

Vodafone's responses to questions raised in Commission's Draft MTR Report

Chapter 5

Question 5.1

The Commission is seeking the views of parties on the likely impact of regulated mobile termination rates on retail mobile prices. The Commission is particularly interested in any quantitative assessment of the likely benefits or detriments arising in this market, including any assumptions made and data used.

We discuss this issue in Section IV pages 33 - 40 of our main submission.

Practically we would have to respond

Vodafone would have to respond if there was a reduction in our termination revenues in the order of that we predict from the proposals in the Commission's Draft Report.

It is difficult to say exactly how we would respond, however there are at least two ways that a response could affect retail mobile pricing:

- We might reduce our expenditure on recruiting or retaining customers – Because lower termination revenues reduce the value associated with having a customer on the network, they reduce our commercial incentives to attract and retain customers. The net result could be lower handset subsidies, lower dealer payments for new customers or fewer special deals to attract and retain customers. The net impact could be lower growth in mobile penetration.
- Higher (or fewer reductions in) prices for access/subscriptions and mobile calling – As we point out in our submission, in developing pricing plans our analysts do take termination revenues into account. So logically lower termination revenues could mean higher prices. In practice we predict that mobile calling rates will continue to fall. So it may be difficult to distinguish the impact of efforts to recoup lost termination revenues on retail prices. We note that Enders Analysis points that off-net prices have increased for some contract customers, and contract prices have fallen for larger bundles of minutes in the UK.

Quantitative analysis

We think it is very risky for the Commission to assume that there will be no impact on retail mobile prices. It leads to an unduly rosy account of the benefits of regulating MTRs. The Competition Commission (2004) suggested that the waterbed effect could increase retail prices by between 4% and 7% relative to the level they would be at in the absence of regulation (para 2.564).

In its report, *Modelling Regulation of Mobile Termination Rates*, Covec estimates that only a very small increase in prices for mobile services would result in detriments in the mobile market that would offset any gains in the FYM and toll calling market.

Covec takes the average revenue per user (ARPU) of the mobile networks as the price in this hypothetical market, and the number of subscribers as the quantity. Covec shows that an increase in ARPU of \$2 per subscriber per month (or around 3.5%) may be sufficient to offset all of the potential gains from regulation in the FTM and toll calling market.

Even if the Commission does not believe that the waterbed effect is very strong in New Zealand, this demonstrates that even a relatively weak effect will be sufficient to undermine the argument for regulation MTRs.

Question 5.2

The Commission is seeking submissions on the cost-benefit analysis undertaken as part of this investigation, including specific submission on the assumptions and data used, and the general overall approach.

We refer the Commission to the Covec Report *Modelling Regulation of Mobile Termination Rates* attached as an appendix to Vodafone's submission for more extensive comment on the Commission's cost-benefit analysis.

Vodafone believes that the Commission's quantitative cost-benefit analysis has significantly overstated the net benefits of regulating mobile termination rates, for a number of reasons.

First, the Commission has been very optimistic regarding its passthrough assumptions. As an upper limit, the Commission presents the case of a transition to cost-based pricing (i.e., perfect competition) in the fixed-to-mobile market. This may be a theoretical possibility, but we believe it is extremely unlikely to eventuate in practice as it requires fixed-to-mobile firms to not only compete away all of the increased margin arising from a reduction in the mobile termination rate, but also to compete away all existing margins that they are currently making.

As a lower limit, the Commission presents results of a scenario based on historical observations of pass-through. We believe this approach is flawed for two reasons.

- First, the price under the factual (i.e. with regulation) is calculated relative to the price under the counterfactual (i.e. without regulation) assuming some rate of passthrough of reductions in the mobile termination rate. Calculating factual prices in this way guarantees that the factual price will be lower than the counterfactual price whenever the termination rate in the factual is lower than the counterfactual. This biases the results under this scenario towards generating a positive benefit of regulation.
- In addition, the Commission assumes that the instantaneous rate of pass-through is equal to a rate that it has calculated occurred over a seven-year historical period, and makes no attempt to control for other factors that may have influenced the fixed-to-mobile price over that period.

As the Covec report makes clear, the likely outcome of regulation on fixed-to-mobile prices is a much lower rate of pass-through, due to a number of factors.

- First, an integrated firm has lower incentives to passthrough since it does not face a reduction in costs on calls that originate and terminate on its own network. Since other firms can predict this response from the integrated firm, it weakens the incentives of other firms to pass-through, and results in lower rates of passthrough than would occur if no firms were integrated.
- Second, the nature of the market including the presence of switching costs and the one-bill effect makes new entry less likely than it otherwise would be.

- Finally, even if entry does occur, Covec shows that it is unlikely to result in large reductions in the average price unless entrants are able to capture very large amounts of market share.

As well as its excessive optimism regarding passthrough there are a number of other flaws in the Commission's approach. Its modelling of demand and supply in the fixed-to-mobile market is highly simplistic and is based on a single point estimate of the elasticity of demand. It makes no attempt to account for other factors that influence the price and quantity of fixed-to-mobile calls, such as the mobile penetration rate.

As the Covec report shows, a simple econometric model using publicly available historical data is able to explain historic prices and quantities in the fixed-to-mobile market very well, and is therefore much more likely to explain predict future behaviour in this market.

Further bias is introduced into the Commission's modelling by its treatment of indirect costs. As these are proportional to benefits, only the direct costs prevent the Commission's model from always generating positive net benefit numbers.

As discussed in our main submission, we do not believe that the Commission is correct to count wealth transfers from producers to consumers as a benefit in its cost-benefit analysis. There is no justification for departing from the orthodox public benefit approach used under the Commerce Act in the case of Telecommunications Act investigations, and there would be no legal or economic justification for taking such transfers into account.

In addition, as shown in the Covec report, there is a mathematical error in the Commission's calculation of indirect costs in the public benefits case which causes it to understate these costs.

Chapter 7

Question 7.1

- (a) Will regulation of 2G mobile voice termination and not 3G create price distortions and therefore problems for consumers?
- (b) If so, what will these problems be and how could they be resolved?

It is difficult to predict what impact 2G regulation may have on new technology developments. At the moment, Vodafone's 3G network is still in development and as of yet we have no commercial offering in the market.

However several points seem clear.

- First, regulation of 2G mobile voice termination will distort prices. The form of regulation being contemplated places severe restrictions on the structure of prices though the Commission has not explicitly considered the overall level of mobile prices relative to costs. Regulation of 2G mobile voice termination would inevitably be highly distortionary.
- However, regulatory forbearance in respect of 3G termination would not create additional distortions. The regulation of price structures is an experiment (albeit one that several regulators have undertaken), the benefits of which remain to be

determined. Because the Commission's proposals are also highly intrusive, they should be contained as narrowly as possible.

- As between service providers, the experiences of other jurisdictions in handling regulated rates for 2G termination but non-regulated rates for 3G termination suggest that the solution is not difficult. It simply involves the use of a blended termination rate based on estimated relative traffic volumes for 2G and 3G termination.

(c) How would regulation of 2G voice termination and not 3G hinder take-up of 3G services?

We believe that regulating 2G voice termination but not regulating 3G will not hinder the take-up of 3G services. However, it may well hinder our ability to roll out 3G services. It is our firm belief that designating 3G termination would seriously inhibit both the roll out and take-up of 3G services.

It is important to remember that Vodafone is taking a significant commercial risk in constructing a 3G network. Once capital is committed, our incentives will be to maximise traffic on that network in order to reduce the average cost of service. We intend to use all of the pricing flexibility available to us to achieve this goal. This includes both the overall level of prices and the structure of prices.

Our ability to demonstrate value to our customers and our potential customers would be severely compromised if the Commission was to include 3G termination as a designated service.

(d) Can it be demonstrated by way of example how regulation of 3G voice call termination would adversely affect efficient investment in new technology?

Yes. Assume that innovation is risky in the sense that capital must be committed, but the timing and level of revenues is uncertain. This assumption is consistent with the current situation regarding 3G: at this point there are significant commercial risks involved.

If 3G revenues are regulated now, the business case for 3G investment will worsen. At the margin this will deter some investment. The precise nature and scale of the deterrent cannot be predicted at this stage, but there are a number of dimensions (margins) of investment that can be varied (the speed and scope of rollout are two examples).

If the Commission foreshadows its intention to regulate 3G at some future date, the same effect arises. Bearing in mind that revenues cannot be predicted with certainty, such a regulatory stance would shift the distribution of possible revenue streams downwards, which would again worsen the business case.

More generally, as the Commission itself recognised during its unbundling investigation, regulation should be confined to persistent bottleneck services provided with mature technologies. If this policy is not adopted and clearly endorsed by the regulator, **any** innovative investment is at risk of regulation and so all are deterred to some extent. It is apparent, however, that the threat of regulation will only be implemented when innovative investments are successful. This would make innovation a lose-lose proposition. It either fails commercially, or it succeeds and is then regulated.

In the specific case of 3G, we ask that the Commission remember that there are no 3G services yet, no indication of what prices or costs will be and no consumers being disadvantaged from 3G pricing. Under these circumstances regulation cannot possibly create any benefits, and will most definitely create costs.

We refer the Commission to Section VIII of our submission which provides further comment on this issue.

(e) Should 3G networks be described more precisely in the service description, and if so, how should 3G networks be described?

No.

Question 7.2

(a) Should there be any mark-ups or variations in the calculation of the TSLRIC?

Yes. In its standard form, TSLRIC provides compensation for the incremental costs of a service, which may include both fixed and variable costs, plus a share of the cost of assets that are partly used by the service at issue and partly used by other services. In its standard form, it could be argued that the sharing of jointly used assets is assessed using a pro-rata adjustment based on a simple allocator, such as minutes of traffic. For example, if half of the traffic through a base station was incoming and half was outgoing, each would be allocated half of the capital and operating costs of the base station.

One of the principles behind this approach is that all costs would be (just) recovered if all services were priced at TSLRIC. It is therefore a form of cost of service regulation.

This TSLRIC approach is economically inefficient when there are different elasticities of demand across services. It results in some TSLRIC prices being too high and others too low. As is well known, the efficient way to recover joint and common costs is to set mark-ups over variable costs that vary inversely with the elasticity of demand. This is known as the Ramsey approach to pricing. It is important that any TSLRIC prices for termination are set using this approach.

The same reasoning applies to externalities that arise through the termination service. Where these can be quantified, they should be included in any TSLRIC based access price.

(b) If so, what is the justification and exactly how should these be specified in the final pricing principle?

The Vodafone justification and line of argument has been described in detail in part (a). We would also be happy to provide the Commission with proposed drafting of such specification during the cross-submission phase of this investigation if that would assist the Commission.

(c) Are there any other ways in which TSLRIC needs to be specified more tightly than the existing definition in Part 1 of Schedule 1?

Refer to Vodafone's response to questions 7.2 (a) and (b) above.

(d) If so, what is the justification and exactly how should the final pricing principle be amended to take them into account.

Refer to Vodafone's response to questions 7.2 (a) and (b) above.

Question 7.3

Should the proposed alteration include a requirement that the Commission must require the access provider to complete a section 45 calculation for the mobile termination service?

Yes. Under section 45, the Commission may require the access provider to calculate the price payable for the designated access service in accordance with the final pricing principle. If, as is suggested in the Commission's Draft Report, the final pricing principle is TSLRIC, Vodafone would expect to be required by the Commission to calculate the TSLRIC for the designated service. Vodafone supports the idea of the access provider preparing a section 45 calculation for mobile termination.

Vodafone has access to the resources and skills required to complete a calculation of the price of the designated service in accordance with the final pricing principle. It is the access provider that has the best understanding of its own accounting data.

Question 7.4

(a) Should any provider or potential provider of fixed-to-mobile services be able to apply to be an access seeker?

Yes – however access to a regulated rate should be conditional on demonstrated pass through of savings at the retail level.

(b) If not, what conditions should apply and why?

Vodafone believes that access to a regulated MTR should be conditional on the access seeker reducing its weighted average retail price for fixed-to-mobile calls by an amount equal to the regulated reduction in the MTR. In the Draft Report, the Commission assumes this passthrough will occur, but does not provide any enforcement mechanism for passthrough. The Commission ought to impose such a condition to address the risk that access seekers, rather than end-users, prove to be the actual beneficiaries of regulated MTRs.

(c) Are there any additional matters that need to be dealt with in the service description in light of section 18 of the Act?

No.

(d) Should Telecom and Vodafone be excluded as access seekers?

No, all persons who operate a PSTN should have access to the designated service, other than in respect of calls that originate from mobile numbers.

(e) Is there anything the Commission can include in the wording of the service specification to assist providers of fixed-to-mobile services to achieve timely access to a regulated mobile termination rate applying to both mobile networks?

No. The Commission is not permitted to alter the requirement of section 22 that an access seeker must first make reasonable attempts to negotiate access with an access provider, before a determination can be sought. Nor can this be done by means of a service specification.

The requirement to negotiate before seeking a regulated solution is a fundamental part of the Act's policy.

When the requirements of section 22 have been met, the Act prescribes stages in the determination process. Again the Commission does not have the ability to alter these stages.

This issue is currently being addressed by the Ministry of Economic Development in its "Implementation Review of the Telecommunications Act 2001 – Discussion Paper" of November 2004, and it is more appropriate that this issue is addressed by the Ministry at the Government level. The Commission and other parties have the ability to make a submission on the operation of the Act in that context.