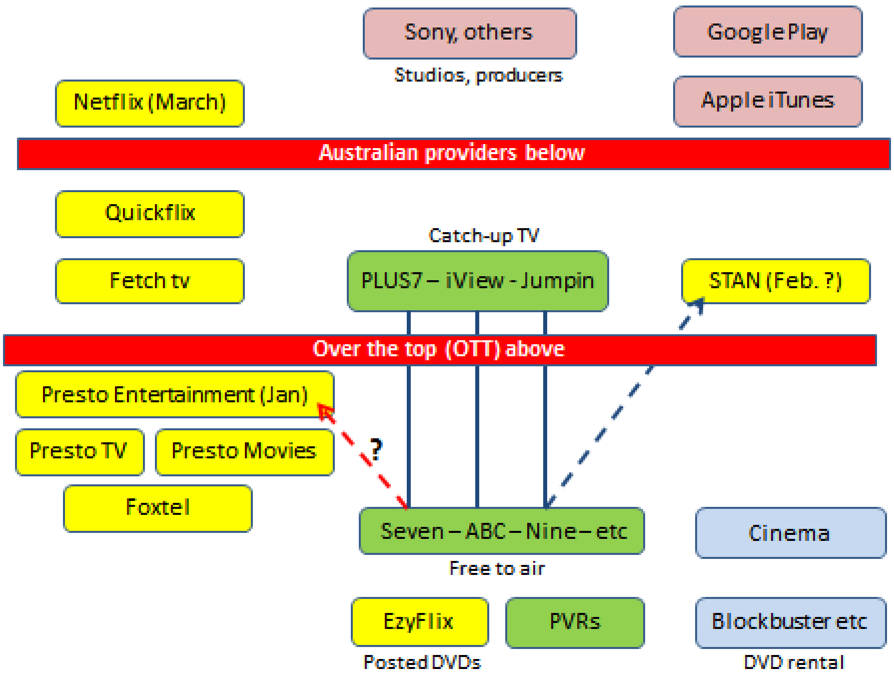
ECONOMUSE

Netflix - the elephant in the pay TV room

Foxtel and STAN go over the top to fight Netflix this year. What are the implications for regulation, existing content providers and the carriers in Australia?

Last week Foxtel re-launched its streaming services but Seven Network's participation in Presto Entertainment is on hold as the ACCC is considering whether to block the joint venture. It seems that is largely because of Foxtel's current dominance of the pay TV market.

In fact, as the ACCC knows, the elephant in the room is Netflix, which will launch In Australia in March. By then Stan - the $100m joint venture between Fairfax Media and Nine Entertainment (with no objections from the ACCC) - will have launched its own subscription video on demand service (SVOD). The landscape is getting crowded.



In the chart, the yellow boxes are subscription services. Quickflix is the local Netflix look-alike service already here. FetchTV offers posted DVDs (which is all that EzyFlix does) and streamed movies through Optus, iiNet and others.

The green boxes are free services with some broadcasters offering catch-up over broadband.

Where broadcasters rely on advertising, they are likely to lose audiences to the new services. Also at risk are the blue boxes in the lower right corner.

Top right are the mavericks. Google and Apple are established brands with great service and deep pockets. A new development is that some US content producers, like Sony, are by-passing traditional distributors. In the USA, traditional (particularly cable) distributors like Time Warner and Comcast saw subscribers fall for the first time in 2013 as customers "cut the cord" to go over the top to access the likes of Netflix and others.

Note that Foxtel distributes its content over HFC, satellite and the NBN – it is not over the top so delivery quality is controlled. Will Netflix try to get paid peering with Telstra and other large ISPs of the kind it has with Comcast, AT&T and Verizon in the USA to improve service delivery and ignite net neutrality concerns here?

Even though Netflix is OTT, it has powerful competitive advantages, apart from the size of its library of content and low prices. It now has its own content delivery network (CDN) – it used to use Akamai, Level 3 and Limelight. It also has analytical software to determine the likely requirements by content and device. The results lead to caches being pre-loaded with content with different bit rates for different connections.

Scale is a key consideration as content is expensive. Stan has said ahead of launch that half of its $100m war chest will be spent on securing exclusive premium content including new productions. That has to include first release US material which thousands of Australia's obtain now using VPNs to circumvent geo-blocking. Sandvine reports that even before Netflix has arrived, approximately 2.5% of Australian subscribers are accessing Netflix.

Foxtel has access to first-run HBO content like House of Cards. Netflix paid US$100m for that series in the USA. Over time, could Netflix try to have exclusive use here too? Would the ACCC allow that?

Obviously, there is going to be a shake-up here. Who will fail? How many subscription services can the Australian market sustain? No single service is likely to provide all that a customer wants. But, how many services would any customer buy? Deloitte's Predictions report forecasts that 20% of homes in major markets will buy three or more pay TV subscriptions. But, in the Australian market the quality of free to air broadcasting is very good and it has first rights of access to premium sports content due to the anti-siphoning rules. So, subscription services have a battle on their hands to acquire compelling content.

Scott Lorson, the CEO of Fetch TV, says "one or possibly two winners will emerge in the SVOD space. But there is no denying that there will be a bloody battle with high stakes".

How bloody could it get? I think we know how the ACCC would respond to another stunt like the one Richard Freudenstein, now the CEO of Foxtel, pulled off at BSkyB when he was CEO. When Bill Gates announced plans to buy into the UK cable sector in 1999, BSkyB announced a £450m write-off to provide customers with free digital set-top boxes along with free internet access and a 40 per cent reduction in their telephone bills. As Neil Chenoweth observed: "the sheer scale of this hand-out … blew the cable operators away" (from Virtual Murdoch – reality wars on the Information Highway").

Mike Sneesby, CEO of STAN, thinks that any provider needs to get a million customers within four years to survive. And, he thinks that there are just three million customers in the addressable market. That's bad news for Foxtel which has around 2.5 million now.

The three million is low; presumably because he does not think that SVOD will cannibalise free-to-air TV. Quickflix disagrees, which would make for a larger SVOD market.

The answer may depend on a relaxation of the anti-siphoning rules which were put in place to protect free-to-air broadcasters from Foxtel. But, with the NBN's ubiquitous access and a plethora of OTT providers, are the rules redundant now? Removing anti-siphoning rules would lead to vigorous bidding for sports rights, to the benefit of local sport (and not Hollywood, which was the case in the Foxtel and Optus Vision battle for movie rights for HFC networks).

But, what about the impact of SVOD on the NBN, mobile networks and other carriers in Australia? Within two years of launching in the UK, Netflix was the second largest driver of traffic on fixed networks. Well over half of traffic will be video content.

The usual way to make money out of content is from advertising, subscriptions or pay per view. None of these are readily accessible to traditional carriers; whether fixed or mobile. Yet their networks will be dominated by a tsunami of content they must accommodate with little or no reward.

Historically, platforms and content/applications were tied together. Packer and Murdoch went to Blount to form Foxtel on the assumption that their content would justify the investment in the HFC network. Of course, the late entry by Optus Vision changed that. But the digitisation has changed the business model. Now, content providers can go over the top to sell directly to end users.

As ISPs become more like dumb pipes, the obvious answer for carriers is a "clip fee" or usage based pricing. In the USA, fixed carriers have been moving towards data caps. We already have them. And, as I have argued previously, usage based pricing is inevitable for the NBN and ISPs.

The ACCC should not hobble local champions (e.g. by preventing the joint venture between Foxtel and the Seven Network) when strong competition from overseas comes to Australia. I believe it is conscious of the danger of regulating emerging markets.

Back in 2005, Graeme Samuels (then head of the ACCC) was afraid that exclusive rights might be used to foreclose some mobiles or ISPs: "I like to put it this way: if you can't control the arteries, what you do is get hold of the blood." Fortunately, he did not intervene and we are none the worse for that.

There is no shortage of arteries today. Digital networking has broken the umbilical links between platforms (arteries) and content and applications (the blood).

The first duty of a regulator is to do no harm. Its decisions should not distort the investment decisions of incumbents or those of new entrants. It is a tricky job. With a strong new entrant about to enter the market, the best course right now would be to do nothing. Let competition rule.

John De Ridder
John De Ridder is an independent telecommunications industry economist.