Mobile Termination Conference

INTRODUCTION

Telecom New Zealand Ltd

Bruce Parkes
General Manager
Government & Industry Relations

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This conference is about whether the Commission will recommend to the Minister that a dynamic, competitive industry delivering huge value to customers while at the same time making modest rates of return and struggling with a hugely complex and uncertain future, should be regulated. The effect of the Commission's draft report will be a very substantive negative for both telecommunications customers and those investors who fuel the New Zealand mobile market. If confirmed as a final report and accepted by Government, it will be a profound error.

The consequences of the draft report are simple.

1. Prices will rise in the mobile services market. Professor Hausman estimates relative to no regulation, there will be a 7% price increase with a result that 120,000 New Zealanders will not purchase a mobile phone because of regulation.

2. Fixed line and mobile customers will suffer because they will have 120,000 fewer mobile phones to call. The cost to consumers of not being able to make a call at all is far more substantial than the gain of having a cheaper fixed to mobile call for those calls to mobile phones that will still exist despite regulation.

3. From making modest returns to shareholders, Telecom's mobile business will become a destroyer of shareholder value.

I will now turn to each of these effects.

Firstly, the effect of regulation will be to increase the cost of mobile services in New Zealand, with the impact of reducing demand.

Termination revenues form an integral part of the way Telecom sets prices for both mobile termination and mobile services. The two are not distinct services but have a close interrelationship. The demand and price for one affects the other.

This close interrelationship is best illustrated by the somewhat unglamorous term of ARPU, or average revenue per user. This measure is one of the key variables focused on by our mobile group and by analysts. As Mr Kenrick, our General Manager of Mobile, will discuss, termination revenues are very much counted as part of a mobile subscriber's ARPU and as such is an important part of how Telecom Mobile sees the profitability of its customer base.

Telecom Mobile, as would any mobile provider in New Zealand, is therefore looking to strike a sweet spot where the balance of termination prices and mobile services prices optimises the overall profitable use of our billion-dollar plus mobile investment. In short, mobile telephony is a classic two-sided market. As such, the Commission has got its economic framework for assessing the regulatory question completely wrong. By assuming no interaction or interrelationship between mobile services and termination services, the Commission treats the two services as separate markets. This results in a myopic investigation into termination prices relative to some measure of cost.

In reality, Telecom sets all its termination and mobile services prices (with the exception of handset prices) at above marginal cost but chooses to optimise from which revenue streams we recover our fixed and common costs.

As Professor Hausman will discuss, decreasing termination revenues has the same effect of an across-the-board increase in the mobile industry's cost structure. Faced by this across-the-board effect, profit maximising companies, of which Telecom and Vodafone most certainly are, will increase prices such that marginal costs align with marginal revenue. This effect will occur irrespective of whether Telecom or Vodafone have market power or are earning monopoly rents.

The effect in the marketplace will manifest itself in the form of higher mobile services prices being either higher handset, outbound calling or texting prices. We would not predict exactly the mix of effects other than that some or all of these mobile services price components will increase relative to the non-regulation scenario.

Professor Hausman estimates that the net effect of this will be to increase prices by 7% and reduce overall mobile demand by approximately 120,000 mobile subscribers.

This effect can be best illustrated by considering the large number of low-value customers that Telecom has. Often these customers are prepaid customers.

Such a typical customer may be a teenage girl. We'll call her Genevieve and she may or may not go to Wellington Girls High and may or may not have a father called Bruce who works at Telecom. On the face of it Genevieve, our archetypal low-end customer, isn't much of an economic proposition for either Telecom or Vodafone to actively pursue. She hardly ever makes an outbound voice call, but is inherently programmed via a teenage texting chromosome in the human DNA to text seemingly all the time.

With a bit of luck, Telecom might make the occasional additional bit of revenue from Genevieve via a Caller Tune or a Ring Tone. But basically, we are looking at a capped amount of revenue of $10 from $10 texting which, after GST and costs including the termination costs of every text sent to 021, leaves not much as a contribution to the fixed and common costs of running a mobile network and to cover the sales and marketing costs and probable handset subsidy that went into acquiring Genevieve as a customer.

By herself Genevieve may well not be worth having as a mobile customer. However, as explained, we look at the total picture of the value of Genevieve as a customer. While Genevieve does not make many outbound voice calls, her mum and dad certainly ring her on her mobile phone. "Where are you", "when are you coming home", etc. The existence of Genevieve's mobile phone therefore has huge value to those who call her phone. Once the termination revenues from these calls are counted in Genevieve's ARPU then Genevieve starts to look like an economic proposition and worth pursuing as a customer.

If regulation removes nearly half of the termination then Genevieve's ARPU goes down very significantly, and she starts to look an uneconomic proposition for any mobile network to pursue. The economically rational response by the market is to increase mobile services charges to ensure Genevieve's ARPU is maintained in positive territory.

These are not fanciful or idle observations. It is straight economics and economic rationality. Neither Telecom nor Vodafone or anyone else who builds a mobile network in New Zealand is interested in uneconomic customers. If a customer's ARPU becomes uneconomic, prices will rise such that the customer pays more or does not connect.

The worst outcome is the possibility that Genevieve can no longer afford to maintain the cost of a mobile phone or cannot afford the higher handset price to enter the mobile phone market. The effect of regulation could be that Genevieve's mother cannot contact her daughter who is out at some party on Saturday night and is an hour late coming home.

This might, of course, lead to Genevieve's mum and dad being motivated to pay for her mobile phone. So Genevieve's parents might end up with cheaper fixed to mobile calls but having to pay for their daughter's phone. In this case, the Commission will have not so much robbed Peter to pay Paul but robbed Peter to pay Peter.

In any event, of course, regrettably not everyone can afford the additional cost of paying the mobile phone costs of those people they want to call.

The point I am illustrating here in a personalised sense is that there is enormous value to connecting an additional mobile phone to both the mobile phone user and those who call that phone. The Commission must take a holistic view of the way these markets interrelate and must look at the flow-on consequences of attempting to regulate one slice of the market only.

Telecom mobile profitability

While the waterbed effect and two-sided market economic framework does not rely on the existence of monopoly rents or market power, it is very much worth the Commission understanding the profitability of Telecom Mobile. Telecom Mobile does not earn significant returns, and as a business faces a very risky and uncertain future particularly in respect of technology choices. It goes without saying that termination revenues are a very important part of Telecom Mobile's profitability.

Telecom has provided confidential information to the Commission on the economic value added, or EVA, produced by Telecom Mobile. This uses the Commission's Mobile WACC from TSO proceedings.

While one can debate the appropriate rate of return, overall the picture of Telecom Mobile is a business that has been covering its cost of capital in general but is hardly one earning anything that could be described as excessive rates of return. Moreover the future of mobile players in New Zealand is a murky and highly risky one as Stephen Crombie will discuss later in the conference. We face very significant investment decisions which are full of uncertainties in terms of likely return on that investment.

Something worth reflecting on is that we can go back in time and answer the simple question of "what would Telecom's EVA performance have been if termination rates had been 16c over the last few years". Given the huge significance of termination revenues to mobile ARPUs, I can tell you that Telecom Mobile would not be a pretty picture. Its EVA performance would be anaemic and well below that needed to attract investment capital.

Of course this is a hypothetical analysis as the reality is as the economic theory predicts Telecom (and Vodafone) would have adjusted their mobile service prices to attempt to be profitable.

It is difficult to see how the Commission believes making investment in mobile infrastructure uneconomic is in some way good for customers.

Regulation of 3G

I want to turn now to the question of the regulation of 3G.

The Commission has sensibly concluded that there are significant risks inherent in endeavouring to regulate new and highly risky investments.

We are concerned that the Commission's CBA modelling implicitly appears to assume that all existing Telecom traffic is 2G. This, of course, is far from the truth. A significant proportion of our voice traffic is 3G.

It is worth stepping back here and thinking about the big picture in terms of the Telecom-Vodafone rivalry. Telecom now has a technology leadership position in the New Zealand market. We have in our view of course a faster and better performing network and can therefore offer a superior customer proposition. This is a result of significant investments and risk-taking over the last few years by Telecom where, as evidenced by our market share position, Telecom has been on the back foot.

The Telecom Board in 2000 elected to go down the CDMA route. This was a long-term strategy based largely on a belief that over time CDMA offered us the potential for a technology advantage over GSM. Telecom had the option of rolling out a GSM network and this was seriously considered. However the view was that as the David competing against the international Goliath we wanted competitive advantage, not simply the same as our competitor.

The path has not always been an easy one. GSM's superior global scale has often meant we have had to work hard to compete in terms of handset range and price. But we are now starting to see the benefits of our decision. The first significant manifestation of this was with the launch of our 1XRTT network in 2002 which offered us better data speeds than Vodafone's GPRS. In November last year, we invested again in the network with EVDO offering even more advantages in terms of speed and network performance coupled with the ability to offer enhanced services that are superior to Vodafone.

A good example of this was the lead article in last Thursday's *Dominion Post* foreshadowing the launch of Push to Talk. The reporter compares the two networks noting that Telecom's delay on the voice call is one second compared with Vodafone's two seconds because of Telecom's superior network speed.

In short, Telecom has been repositioning Vodafone as either Slowdafone, or a little more unkindly, Skodafone.

We know, of course, that Skodafone won't stay still – but as we speak, Telecom Mobile is, we would maintain, the technology market leader.

The phrase "third generation cellular telephone network"' is used in the Commission's draft service specification and is a defined term in the Telecommunications Act. The definition in the Act appropriately references technology standards recognised by the International Telecommunications Union (ITU).

Those ITU standards are quite specific as to what is 3G. CDMA 1XRTT and EVDO are third generation mobile technologies and as such, are not covered by the Commission's draft service specification.

The exclusion of 1XRTT and EVDO capable phones from the purview of regulation is quite appropriate. It is a strong signal by the Commission that Telecom is not to be penalised for pursuing a risky technology strategy in search of competitive advantage by investing in CDMA and beating Skodafone – I mean Vodafone – to the 3G punch.

The Commission's CBA should therefore exclude existing 3G traffic from its analysis. This being 1XRTT voice traffic. This will have the obvious effect of reducing the purported benefit of regulation.

We recognise that this is a tricky issue for the Commission. But we would urge the Commission to take a principled stance around the principles of:

- Recognising the dynamic efficiency benefits of protecting incentives to invest in risky investments; and
- Not penalising those who take risks to earn a market leadership position.

More broadly on the impacts of regulation, Telecom would make the following points:

- Telecom faces a high risk mobile future. There are a myriad of technology futures of varying costs, we cannot be sure whether we will end up at a competitive advantage or disadvantage in the longer run.

- We face market uncertainties in respect of customers' willingness to purchase new services and to increase their ARPUs.

- The combined effect of these risks is that Telecom Mobile is not looking at a land of milk and honey in the future. We face very considerable challenges to remain both competitive and profitable.

Against this backdrop, Telecom is adopting as much as possible an incremental approach to strategy. We have implemented incremental investments such as EVDO which cost in the region of $40 million. This is incremental in terms of cost – tens not hundreds of millions – but also incremental in terms of coverage. EVDO coverage to date is only in limited CBD and holiday spots.

We will, however, face much more significant investment decisions – widespread EVDO coverage or widespread newer forms of CDMA 2000, WiMAX options may feature or even UMTS as that technology path matures. These investment options are in the hundreds of millions category.

The effect of regulation is to increase the riskiness of these investment options. The waterbed effect of reducing termination revenue to cost will mean obviously less termination revenue but also higher mobile prices and lower overall subscriber numbers. All this makes the business case harder.

One of the big motivators for 3G investment is of course a lower wireless cost structure. It should be somewhat apparent that regulating such investments at TSLRIC will have a dampening effect on investment incentives. If the result of investment is to lower cost structures and lower termination rates down to the new cost structure, the prize for risk taking has been materially diminished.

The intense rivalry between Telecom and Vodafone will mean we will both be looking to jostle for leadership and push as far and as hard as we can, subject of course to the overall goal of maximising long-term shareholder wealth.

What the Commission needs to understand is that TSLRIC cost regulation will have an industry-wide effect. It will constrain and limit the profitable options any mobile player has.

Hence the effect must be that the intense rivalry or leadership will continue but for a smaller prize. It will still be a dog fight – except the bone will be smaller.

The smaller bone for customers will be either slower deployment of technologies and a year without something means all the consumer surplus is lost, not just the dead weight triangle. Or the smaller bone will be new services but not so widely available.

Worse case of course is new services are simply not built – and then as the saying goes – "and then the poor dog had none".

Wealth transfers

The Commission has indicated that it does not want to hear from economic experts on the wealth transfer issue, and only on legal interpretation issues. Mr Hodder is available later in the conference on these legal issues.

But one point I would like to emphasise is that it is quite clear what the intention of the Act's drafters was in this respect. We give in our submission a number of quotes from officials who gave clear advice to the Government and the Select Committee that it was intended that the Section 18 reference to the long-term benefit of end users was that this was a proxy for overall economic efficiency and a test of what was to the overall benefit of New Zealand.

This is the right economic and policy outcome and the Commission should interpret Section 18 to this effect. To not do so would result in an implementation of the Act clearly at odds with Parliament's intention.

One further factor to note on this matter is the very large interest in the Commission's approach to wealth transfers.

Contact Energy, Vector, NGC, Auckland Airport, Business New Zealand and the New Zealand Business Roundtable have all expressed very significant concerns at the Commission's philosophical approach.

The message here to the Commission is that against a backdrop of infrastructure investment being a major Government policy issue, we have the leading investors in telecommunications, gas, electricity and airports expressing significant concerns at the effect on investment incentives from setting the bar for introducing regulation too low.

Non-regulation counterfactual

The Commission has assumed in the absence of regulation that mobile termination rates will decline at 1c a minute for the next five years with an end point of 22c by 2010. We would suggest that this is an unrealistically moderate rate of decline.

It is our expectation that the marketplace will deliver a continuing trend of lower termination costs in the absence of regulation. Vodafone has indicated that a trend of CPI-10% is an expectation they would be comfortable with. As a rough calculation this would bring prices to the low twenties over three years. This is not a forecast Telecom would be uncomfortable with.

Conclusion

In conclusion, the Commission's draft report is a profound error. You will harm mobile customers and you will harm fixed to mobile customers. Mobile termination and mobile services are inter-related, and as such the Commission should adopt a two-sided economic market framework. The waterbed effect will be real and material. Mobile prices will be higher than they would have been in the absence of regulation. There will be fewer mobile phones which will make fixed to mobile callers worse off. The Commission's CBA counts the positives of regulation but none of these negatives. A complete analysis of costs and benefits reveals that regulation will be a major negative for consumers and producers.

On this basis, we would strongly counsel the Commission not to mess with success and not regulate mobile termination rates.

Telecom