

**COMMERCE COMMISSION HEARING**  
**RE: MOBILE TERMINATION CONFERENCE**  
**Held on 25 February 2005**  
**Commenced at 9.00 a.m.**

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**Econet Wireless**

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Mr Andrew Mikkelsen

Mr Andrew Davis

Mr Jim Myers

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**CONSUMER SURPLUS/TOTAL WELFARE TEST DISCUSSION**

CHAIR: Good morning, we'll resume. We are scheduled now to

hold a session to discuss the Commission's approach in the draft report to what we have called the treatment of wealth transfers.

This issue is one that is not new to the Commission. A similar consideration under the Telecommunications Act arose in the Commission's enquiry into local loop unbundling, and at that time the Commission reached a conclusion for the purposes of that report that it could and should take account of wealth transfers, or transfers of surplus from producers to consumers in reaching a judgment as to the balance of benefits and detriments in the case of regulation.

In the Commission's issues paper on mobile termination regulation, which initiated this enquiry, the Commission reiterated the same stance. That is, that the Commission considered that while section 18 of the Act made it mandatory for the Commission to have regard to efficiencies, that this was not an exclusive limitation of the issues the Commission could consider, and that where the Commission considered it was necessary to do so, it could and should have regard to distributive concerns.

This issue is laid out at pages 11-13 of the issues paper and essentially the same discussion carries forward into the draft report.

This particular approach that the Commission has taken has been challenged by a number of parties in this investigation, Telecom, Vodafone, the New Zealand Business Round Table and others have argued that the Commission is wrong in its interpretation of the statute and have argued that the Commission should have regard only to efficiencies and not to distributive concerns unrelated

directly to efficiencies.

Other parties, including TelstraClear, have argued that the Commission has correctly interpreted its statute. So, the issue is one where there are a range of views.

We have paid particular attention to the question in the context of this conference because, of course, within the context of the cost benefit analysis, the values, the dollar values attributed to wealth transfers is proportionately large in comparison with the dollar values that would be driven out by a net public benefits approach which netted out any surplus issues and regarded a transfer of surplus from producers to consumers as neutral.

So, the issue is very large in that particular context but at the same time very narrow, in the sense that the issue is limited for this purpose to the view that the Commission has taken as to its entitlement, and indeed its obligation, to consider wealth transfers under the statute.

I say that because there have been extended submissions put before the Commission as to the treatment of wealth transfers under an efficiencies approach and the Commission has indicated it doesn't feel the need to hear further argument on that point because it has taken the position that it should have regard to wealth transfers, not by virtue of those transfers being a direct consequence of efficiency gains but on the footing that it is a wider consideration that is open to the Commission to take.

So, that is the background to this issue. We have asked for this session this morning so that we can explore exactly this topic and, as it is a topic that flows from the interpretation of the statute, we've asked that legal representatives particularly be available to address it.

As a matter of, let's say, convenience, we have taken Mr Berry's memorandum as a platform for the discussion, and I hope you'll allow us to do that, Mr Berry, though the point is argued by other parties. Mr Berry's memorandum of 23 December, which was included with the submission of the New Zealand Business Round Table, perhaps is a convenient way for us to approach the issue.

With that background then, I propose to explore this issue with you and we will, of course, then take the issue away and see where our final view comes out on this topic.

Is there any question that anyone has about that before I get underway?

MR KNIGHT: We are just trying to locate a copy of Mr Berry's memorandum. We now have it.

CHAIR: Very good. Mr Simpson, you don't have that either?

MR SIMPSON: No, not at the moment.

MR KNIGHT: You can come and sit by us.

CHAIR: Well, we'll see how we can deal with that. Can we just provide one of our copies?

MR HODDER: Commissioner Webb, can I ask a question?

CHAIR: Of course, Mr Hodder.

MR HODDER: I haven't seen Mr Berry's memorandum before. In anticipation of this session I had prepared a brief note to try and summarise where we are at. I apprehend you have in mind to go into a question and answer session rather than seek a restatement of position. Am I correct on that?

CHAIR: Two points. First of all, I'm sorry you don't have the memorandum. It is on the public record as part of the submissions and I certainly had thought to use it as a convenient way to approach the issue. If this is awkward because you haven't seen it then I'm quite happy to approach it more generally. Perhaps that's what we should do.

As to the first point you make, I am quite open to that if you think it would be helpful just to briefly say what in your case Telecom's position is on this issue, that would be perfectly acceptable. Is that something, Mr Gray, that you're ready to do on your side?

MR GRAY: I can do that, Sir.

CHAIR: Mr Simpson?

MR SIMPSON: Yes, the same, Sir.

CHAIR: Very well, let's do that. If we could do this in a short, succinct way so we can then get to the discussion. Mr Hodder, would you like to begin?

MR HODDER: Thank you, Commissioners. We actually have reduced that to writing, and there's about two and a half pages which should take about four minutes to get through at a reasonable quip, but I'd also like to distribute with it, and I will pass it up, but distributing with it the MED advice to the Commerce Committee which we see as being quite critical in the issues that you are considering. I imagine the Commission has access to it but we have copies which we hope are convenient for you and for the other parties. They don't take any great time to address. So, Mr Caradus is just distributing copies, I think, of that now.

CHAIR: Please go on.

MR HODDER: It is somewhat melancholically to disagree with the Commission on a matter but particularly for legal interpretation, the position for Telecom is the section on wealth transfers in the Commission's draft determination does require reconsideration and that a proper analysis of the Act says the producer consumer wealth transfer is an irrelevant consideration.

Why do we say that? There are two inter-linking factors that go into that; one is the onus issue, which you've been addressed on and which is not mainstream to

this session, and the other is the clear statutory directions on sections 18 and 19. On the onus issue our view of the structure of the Act is there is a substantial onus that goes to the way you interpret the Act on that way.

I've dealt with that in paragraph 2 to some extent.

So, let me focus on sections 18 and 19. The clear proposition there is that the Commission must make the recommendation that best gives effect to the section 18 purpose. It is the only direct statutory instruction that the Commission has in relation to its current task, and the point that we are trying to stress in relation to this is the Commission has to be clearly satisfied there's going to be an improvement over the status quo.

Status quo is the default position, that is that the economic and social outcomes you can expect from market forces in the medium and long-term, that has to be shown to be clearly inferior before the Commission has a mandate to move forward with a recommendation that it's now considering.

The essential point in all this for Telecom, paragraph 5, is that the Act is clearly not focused on retail price control but, with respect, that's really the underlying premise of that part of the draft determination to which these remarks are addressed.

If that were what Parliament had intended, then there can be little doubt there would have been a direct replication of or direct link to Part IV of the Commerce Act which provides just for price control at retail level.

So, section 18 is focused on promoting "competition". The Commission doesn't need to hear from me about what competition is. The long-term benefits of end users points away from short-term retail price considerations.

The limited scope of the Act, which is the underlying

premise of all of the submission, relates to the fact that what is to be regulated under section 18 are certain telecommunication services provided between service providers. That again points away from the focus on retail impact.

I refer to the Fletcher report which was talking about a narrowly target legislation.

The language there, levelling the negotiating playing field, light-handed nature of the regulation proposed, is clearly consistent with what Telecom is contending is the position that is appropriate in the context of this enquiry.

I should also at this point turn to those three extracts that we've handed up to you from the MED advice to the Select Committee. They can be considered in chronological order.

The first, you will see at the bottom of the page, is June 2001; the second, which is a two part table, is July 2001; and the third, August 2001.

This is the advice given by MED which just prior to this had been responsible for putting into or helping the Minister put through Parliament the Commerce Amendment Bill which gave section 1A of the Commerce Act which has the language of long-term benefit in it.

So, the sequence, if it's relevant, is on 2 May 2001 the Telecommunications Bill was introduced. On 26 May 2001 section 1A of the Commerce Act comes into force.

Both of these things are driven out of the Ministry of Economic Development.

It's for that reason that we focus on this part of the travaux préparatoires, rather than some other parts because this is the consistent advice you're getting in for the most relevant Parliamentarians in the legislative

process yourself.

Page 15 of the first document makes it absolutely clear what this is about, in our submission.

You will see the second bullet point describes the purpose. The purpose is framed in terms of efficient competition, any connectivity and efficient investment and infrastructure.

The next bullet point, clause 15 as a whole is intended to ensure that decisions of the Commission or Minister under Part 2 result in long-term efficiency, i.e. maintaining efficient long-term incentives to invest and innovate, rather than trading off long-term gains in favour of short-term benefits such as short-term price drops.

Part 2, the next bullet point, Part 2 does not enable the regulation of services at a retail level.

That's not an accident or something that's got blown away.

The next document, July 2001, goes through and reviews the submissions. On the first page, which is page 13 of the document, there is a criticism of Telecom's submission. What the Ministry says in the right-hand column is "the phrase "efficient telecommunications for the long-term benefit of end users" is equivalent to net economic benefits."

The next point down talks about the onus of proof issue.

Over the page, page 15 of the document, we see a disagreement with the Law Society's submission. The current formulation of the purpose clause gives effect to the Government's objective in maximising net benefits to New Zealand from the provision of telecommunication services and Telecom's misunderstanding the intent of the Commerce Act purpose which is not to favour competition

where society does not benefit.

The same thing on page 16 in relation to the United Network's submission. The current purpose statement is intended to be a robust proxy for the whole of society. Consequently, efficiency gains will be measured for the whole of society.

In the third document, a month later, a month before the Bill comes back from the Select Committee, it says the same thing in a variety of ways. If I pick up paragraph 9:

"The Telecommunications Bill achieves its end not by promoting competition per se but by regulating bottleneck services so that other telecommunications providers can efficiently access those services."

Paragraph 17:

"The intent of the bill is to maximise net benefit to New Zealand."

Paragraph 18:

"The term "efficiencies" be adopted as it will achieve consistency with the Commerce Act and is well developed in case law."

Paragraph 20 talks about the principles which we now find in section 18.

I am sorry to take you back to that, but in our submission that's fundamental in analysing what this was about. The Ministry was of course completely neutral in relation to this matter. It wasn't advancing a partisan submission. It is, in our submission, inconceivable that Parliament was misled by this consistent emphasis from these documents about what the purpose clause meant.

When one comes to the Interpretation Act requirement to have regard to the purpose of the Act, we look at section 18 itself. If there's any doubt about the wider context of that we say it comes from those documents.

My paragraph 8 of the note, I refer to a clear preference for a private ordering, which is explicit in the Act. The Act comes into play as a default mechanism and private ordering does not work.

Section 22 which limits the circumstances for an application for access makes that absolutely clear.

It's also, in our submission, perfectly appropriate to attribute to this overall approach the kind of concerns about being cautious expressed in the Trinko case where it talks about difficulties, the distortion of investment and the minutes of adjudicative oversight when one is trying to do adjudication in the context of a predictive regime. We say the same thing applies here.

The next point and the next heading is one where we take issue with the Commission's approach. A point not emphasised in the earlier submissions.

The submission is simply that Schedule 1 is relevant to the task the Commission's undertaking at this stage. There is a proposition that says Schedule 1 has cost based pricing, you drove the approach to section 18 from Schedule 1. The submission is, that's wrong.

Schedule 1 answers the question of how to regulate, it doesn't answer the question about whether to regulate.

More importantly, it's subject to expiry or change under sections 65-67. They are not permanent provisions. They are deliberately subject to change without reference back to Parliament.

It isn't correct to say the Act contains with it a simple endorsement of cost based pricing and what has to be done is drive cost based pricing throughout the entire telecommunications markets.

My paragraph 10 emphasises that point. The whole structure of sections 65-67 is the Minister and anybody else, including the Commission, might float the idea which

the Commission will follow-up, that there be a consideration of whether Schedule 1 is appropriate. It's obviously no answer to a request from the Minister to say should we take the Baumol-Willig rule prohibition to say it is in Schedule 1 therefore we interpret section 18 that way. That begs a question that a Schedule 1 review has to take into account. The submission is you put Schedule 1 to one side and the only statutory direction you have is section 18.

The Commission has already seen the detailed submissions about the coalescence between the language of sections 1A and 3A of the Commerce Act and the Act we're now concerned with.

There can no doubt in the context and the timetable already mentioned there's a conscious alignment of the language between sections 1A and 3A of the Commerce Act and sections 18(1) and 18(2) of the Telecommunications Act.

The proposition is simply that where there is reference to long-term benefit and reference to efficiencies, then you simply don't get into distributive issues involving producer consumer wealth transfers.

Section 1A language, "long-term benefit" was challenged in the Air New Zealand/Qantas case, where I had the luxury of being able to cruise along behind the Commission in terms of my role in that case, but it was a detailed argument and I would counsel being cautious about the summary of the submissions in the judgment in that case that precedes the critical paragraph there.

On my recollection, the Court in that case would have received a thick end of 100 pages of submissions on what section 1A meant. The bottom line, as the High Court said, it means real resource impacts, the reference to long-term benefits to consumers does not take you anywhere

near the concept of wealth transfers.

So, the proposition is that that decision is directly relevant and it's compelling. The argument is detailed as could be wanted and the proposition was rejected.

The same point comes through, of course, from that Select Committee advice received from the MED I have already referred to.

The next proposition really addresses, this is paragraph 12, addresses the idea of monopoly profits, which is the theme that really starts off the discussion in the Commission's paragraph 60. The competition is limited and there might be monopoly profits if they are established on the evidence. The Act expects or requires regulation to drive those out to achieve competitive retail prices. But that's not the position of the Commerce Act. Under the Commerce Act you can have efficiencies that establish public benefits and approvals notwithstanding the concept of ongoing limited competition.

The moment you start thinking that competitive retail prices is what we're trying to achieve, you're moving away from the section 18 purpose towards a concern at the retail level, which is simply not what section 18 says. It's not what the MED said it was about and it's not what is to be found in the Act.

The final point goes to the question of competence. This is not meant to be in any way disrespectful but the Commission's expertise and experience comes from its work in relation to competition policy matters primarily not wealth transfer and distributive matters. Those are the field in which taxation and social welfare policies play out and that is said well in the Commission's own guidelines.

The structure of the Act says the Commission provides

advice to the Minister. It provides advice because it is an expert body. The Minister makes a political decision whether to go ahead with further regulation or not.

The political component of this policy area is in the welfare area and that is a topic the Minister gets advice from the rest of central Government and the mainstream of Government agencies he or she is accountable for, not from the Commission.

So, I then summarise the position briefly in paragraph 15, but you've heard enough from me so far, I suspect. Thank you for that.

CHAIR: Thank you, Mr Hodder. Mr Gray, perhaps you could help us next?

MR GRAY: If it pleases the Commission, I can be as and perhaps even more succinct because the submissions I would make are consistent with those made by Mr Hodder and made by Dr Berry on Wednesday.

To Vodafone, the questions really come down to this: The meaning of sections 1A and 3A of the Commerce Act are now well understood, they've been explained again by the High Court in Air New Zealand and for present purposes, there's no principal controversy about them.

The question is whether sections 18 and 19 of the Telecommunications Act are the same or different in their application to this industry than sections 1A and 3A of the Commerce Act in their application to other industries which fall under that piece of legislation.

The only real difference that can be pointed to is the distinction between the word "consumer" in the Commerce Act and the words "end user" in the Telecommunications Act.

So, the first question is, does the use of different words tell us anything? And it has to be conceded that where Parliament elects to use different words, then it

needs at least to be seriously considered whether it intends different meanings.

But, of course, in telecommunications, consumers are not necessarily end users and, therefore, and in the case of a comparison between section 18 and 19 and sections 1A and 3A, Vodafone's position is that the choice of different words is actually a deliberate attempt to achieve the same meaning and not a different one, and it is to clarify that it is a public benefit test, one that delivers benefits that are available to New Zealand as a whole, rather than just to some sectors within the community.

If one asks, is there a different context emerging from sections 18 and 19 which help us to find a different meaning for the words "end users"? Well the answer is, no, there's not.

And, of course, just as when Parliament uses different words it might be taken to intend different meanings, so also if a dramatic departure from what is previously been understood is intended, then very different words are used, very clear and different words, and there can be no doubt that there are no such very clear or very different words used in sections 18 and 19 than is the case with sections 1A and 3A of the Commerce Act.

So, within the purpose provisions themselves, it has to be accepted that at least on their face they're almost identical to the provisions of the Commerce Act and the one distinction is not material and, in fact, reflects a deliberate attempt to achieve the same end and not a different end.

It's said that the section 18 reference - sections 18 and 19 reference to having regard to economic efficiency is not exclusive but neither is it in section 3A of the

Commerce Act. So, again, it's a distinction without a difference when one is comparing the purpose provisions of the two pieces of legislation.

So, within the body of the Act itself, there is nothing that suggests a departure from the standard approach to treatment of benefits.

The Commission has placed some reliance on the terms of Schedule 1. Mr Hodder has submitted that in many ways those terms are irrelevant because the Commission doesn't get to them until it's already had its Schedule 3 investigation and has arrived at Schedule 1, and of course that must be right.

But even if it is not, Mr Berry made the submission on Wednesday that the provisions within Schedule 1 that the Commission refers to are directed themselves to efficiency and not to distributive effects.

And it cannot be said that the exclusion of the application of the Baumol-Willig rule, or the exclusion of recovery of costs arising from inefficiency, or any other inappropriate costs, is a direction to embark on a distribution of wealth within a decision that's being made. They're simply directions that what the Commission is concerned about when it arrives at Schedule 1 is efficient cost and pricing that bears a reasonable relation to efficient cost.

So that, those provisions themselves are consistent with the purpose of sections 18 and 19 and consistent with the purpose that the Commerce Act has in sections 1A and 3A.

So, it's not possible to find from within the legislation any words which direct or permit the Commission to embark on some kind of wealth distribution in its work.

Can the Commission nevertheless find a power or a

purpose elsewhere? Is there general legislation or some general approach? Well, the answer is no. I suppose the Commission has pointed to the authorisation public benefit and detriment discussion in the AMPs-A decision from the early 1990s, and in that and we've got to assume that Professor Brunt probably was very influential in the drafting of that part of the judgment, and there's a decision to the decision of the Australian Tribunal in Rural Traders Co-Op, and one can postulate Professor Blunt probably was developing a line of thought in those two decisions.

But again what Professor Blunt is talking about in those passages is allocative efficiency and not wealth distribution.

So, if the Commission wants to look at that legislation and say, we are now entitled to ask ourselves whether \$1 in the hand to Vodafone is less valuable than \$1 in the hand of TelstraClear, because we are not - in talking about dollars being delivered to consumers or end users in this case but merely to other produced, unless there's some pass through requirement, absent pass through we're allowed to ask ourselves, is \$1 in the hand to Vodafone more or less valuable than \$1 in the hand of Telecom or TelstraClear? The answer is yes, it might be, and if there is a consideration that it is, we value the benefit to the community as a whole of that \$1 being distributed within the community. But that's not what the Commission has done in this case.

It hasn't said, we think that if we take some money off mobile operators and give it to somebody else the community will be better off and now we'll ask ourselves by how much will the community be better off?

What the Commission has done is said, well, we think the overall benefit gain, the wealth gain, will be the

amount of the transfer. Well, of course, that can't possibly be right.

So, we say that first, there's no support within the AMPs-A decision or the Rural Traders decision of the Australian Tribunal that's relied on by the Commission for anything other than a normal assessment of allocative efficiencies if they can be found, but that's not what the Commission has attempted in this case.

Mr Hodder has observed that this is an expert body and that issues of wealth distribution are matters of high policy best left to Government.

I know that debate and similar debates have been rehearsed before this Commission before and I don't really want to get into the to and fro on that. I accept that this is a body involved in policy and that the function that it's carrying out at the moment is an investigation which necessarily involves some policy components.

But, with respect, I think Mr Hodder's point is a right one, and that is, this is an expert body charged with understanding and making recommendations in respect of the telecommunication industry.

All it can do in that is identify how competition might be promoted within that industry and if changes are to be made by regulation, how those changes will benefit the industry.

If something is thought to be beneficial to the community as a whole rather than to the industry, and therefore there ought to be some interference to redistributed wealth within a community, then that truly is a Governmental matter rather than a matter for this tribunal.

In my submission, Mr Hodder's point is a strong one.

So, in summary, and really summarising all of the submissions and trying to gather them together, the

purpose provisions of sections 18 and 19 are no different from the purpose provisions of sections 1A and 3A of the Commerce Act and should be applied in the same way.

There is nothing within the words of sections 18 or 19 which suggest a different approach.

There are no words elsewhere in the Statute that suggest a different approach.

Reliance should not be had on Schedule 1, but if it is, even then the provisions relied on by the Commission are efficiency considerations and not wealth distribution considerations.

There is no support within general common law or in the decisions of the High Court or the Australian Tribunal for far reaching wealth distribution within the regulatory process.

The support that the Commission has sought to derive from reported cases, in fact, is a discussion about allocative efficiency and the Commission has not attempted to evaluate any allocative efficiency gains which it believes might have occurred.

Those are my submissions.

CHAIR: Thank you, Mr Gray. Mr Berry, you had the opportunity to address us on this issue on Wednesday but I want to give you the opportunity now to add anything further at this stage before we come to the discussion.

MR BERRY: I think I have addressed reasonably fully all the arguments I had.

I think the more I have reflected on it, and hearing these other submissions, it seems to me that there must have been a clear recollection at the time the drafters of the Telecommunications Act looked at sections 18 and 19 that they were doing something akin to sections 1A and 3A of the Commerce Act, and there is a history there going back at least to 1988 where the total surplus standard has

prevailed and where transfers of wealth have been treated as neutral.

So, against that history, I would have expected to see something very clear in section 18 clearly pointing to transfers of wealth to work away from what has been the accepted methodology.

So, I think the legislative history does raise a hurdle there that will have to be jumped over for a contrary view to be taken.

Just one other observation, the term "end user", I think is more or less equatable to public benefit. The way the definition is framed is that it includes intermediaries, it includes economic agents, it includes the ultimate consumer, and so I see more and more very little difference between that concept and public benefit, hence I think there's nothing that can be made to try and extinguish the applicability of section 3A.

Just one other thought that's only just occurred to me as I've heard the arguments today, I find it somewhat puzzling that we would walk into a situation where we would have a statute with two conflicting purposes.

Again, we've had this great efficiency debate through 100 years of antitrust where you either say that efficiency or distribution is the goal. I just can't think off-hand where you would have a regime where a regulator can pick and choose randomly between a one or the other approach. I may well be wrong, but I simply put the observation on the table that it just seems to me where there is a prevailing goal of efficiency, which I read into sections 18 and 19, it seems quite a philosophical problem to also say that there is a distribution standard within the same legislation, but I've only just thought of that. I must confess I haven't given that particular thought.

But beyond those comments, I have nothing further to add to what I've already stated.

CHAIR: Thank you, Mr Berry. Mr Simpson?

MR SIMPSON: Thank you, Sir. I have actually prepared a paper but I haven't copied it, but I've found Mr Hodder's written material quite helpful, so perhaps after we've finished I will get it copied and distributed later.

We consider there are a number of fundamental errors running through the contentions we've just heard, and they are these:

First, a failure to recognise that this is primarily one of law and not economics.

Second, there's a failure, or refusal, to give recognition to the distinction between a public benefit test, such as that that applies under Part V of the Commerce Act, and a consumer benefit or end user benefit test, such as applies under Parts IV and IV(A) of the Commerce Act and section 18 of the Telecommunications Act.

Third, a failure or refusal to give recognition to the differences between the two Acts. I must say, we've heard a lot this morning and in the written material about established practice and established precedent of regarding wealth transfers as neutral, but I believe it's accurate to say that those authorities and practices are confined to Part V applications under the Commerce Act which deal with acquisitions and authorisations for trade practices, restricted trade practices. That part of the Act clearly prescribes a public benefit test, not a consumer benefit test, not an end user benefit test.

I, therefore, take issue with Mr Gray's summary of the issue here. It's not a comparison between or a contrast between consumer benefits and end user benefits but, rather, a comparison of public benefit versus end user/consumer benefit.

I just want to deal with each of those three errors in turn and then turn to the Air New Zealand case.

The first point was that this is governed by the law and not economics. The Telecommunications Act was passed to rectify market power and the Commission must not compromise that objective by allowing the Act to be hijacked by economics.

In particular, economic theory or Telecom's view of it must not be allowed to deprive the Commission of its mandate under section 18 to take wealth transfers into account.

The quantification of those transfers and the weighting to be given to them is, of course, a matter of judgment, but there's a clear mandate from Parliament to adopt the purpose of promoting competition for the benefit of end users, and the discussion we've had about it's for Parliament to decide policy or the Minister to decide policy once the Commission has made its recommendation is not correct.

The policy decision has already been made by Parliament. It was made when the Act was passed in December 2001 and it was made having regard to a history of consumers being overcharged for services by the lack of competition of the dominant of an incumbent.

Turning then to the public benefit test versus an end user test. There is a clear distinction between these two tests. If Parliament had intended it to be a net public benefit test, they would have used the words "public benefit". The distinctions illustrated clearly, in my submission, by the distinction between Parts IV and IV(A) of the Commerce Act and Part V of that Act.

In the submissions already filed we've referred to the requirements of these three parts. Clearly, Part IV and IV(A) is referring to consumers and persons acquiring,

and that's to be contrasted with Part V, which deals with a net public benefit test.

We've also referred to the two reports under Part IV, the Airfield Activities report and the Gas Control report, and I would refer the Commission to particularly paragraphs 97-101, 2.56-2.63 and 8.248 of the Airfield report, and 6.1-6.2 of the Gas Control report where the Commission has clearly stated that, and clearly recognised a distinction between a public benefit test which regards wealth transfers as neutral, and a consumer or acquires in that case a test which has regard to wealth transfers.

Telecom and Vodafone have refused to recognise the different approaches taken by the Commission in these inquiries, notwithstanding their direct relevance to the application of any statutory consumer benefit test or end user test, such as under section 18.

Telecom attempts to part company with Part IV on the basis that there is the absence of the long-term qualifier in section 52 of Part IV of the Commerce Act, and although Part IV omits reference to the phrase "long-term", this is in my submission a tenuous basis on which to base its contentions.

The relevance of the analogy with Part IV is the distinction the Commission has made between acquirers, consumers and end users, on the one hand, and the public on another, which is a larger audience and includes producers such as Telecom and Vodafone.

They also suggest that Parts IV and IV(A) is concerned with a different objective, yet they play substantial reliance on the Air New Zealand/Qantas case which was decided under Part V of the Act. Now, Part IV and IV(A) are close analogies to section 18. Section 66 and Schedule 3 of the Telecommunications Act provide for the regulations of telecommunication services. This is in

one sense, at least, a form of price control between access providers and access seekers.

Part V is quite different. Indeed, we heard Mr Gray refer to Part IV of the Commerce Act yesterday by way of an analogy.

Then turning to Part IV(A), although there are differences between section 18 of the Telecommunications Act and 57E of the Commerce Act, those differences are simply not material to the issue of whether the Commission may take wealth transfers into account.

A key difference between those provisions is that Part IV(A) identifies the means by which long-term benefits of end users are to be promoted by price controls, and they are, limits supply ability to extract excessive profits; ensure suppliers face strong incentives to improve efficiencies and provide quality that affects consumer demands; and ensure suppliers share benefits of efficiency gains with consumers, including through lower prices.

These mechanisms facilitate wealth transfers from producers to consumers and reflect a proxy for the outcome of effective competition and reflect consumer surplus test.

And those three examples will be reflected in regulation under the Telecommunications Act.

Section 18, on the other hand, doesn't contain these prescriptive mechanisms. They are contained within Part II in Schedules 1 and 3 of the Act. Section 18 merely refers to the promotion of competition for the end users. This distinction does not diminish the relevance of the Commission's application of the consumer benefit test to include wealth transfers in its cost benefits analysis.

Just finally before I leave the Commerce Act, Part V,

as I said, refers to a public benefit test and at least Telecom has relied upon the so-called established practice laid out in the Commission's guidelines to the analysis of public benefits and detriments, the written 1997 guideline, but that is clearly and expressly stated in the guideline that it is limited to applications for authorisation under Part V which, as I've said, incorporates a public benefit test. It is therefore of no relevance and no assistance in defining how one should approach the Telecommunications Act.

I then want to contrast that analysis with the Telecommunications Act itself. I concede immediately that Parliament intended to align many of the concepts in these two Acts, and we see that in sections 1(A) and 3 of the Commerce Act and section 18 of the Telecommunications Act. But there are significant differences and they must be respected. They have a different legislative history and they have quite different provisions.

An example of that is the elimination of the Baumol-Willig rule and the substitution of forward looking cost based prices. The Commerce Act does not do away with the Baumol-Willig rule and it does not mandate forward looking cost based prices. So, that's a significant difference in itself and one directly relevant to the issue of wealth transfers.

I want to look at the legislative history for a minute because, in my submission, the three Ministry papers that we've received from Mr Hodder this morning do not contain a strong directive, or in many of those any directive whatsoever as to whether the Commission is to take wealth transfers into account. Indeed, they don't mention the concept.

But if we look at the Fletcher report, in my submission, that clearly gives an indication that they

considered wealth transfers would be taken into account.

Page 50 of the report contains the following passage:

"The Inquiry was also criticised by some submitters for appearing to give consumer welfare higher weighting than producer welfare. This criticism was directed at the access objective, in particular the inclusion of the words "long-term interests of end users", which some submitters suggested were biased against suppliers in favour of consumers.

The Inquiry does not agree with this view. Any inappropriate compromise or bias against producer surplus would not be in the long-term interests of end users.

Further, as noted above, all of the elements of the objective require efficiency, such as efficient competition or efficient investment, which the Inquiry consider protects the long-term interests of providers.

The Inquiry notes that innovative and efficient competition in electronic communication services, which its recommendations are designed to support, will create opportunities for producer surplus through efficient investments in the supply of innovative services. It will also erode that surplus away over time through competition, which will likely set the stage for further innovation."

Now, that passage does refer to protection of the interests of providers through efficiencies, and clearly we need to address section 18(2) of the Act which promotes efficiency, but that acts as a break to the predominant purpose of the Act, which is promoting the long-term interests of end users.

So, certainly it would not be permissible for the Commission to, for example, regulate at 50% of TSLRIC because that would be inefficient and it would hurt the interests of producers and it would, in the long-term, be

detrimental to the interests of end users.

But wealth transfers that are affected without damaging efficiency and without hurting producers in that sense are mandated by the Act and, therefore, efficient prices, such as those derived by TSLRIC based prices, will achieve both goals, and they are not to be seen as alternatives, the promotion of the interests of end users do not conflict with efficiencies, they merely ensure that you don't overreach in achieving that first objective.

Then turning to other parts of the Fletcher report, on page 54 and 63 the enquiry considered the net effects of the enquiry's proposals and then went on to refer to the consumer wealth transfers of, in the first page, \$328 million, in the second \$208 million. So, clearly the enquiry itself which recommended the enactment of this Act, regarded wealth transfers in favour of consumers to be something taken into account. And that's reflected in the second reading of the Bill by the comments from the honourable David Cunliffe where he says:

"It clarifies that consumer welfare is the overall objective of this Bill. It also makes clear that competition is the primary basis for calculating that welfare. Of course, there are efficiency sub-tests, as there needs to be, and that is in line with the Commerce Act."

Which, again, reflects an understanding that the promotion of end user benefits is not in conflict with efficiency gains but is a sub-test to be taken into account to ensure the Commission does not overreach in achieving that objective.

I then want to talk about section 18 and Schedule 1.

CHAIR: Could you be brief, Mr Simpson?

MR SIMPSON: Yes, I will. I appreciate I am a bit longer than the others but I think I'm the only one that's running the

contrary position, so if you could give me a little time, thank you.

In the paper I have referred to a number of cases on statutory interpretation. I don't intend to trouble the Commission in this passage but there's a clear mandate from the principles of statutory interpretation to respect the statutory language and to respect, therefore, the distinction between consumers and the public as a whole.

There is a difference, they are not the same, and that must be respected.

In relation to Schedule 1, it's been suggested that that schedule is either irrelevant or unhelpful, but it does exclude the application of the Baumol-Willig rule and it does introduce forward looking cost based pricing.

It is, therefore, Parliament's - reflects Parliament's intention of driving out economic profits and to see those pass through the next market to the end user market in the form of lower prices will then affect wealth transfers.

Now, if Telecom's competitors receive services, input services by TSLRIC and other forward looking cost based prices, then that will improve their ability to compete with Telecom and competition will then drive through the pass through concept.

I just want to address quickly the issue of, should the schedule be taken into account? Section 19(B) says that if should and, with respect, the attempt to limit the application of section 19(B) is not compelling.

Statutory interpretation principles also require the schedule to be taken into account and, indeed, I refer to the Thomson v Burrows and the Eldorado Oce Cream cases, both of which direct a party or a Court interpreting the Act to have regard to schedules. The Act must be read as a whole, it must be given a purpose of instruction, and it

must be interpreted in a way that gives a functional regime right throughout the Act and therefore it's not correct, as Telecom suggests, to ignore Schedule 1 on the basis that it is only relevant once you've decided to regulate but not whether you should regulate. That's clearly not the case because in deciding the former question you need to look at how will regulation work, so that you're then able to carry out your cost benefit analysis comparing the factual and counterfactuals.

Finally, I just want to touch on the Air New Zealand case. That case was concerned with the Commerce Act and it was concerned with Part V. So, it's not surprising in that case that the Court reached the view that wealth transfers should be regarded as neutral.

What's interesting is that in paragraph 240, which recites the positions of the appellants and the Commission, which positions were adopted and accepted by the Court, and again in paragraph 241, which reflects the Court's own decision, that the Court recognised a distinction between consumers and other members of the public, such as producers, and indeed the first sentence reflects that.

But the Court was faced with a potential inconsistency between the consumer benefit test under section 1(A) of the Commerce Act and the public benefit test under section 61.

What it was attempting to do was reconcile them. It began by saying that the new section 1(A) did not override the long established practice of ignoring wealth transfers when assessing benefits to the public.

That was justified on the basis that public includes both consumers and producers.

But the Court's attempt to - the Court attempted to reconcile the two by reference to the need to balance

efficiency detriments from transactions in question with efficiency gains from the transaction. It held the balancing of these real resource impacts on the economy best served the long-term interests of end users.

So, it was attempting to use efficiency to try and reconcile the two concepts, but that case is confined to that part of the Commerce Act, i.e. Part V. It says nothing about how Parts IV and IV(A) will be applied and it's of no relevance at all to the long-term end user test in section 18 of the Telecommunications Act. It's also directed at ad hoc wealth transfers. We're not talking about ad hoc wealth transfers before us today. We're talking about direct and rational wealth transfers, a form of price control.

Now, the Court was right in its approach. McCosh's application in the case of *Allison v Kealy* clearly states, and this is now a very settled principle of law, when you have a general provision such as 1(A) of the Commerce Act and a specific section such as 61 of the Commerce Act, the specific always overrides the general. All that the Court were saying in paragraph 241 of its judgment is that the consumer benefit test, this general policy of the Commerce Act, did not override the specific public benefit test and all the Court was saying is in the concept of Part V applications for authorisations, that the benefit of consumers is best served by looking after the public benefit.

It says nothing about how that would apply where you're under IV and IV(A) of the Act, which is looking after the interests of acquirers of services or consumers.

As I noted before, the Court did not say anything about Parts IV and IV(A). It did not conclude that the Commission was required to disregard wealth transfers when undertaking cost benefit analysis under those parts of the

Act.

I also note, Sir, that the paragraph upon which everyone, other than me, seems to be placing so much reliance represents one brief paragraph out of 431 paragraphs that make up the judgment and, with respect, it's taking the judgment too far to suggest that this represented a significant policy shift in terms of how cost benefit analyses are to be regarded when one has an Act with a specific consumer benefit test in it, or under Parts IV and IV(A).

I won't spend a lot of time on foreign owned producers, but 242 of that judgment clearly also signals that the issue under discussion in that case is confined to wealth transfers within New Zealand. It says that transfers between New Zealand and other countries are not necessarily to be regarded as welfare neutral.

Mr Gray has suggested or asked the question, is \$1 in the hand of Telecom and Vodafone - sorry, TelstraClear more beneficial than \$1 in the hand of Telecom and Vodafone? With respect, that's not the question.

The question is, is \$1 in the hand of Telecom and Vodafone's foreign shareholders better than \$1 in the hand of the New Zealand end user?

I think that's it for me.

CHAIR: Thank you, Mr Simpson. This has been very helpful. I have in the limited time available a couple of points I want to cover off. We will run a little over on this session and I'll just come briefly round the table for any final comments.

It does perhaps seem from this conversation that one of the key issues in coming to review is whether the Commission is dealing here with a public benefit test or some narrower form of test which focuses on a subset of the New Zealand community.

There has been discussion as to whether the term "end users" in the Act is equivalent to the public benefit, or even equivalent to consumers, or is in fact some narrower - reference to some narrower group, and I think it was perhaps you, Mr Berry, that made a comment that suggested that you felt that end user could include immediate parties standing between the ultimate consumer of a service and perhaps an upstream supplier.

The question I have is this, on this particular point, and I'd like to ask you, Mr Berry, to comment since you raised the issue. The definition of "end user" in the Act refers to a person who is the ultimate recipient of the service. There is an extension of language but the context is that we are asked this question in relation to a telecommunication service, so the question is, who is the ultimate consumer of a telecommunication service or if that service itself is an immediate input we look through that immediate party and it goes to the ultimate consumer again.

It does seem to me there's a strong, let's say, weight to the argument that end user in totality in this definition must mean the party who ultimately consumes the service at the end of a supply chain and does not apply to immediate parties in the supply chain.

I want to ask you if you have any comment on that?

MR BERRY: On a first reading, that may seem a legitimate interpretation, but at the end of the day, it seems to me it produces intermediates and other economic agents may equally fall within that end user category as well. I just don't think there's a black and white clear answer to it. I think it is a very expansive definition.

Can I just pick up on that public benefit test because I think there are some problems talking through the language of the other statute because at the end of

the day, we have to come back to what is meant by sections 18 and 19, and it seems to me that, just going straight down the path of that legislation, the reference to "long-term benefit" clearly is indicative of efficiency and there is as much said in the legislative debate and, therefore, for the sake of clarity, we are told to have regard to efficiencies.

So, we've landed on that base, regardless of what section III(A) of the Commerce Act has to say, it seems to me.

I think it is inevitable, given that efficiency is not defined in the Act, it is one of these terms of economics where we look to be informed by economic principles as to how we interpret it.

So, I have difficulty thinking this is some abstract legal theory that is dangling out there without reference to economic principles and, I'd have to say, every time I hear a reference to AMPs-A a cold shudder runs down the back of my spine. When you think about the Court of Appeal trying to define the word "dominant" with reference to the dictionary, I think you only need to start looking at that to see the limits of a technical legal approach to what is an economic concept.

CHAIR: Thank you.

MR GRAY: Can I make -

CHAIR: Mr Hodder, I wanted to ask you a slightly different question, which comes out of your submission, and that is this -

MR GRAY: Can I make one point on that topic, Sir?

CHAIR: Sorry, Mr Gray, let me finish this point and if you could capture your point for a closing comment because we are limited on time.

Mr Hodder, the question I wanted to ask you was, given section 18's focus on the promotion of competition,

and given the Commission has identified in its report that it considers that the pricing of mobile termination rates in New Zealand is potentially a barrier to entry to the fixed to mobile market and that the reduction of those prices would therefore lower barriers to entry and promote competition in that market, does that allow you to accept the proposition that having regard to the consequences of the price reduction itself is a relevant factor for the Commission?

MR HODDER: If you said "relevant factor" at the end, the answer is no, Sir. If the Commission is persuaded on the evidence that the first part of what you've said, then I can't argue with that being squarely within section 18, but it's the consequences in terms of wealth transfer that we are focused on here, and the answer is no.

CHAIR: Very well. My final question relates to a matter raised I think by - certainly by Mr Berry, I think also by Mr Gray, perhaps even by you, Mr Hodder, and that is really I think an observation as to whether the Commission is competent to consider matters of wealth transfer.

I see certainly it's in your submission, Mr Hodder, that this is a matter that the Commission should properly leave to Government.

I have to say that it can be said that that is exactly what we are doing. What we are doing here is, having reached a view that a reduction in price would reduce barriers to entry, and having quantified the effect of that reduction in price, we report to the Minister quantifying the benefit that we would see, which is a combination of factors, flowing from the imposition of regulation.

Is it not the case that, given that our function here is purely reporting and recommendatory, that indeed the policy judgment, whether or not it captures those wealth

transfers, is left entirely for the Minister?

MR HODDER: I fear I would simply be repeating what I say in the submission if I answer in detail.

The basic proposition, in our submission, is the total surplus approach has been endorsed in the legislation that we're now considering, the Telecommunications Act, and within that, the Commission has been chosen to carry out a role because of its expertise and experience developed under the Commerce Act and principally in relation to competition policy.

As is well understood, once you get into the question of distribution of benefits, which once - the phrase is a very wide concept, it may not be relative to a simple one we're talking about here, then you're into an entirely different ball game and the distributive effects - the consequences of the distribution itself have to be weighed in balance. It simply isn't a matter on which the Commission and the expertise built up within the staff and Commissioners are addressed to.

So, it comes back to a question of deference, in a sense, I suppose. The Minister can be expected to defer to the Commission on matters of competition policy. The submission is simply that the Commission needs to defer to central Government advisers on the wider policy issues, such as wealth transfer.

If there are quantifications in the process that are of assistance, don't disagree with those, but they can't inform the Commission's own recommendations, that is confined to competition policy issues.

CHAIR: Thank you gentlemen. I'd like to just invite each of you, and I'll start with, Mr Simpson, to add any brief final comments. I'm afraid we are constrained for time but I want to give you an opportunity to add any final comments on this point. Mr Simpson?

MR SIMPSON: No, I have nothing to add, Sir.

CHAIR: Mr Berry?

MR BERRY: No, I have nothing to add.

CHAIR: Mr Gray?

MR GRAY: In your question, Sir, to Mr Berry you talked about

the definition of "end user" which has the word "or" in it and you regarded the word "or" as creating an extension.

The question is whether the word "or" means that either of the two categories of persons defined are an end user or both.

In your question to Mr Berry, the assumption seemed to be that it could only be one of the two, and in Mr Berry's answer to you, Mr Berry seemed to assume that it could be both of them at the same time.

If Mr Berry's construction is correct, then it is true that both immediate and final consumers are caught by the definition of "end user", and that is the point at which the debate turns.

CHAIR: Thank you. Mr Hodder?

MR HODDER: Two points perhaps, Sir.

In relation to the comments addressed to you by Mr Simpson, there really isn't, in my submission, a proper response in there to the clear thrust of the MED advice. In my submission, it is impossible to read the MED advice and not understand what Parliament was acting on was a clear correlation between the languages of sections 1(A) and 3(A) and the body of jurisprudence that had developed around it, both in Commission and Court decisions, and section 18.

In my submission, it's quite a stark choice for the Commission. Either Parliament was, in a sense, misled by what it was receiving from the MED and the Select Committee on a consistent basis, or in fact the submissions that are being advanced, contrary to those by

Mr Simpson, are correct and there is a direct parallel, a direct alignment, between the language of the two Acts and it is summarised in that as being a net benefit to New Zealand population, the phrase from the work is proxy for net benefit for New Zealand, and the overemphasis on end user when we are all in a sense end users in the long-term goes off to a different point.

That, in part, goes to the second point, which is that a focus on Part IV(A) of the Commerce Act doesn't take us very far. When one looks again at the MED work, it's not referring there to Part IV of the Commerce Act, it's referring to the Commerce Act jurisprudence around Part V which is being applied directly across in terms of principles.

That's probably all I can usefully say, thank you.

MR SIMPSON: Sorry, Sir, there is a brief point I wanted to make and that is it's been suggested that intermediaries or producers could somehow fall within the end user test, and it's true that Telecom uses telecommunication service at an end user level but it can only be an end user in that capacity, not in the capacity as a provider of telecommunication service.

So, when you're looking at the benefit of end users, you're looking at end users in that capacity of consumers of those services, not as providers or intermediaries.

CHAIR: Very well. Thank you, gentlemen. We will close the session now and - we are running just a little late. I'd like to resume the session at 10.25.

Now, just a reminder that this is a closed session. On the schedule we will begin the session with Vodafone, which means that those attending that session - the only people who can attend that session are Vodafone staff and advisers and those persons, other persons, who have signed deeds of undertaking under the Commission's

confidentiality order. Closed sessions are scheduled to run until the lunch break and we will resume in public session at 1.20. Thank you.

**Conference adjourned from 10.10 a.m. until 10.25 a.m.  
Pages 330-386 held in Closed Session**

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**SERVICE SPECIFICATION DISCUSSION**

CHAIRMAN: Very well, we'll resume. This session is to focus

on the draft service specification in the Commission's report, which is found at page 116 of the draft report.

For the purposes of this particular session, the Commissioners are interested in exploring with the parties the manner in which the Commissioners framed the various elements of the proposed regulated mobile termination service.

Now, that means, of course, that we need to say at the start of this conversation that we have no settled view on the underlying premise as to whether mobile termination should or should not be terminated; nor indeed as to whether, if the recommendation is that there should be mobile termination regulation, whether it should be structured in the form that the draft service specification suggests.

And by the same token, it's obvious that the parties around the table will have their own positions on the underlying assumptions that are behind this service specification.

We must, I think, accept all of those positions as given and it will not be helpful if we relitigate them through this conversation about the service specification.

I hope that that is understood.

So, with those preliminary remarks then, what I would like to do is to come to the service specification itself and to focus on some of the issues that have been raised throughout the submissions and this conference relating to the service description itself.

The first of those issues is the question of what I might think of as the second part of the description itself, which is the first box where we describe the

service as termination and then I'll summarise some words "of voice calls on a cellular mobile telephone network which must not be a third generation cellular mobile telephone network providing voice services".

Now, there have been some criticisms made of this particular language, even accepting the underlying assumption as to whether it is sufficient to rely on the definition of third generation networks contained in the Act or whether something more is required.

I think I would like to direct this question, first of all, to TelstraClear. Mr Forsyth, could you summarise for us briefly TelstraClear's position in regard to the meaning of third generation cellular mobile telephone network and whether and why TelstraClear believes that some further description of these words is required?

MR FORSYTH: I think the only other thing I would add to that which we have provided in our submissions, is that it's our view that the definition as currently in the Act requires, at least, clarification, and I think we've provided that clarification, it probably wouldn't help for me to recall it off the top of my head, leaving aside our objection to the exclusion but as far as definitions are concerned.

MR ALLEN: Just to add to that, the comments from Telecom that their 027 network as a 3G network illustrates the reason that clarification could be helpful to make it clear that that network is, in fact, 2G, as TelstraClear and Vodafone have both argued.

CHAIR: Yes. Perhaps we might come at it in this way.

Mr Parkes, the key words here are "third generation cellular mobile telephone network providing voice services", and we should come back to this point because I'd like to hear whether Telecom considers that it currently operates a third generation cellular mobile

telephone network providing voice services?

MR PARKES: Well, yes we do, and just to clarify Mr Allen's comment, our position is not that 027 or CDMA full stop is 3G. It's 1XRTT capable phones where the voice traffic is carried over the 1XRTT network and EVDO.

So that, the CDMA 2000 phones that are on the network, we wouldn't count, or the ITU standard, I think, wouldn't incorporate those 027 phones. So, it's not as simple as 027 is 3G, 025 is 2G.

So, we are referencing the ITU standards in the Act which pertains to the Act's definition of 3G, we have gone back to that standard, looked at the technologies.

CHAIR: So, your position is that building the third generation network off the ITU standard is the right definition; is that your position?

MR PARKES: Well, it's the definition of 3G, third generation mobile, that the Government has incorporated into our Act, so yes.

CHAIR: That's your position. And it is your position, I think, that Telecom currently operates such a network, is that right?

MR PARKES: Yes, that is correct.

CHAIR: Mr Stiffe?

MR STIFFE: I wonder if it may assist to take a slightly different approach to this because I think my observation over the last few days, and certainly Vodafone's position is that, while we would say that Telecom is currently operating 2G network with respect to voice, we can see there are arguments either side, and the arguments will persist well beyond the end of this conference, I suspect.

It does seem clear to us that a situation that arises that created such a large asymmetry between Vodafone and Telecom would not only make a nonsense of the proposed regulation, but it would also, I think, make a nonsense of

the Commission's analysis to date.

Maybe one way around this is not to talk about 3G at all because what we're trying to describe in 3G is what you don't want to regulate, and maybe there is a better way of addressing this by actually trying to describe fully what is going to be regulated.

So, we take an approach that actually doesn't require any reference to 3G in the service specification. We simply find a simple way, probably not so simple, but a way of describing the networks that exist today so that there is little chance for avoidance of the regulation, if it were, to be put into place of course.

CHAIR: Is it your suggestion that we should be looking to focus, as I think has been suggested previously, on the nature of the service itself, rather than on the description of the network that is the platform for the service?

MR STIFFE: Well, I think what it ultimately will come down to is a description of the current platform that is providing the current service as we see it today.

Our contention is still that 3G, as we see it, should not be regulated. So let me be plain about that, we are not seeking that to be included.

But I think there is probably sufficient both technical and commercial expertise around the table to draft something that describes the networks as they stand today and the service as it stands today, without leaving so much wriggle room.

I suspect that getting into a drafting exercise this afternoon may not be very helpful. But if we can get some agreement on the principle that we're following, then I doubt that it would take very long to actually do that exercise.

MR FORSYTH: I wonder if I might add from TelstraClear. I

think Peter's suggestion is a useful one. It's certainly, I guess, where TelstraClear were seeking to make the distinction. We, like Vodafone and, I think, like Telecom, do not support the regulation of 3G networks when we think of them as what it is that 3G networks are designed to deliver, which are a raft of new and, we've all heard, uncertain risky services which are data based services.

The distinction that we think is a bright line distinction, and it gets us past the discussion we're having at the moment, and as Peter notes we'll continue to have, is the distinction if we're talking voice, as I think we should be, between switched voice and packet voice, if you will, or voice over IP. And we think that distinction is a very bright line distinction and one that can be not only clearly articulated in a regulation, but also one that can be clearly differentiated operationally between the parties.

You can't mix minutes and IP, other than explicitly mixing them.

So, we don't need to get into the inevitable argy-bargy that will go on between lawyers, economists and possibly even technicians if they're asked, as to what is 2G, what is 3G, etc., so we would support that.

CHAIR: Yes, perhaps I'll take Mr Parkes first and then come back.

MR PARKES: Firstly, I'd just like to step back and look at the bigger picture, which is that whenever regulation is considered, it's not going to fall into some neat compartment. This is not like a race where all the operators are sitting at the start line waiting for the starter's gun. The Commission are looking at regulating halfway through a race and as it happens, Telecom is now ahead. As I said in my opening remarks, in 2000 our board

made a very risky decision on CDMA. There were a very large number of sceptics both in and outside the company that said, "You're crazy, this new technology is still too early to see if it's going to blossom. It may end up being an orphan. This is a huge risk."

But there were those that said this offers us huge advantages if the risk comes off of technology superiority to Vodafone. We're going to struggle if we just have the same technology if we're David against Goliath. We need a competitive advantage and that's why we went with CDMA.

The last three or four years has seen CDMA become a real contender in terms of a global standard and we are seeing, and starting to realise, the benefits of that risky decision.

It is a fact that the ITU define 1XRTT EVDO and 3G and for good reason. As Professor Hausman reminded me yesterday, he says he's a very happy customer with his data card in his laptop, which is permanently attached to himself, seemingly. He's sitting there getting 1 meg per second off our CDMA investment; double what he gets in Boston, he tells me. If that's not 3G fast data applications as Mr Forsyth says, I'm not sure what is.

So, we have probably the reputable international guideline as to what is 3G, the ITU.

The Commission, it seems to me, ought to have considerable problems or troubles if it was to regulate or penalise Telecom for taking risks and taking a lead in the race. You would end up taking up Mr Stiffe's proposal, you would end up regulating our 3G investments but not the equivalent Vodafone 3G investments.

So, we would be regulated and they would not.

That seems to be a very negative signal to send to someone like Telecom who's taken very significant risks.

If I could turn to Mr Forsyth's comments, in terms of

circuit switched or packet based voice, I made a packet based voice call on a mobile phone not a few hours ago, waiting for the closed session, using Push to Talk.

That's a packet based voice application. We're expecting, within 12 months, on more standard voiced calls on our mobile network for those calls to be packet based.

So, the bright line would rapidly become blurred under Mr Forsyth's proposal.

CHAIR: Mr Stiffe, you wanted to add something?

MR STIFFE: Yes, I would absolutely agree with Mr Parkes, that this is a problematic issue, but it is simply intolerable to put such an asymmetry into the market through a regulatory instrument.

The point that I was going to make, though, in response to Mr Forsyth, is that I'm not certain that drawing a bright line distinction between circuit switched voice and voice over IP is exactly the right way to do this.

What I do suggest is that if there is going to be regulation of fixed to mobile calls in this market, then we should be clear about what is going to be regulated, and I think that is a more helpful way of starting this conversation, rather than trying to carve out what is not, and that is our proposal. And I suspect if we'd never put 3G in the service description in the first place, instead we focused on what was going to be regulated, so existing services and described them in a particular way, we wouldn't have to have this debate about where is the line between 2G and 3G.

CHAIR: Yes, that's a very helpful comment. We do, of course, have an affirmative statement of what it is that would be regulated under this service description but it's the carve out that causes the problem, rather than - I haven't heard any objection to the description of the service as a

termination of voice calls on a cellular mobile network, regardless of whether it's switched or IP, but then comes the question of the carve out which the Commission has currently favoured on the grounds that it does not generate the same level of investment risk to 3G networks.

What I'm having difficulty with, I must say at this moment, is seeing how it would be possible to move away from the use of the terminology of 3G networks, however defined, while at the same time preserving the essence of the carve out. So, that's still the difficulty I'm having.

I think it's very appealing to focus on an affirmative statement without more and just leave the affirmative statement to speak for itself. But the question then to me is, well, is it possible to define an affirmative description of the voice termination service which would still preserve the essence of the carve out?

Mr Forsyth suggested one approach, which is to reference the calls as switched voice calls and, Mr Stiffe, you have cast doubt on that.

So, I think we're still rather, you know, we're not quite there, I didn't necessarily expect that we would, but if there's anything more you can say on this point it would be very helpful.

MR STIFFE: Just perhaps one comment, and I suspect I've exhausted my thoughts on this after this, that we are very concerned about 3G because this is about future investment where we don't know where the costs lie and for practical reasons, and largely it is a practical issue from Vodafone's perspective, at the risk of getting the regulation wrong we think that future investment that is coming, and non-incremental investment, should not be included in the regulation.

I think at the heart of things, even in the report,

when you're talking about 3G, what we're really perhaps meaning is we don't want to extend this regulation inappropriately to future non-incremental investments, and 3G is obviously what is in everybody's minds at the moment.

So, again, I'm just trying to think of ways to get around this issue about trying to rely on a particular definition of 3G or 2G.

CHAIR: Yes. I think the issue is very clear, though, and I'm not sure we can perhaps push it any further in this conversation. I think it's been helpful to have these contributions and I think we'll have to take this point away for further thought.

MR PARKES: I just want to ensure I understood Mr Stiffe's proposal, which I read to mean that you would define the technologies, you would list - in terms of the Telecom network, you would say it would be the 025 network, the digital amps, CDMA 2000, 1XRTT, network technologies that were covered by regulation but future technologies would be excluded? Is it reference to the actual networks that are deployed?

MR STIFFE: My intention today is not to try and actually craft the words. But I think, maybe between us, as an industry, and with the Commission's help we may be able to come to a definition that was able to accommodate each of the players here.

CHAIR: Let's leave that point just sitting there, I think, for the moment. We've probably taken it as far as we can.

I want to come on to the next element in this service description which has attracted some comment, and that's the definition of "access seeker" in the definition which refers to, at the moment, an access seeker as being a person who provides or will potentially provide fixed to mobile services and seeks access to the regulated

termination service.

Now, there's been some criticism raised of this definition. I think on the part of the Commission I can say that the language was used with the purpose of making it clear that the party we saw as being able to gain access to the regulated termination rate was a party who was using such a service for the purpose of providing a fixed to mobile retail product.

But I want to just see whether there's any remaining questions that are outstanding in the minds of the parties about that point.

MR STIFFE: We have proposed, again, a slightly different approach, where our understanding is that mobile to mobile calls, or at least calls that originate on mobile numbers, are taken to be excluded.

We are a little concerned that someone that deployed a fixed service equivalent over a wireless network may somehow not gain access to the service. So, you could imagine either an existing player in the market, like Vodafone, if we did choose to provide a fixed service equivalent from our mobile network, and we wanted to get access to the regulated rate, that under the current description of calls that - a person that provides fixed to mobile services, that description may allow for some play by the access provider, perhaps.

So, we want to be clear that actually what we're talking about here is that mobile to mobile services are effectively carved out, or at least calls from mobile telephone numbers and everything else is in.

CHAIR: You are putting emphasis on a carve out?

MR STIFFE: Yes, is the short answer, for a call originating from a mobile number.

CHAIR: A call originating from a mobile number?

MR STIFFE: Yes.

CHAIR: Of course. This issue is itself under dispute?

MR STIFFE: Indeed.

CHAIR: As to whether we have the exclusion right?

MR STIFFE: Indeed.

CHAIR: But we are staying within the frame of the Commission's view at the moment?

MR STIFFE: Yes.

CHAIR: Mr Forsyth, Mr Allen, did you want to comment on this one?

MR FORSYTH: No. I think we understand the distinction that Peter is making and I think it's probably a distinction that we would support. And, again, without getting into the drafting, I think it's sufficient to say yes, we support the concept. I am not quite sure how you deliver that in drafting but we'll leave that to you.

CHAIR: Mr Parkes, did you have anything to say on this?

MR PARKES: I am checking I understand what Mr Stiffe is saying.

CHAIR: Go ahead.

MR PARKES: I know this isn't cross-examination. You're saying that you have a wireless network but you may provide a fixed service look alike?

MR STIFFE: Yes.

MR PARKES: And market it as such?

MR STIFFE: Yes.

MR PARKES: Someone may then turn around and say it might have a 9X number but it's a wireless service so you don't apply?

MR STIFFE: Yes.

MR PARKES: Presumably, the same might apply to someone like WOOSH?

MR STIFFE: Indeed.

MR PARKES: I think that would not be a sensible policy outcome, thinking on my feet. The technology - there

would be a technology differentiator.

CHAIR: Okay. All right. Well, I think that -

MR STIFFE: I will just add one more point, and it's actually not in here, in the Commission's service description, but clearly one of the other issues and avenues for gaming is the use of some players to have commercially negotiated rates and some to have regulated rates and then to use transit agreements effectively to arbitrage between the two.

So, it would seem to us also to be helpful to stipulate that the calls that are covered by this regulation for an access seeker are the calls that originate on its own network, and that is simply a guard against arbitrage and gaming of the regulation.

CHAIR: Thank you. Is there anything else on this point? No?

MR FORSYTH: If I might just respond to Peter's most recent suggestion.

CHAIR: Sure.

MR FORSYTH: I don't think that would work, and the most obvious answer is we have customers who utilise call preselection who "exist" on the Telecom network but choose to have TelstraClear carry their call for termination on, let's say, Vodafone's network.

MS DODD: Could it be covered off with reference to - I wonder whether the concern could be covered off by referencing a need to have a retail relationship with the caller.

MR FORSYTH: No, we have wholesale as well.

MS DODD: Okay.

MR STIFFE: Our point simply relates to that issue of arbitrage, and there may be different ways to word the provision. We're not hung up on the actually wording but we think it would create a dangerous commercial environment to neglect it.

CHAIR: We certainly want to be very alert to arbitrage issues.

There's no question that the approach we are taking here, which is designed to be targeted very specifically at the problem we feel exists, gives rise to arbitrage opportunities, and I'm sure that everybody would agree it's not possible to eliminate arbitrage risk, but it's a matter of whether we can sensibly mitigate it without opening more and fresh arbitrage opportunities.

So, I think this conversation illustrates the point very well.

Can I just come on then to - perhaps to very briefly clear off the matter of the pricing principle and then I want to come on to a couple of other issues that have been raised by Vodafone.

We have proposed benchmarking as an initial pricing principle, followed by TSLRIC.

There have been some submissions made to us, particularly in relation to, first of all, the difficulty of finding a suitable appropriate group of comparator countries for benchmarking, and there have also been submissions made as to whether a TSLRIC price would adequately capture externalities.

I think the second point is perhaps one that there may not be much more that can be said about, but I'm interested on the first point, whether it's the view of those who criticised the concept of benchmarking that there is some other form of initial pricing principle that would be more robust and preferable.

So, I'm interested in hearing if there are any views on that. Mr Stiffe?

MR STIFFE: Since we've put something up in the cross-submissions I guess, yes, we are quite keen on moving away from benchmarking.

The problem for us in benchmarking, and I think it's been illustrated in the submissions that you've had so far

and to an extent in the discussions that we've had during the last few days, is that finding reliable benchmarks is actually quite difficult, and particularly trying to predict where on the regulatory, sort of, curve, different countries are at is also very difficult.

I would also remark that some countries, while they may say that they have adopted a cost based analysis, that's perhaps more a political answer rather than a real economic answer, and I'm sure you are aware of the debate that we're having in Australia at the moment over whether the comparison of comparisons that was adopted by the ACCC is actually an appropriate estimate of what TSLRIC is. So, we think benchmarking in and of itself is fraught with risk.

And what we sought to do by proposing a CPI-X, and being very brave and actually suggesting an X, was a pragmatic way of effectively locking in past behaviour into future prices, and that is why we offered up the approach that we did.

CHAIR: Very well. Mr Forsyth?

MR FORSYTH: We would certainly concur that benchmarking is not a simple exercise but there again it's not an impossible exercise.

I guess in that last suggestion about CPI-X, as Mr Stiffe has noted, in locking in the past, well, I think that's just the thing we want to avoid.

I think most of us have the view that the rates that New Zealand suffers under at the moment, i.e. the past hopefully, are extremely high and I think any sort of pricing principle which gave benefit to locking in those rates with some sort of minus, I think would be quite detrimental to achieving the purpose of the Act.

So, no, I think we should strive to deliver a TSLRIC price and for pragmatic reasons, and the Act I think is

well constructed to support this, an initial pricing principle can be found relatively quickly through benchmarking. I think that's quite workable.

MR ALLEN: If the cost benefit analysis model is rerun using the Vodafone proposed glidepath, the net benefits that would originate from the model would be materially lower than using TSLRIC and benchmarking.

CHAIR: I am not on price path at the moment but I understand the point you're making.

Mr Parkes, do you have anything to say on this issue?

MR PARKES: I think we've traversed in previous hearings our views on benchmarking generally, so I won't bore you on that. I could be very mean and ask Professor Hausman to give us his views on TSLRIC, but I won't, they are probably well documented as well.

So, I will resist saying benchmarking and TSLRIC are equally unproductive and you shouldn't regulate.

We had a view on the final pricing principle more than benchmarking, if I can make some observations on that.

CHAIR: Yes, of course.

MR PARKES: We will, if regulation proceeds, be dealing with regulation of at least Vodafone and the Telecom Mobile network.

We were unclear how the Commission intended to proceed in terms of TSLRIC modelling of the costs, of either both networks or would you be looking at the costs of one network?

Our preference would be to use some generic costing exercise, probably based on GSM as the scale, global scale leader.

Most of the networks you'd be benchmarking against would likely be GSM networks.

We are concerned at the considerable overhead that

TSLRIC modelling imposes on organisations, Telecom in particular.

There's also an issue of whether the Commission should choose the higher cost network in order not to take away any incentive to invest in lower cost technologies.

So, the Commission might want to think about giving itself the flexibility in terms of how it actually implements TSLRIC, so something like taking one reference network, and again I think GSM as the clear global scale leader would make the most sense, and maybe some principle around ensuring there's some sort of symmetry of rates between networks based on what is likely to be the higher cost networks and in order not to remove incentives to gain a lead in the race.

CHAIR: Thank you.

PROFESSOR HAUSMAN: I don't expect this is going to convince you, but if you look at the TSLRIC estimates of long distance and the prices that are being charged, if that doesn't give a regulatory Commission pause in terms of, I understand there are about 12 long distance providers at least in New Zealand and there are no barriers to expansion, I'd like to know whatever will give regulatory Commission pause. You are finding a very large gap, as I understand it, between TSLRIC estimates of long distance and what's actually being charged.

If I remember correctly, two years ago you found the long distance market to be competitive yet we find this very large gap.

So, you know, I don't expect regulators to back off TSLRIC, it seems to be the favourite thing. But when you have a gap like that in a market that you found competitive, if I remember right, it does raise doubts to an economist about exactly what TSLRIC is measuring.

CHAIR: Yes, thank you, Professor. If there's nothing further

on this particular point, then the next point I wanted to come to was the submission made by Vodafone, that if the Commission were to recommend regulation, it should consider a price path for the imposition of that regulation on the footing, if I understand correctly, that the price path itself would have benefits for end users.

I want to just draw this point out a little bit because it's quite clear that with the Commission's current proposal, which is for essentially a single price fall to a regulated rate, has quite different impacts so far as the access providers are concerned, but I'm interested in knowing what would be the - let's say the comparative benefit to end users of a price path rather than a single regulated rate fall, and, Mr Stiffe, this issue was raised by Vodafone, can you just speak to that point because I didn't quite understand exactly your submission on this issue of how end users would benefit from a price path.

MR STIFFE: Sure. I think the concern we had is perhaps the Commission is only considering the benefits to fixed to mobile callers, retail fixed to mobile callers, and not necessarily to the mobile customers themselves who are also end users, of course.

So, our concern about a sudden drop down to whatever rate, particularly if you're looking at rates around 16 cents, that would have a very significant and detrimental impact on mobile customers, aside from the detrimental impacts, of course, it would have on Vodafone itself.

CHAIR: And can you say why the price path is superior from that point of view?

MR STIFFE: I think for us a price path allows a gradual adjustment on both sides.

I mean, we know that in a fixed sense pass through,

unless there is a regulated pass through and perhaps even then, pass through will not be immediate.

Nevertheless, the impact on the mobile business will be immediate and the steps that it would need to take to try and rectify the situation would be more or less immediate.

We also have problems, of course, that because we price on the basis of the lifetime value of our customers, we've already invested in a whole lot of customers based on our future expectations of revenue from them.

So, a sudden and dramatic drop would mean that those previous investments in our customers would be - or, at least, our calculations would be rendered useless. We would have to try and find some other way of being able to deal with the problem, all of which, in our view, as well as being impactful on us, would be impactful on mobile end users.

CHAIR: Mr Parkes, my recollection is that Telecom's position on this was that whatever the merits of a price path, the Commission didn't have the power to recommend a price path; am I right in that?

MR PARKES: Yes. When we read the Act and the genesis of the Act, we read it has the regulation of competitor to competitor input products. The Act, section 18, I think, talks about the regulation of the supply of certain telecommunication services between service providers.

So, the Commission and the Act is about regulating services which service providers provide to each other as inputs and then the competitive forces are let loose and that is the way that retail prices would be set.

We wouldn't see the Commission having the power, and certainly not being the intention of the Act, for the Commission to step outside of the wholesale area into dictating what should happen to retail prices.

CHAIR: I think you are ahead of me, Mr Parkes. I think that was my next topic.

MR PARKES: Sorry.

CHAIR: The pass through requirement, this conversation is about a price path termination rate itself.

MR PARKES: I will take that and reclaim that. You're taking about the glidepath for termination?

CHAIR: The glidepath, thank you, the glidepath. I would like to hear Telecom's view on whether a glidepath would be in the interests of end users if a decision were made to regulate termination rates.

MR PARKES: I guess a general point, bearing in mind we think regulation would be very bad for customers, both mobile and fixed to mobile, if you're going to do something unwise like regulation, try and spin it out. I don't know if I can put it any more elegantly than that.

We think it is costly to customers, so a glidepath would minimise the negative impacts on customers. And I'd certainly echo Mr Stiffe's comments, in terms of the way Telecom makes pricing decisions, sets handset prices, contractual terms for 2-3 years for customers, those are done on the status quo in terms of the estimates of inbound revenue.

Typically, term customers on contracts for 2-3 years will be high value customers. Often they will be getting the top of the range handset, frequently for little or no up-front cost, and obviously there's a major cashflow negative to attaining that customer, which hopefully is more than made up through the term of the contract.

That would have quite an effect if the termination revenues were to be substantially reduced during those term contracts.

We would need to look at what efforts we could do to make sure those customers remain profitable but it is

difficult once contracts have been signed with customers.

CHAIR: And the longest duration of contracts that are in the retail space, what would that be?

MR PARKES: Anything from 12-36 months.

CHAIR: 36 months. Is that true also for Vodafone, Mr Stiffe?

MR STIFFE: Yes. I think the issue, though, is not just the formal contracts that we have. We also assume that customers will be with us, and a lot of our prepaid customers, of course, don't have any contracts at all, but we still in - when we price those customers we have an expectation that they will remain with us for a period of time; they're not here today, gone tomorrow.

CHAIR: Yes, I'm sure that's right, thank you.

Mr Forsyth, the issue of price path/glidepath as it's been called, I think TelstraClear said this was something we should not do.

Perhaps I attributed your position to Mr Parkes, but is it right that TelstraClear's position was that not only was this something we should not do, it was something we could not do?

MR ALLEN: No, I don't think that's right.

CHAIR: Oh.

MR ALLEN: If you wanted to do it, I'd say you could do it, but the point we're making is we wouldn't think you would want to do it, it would be inconsistent with section 18. And the long-term benefit of end users, and I think Bruce Parkes articulated it well, he said we don't want the regulation. If we're going to have the regulation, let's do what we can to delay the effect of regulation and that's exactly what a glidepath is about, it's stalling the full effect of the regulation. There's no benefit to an end user of having a delay in getting reduction in price.

As I noted before, if you ran the cost benefit

analysis doing a comparison of what would the net benefits look like if we used a glidepath or not, quite clearly I think it's fair to say that the net benefits would be substantially higher from not using a glidepath.

I'd also note that Vodafone has made much of the size of the reduction that would - that the current proposal would give cause to but, again, that is a matter - that is a consequence of the fact that Telecom and Vodafone's fixed to mobile termination rates are high.

If they weren't high, there wouldn't be the big reduction that they're concerned about.

MR FORSYTH: If I might just add to that. We've heard from Mr Parkes and also Mr Stiffe as to the problems of contracts etc., and I would note, as we have noted in our submission, that the proportion drop that we're looking at here in the Commission's draft report is less than that which the Commission delivered in its determination with regards to PSTN termination, origination termination. And, naturally, operators of fixed networks, including ourselves and Telecom, similarly have contracts with customers, within which we make certain presumptions as to the underlying costs of our business.

So, I don't think, you know, the mobile market is so any different to any other market and, as I say, the task that the Commission is faced with is one not created by its doing. Your role is to deliver to the end user and the magnitude of that, the benefit that you deliver to a large extent has been created by the actions of Telecom and Vodafone.

CHAIR: I want to give Mr Parkes and Mr Stiffe an opportunity for any final comment before I move on to my last point.

Mr Parkes, would you like to speak?

MR PARKES: Responding to Mr Allen's comments, the economic arguments we've had around the waterbed effect I think

need to be an important part of the Commission's consideration here.

Effectively, in their halving of termination rates, or a considerable reduction in termination rates overnight, is a considerable shock to both ours and, I would suspect, Vodafone's business model.

The waterbed effect, as we've said, will be a material one and in terms of Mr Allen's comments that customers want price reductions now, I would say that mobile customers would prefer the price increases that would follow from mobile termination not to happen immediately.

So, the Commission needs to think of the two sides of this two sided market in terms of the substantive shock to the business models and the consequences of pricing that will follow. There's no doubt about that. And that will impact not just on callers to the mobile phones but to mobile customers.

So, I think that's an important point for the Commission to consider.

CHAIR: Mr Stiffe?

MR STIFFE: May I make just four very brief comments.

The first one is in relation to trying to compare this to, I think, some people would say a halving of the PSTN rate and, therefore, it's not so bad as we might think. A 40%-odd reduction in mobile termination rates would yield about a 15% drop in Vodafone's overall revenue. I suspect the PSTN regulation didn't have the same proportionate effect on Telecom.

So, comparing percentages is actually not a very helpful way of looking at this particular issue.

The second comment is that, in our view, this is not about trying to let Vodafone off lightly or anything like that, this is about actually meeting the objective of the

Act and having a look at the impact on all end users, and not only just the impact but the long-term impact.

So, we think a glidepath, as it is sometimes called, if you're going to regulate, is the only way to regulate consistently with the objective of the Act.

To Mr Allen's comment, that if you follow a glidepath there's no benefit in the cost benefit analysis, well, that's just consistent with our view that you shouldn't be regulating at all.

I guess the final comment, that you've got to regulate all the way down because the fixed network customers want reductions right now, well, the fixed networks have never, ever stepped up and said they're going to pass all this through, in fact they've said they're not.

So, cutting to the bone and below the bone, mobile termination rates isn't going to have the effect that is asserted by TelstraClear.

CHAIR: Thank you. Mr Parkes?

MR PARKES: Sorry, can I just make one more comment which

relates to the existence of our 025 network, which hasn't come up particularly in the last two days, but we have a unique challenge with our mobile business in that we are migrating from 025 to 027. We are well down that path. The CDMA network has run its course and we have been quite public with the fact that we intend to shut off that network some time in 2007.

We have a very considerable number of customers, hundreds of thousands of New Zealanders, and without wanting to risk this becoming a family affair, including Genevieve's grandmother, but I won't bring her into it. My mother has an 025 phone from Warehouse days which I think is over five years old now, but we have a large number of low value customers with very robust handsets

who are ticking along, not making many calls, but we will need to migrate those low value customers hopefully to 027. I'm sure Vodafone have a different view on where they might end up.

I think there's an issue there that the Commission may need to consider in terms of a significant change to the business case for transferring those customers off a network that is about to be turned off. Given that these customers are a large rump of very low value customers, economic because they're connected, but we face quite a challenge in order to migrate those customers with new handsets and the sales and marketing costs.

A very sudden change to the economics of supplying low end customers will make that transition issue more challenging for Telecom and we are looking at a very large number, hundreds of thousands of customers in this instance. So, that may be a unique feature of the New Zealand environment that may warrant a more gradual introduction of reduced termination rates.

CHAIR: Yes, thank you. I want to just very briefly, because we're nearly running out of time here, just come to the final point on my list, which was again the issue raised by Vodafone in response to an invitation from the Commission to submit on the point, that if mobile termination were to be regulated there should be a condition imposed on access seekers, an eligibility condition which would link their eligibility to demonstrated pass through of all or some significant part of the cost reduction through into fixed to mobile retail rates.

Mr Parkes has in fact already defined Telecom's position on that, so I don't perhaps need to ask him again.

Mr Stiffe, unless there's something you want to add

to that point, I would simply ask Mr Forsyth to define TelstraClear's position on that. But, Mr Stiffe, did you want to add anything to it?

MR STIFFE: I think the only thing would be that I think a number of players, and probably Telecom and TelstraClear, have indicated that they don't think the Commission is allowed to require a form of pass through as a condition of getting access to a regulated price.

Our analysis, and there's been some quite extensive analysis done of the Act, would indicate that there is nothing that prevents the Commission from doing so.

We agree that the Commission cannot regulate retail prices but we're not actually asking here for the Commission to regulate retail prices. This is an access condition that relates to the average prices charged by an access seeker.

If they choose to charge different prices, there's nothing preventing them from doing so, it simply means that they don't get access to the regulated rate, and, of course, if the Commission in our view has made some pretty heroic sort of assumptions in terms of pass through in its modelling, if those rates of pass through are not going to occur, and we've had very strong indications I think from the fixed players that they are certainly not going to promise any level of pass through at all, and certainly not into fixed to mobile prices, that if there is no guarantee or likelihood of pass through, then the case for regulation is very weak indeed.

CHAIR: Mr Forsyth?

MR FORSYTH: Yes, I think our position is very clear, and it happens to coincide with Telecom's, that the Act doesn't legally provide for the Commission to set or influence a retail price.

Other than to say -

CHAIR: You may not want to go any further than that.

MR FORSYTH: No, other than to say that we will see, as we have seen in other services where the wholesale price is reduced, competition works in the downstream market to deliver those benefits, not only in price but in greater competition, more innovation in the retail market.

MR ALLEN: I wonder if I could add to that. Going back to the section 18 purpose of promoting competition, it would be difficult to see how imposing a retail price control on the retail market would promote competition in that market.

The other thing, as a minor point, is I struggle to see how a potential new entrant would be able to make that commitment because they don't have existing fixed to mobile retail prices from which to reduce their prices from.

MR CURTIN: Just if I could follow-up some of these points.

I take your point about the Act and whether it allows us to do things, I note that, but I do note you've been very strong on the issue of the consumer welfare test, as opposed to a public welfare test; you've been strong on a large reduction in the rate; you've been strong on an immediate reduction in that rate, up to the point of where we might be inclined to try and make sure that that actually reaches the consumer in the marketplace and then you say - I take your point, we can't do that, but in the cross-submission you're arguing we shouldn't do that. I suppose I'd like to hear a little bit more from you on that point.

MR FORSYTH: Well, I think it just goes to the statements we just made, that the purpose of the Act is to support competition and through competition to deliver benefits to end users.

As Mr Allen has just pointed out, regulating the

retail price by whatever means is not conducive to that.

MR STIFFE: If I may, just one last comment from me and then I will promise to shut up for the rest of the day.

We also hope that competition flourishes in all of the markets that we operate in in New Zealand, not just the mobile market where we're currently in, where it's already live and well.

The issue of pass through is that past experience tells us that the margins have been widening, not narrowing, and because only partial pass through is happening and, you know, it's very difficult for us to really believe statements that say everything will be all right and competition will solve it, because it's hard to see how the competitive framework will actually change.

The pass through condition that we have been talking about is not a price control, it's not a retail price control, but could perhaps be seen by the Commission as, I guess, a bit of an insurance mechanism that it can put - if all of this competition breaks out, as everybody hopes it will, then presumably it will not be necessary.

But there is nothing in the Act that specifically provides for a pass through requirement. We acknowledge that. But equally, there is nothing in the Act that actually says that you cannot do it.

CHAIR: Very well. I do want to draw to a close because we're due to come to the closing remarks, so if I can ask you to be brief, Mr Parkes first and then Mr Forsyth.

MR PARKES: There are over three million cellphones in New Zealand, around or less than two million fixed lines.

The easiest way for a New Zealander to call another mobile phone is through using a mobile phone.

Vodafone are a participant in the marketplace for calling mobile phones. They are not on the fixed to mobile but they are in the business of providing calls to

mobile phones. They have a significant ability to influence the market dynamics and drive that price down through the way they price outbound calls to mobile phones on their network.

MR FORSYTH: I guess I just have two observations to make.

One is that prices have been coming down, and we have provided evidence of that, and noted that while some of our headline rates have remained the same, we have introduced what we think are innovative pricing products, such as Z Talk etc., and they are introduced in a manner where we think assists us build our value relationships with our client.

The Act is all about reducing bottlenecks and assisting competition. I don't think anyone is suggesting that the retail fixed to mobile market is a bottleneck.

CHAIR: Very well. Thank you, gentlemen. We will close this session. Now, I would like to go straight into the closing comments. We will just take five minutes to setup and then - so, the Commissioners will stay here in the room and as soon as ready we will then begin the closing comments with Mr Edwards for Econet Wireless.

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**CLOSING COMMENTS ON BEHALF OF ECONET WIRELESS NEW ZEALAND**  
CHAIR: We will resume now for the final session of the

conference. This session is closing comments. The first speaker will be Mr Tex Edwards.

MR EDWARDS: Thank you, Commissioner Webb. Econet has found

the conference very useful and we hope we've been able to contribute to the debate despite the fact that the bulk of our comments are limited to our opening and closing addresses. We feel we have an important contribution to make given our role in the industry and our experience in operating GSM networks in other countries.

We are only a mobile player with no landline interests.

I would like to reiterate Econet's summary position. The Commission is right in analysing the market as being ready for an adjustment, given the exorbitant prices paid by New Zealand consumers relative to OECD counterparts.

However, it would be a mistake to prefer direct price regulation over the encouragement of new entry and the promotion of real competition at the retail level through networks construction. We are concerned that the regulation of fixed to mobile termination rates would have the effect of reducing incentives to enter, and entrenching the structure that exists today which has been so harmful to the interests of end users. Across this range of discussion topics in this conference, the positions that have been taken have been set out against a background of the current market structure where no real competition exists.

If that dynamic were to change, we believe the discussion would have proceeded quite differently, and the Commission would be less disposed towards direct price regulation.

We are not convinced by the arguments of Telecom and Vodafone that retail prices will automatically rise should the Commission decide to regulate. It seems to us intuitively that there would be no justification for them to raise prices given that New Zealand prices are currently amongst the highest in the OECD.

However, even if prices were to be increased, the only reason they would be able to do so is because there is no effective price competition in the market. In a competitive market, the clawback gains would be subject to competitive pricing pressure and therefore would not lead to an overall rise in retail prices.

However, in this instance, we are under no illusion that Vodafone and Telecom have different cost structures and the price implication of regulation would be different for both organisations.

As Professor Hausman pointed out, the arguments around retail prices seem to be based on some fallacious argument that there is a current level of profitability that must be maintained.

Therefore, the argument goes, if revenue is artificially reduced, the operators will have to increase the price of their services to clawback their former level of profitability.

However, as Professor Hausman said, operators have an incentive simply to maximise their profits, taking into account all of the market conditions that exist at the time.

It doesn't matter what the former price point was. The issue is what conditions will allow.

Telecom and Vodafone tell us that prices will increase as a result of the regulation. As we've said, we are sceptical about how this can be justified. But even if they are right, that could only happen in the current

uncompetitive market. In a competitive market, market conditions would impose a constraint on the pricing levels which the operators could achieve.

At the end of the day, the issue is the number of players in the market, not the mobile termination rates. After all, the current high retail prices, which is the evil the Commission is attempting to address, are simply the natural consequence of a lack of effective competition.

A licensing mistake was made in the mid-90s in GSM and the consumer is now paying for it.

Respectful to the questions that the Commission have asked us in the course of this enquiry, and our strong view on GSM operating costs.

We understand that Vodafone was to present to you, Commissioner Webb, information in a closed session refuting arguments on Wednesday about the lower cost structure in New Zealand versus other markets. We were not present at the closed sessions but we would like to reiterate our views on the lower cost structures here in New Zealand. The basis of our view is our experience in operating GSM networks in other countries and our analysis to date as a perspective new entrant into New Zealand. We would be delighted to flesh our observations out with the Commission at a later date.

We believe the GSM operator in New Zealand has a cheaper cost structure than most OECD countries because of the following:

Number one, the very low cost of distribution in New Zealand. There is no retained ARPU payable in distribution channels and arguably, distribution channels are monopolised.

Secondly, the absolute quantum of spectrum that Vodafone has available to it relative to international

operators. Vodafone has 25 + 25 Mhz of GSM spectrum, whilst the normal international level is 7.5 Mhz where a subscriber base would normally be several times larger.

Thirdly, GSM handsets. Subsidies in New Zealand are unnecessary because there's little retail competition.

GSM handsets, as we've acknowledged, are a lot cheaper than CDMA handsets and in many markets, including the UK, handsets will be provided free to customers on a contract plan. In the same situation in New Zealand consumers can pay \$800-\$1,000.

Another possible misinterpretation is that it's been suggested in New Zealand operators incur higher capital costs because of our unique geographical conditions and low population density in this beautiful country. May I point out that infrastructure supplied by equipment suppliers are very willing to sell on a per customer basis, not on a coverage basis, and costs from equipment suppliers are always mapped to the amount of customers and the capacity on a network. It's often a misinterpretation by existing operators that our unique geography here have some special costs associated with it.

Vodafone's lower cost structures will exist with or without the regulation of fixed to mobile termination rates. It is these cost structures which determine overall price levels and provides Vodafone's key strategic advantage over Telecom.

Regulation of fixed to mobile won't give consumers access to more competition at the network level and won't right the wrong of a GSM monopoly.

In summary, the market is uncompetitive and needs to change. And the fact that operating a network in New Zealand is cheap relative to the OECD means that price comparisons with other OECD countries are relevant and should be considered in analysing the issue. But the way

to address the issue is through competition, not through direct price regulation of fixed to mobile termination rates.

Much has been discussed about fixed to mobile substitution. When discussing Vodafone's incentives to keep mobile termination rates high, since Vodafone is a net receiver of termination revenues, there seems to be some confusion. The idea was that Vodafone also has an incentive to reduce mobile termination rates so that their customers can receive more calls and Vodafone more termination revenue.

We refute that point.

The single biggest revenue opportunity facing mobile operators today is fixed to mobile substitution, where calls that would historically been made over the fixed line network are transferred on to the mobile network. Put another way, fixed to mobile calls become mobile to mobile calls.

This is the biggest sea change in telecommunications over the next 10 years.

If a mobile operator can keep termination rates artificially high, then this gives them a competitive pricing advantage over the fixed line operator in offering closed network solutions. This artificial competitive advantage can then be used to transfer dominance in the mobile voice market into dominance of what was once the fixedvoice market.

The result of this is that the mobile operator who competes against the fixed line operator has an enormous interest in keeping mobile termination rates high.

The suggestion that Vodafone may consider dropping their mobile termination rates so that they were in line with fixed termination rates is a difficult argument to make. Mobile termination rates are circa 30 cents, fixed

line termination rates circa 1.4 cents.

A profit maximising firm will not reduce their mobile termination rate by 29 cents to pursue increased termination traffic. They will instead keep termination rates high and accept lower termination traffic and increased outgoing traffic.

Vodafone to Vodafone calls obviously incur no termination costs. However, there is no requirement to reduce retail prices for this type of call. Therefore, with market share at circa 65% and rising, Vodafone gains substantially from high mobile termination rates as the profitability increases, that each call made will be a Vodafone to Vodafone call, for which no termination rate is payable. In this way, a "closed network" develops which is a hugely compelling situation given the size of the fixed to mobile substitution opportunity. Therefore, the dominant GSM operator has every incentive to keep mobile termination rates high, and there is no countervailing incentive to reduce them.

We'd like to reiterate our position that no distinction should be made between 2G and 3G regulation. Networks in New Zealand have gone through many transitions from AMPS to D-AMPS, CDMA, 1XRTT and EVDO and GSM, WAP, and GPRS. 3G is just another evolution.

Additionally, it's our view that a lot of the 3G investment is actually fixed to mobile substitution investment and should be viewed with regard to a different business case.

In closing, we'd like to reiterate that OECD style regulation provides an incentive to invest for new entrants. It is this investment, not incumbent investment, that needs to be promoted.

Mobile termination rates may well need to change down the track but this is not our peer group of OECD

regulatory systems have worked. Without exception, they have ensured that GSM competition is the first step. Many years later they have regulated mobile termination rates.

Regulating the price now is the wrong way around.

We'd also like to close with acknowledgment from the group CEO of Vodafone PLC Arun Sarin when he was quoted in the National Business Review of New Zealand on 8th April last year. He said that New Zealand operations punched well above what the financial numbers would suggest and that "if I could take the New Zealand company and scale it to the rest of the world, I could retire early and say my job is done". This is the power of GSM. Vodafone stands out in New Zealand because it's unopposed in GSM.

I, like many others, would like to retire early.

In summary, therefore, we believe that the key to reducing prices is new entry in GSM, not the deregulation of termination rates.

Thank you for your time and I appreciate your consideration. Thank you.

CHAIR: Thank you, Mr Edwards. We will now hear from TUANZ.

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**CLOSING COMMENTS ON BEHALF OF TUANZ**

MR NEWMAN: I am Ernie Newman, Chief Executive of TUANZ.

TUANZ repeats at the end of this conference what we said at the start, this investigation is about good services at fair prices for the user. Sometimes the focus seems to be more on the service providers. Indeed the dialogue these last three days has been heavily dominated by the three major carriers; and even the seating arrangements in a subtle way have implied a four sided conversation among them and the Commission.

But it is the end users whose interests are the purpose of this process. The same end users who, according to the OECD, are paying the developed world's highest prices for mobile phone services.

The same end users who according to the Ministry of Economic Development would have to see their cellphone prices nearly halved to get us even to the average of the OECD countries, let alone the top.

Commissioners, this is not a market where the operators are struggling for profitability. It is not a market where future investments are hanging by a thread in fear that regulatory action will collapse the business case.

And it is not a market where aggressive competition is driving down core prices.

Yes, superficially the signs of competition abound in innovative services and branding based competition for new connections. But the reality is that core voice pricing is exceptionally high by world standards because a duopoly is charging the customer for core services far more than can be justified.

Termination rates are a case of not merely imperfect competition, but market failure. The customer who pays

the termination charges can't send signals directly to the operator who imposes them because the party being called has only one cellphone. That's why regulators in many countries have Acts to constrain them. That's why here in the land of the world's dearest cellphones it is imperative that you follow suit.

Telecom specifically, supported by their expert witnesses, have claimed that if you regulate termination charges they would increase the price for mobile subscriptions. They argue that 120,000 New Zealanders would no longer be able to afford a cellphone.

120,000, that is a huge number in a market this size and it shows the scale of the problem we're dealing with here.

TUANZ is astounded at this proposition. The process the Commission is proposing is a well worn track of regulators worldwide. TUANZ has seen no evidence anywhere in the world that regulation has had a significant adverse effect on subscriber numbers.

I have for the past three years chaired an international group comprising 25 user associations like TUANZ spread across the developed world and mobile termination charges with their adverse impact on users have been a regular topic on our agendas. I meet my counterparts from these associations several times a year, and am in dialogue with them daily. Never once have I heard it reported that in any country regulation of termination rates has led to a significant downward impact on subscriber numbers.

That is not to say that because TUANZ hasn't heard of such an impact, it hasn't happened somewhere, but it's easily ascertained.

We urge that the Commission check this point with regulators and statistical agencies. Having found the

answer, we urge that you be guided by that real life experience, those real outcomes.

Please don't be sidetracked by theoretical outcomes such as the inverse function theorem that the expert witnesses have been arguing over. Real life experience is the best guide.

Further, Telecom's proposition is that if termination rates are lowered it would respond by increasing subscriptions and that young people with prepay phones would be hard hit. Telecom implies that these excessive termination charges are necessary so they can hold the subscriptions for the Genevieves of this world to an affordable level. TUANZ does not believe any forward looking business would treat its next generation of customers with such disdain. We strongly doubt there would be such a response from either of the mobile phone companies, and certainly not from both.

TUANZ said in our opening presentation that we expect the reduction in fixed to mobile termination charges to be passed to the calling party so as to reduce the extremely high cost of these fixed to mobile calls. We look to the Commission to monitor the pricing behaviour of the originating carriers to make sure this occurs.

As a final aside, TUANZ notes and supports the urging of the Business Round Table that you bring to the attention of the Government the depressing impact the Kiwi Share is having on the cellphone market. We believe that the Kiwi Share should be regarded as a transitional arrangement and continually reviewed for relevance. Such a review is well overdue, and should include fixed to mobile substitution as one of many elements.

Commissioners, TUANZ wants a fair deal for users. We are not getting it. There is a clear linkage between these excessive termination charges and our woeful

position as the land of the dearest cellphones.

New Zealand will not climb up the OECD league table for standard of having unless we learn from other more successful countries, especially in core services such as communications that have a profound impact on our productivity and lifestyles. Please play your part.

Thank you.

CHAIR: Thank you, Mr Newman.

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**CLOSING COMMENTS ON BEHALF OF TELECOM NEW ZEALAND**

MR PARKES: Can I start by inviting Professor Hausman to

address two specific issues as part of our closing

address?

CHAIR: Yes, of course, on the basis that it is part of your

closing rather than new issues.

MR PARKES: It is, yes.

MR HAUSMAN: The two issues I'm going to address, first, is

Commissioner Webb asked on Wednesday about looking at the

Telecom accounts and seeing that minutes had increased -

fixed to mobile minutes are increased by 5.6% while mobile

subscriptions had increased by 16%.

I think the same issue was raised this morning.

So, I've looked into this and it turns out that the number of FTN minutes in New Zealand in the year ending December 2004 went up by 7.8%, and this is included in Covec's submission on page 8 in this proceeding.

It turns out also that Covec demonstrates the average FTN retail price fell by only 4% over the same year.

So, therefore, if we were to assume the Commission's elasticity of 0.6, you can see that the majority of the fixed to mobile growth must be represented by fixed to mobile calls of new mobile subscribers.

It would be incorrect, however, to focus only on Telecom FTN minutes as inherent in Commissioner Webb's question because, of course, Telecom is losing market share in fixed to mobile minutes, they don't know exactly what their share is, but this means that certainly their growth, which was at 5.6%, is going to be less than the market growth of 7.8%, and, in particular, it's just about 40% less.

It's also not clear to me that the new mobile subscribers being added are receiving fewer mobile calls.

As I testified, I believe there's a lag. In fact, if one checks, you'll see that in 2003 fixed to mobile minutes went up by 5.2% according to Covec. Well, in 2004 they went up by 7.8% despite the market growing for mobile subscriptions about 16 or 17% in both years.

So, hopefully that answers Commissioner Webb's question about what is happening in fixed to mobile minutes.

The next point I'd like to just briefly discuss is this question about vertical integration and how that will affect the market dynamics.

We've heard a lot of claims on both sides, but I think it's important to remember that, as both Telecom and Vodafone have said, it's the ARPU of the customers that is very important and that ARPU, the revenue per user, has to be economic for it to be worthwhile to serve that customer.

Now, vertical integration of Telecom does not create a barrier to entry.

Any network provider, be it Vodafone or Telecom, is of course going to have a lower marginal cost for service than its cost because of the necessity to cover its fixed and common costs.

However, the economic value of the service will be the market price. For Telecom's fixed line business, when setting Telecom's fixed to mobile price, the market price for termination is Telecom's opportunity cost.

In other words, the starting point will be the termination revenue Telecom could earn from a third party if that third party provided the call such as TelstraClear.

If Telecom based its fixed to mobile price on a lower term price it would be better selling its mobile termination services to third parties only.

The thing I would like to stress rather than a theoretical discussion of barriers to entry is to note, as I said a few minutes ago, that it's my understanding there are over 12 fixed line providers which resell Vodafone and Telecom Mobile terminating services.

So, I find it very hard to see why there can be a debate over barriers to entry when there has been a line of entry and there are at least 12 fixed line providers. I have been told if you take calling card providers you will get over 50.

The market facts by themselves demonstrate the absence of barriers to entry.

This leads on to the question of a price squeeze and a possible price squeeze. The economic theory is quite clear, and certainly the case law in the US is quite clear as well, that it doesn't make sense, economically or rationally, to engage in an attempted price squeeze unless you can drive all your fixed line competitors from the market and increase prices to monopoly levels.

Now, I think Telecom could not hope to succeed in the strategy because much of TelstraClear's fixed line network has stuck with no alternative views. Thus, TelstraClear has significant barriers to exit, and in economics barriers to exit are just as important as barriers to entry in considering what might happen.

CHAIR: Can I just stop you for a moment, Professor Hausman.

Mr Knight, I'm afraid this has turned into expert evidence rather than a Telecom closing statement and I must ask you to move to your closing statement now and to include whatever comments Telecom wishes to make as part of its closing statement.

It is not proper for Professor Hausman to advance his personal views to us at this time and I intend to treat the comments that we have just received as comments made

on behalf of Telecom New Zealand and not expert evidence.

So, can we move directly to the remainder of your closing comments, Mr Parkes?

MR KNIGHT: I think Professor Hausman is now finished anyway.

CHAIR: Thank you.

MR PARKES: Thank you, Commissioners. I will confine my closing remarks to some of the topics covered in the last three days.

Starting with the OECD study. It is clear that the Commission has relied to a degree 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:

Firstly, benchmarking of prices across countries is notoriously fickle.

Secondly, the choice of the basket of services for comparative purposes and the exchange rate chosen have huge implications for the results from the OECD study. Altering of those assumptions can deliver very much a different picture of New Zealand's relative price performance.

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.

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.

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.

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.

In short, we have excellent penetration of mobile phones, no evidence of monopoly profits and high uptake. The quality of service has also improved significantly in the mobile sector. Taken together, these are not symptoms of a country where mobile prices are - where mobile services are overpriced.

One of the more interesting parts of the last three days has been the presence of Econet, a welcome addition to the regulatory party. It's always good to see another network builder or potential network builder making an appearance.

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, and I think also in his closing remarks, was saying something similar. I hope this is a correct summary of Mr Edwards' position, but I believe what he was saying is if you really want to deliver benefits to customers, then the entry of a new network is overwhelmingly the best way to achieve that.

Regulation of termination rates would be a hindrance not a help to the Econet business case for market entry.

Mr Edwards did say that 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 TSLRIC, the message was straightforward - don't do it, you'll only make it harder for me to enter the market.

Hence, we have the two existing players and a player keen to setup a network and who has spectrum and direct Government support through the Maori Trust involved with Econet saying that the proposed regulatory intervention will be bad for their investment case.

Food for thought for the Commission.

Turning to the issue of 3G. There has been much discussion on the inclusion or exclusion of 3G and how 2 and 3G could be delineated.

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.

The following options were canvassed during the last few days. Firstly, don't regulate at all. The impact of investment in the risky mobile market will be too great. More on that option later.

Secondly, 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 at all, whereas all of their's, all of Vodafone'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."

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.

The fourth option canvassed with that option, I think implicit in the Commission's report, at least in termination of the CBA, which excludes 3G but regulates 2G, and with 2G including all existing traffic.

One would presume that this would include, therefore, 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 would surely send investors.

The fifth option tabled by TelstraClear is that all voice calls terminating on mobile networks should be regulated at TSLRIC 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.

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

Commissioner Webb said at the beginning of the Thursday morning session on the waterbed effect and two

sided markets that this was a very important session.

Commissioner Webb was right. It was very important, if not the pivotal session of the conference.

The material before the Commission forms a compelling argument that the Commission should change its 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 TSLRIC would not be the socially optimal outcome.

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, will increase mobile services prices if termination rates are reduced to TSLRIC.

These economically rational incentives will take effect irrespective of the following three factors: whether either any company is earning excess returns; whether any company is vertically integrated; whether any company has market power.

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 assume that both these conditions are not unreasonable. Inbound calls are an important part of the revenue received from our marginal low end customers. It is simply incorrect to suggest that there is a 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.

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.

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 did hear him say this, he almost suggested it was beyond even his powers.

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 TSLRIC 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.

So, this is all a bit of a conundrum for the Commission.

However, we would suggest the Commission does have a way forward.

Firstly, it can conclude that a two sided market is an appropriate economic framework to consider the issue of mobile termination prices.

Secondly, it can conclude that the waterbed effect is real and is material. As such, moving to TSLRIC prices would result in customers, both fixed to mobile and mobile services customers, being worse off.

The Commission could conclude therefore that the status quo is a better outcome for customers than TSLRIC modelling but it 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.

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 20s in terms of cents per minute; Vodafone, I think, refer to CPI minus 10%, we were more explicit.

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 one cent a minute will come to pass. Failure to deliver on these expectations would invite, of course, the issue to be re-opened.

So, in conclusion. Ultimately this conference is about customers and in the long run what is in their long-term interest.

I cannot conclude my closing remarks without reference to our archetypal customer, Genevieve, who I'm going to suggest to Mr Kenrick should get a new phone, a 3G phone, as a royalty payment for the use of her name during the conference.

The Commission has a very serious job here. There are, as identified by Professor Hausman, over 100,000 Genevieves whose access to an affordable mobile phone will be put at risk if the Commission regulates. The people that call the Genevieves of the world also face substantial costs from regulation.

But it is not just current customers the Commission puts at risk but future customers, given 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 want ago mobile phone. Their message to you, Commissioner's, 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 marketplace to deliver and if it doesn't, revisit the issue.

Thank you for the opportunity to participate in this conference and we look forward to your final report.

CHAIR: Thank you, Mr Parkes.

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**CLOSING COMMENTS ON BEHALF OF TELSTRACLEAR LIMITED**  
MR FORSYTH: Just before I deliver TelstraClear's closing

comments I have a matter of housekeeping.

Telecom has asked me to clarify a comment that I made yesterday in which I mentioned rates.

Yesterday during the discussion regarding the impact of excluding regulating for 3G switched voice termination, I mentioned in my comments the rate of 28 cents per minute with reference to Telecom. I mentioned this rate, as I also mentioned the rate of 16 cents per minute, as these are the rates that the Commission uses in its issues paper and modelling.

I was not wishing to suggest that either rates used for illustrative purposes were necessarily actual rates charged between parties or determined by the Commission.

My point regarding the ineffectiveness of excluding regulation for switched voice over 3G remains unchanged, regardless of whether the unregulated rate is 28 cents, 18 cents or even 38 cents.

To TelstraClear's closing comments, three days of detailed questions and answers on a number of topics have, in TelstraClear's view, reinforced the Commission's draft view that the designation of fixed to mobile voice termination services would promote competition to the long-term benefit of end users in New Zealand.

Unequivocally, we would claim, Telecom Mobile and Vodafone have monopoly power over the setting of the termination rates on their networks.

The rates for mobile voice termination and other mobile services are, by international standards, high. Consumers are paying too much.

Regulating voice termination will result in lower rates being paid by consumers and lowering of voice

termination rates will facilitate competition in the fixed to mobile and tolls market to the long-term benefits of end users.

The OECD, the European Commission and the UK, Australian and Irish regulators, amongst others, have all concluded that regulation of fixed to mobile termination rates is necessary, efficient and to the long-term benefits of end users.

TelstraClear does not consider that there are any reasons why leaving fixed to mobile termination rates to the whim of incumbent mobile termination access providers in New Zealand is efficient when it has been found to be inefficient and the long-term detriment of end users in a large part of the world.

While there are clearly inter-relationships between fixed to mobile termination services and retail mobile services, these inter-relationships do not operate in a way that effectively constrains fixed to mobile termination rates.

As Professor Valletti has said, and the OECD, the European Commission and the UK and Australian and Irish regulators have found, in the absence of regulation, fixed to mobile termination rates will be set at monopoly levels because they can.

The levels of competition in the mobile services market will determine what proportion, if any, of fixed to mobile termination profits is passed on to mobile end users but will not act to constrain fixed to mobile termination rates.

While the rates charged by Telecom and Vodafone to each other may converge, due to the reliance of both termination access providers on each other, fixed network operators are not able to excerpt much countervailing buyer power against a mobile terminating operator.

On Wednesday, Charles River Associates argued that the costs of doing business are not a barrier to entry, rather a barrier to entry exists when there is an asymmetry between the costs faced by an incumbent and the costs of an entrant.

TelstraClear more or less agrees. This is exactly the case in the fixed to mobile toll call services market. Regulating fixed to mobile will not only reduce overall input costs but will also reduce, if removed, the asymmetry in the costs face by an incumbent versus an entrant.

The introduction of carrier preselection removed a technological barrier to entry. The introduction of portability will remove a barrier to switching.

Customers are now becoming increasingly aware of, and sensitive to, the costs of fixed to mobile calls. What is needed now is to remove the ability of the vertically integrated incumbent provider to raise the costs to competitors of providing the fixed to mobile services to be addressed.

As the draft report recognised in recent 2004 reports, both the ACCC and Ofcom have found evidence that reduced fixed to mobile are flowing through into lower retail fixed to mobile rates.

If fixed to mobile termination rates are designated to an efficient cost based level, competition will be promoted, prices will come down, fixed to mobile end users will benefit.

On Thursday we were told that the impact of a reduction of fixed to mobile on the retail mobile services market would depend on the level of competition faced by the operators in that market.

The greater the level of competition, the greater flow through of impacts of changes in the termination

rate.

The New Zealand mobile market appears to be significantly less competitive than mobile services markets overseas, such as the UK and Australia.

Firstly, the market is highly concentrated, currently it has two players in the mobile services market with similar market shares.

Secondly, as the Commission pointed out in its draft report, mobile access and calling costs appear to be consistently high when benchmarked against OECD countries.

And no evidence has been produced today that there is any reason to presume that it is more costly to provide mobile services in New Zealand.

And lastly, there are significant barriers to entry at the network level in the New Zealand mobile market. As noted by the Commission in its draft report, these include the importance of achieving comprehensive coverage and the need for substantial sunk investment.

Against this backdrop, Vodafone and Telecom both argue that the effect of a regulated reduction in fixed to mobile termination costs would be to increase prices and reduce subscriptions in the mobile services market.

Yet regulators in countries with four or more mobile operators, such as Australia and the UK, with lower OECD price rankings and who already have many more innovative services than New Zealand, concluded that fixed to mobile termination rate reductions are unlikely to have an effect on mobile prices and penetration.

No cogent empirical evidence has been presented that this waterbed effect has, in fact, occurred in countries where fixed to mobile termination rates have been regulated. This is despite fixed to mobile termination regulation having existed in a number of countries for a number of years.

The empirical evidence that has been presented in submissions has been limited to penetration data in a selective time period in the UK. More recent UK data, as presented in TelstraClear's submission, contradicts this and negates any waterbed effect.

In its recent report, the ACCC concluded a waterbed effect was unlikely to occur and indicated that it was provided with little evidence to suggest that mobile subscription charges have increased in the UK in response to regulated reductions in the price of mobile termination services.

Why designate the need for regulatory backdrop to fixed to mobile negotiations? On Thursday we heard mobile termination access providers expected prices to come down in line with cost reductions. As always, it needs to be remembered that in the New Zealand context, the regulation of fixed to mobile termination services merely sets the regulatory backdrop against which the voluntary good faith intentions of the monopoly providers can be tested against and held to.

When regulation of fixed to mobile is in place, there will be every incentive and no constraint on the mobile operators to voluntarily reduce prices. If they fail to reduce prices to efficient levels, then and only then can the regulator step in and determine a price.

In recommending the designation of fixed to mobile first termination services, the Commission would not be setting the price for the service at that time, rather the Commission would, by recommending the creation of a regulatory backdrop to these negotiations, be addressing the asymmetric bargaining power present when there is a problem as it has in the case of fixed termination where similar access bottlenecks concerns exist.

Are we regulating a voice termination service or a

The bottleneck nature of a switched voice termination service fixed to mobile is a bottleneck regardless of what technology is used within the network to deliver the call.

Moving from 2G to 3G does not remove the bottleneck, nor does it reduce the mobile operator's market power.

We heard yesterday that Telecom considers that their 027 network, or a large part of it, is a 3G network. On this assertion, providing a carve out for 3G switched voice would render any regulation today or in the very near future worthless.

We have heard that 3G, for Telecom at least, refers to a number of incremental network investments. These investments have been to provide the opportunity to deliver new data based services.

The ACCC and Irish regulators have both recently decided that efficient 2G voice termination costs are a good proxy for efficient 3G voice termination costs. They have chosen to regulate 2G and 3G voice termination based on that 2G efficient cost.

This is the correct approach. We agree with Vodafone that regulation should ensure that mobile network operators are able to recover the efficient costs of termination.

The determination process should ensure that mobile operators do not under-recover the blended cost of terminating voice calls on their networks.

The terminations calculate the cost based price for a designated service at a point in time for a specified period.

Will efficient investment be deterred by designating mobile voice termination? TelstraClear agrees that regulation should be careful to avoid deterring efficient investments. However, we consider that it is not

efficient for monopoly prices charged to fixed network consumers to fund investments in new non-voiced services to mobile customers.

In setting the fixed voice termination rate at 1.13, the Commission did not permit a higher price to be determined because of the need to deter fixed network operator investments in broadband internet access technology, for example.

Nor should mobile voice termination rates be permitted at bottleneck monopoly levels because a mobile operator has chosen to take a punt on technology to allow it to offer potentially risky new non-voice services.

We note that the Australian and UK regulators found that regulating mobile terminating rates was likely to improve dynamic and allocative efficiency, not the opposite.

In the absence of regulation, fixed to mobile termination rates above the efficient level encourage greater investment in equipment used to provide mobile services than is optimal and lower investment in equipment used to provide fixed to mobile services than is optimal.

The cost benefit analysis.

We consider that the above qualitative reasons why fixed to mobile termination rate regulation will promote competition to long-term benefit of end users can be demonstrated quantitatively. The cost benefit analysis in the draft report understates the benefits of regulation due to the compounding effect of conservative assumptions.

The terminal value should be included in the model. Benchmarked fixed to mobile termination costs should be reduced and the relative impact of regulation on fixed to mobile pass through is understated, as is the organic growth in fixed to mobile call volumes.

Further, TelstraClear does not consider that in the

absence of regulation fixed to mobile termination rates will drop to efficient levels.

The existence of countervailing buyer power is true in the case of mobile to mobile termination but not true in fixed to mobile termination.

Indirect costs should only be modelled if these effects are individually specified and quantified. TelstraClear has explained why 3G investment effects and the waterbed effect should be discounted.

No other indirect costs have been specified at the conference.

Fourth, if 3G is carved out from the regulation, this indirect effect should not be included in the cost benefit analysis.

Lastly, wealth transfers. The Act via section 18 and via Parliament, as articulated by the Honourable David Cunliffe and other speakers, has made it very clear that the purpose of the Act is to deliver benefits to end users. The Commission's approach in their draft report, as it was in their LLU investigation, is a correct interpretation of the Act.

And finally, concluding remarks, I would just note that, as we have stated before, Telecom Mobile and Vodafone have monopoly power. The rate for mobile voice termination and other mobile services in New Zealand are very high.

Regulating voice termination will lower the rates to consumers and lowering the rates to consumers will facilitate competition.

Thank you very much for the opportunity to participate.

CHAIR: Thank you, Mr Forsyth. Mr Sullivan?

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**CLOSING COMMENTS ON BEHALF OF VODAFONE NEW ZEALAND**  
MR SULLIVAN: Thank you for the opportunity to make a few final

remarks. I believe the past three days have been constructive and fruitful, the dialogue very productive. We look forward to future discussions on termination and other regulatory issues.

In my opening statement, I said our case was made up of three key points so I will refer back to those points in wrapping our case up and to the overall question, whether regulation of mobile termination will promote competition in the long-term best interests of end users.

When I apply this overall question to the discussion in the past three days, I conclude that our case is even stronger.

This regulation will not promote competition and it will not generate long-term benefits for end users.

Why do I state that? First, Vodafone have stated the business case for further regulation of mobile services just does not stack up.

That is still our view.

Nothing that we have heard in these last three days have changed our mind. The mobile sector is very competitive with no need for further regulation.

Secondly, we do not think that regulation of mobile termination can be substantiated on the facts. This conference has strengthened our views on this. In fact, more progress has been made in the last three days than in the last six months.

We used to think that everyone disagreed with the key issues underlying the MTR debate. We are pleased to be proven wrong and see stronger alignment between the parties and the Commission.

The two key questions that we thought there would be

major disagreement on were the waterbed and on pass through.

In regard to the waterbed, I can't claim to have understood everything the economists said, but it seems to me that they agreed with each other and that the mobile prices would be affected by termination regulation provided that some pretty undemanding conditions were met, and these conditions are obviously happening in New Zealand.

As I have said, the way we price supports all such economics. We think about all revenues from customers and the cost of all services provided to customers. If termination revenues fall, then something else has to give. This is one reason why regulators in other countries have moderated the shock for mobile customers from regulation by using a glidepath to introduce changes over time.

On pass through, we have said the draft report was predicting impossibly high falls in retail fixed to mobile prices as a result of the proposed MTR regulation.

At the same time, the draft report was saying that the retail fixed to mobile market was not competitive. To us these two things just don't go together, something didn't match up.

As it transpired, apart from the Commission and Vodafone, no-one else even wanted to talk about pass through. I find this strange because higher pass through is a single most important element. If pass through doesn't increase, there are no benefits from the MTR, even taking as a given all the other assumptions that we disagree with.

Why Telecom and TelstraClear are suddenly so shy to discuss pass through is clear from what themselves have said. The key take out for fixed operators from MTR is

increasing margins for fixed to mobile calls.

But increased margins for fixed operators surely doesn't make end users better off. I think the Commission has agreed with us on this.

Commissioners, when you add all this up, it means there is still some work to do. We think that once the numbers have been rerun you'll find it very hard to justify the regulation proposed. We just cannot see how regulation can stack up on the facts and we are even more sure of that now.

The third point in my opening comments was that the regulation proposed was unbalanced. Telecom is protected from regulation by the increased margins of its fixed calling business. Vodafone has no such protection.

There was some discussion yesterday about whether the integrated nature of Telecom meant the waterbed was more likely or less likely. I think where the economists got to was to say the waterbed is just as likely regardless of whether Telecom is integrated or not.

Our point here, though, has nothing to do with the waterbed effect. What we are saying, if the Commission wants to promote competition in the mobile market, the last thing it should do is regulate to give our main competitor an unnatural advantage.

We trust you accept our intention to drive market based competition to fixed line customers. If so, the Commission is potentially distorting this market. It is a flawed regulatory approach. We already face this kind of disadvantage as regards the TSO and we don't think the Commission should follow the same model in the case of MTRs.

The distortion is made even worse if the Commission accepts Telecom's argument that its existing network is 3G. At that point, regulation of mobile termination is

effectively just regulation of Vodafone and why would that be a good idea?

We asked at the beginning of the conference how regulating Vodafone could help TelstraClear compete with Telecom in the fixed to mobile market and we're still waiting for an answer.

Before I conclude, I just want to say a few words about 3G. There's been a lot of discussion on this with some saying that the regulation of 3G termination will not have any impact on our plans. This is just wrong. When I signed off the 3G business case I did not expect to be facing regulation of this service before it was even launched.

The next 12-18 months in the mobile market will involve a significant change as true 3G services become a reality for customers. To make that happen requires both significant capital expenditure as well as heavy spending to get 3G handsets into the hands of consumers, and I am suggesting we might employ Mr Edwards as our procurement manager because he seems to be able to buy things significantly cheaper than we can, so we will talk about that after the conference.

To take away the funds that we have been relying on to underpin capital and operating expenditure would sharply change the picture on 3G and especially if a distorted regulation means our current 3G competitor carries a competitive advantage.

So, let me conclude. We recognise that the Commission is under pressure on this issue. There is strong public and political interest in reducing fixed to mobile calling rates and a lot of noise from those who have not invested in this market.

As well, many other countries have regulated termination and many other regulators seem to treat it as

beyond debate that regulated termination rates is in fact a good idea.

We have asked you to be careful in using those overseas precedents because their legislative tests are different and we think the Commission needs to ignore those pressuring it to regulate regardless of fact.

But we do appreciate the Commission is in a tough spot. Mobile termination regulation is a critical issue for the mobile market. We think that cutting termination rates will mean higher mobile prices, fewer customers and less growth in investment in the mobile market, as a result creating a higher hurdle for further investment.

In terms of the long-term benefits for end users, we think mobile termination regulation fails the test. But Vodafone can offer a slightly more positive picture than that. We think that competition is alive and well in the mobile market and although it is less than 20% of the total telecommunications market right now, we are always looking for new opportunities to grow.

Vodafone will continue to compete with our integrated fixed and mobile friend, we will continue our investment in 3G and will aggressively go after fixed line customers who have yet to enjoy the experiences of infrastructure competition.

Vodafone is 100% committed to investing in New Zealand. We look forward to offering true broadband competition over mobile and we'd like nothing more than to speed up our work here and drive home the real benefits of competition to consumers. This is the real opportunity and we urge the Commission to look at how the fixed market can be made more competitive and to allow the market to grow.

Commissioner Webb, Commissioner Curtin and Commissioner Stevens, thank you for your time and

attention.

CHAIR: Thank you, Mr Sullivan.

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**CLOSING COMMENTS BY COMMISSION**

CHAIR: That completes the closing remarks to this conference.

I want simply to thank you for your participation.

As I said at the outset, the Commission recognises that there are very large and important commercial interests at stake in this debate and there are potentially very large benefits available for end users, depending upon the view that is taken of the outcome.

The Commission's draft report will now be taken away for further consideration by the Commission.

We recognise that the industry end users are looking for this process to be completed as soon as possible but by the same token, given the importance of the issues, we will wish to weigh very carefully what has been said and take what time is needed.

I, therefore, have nothing to say today about a likely timetable for the Commission completing its work, other than to say that we will move as quickly as we reasonably think we can do.

So, thank you again and this session is closed.

**Conference concluded at 3.50 p.m.**