

# Telecom New Zealand

## Closing Comments

Commissioners

1. I will confine my closing remarks to some of the topics covered in the last 3 days.

### **OECD**

2. It is clear that the Commission has relied on the MED's OECD report on New Zealand's relative mobile performance in terms of price. We would reiterate the following points in this respect:
  - 2.1. Benchmarking of prices across countries is notoriously fickle.
  - 2.2. The choice of the basket of services for comparative purposes and the exchange rate chosen have huge implications for the results from OECD study. Altering of those assumptions can deliver very easily a much different picture of New Zealand's relative price performance.
  - 2.3. The MED itself has received significant criticisms and input into its benchmarking study to the extent that it is now calling an industry conference in a few weeks to examine its approach.
  - 2.4. Professor Hausman tabled a Merrill Lynch study which is an independent study and presents a picture of the revenue earned per mobile minute in New Zealand as being very much not out of whack with other countries. This mirrors a similar City Group study tabled in Telecom's submission.
3. This conclusion is verifiable through other observable facts. Firstly mobile penetration in New Zealand is relatively high, and growing, whereas you would expect the opposite if a low GDP country like New Zealand had very high prices.

4. Secondly, as stated by Telecom in its opening submission our Mobile EVA performance and return on capital is not one that could be described as excessive.
5. In short, we have excellent penetration, no evidence of monopoly profits and high uptake. The quality of service has improved significantly. These are not symptoms of a country where mobile prices are over priced.

### **Econet**

6. One of the more interesting parts of the last three days has been the presence of Econet, a welcome addition to the regulatory party. Its always good to see another network builder or potential network builder making an appearance.
7. It is abundantly clear that the two mobile operators in New Zealand see the regulation of mobile termination as bad for customers and bad for investors. I think Mr Edwards in Econet's opening remarks was saying the same. I hope this is a correct summary of Mr Edwards' position but I believe what he was saying was that if you really want to deliver benefits to customers then the entry of a new network is overwhelmingly the best way to achieve that.
8. Regulation of termination rates would be a hindrance not a help to the Econet business case for market entry. Mr Edwards did say there are other regulatory issues that should be addressed in all fairness. However, in terms of the regulatory issue at hand, that is whether termination rates should be regulated at TSLIRC, the message was straight forward – don't do it you'll only make it harder for me to enter the market.
9. Hence we have the two existing players and a player keen to set up a network and who has spectrum and direct Government support through the Maori Trust involved with Econet saying the proposed regulatory intervention will be bad for their investment case.

### **3G**

10. There has been much discussion on the inclusion or exclusion of 3G and how 2 and 3G could be delineated.
11. One can sense the Commission has a dilemma here – if it goes down a regulatory path almost any option it chooses will have very considerable fish hooks.

12. The following options were canvassed during the last few days:
  - 12.1. Don't regulate at all – the impact on investment in the risky mobile market will be too great. More on that later.
  - 12.2. Regulate 2G and not 3G with reference to the 3G ITU definition in the Telecommunications Act. Vodafone objects to this on the basis that the result would be that a considerable proportion of Telecom's current traffic would not be regulated whereas all of their's would be. They would claim this asymmetry of effect is unfair. On the other hand, we would say it is even more unfair and more damaging to customers in the long run to penalise Telecom for taking the considerable risks of investing in CDMA in order to beat Vodafone to the 3G punch. The Commission as a regulatory agency will, I am sure, be very reluctant to reward Telecom's risk taking and innovation by what would amount to a huge regulatory speed camera fine – sorry Telecom you're going too fast – you're ahead of Vodafone – we need to regulate your 3G but not Vodafone's.
  - 12.3. A third option tabled is that 3G should be regulated but at 2G prices. The fish hooks here are the very material chilling on investment incentives that regulation of 3G would have.
  - 12.4. The fourth option canvassed was the option implicit in the Commission's draft report, which excludes 3G but regulates 2G, and with 2G being defined effectively as current technologies. One would presume that this would therefore include CDMA 2000 and 1XRTT, but one would hope not EVDO given this was a technology that was not launched in October when the draft report came out and is indisputably 3G. The very considerable fish hooks in this option are as just outlined. This amounts to a regulatory speed camera fine with very considerable negatives for the long term signals this sends investors.
  - 12.5. The fifth option tabled by TelstraClear is that all voice calls terminating on mobile networks should be regulated at TSLIRC but this would only apply to circuit

switched voice traffic. Let us be clear, in the short term this would effectively amount to full regulation of 3G. Apart from the chilling effects on investment incentives, inevitably this option presents its own set of delineation issues as the difference between voice and data and circuit switched and IP traffic rapidly becomes blurred. We would expect within the next 12 months to be shifting voice from circuit switch to packet switch on our mobile network.

13. It is clear to us that any of these options have major problems and issues. The clear message here is that the Commission should simply not regulate at all.

**Two sided markets and waterbed effect**

14. Commissioner Webb said at the beginning of the waterbed and two-sided market session on Thursday morning that this was a very important session. He was right. It was a very important if not the pivotal session of the conference.
15. The material before the Commission forms a compelling argument that the Commission should change its fundamental economic framework for assessing the regulatory issue before it. Once a two-sided market framework is adopted and the waterbed effect from regulation is accepted then it is clear that the regulation of mobile termination prices at TSLIRC would not be the socially optimal outcome.
16. We have Professor Hausman's calculus and algebra and Professor Williams' more simple whiteboard diagram which both show in a compelling sense that profit maximising companies, of which Vodafone and Telecom most certainly are prime examples, will increase mobile services prices if termination rates are reduced to TSLIRC.
17. These economically rational incentives will take effect irrespective of the following three factors:
  - 17.1. Whether either any company is earning excess returns.
  - 17.2. Whether any company is vertically integrated.
  - 17.3. Whether any company has market power.

18. Professor Valletti questioned whether the two assumptions that underpin the waterbed effect are real. These two assumptions are that the demand curve slopes downward and the marginal customer receives calls. I think we can safely assume that both these conditions are indeed not unreasonable. Inbound calls are an important part of the revenue received from our marginal low end customers. It is simply incorrect to suggest there is significantly less fixed line consumer surplus associated with the marginal mobile customer. On the second assumption, even in the southern hemisphere demand curves slope downwards.
19. In part the debate with Professor Valletti seemed to be that an outcome where mobile providers set a profit maximising price was somehow a bad thing.
20. It may well be that the status quo is not the socially optimal price, although there is no evidence of this. Professor Hausman explained the complexities of trying to establish such a nirvana through the regulatory process. He almost, and I think I heard him say this, he almost suggested that it was beyond even his powers.
21. However, as Professor Hausman has demonstrated with his analysis, and supported by the evidence provided to the Commission in terms of actual commercial behaviour by the mobile players, it is clear that a TSLIRC price would make customers worse off than the status quo and would most certainly therefore not meet the Section 18 long term benefit of end users test.
22. The Commission does however have a way forward.
  - 22.1. It can conclude that a two-sided market is an appropriate economic framework to consider the issue of mobile termination prices.
  - 22.2. It can conclude that the waterbed effect is real and is material. As such moving to TSLIRC prices would result in customers, both fixed to mobile and mobile services customers, being worse off.
  - 22.3. The Commission could conclude therefore that the status quo is a better outcome for customers than TSLIRC modelling but is not necessarily the socially optimal price. However, the socially optimal price is

difficult if not impossible to determine. It is highly unlikely that the Commission would be more successful at deriving this price than allowing the marketplace to determine a price.

22.4. During the course of its investigation, the Commission has received statements from both Telecom and Vodafone that there are incentives on both companies to reduce termination prices over time and both have made strong statements that they see prices declining over the next three years to the low 20's in terms of cents per minute.

22.5. In the face of the complexities and uncertainties of endeavouring to set a price through a regulatory process that is socially optimal, the Commission should conclude that it will not regulate, but send a very strong signal to mobile providers that the expectations that they have set at this conference that prices will decline at approximately double the rate of the counterfactual of 1 cent a minute will come to pass. Failure to deliver on the expectations set would invite the issue to be reopened.

### **Conclusion**

23. Ultimately this conference is about customers in the long run and what is in their long term interest. I cannot conclude my closing remarks without reference to our archetypal customer, Genevieve, whom I'm going to suggest to Mr Kenrick must deserve a new phone as a royalty payment for the use of her name during the conference.
24. The Commission has a very serious job here. There are, as identified by Professor Hausman, over 100,00 Genevieve's whose access to an affordable mobile phone will be put at risk if the Commission regulates. The people that call the Genevieve's of the world also face substantial costs from regulation.
25. But it is not just current customers the Commission puts at risk but future customers, given that we are still in a growing market not yet at saturation point. The Commission will be pleased to know that Genevieve has two brothers and a sister all of whom over the next few years will be wanting a mobile phone.

26. Their message to you Commissioners is don't regulate termination rates. Our dad and the company he works for have sent you a strong signal as to where market forces will take termination rates – trust the market place to deliver and if it doesn't – revisit the issue.
27. Thank you for the opportunity to participate in this conference we look forward to your final report.