the pay television rights to telecast either AFL or NRL matches; and
- The agreement between two rival pay television operators – Optus and Foxtel – to share content.

To support these allegations, the Applicants advanced a complicated theory of anticompetitive conduct, involving many different firms that span multiple levels of the supply chain. Specifically, the Applicants alleged that the above conduct had anticompetitive effects (i)

[4] Other Respondents include Foxtel, PBL, Telstra, and Optus.

in relevant input markets (i.e., the markets in which Foxtel, C7, and others compete as buyers of AFL and NRL telecast rights); and (ii) in a relevant output market (the market that includes Foxtel as a seller of pay television services).[5] (For ease of exposition, in this paper we do not embark on an explicit discussion of the market definition exercise, but rather incorporate such analysis into our discussion of conduct and competitive effects.)

With the exception of the allegation that Foxtel's bid for the AFL pay television rights was predatory, the Respondents did not dispute the alleged conduct. Instead, the Respondents disputed the assertion that such actions harmed competition. In the following sections, we address the specific allegations of improper conduct delineated above.

III. Respondent's Conduct and Competitive Effects

As noted above, the Applicants' theory of competitive harm stems from the fact that C7 went out of business after it failed to acquire television rights to either the AFL or NRL. News, a joint owner of Fox Sports, possessed a "right of last refusal" for the NRL rights. Accordingly, we assume that had the NRL awarded its pay television telecast rights to C7 instead of Fox Sports, News would have exercised its "last" rights.[6] Given that the NRL rights were awarded before the AFL rights, it follows that the more relevant analytical issues in this case center around the acquisition of the AFL rights. Our discussion of the Applicants' allegations are focused as such.

a. Foxtel's Acquisition of the 2002-2006 AFL Pay Television Rights and its Refusal to Carry C7

The Applicants alleged that Foxtel's acquisition of the 2002-2006 AFL pay television rights was anticompetitive. Specifically, they asserted, in effect, that Foxtel's acquisition of

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[5] We agree that there are relevant input and output markets, though not necessarily as the Applicants (and their economic experts) define them.

It is also the case that the Applicants alleged a relevant channel market (in the context of monopoly allegations). We do not agree that there is any relevant channel market. In asserting that there is a relevant channel market, the Applicants fail to consider the constraints faced by channel providers as sellers (i.e., a channel provider can be thought of as just another seller of rights). As noted above, pay television operators can (and do) assemble their own channels by acquiring content – i.e., rights and programming – directly. As a result, pay television operators have alternatives to buying channels from channel providers.

[6] Indeed, this is a conservative assumption.

these rights constituted a "predatory buy." A "predatory buy" – the flip-side of predatory pricing – is a purchase in which the buyer overpays for a good or service in the first period in order to cause its competitor(s) to exit the market. This allows the buyer to underpay for the good or service in future periods. No firm will make a predatory buy unless it expects to recoup more than its initial losses in subsequent periods – i.e., the price paid for an input makes sense only inasmuch as it denies others access to the input.

Presumably, Foxtel's "predatory buy" was intended to "kill C7." The Applicants appear to allege that Foxtel acquired the rights for such a large sum of money that the only way the purchase would have been profitable is if Foxtel could "recoup" losses with supra-normal profits in the future.[7] This is alleged to occur via a two-stage process: *first*, Foxtel denies access to C7[8] then puts forth its predatory bid, with the combined effect of eliminating competition; *second*, in the absence of competition from C7, allegedly Foxtel would be in a position to recoup its initial losses. Without any recoupment, Foxtel's alleged sacrifice of profits (by bidding high initially) has no adverse effect on competition; on the contrary, the AFL benefits by receiving more money for its rights.

The problem is that the Applicants offered no evidence consistent with their theory. Further, even if it were true that Foxtel overpaid for the AFL rights, *ex ante*, there is nothing that supports the proposition that Foxtel has recouped (or would be able to recoup) its losses. Recoupment is neither possible in the relevant input market (in which Foxtel, C7, and others compete as buyers of AFL telecast rights) nor is it possible in the relevant output market (which includes Foxtel as a seller of pay television services). We discuss each in turn.

With respect to the relevant input market, the following is clear: competition on the buyer side has not been diminished just because C7 is no longer in business. The telecast rights to the AFL come up for bid every few years, and there are several potential future rights-buyers. These include other pay television channel providers, pay television operators, and free-to-air television networks. As a general matter, competition is not platform-specific: free-to-air television networks compete with pay television channels and pay television operators to acquire

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[7] In this regard, it is important to distinguish between a deliberate sacrifice of profits and something that turns out to be unprofitable, *ex post*.

[8] Up to and through the 2001 season, AFL matches were shown on Seven (free-to-air) and C7 (pay). C7 was included in channel line-ups offered by pay television operators Optus and Austar, but not in the line-ups offered by rival Foxtel. C7 wanted to be carried on the Foxtel service; Foxtel refused.

programming inputs. Furthermore, the set of potential buyers should also include potential entrants. Indeed, the Applicants assert that telecast rights to the AFL are a "subscription driver" (thereby making entry particularly attractive).

In hindsight, we can see that the Applicants' theory was wrong. In the most recent auction for the rights to telecast the AFL's 2007-2011 seasons, neither News nor Foxtel won. Seven partnered with a free-to-air network, Ten,[9] and won the AFL free-to-air and pay television rights, triumphing over a joint bid by the free-to-air network, Nine, and Foxtel. The Seven/Ten victory appears to contradict the Applicants' assertion that with the exit of C7, the AFL (and NRL) would be victimized by reduced competition among buyers. (Seven/Ten ultimately ended up on-selling some matches to Foxtel – at a reportedly favorable price to Seven.)

Seven and Ten's combined bid was reportedly substantially more than the winning bid in 2000 (adjusted for inflation). The outcome of the most recent auction was estimated to almost double AFL revenues. Indeed, the victory by Seven and Ten led Judge Sackville, who is presiding over the case in the Federal Court of Australia, to inquire: "Why are we here, given that Seven has the rights to the next round?"

In light of the Applicants' allegations regarding the anticompetitive nature of the Respondents' bidding coalitions, it was surprising that Seven recently joined with Ten to bid for the AFL rights. Apparently, even Seven has correctly concluded that it was mistaken in this claim. In this industry, it is relatively easy for firms to form coalitions to bid for specific content, and, because these coalitions reduce the transactions costs involved in licensing rights, content providers, such as the AFL, benefit. Moreover, the ease with which new coalitions form prevents any single coalition from exercising market power.

Hypothetically, Foxtel might have also sought to recoup by raising the prices for pay television packages to supra-competitive levels – i.e., recoupment in the output market. Not only do the Applicants offer little or no evidence to support this claim, but the Applicants also fail to establish that competition has been lessened in the relevant market that includes the sale of pay television services. Should a pay television subscriber choose to cancel its service, that individual could either turn to another service provider or, more commonly, elect to watch only

[9] Prior to Seven's decision to bid jointly with Ten for the 2007-2011 AFL rights, Ten had been among the Respondents because it was part of the News-led bid for the 2002-2006 AFL rights.

free-to-air television. Thus, in thinking about the constraints that Foxtel and other pay television operators face as sellers, one cannot ignore free-to-air television networks.

We find that a relevant market that is restricted to pay television only is too narrow because it neglects to take into account the constraints imposed by free-to-air television networks. The relevant output market should include at least pay television and free-to-air television. The following supports this conclusion:

- Analysis of prices. Foxtel charges the same prices, irrespective of whether another pay television operator is present in a geographic area.
- Churn evidence. There has been substantial churn from pay television to free-to-air television. Such churn is indicative of the fact that customers on the margin view free-to-air television as an alternative to pay television.[10]
- Markets need not be symmetrically defined. While it is most likely true that pay television does not competitively constrain free-to-air television, such need not be the case in order for free-to-air television to constrain pay television.
- Technology is rapidly changing. The competitive landscape is quite dynamic as a result of the fact that technology (in television and other methods of transmission) is rapidly changing. Indeed, the AFL recognized this fact.

Finally, it is worth noting that even if it were the case that free-to-air television provided little constraint on pay television, Foxtel is still constrained as a seller of pay television services. In particular, the threat of expansion or potential entry provides a competitive constraint.[11]

We find no empirical support for the proposition that pay television prices have increased as a result of any alleged substantial lessening of competition in the output market. Increased prices after Foxtel and Optus began sharing content (discussed in a subsequent section) can be explained by increased quality. Further, even if one were to have observed that quality-adjusted prices increased, this would not be dispositive: it could merely reflect a general trend of increasing price (perhaps reflecting the quest of pay television to find a profitable business model).

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[10] In thinking about delineating relevant antitrust markets here, what matters is the behavior of marginal – not inframarginal – customers.

[11] In this connection, it is worth noting that the fact that entry has not occurred in the Australian pay television industry – an industry that has been historically unprofitable – does not imply that there are barriers to entry. Rather, there just has not been an appropriate economic incentive.

As we will now discuss, Foxtel's acquisition of the AFL pay television rights and its refusal to carry C7 as part of its channel line-ups were procompetitive, profit-maximizing decisions. In particular, as a pay television operator that wanted to telecast AFL matches, Foxtel had two options (a "make" or "buy" decision): either (i) acquire the AFL telecast rights itself and produce the programming for carriage on its service; or (ii) choose to carry a channel (or channels) that owned the telecast rights (e.g., C7). Foxtel chose to "make" rather than "buy." This decision is rooted in rational, profit maximizing, procompetitive rationale[12]:

- Overall, Foxtel found C7's package of programming to be unattractive.
- Foxtel believed that C7 was suffering from quality problems. In particular, C7's presentation of the AFL (i.e., the selection of matches shown on C7 and the presentation of those matches) was of poor quality. It was commonly thought that Seven Network followed a business strategy of "underinvesting" in C7 so that C7 would not cannibalize the profits of free-to-air Channel Seven. While such a strategy may have been in the best interests of Seven Network, it was not in the best interests of the AFL, cable operators, or consumers, as a whole.[13]
- Among other things, Foxtel believed the benefits of "making" included the ability to exercise more creative control over the use of the rights and the branding of the channel.

Moreover, the fact that a pay television operator may inform content providers, such as the AFL, that it does not intend to carry a channel is not incongruent with competition. Generally, a pay television operator is under no obligation to carry a channel simply because that channel wants to be carried.

b. Foxtel and Optus' Agreement to Share Content

As noted above, in early 2002, Foxtel and Optus entered into a "Content Supply Agreement" ("CSA"). The Applicants alleged that the CSA was anticompetitive because it

[12] While both strategies may be profitable, *ex ante*, Foxtel, as a rational economic actor, should pursue its most profitable strategy.

[13] As such, it was not surprising that as Seven Network's contract neared its conclusion, the AFL encouraged other parties to bid for the rights to televise its matches.

inhibited competition between the two parties as sellers of pay television services.[14] The Applicants seem to ignore the fact that the Australian Competition and Consumer Commission ("ACCC"), the agency charged with overseeing competition policy in Australia, had specifically approved the CSA.

To evaluate the merits of the CSA, one must consider the appropriate counterfactual. At the time that Foxtel and Optus entered into the CSA, Optus was a failing firm. Optus' entire pay television unit was unprofitable. It was not even turning a profit carrying C7 and AFL football. Accordingly, the CSA represented the most attractive business option to Optus. Absent the CSA, Optus most probably would have exited the pay television business within a few years (and, in the interim, competed much less vigorously).

Indeed, it is also not clear whether C7's failure to win the AFL pay television rights (and thus Optus' failure to carry the AFL through C7) had a material impact on Optus' decision to enter the CSA. That aside, however, it is important that one distinguish the difference between the exit of weak competitors and competitive harm. C7 exited because it lost a competition on the merits for the AFL rights. If Optus ended up as a weakened competitor as a result of C7 losing on the merits, this is a consequence of the competitive process.

c. Winning Both the AFL and NRL Rights

Perhaps the most peculiar of the Applicants' allegations was the claim that it was anticompetitive for the same bidder – in this case, News[15] – to emerge as the winner in both the AFL and NRL rights auctions. Such a claim appears nonsensical: any attempt to prevent such an outcome would likely ensure a market (or series of markets) that were substantially less competitive. For example, one might create a rule that forbids the NRL and AFL from holding separate auctions, but such a rule would not be procompetitive. Alternatively, one might create a rule that forbids the winner of the first auction from bidding in the second auction. However, assuming (as was alleged by the Applicants) that there are only two possible bidders, such a rule will reduce competition and is likely to lead to low bidding for both sets of rights.

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[14] Contrary to what the Applicants contend, Optus is not merely a "reseller" of content: Optus has unique programming, offering content that Foxtel does not.

[15] While it is not strictly true that News won both auctions, it makes no difference to the discussion. For simplicity, we assume that News did win both auctions, as the Applicants claimed.

IV. Assessing the Allegations at a Higher Level

While we just undertook a detailed discussion of the Applicants' allegations, it is instructive to take a step back and examine the alleged scheme at a basic level. Doing so casts serious doubt on its plausibility. Furthermore, as a general matter, the type of conduct that the Applicants have asked the court to condemn is exactly what courts and agencies should be condoning: good, hard-nosed competition.

a. The Alleged Scheme Is Intuitively Implausible

While we certainly believe that rigorous economic analysis has a lot to contribute to assessing the merits of the Applicants' allegations, it is also the case that good common sense can go a long way. That is certainly true here.

To begin, consider the following: sports leagues, in general – and the AFL, in particular – are sophisticated sellers of rights. Not only does the sale of telecast rights result in a large stream of revenue; also, in selling its rights, the AFL is effectively entering into partnerships with its buyer(s). It follows that it is in the AFL's best interests to choose the buyer(s) that can most fully exploit the rights and maximize the league's attractiveness to consumers. And in a process geared towards arriving at the most desirable buyers, it is competition among different buyers that is in the best interests of the seller (the AFL) for both present and future rounds of rights bidding.

That said, the Applicants fail to advance a coherent argument. In effect, the Applicants contend that C7 represented the sole competitor to Foxtel, as a buyer, in a "market" in which AFL pay television rights were sold, and that absent C7, the AFL would face a buyer (or buyers) with substantial market power. But this begs the question: why would the AFL act against its own self-interest by joining such a scheme – i.e., accepting a bid that eliminated competition for telecast rights in the future? This would not be a profit maximizing decision. In order for the Applicants' argument to be valid, one would need to assume that the AFL (a sophisticated seller) was short-sighted, knowingly acted against its best interests, or failed to foresee the consequences of its actions. One way or another, this makes little sense.

Yet, assuming for the moment that the AFL would (irrationally) partake in such a scheme, even for those participants that could potentially benefit (according to the Applicants), no payout (i.e., recoupment) would come for at least seven years. (The seven-year period includes the two years that Foxtel refused to carry C7 as well as the period from 2002 through 2006 when, according to the Applicants, the Foxtel purposely overpaid for the AFL pay television rights in order to destroy C7.) Few firms operating in an industry experiencing rapid technological change (i.e., the broadcast television industry) are likely to be willing to wait for such a long time before they might be able to recoup (as the sole bidder). In fact, as discussed above, seven years later, when the next round of bidding took place, there were multiple bidders (including Seven itself), and thus no opportunity for recoupment.

Lastly, the success of such a scheme would have required the cooperation of 22 different parties. Coordination among such a large number of firms, many of which operate in different industries, represents an exceptionally difficult organizational problem to overcome.

b. C7 Lost a Competition on the Merits

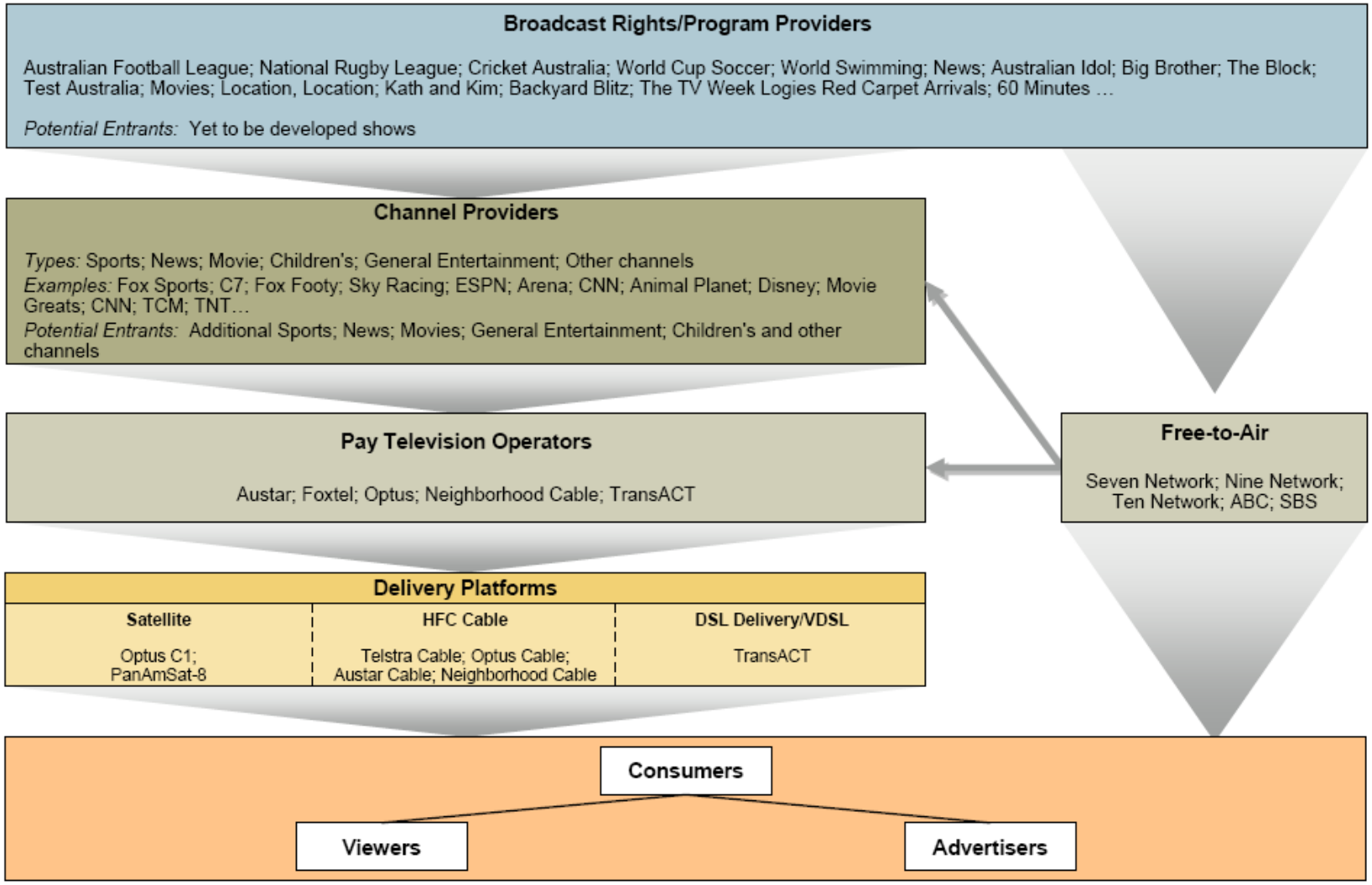
In late 2000, News obtained all AFL 2002-2006 telecast rights. News subsequently sublicensed the pay television rights to Foxtel (and the free-to-air television rights to Nine and Ten). The bid assembled by News for the AFL rights represented a package that the AFL preferred over the other bidders' packages. To the extent that this caused C7 to exit, this did not represent a lessening of competition. Rather, C7 exited because it lost a competition on the merits. As noted above, as a matter of principle, the AFL, as a seller of rights, wants to team up with the partner(s) that can best exploit these rights, to the benefit of fans, subscribers, and advertisers/sponsors. Winning on the merits and offering a better package cannot be detrimental to competition, and it must not be confused with anticompetitive conduct.

V. Conclusion

The trial has ended, and regardless of who emerges as the winner, the costs of this litigation have been staggering. Indeed, as one of the Respondents' barristers remarked: "One of the tragedies is [that Applicants] have spent $100 million on this court case and they could have had these rights three or four times over for that sum of money but at the time they just weren't

prepared to bid…" This fact did not escape Judge Sackville's attention, who noted that the costs were "getting quite close to the point where the total cost of this case will equal what is at stake…" Given the vast amount that the Applicants were prepared to spend, one wonders whether they had an agenda that extended beyond the competition laws.

FIGURE 1


Broadcast Rights/Program Providers
Australian Football League; National Rugby League; Cricket Australia; World Cup Soccer; World Swimming; News; Australian Idol; Big Brother; The Block; Test Australia; Movies; Location, Location; Kath and Kim; Backyard Blitz; The TV Week Logies Red Carpet Arrivals; 60 Minutes …
Potential Entrants: Yet to be developed shows
Channel Providers
Types: Sports; News; Movie; Children's; General Entertainment; Other channels
Examples: Fox Sports; C7; Fox Footy; Sky Racing; ESPN; Arena; CNN; Animal Planet; Disney; Movie Greats; CNN; TCM; TNT…
Potential Entrants: Additional Sports; News; Movies; General Entertainment; Children's and other channels
Pay Television Operators
Austar; Foxtel; Optus; Neighborhood Cable; TransACT
Free-to-Air
Seven Network; Nine Network; Ten Network; ABC; SBS
Delivery Platforms
Satellite
Optus C1; PanAmSat-8
HFC Cable
Telstra Cable; Optus Cable; Austar Cable; Neighborhood Cable
DSL Delivery/VDSL
TransACT
Consumers
Viewers
Advertisers