



Telecom New Zealand Limited

submission in respect of the

**Commerce Commission's Draft Report for its Schedule 3
Investigation into Regulation of Mobile Termination**

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Public Version

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A EXECUTIVE SUMMARY

- 1 New Zealand consumers have benefited greatly, and continue to benefit, in the mobile services and fixed line toll calling markets. In mobile markets penetration has increased, coverage has increased, handsets support more services of increasing sophistication, prices have dropped and continue to drop. In the fixed line toll calling market an increasing diversity of offerings cater to the needs of differentiated customer groupings. Customers are unambiguously better off in these markets year on year, and this will continue in the future.
- 2 Competition in these markets is fierce. Competition in the mobile services market is possibly the highest stakes, highest risk commercial contest in New Zealand. Vodafone and Telecom fight hard for every customer. The pace of technology change, and the significant commercial advantage or disadvantage that could flow from each technology choice, means the mobile services market is one of the most risky and least predictable telecommunications markets. In fixed line toll calling markets a large number of providers jostle for customer recognition and market share. Entry and expansion is easy, and the number of market participants reflect this.
- 3 It is only when one sets the Commission's draft report against this bigger picture that it can be seen how out of step the Commission's analysis and recommendations are with market reality.
- 4 Telecom understands the proposal for regulation to be driven by three ideas: prices are too high in the mobile services and fixed line toll calling markets; regulation can surgically address a perceived problem in an otherwise competitive and dynamic market; and overseas decisions suggest a problem exists and a solution is available in New Zealand.
- 5 Each of these propositions simply does not hold true in New Zealand markets.
- 6 Consumers are paying competitive prices in mobile services and fixed line toll calling markets. Mobile prices are the result of one of the most robust competitive processes in New Zealand markets. Included in this submission is clear evidence that Telecom is not making excessive returns on the mobile business. No-one suggests that Telecom is inefficient – the competitive nature of the mobile services market would punish any inefficiency. Any claim that prices in the mobile services market are above the competitive level is flatly inconsistent with the competitive nature of the market and the low return on investment earned by Telecom and Vodafone.
- 7 Prices in the fixed line toll calling markets are the result of a robust competitive process. It is wrong for the Commission to point to isolated transactions with the largest of corporate customers where retail prices approach termination rates, and ignore the fact that for the vast majority of transactions in the market a robust competitive process involving numerous participants, price transparency and low

barriers to entry and switching results in competitive prices being set above, and unconstrained by, mobile termination rates.

- 8 The draft report is mistaken in hypothesising that competitive markets will produce anything other than competitive prices. Comparisons to rough estimations of “cost” are simply misleading and do not give any indication of whether economic profits are being made. A central feature of telecommunications firms is the need to cover very large joint and common costs. In the presence of these costs, rough estimates of marginal or incremental cost do not predict the competitive price level.
- 9 It is a mistake to hypothesise that one aspect of a market as competitive and dynamic as the mobile services market could be regulated without creating repercussions and distortions elsewhere in the market.
- 10 Mobile operators must invest substantially in each customer up front, by subsidising the mobile handset and connection costs to get price-sensitive customers on-board. Revenue from customers’ outgoing calls and monthly subscription fees is used to subsidise connection costs. Mobile termination revenue is therefore an important component for covering the high fixed and common costs of operating and upgrading the mobile network. The commercial challenge is to earn a return over the lifetime of the customer. This is becoming increasingly more difficult – “device envy” and an increase in consumer sophistication means handsets (and therefore, potentially customers) roll over at a high rate. The expected lifetime of a handset is currently approximately [*JTCNZRI*] months.
- 11 If regulation reduces mobile termination revenue, Telecom must increase its prices. For the reasons explained in detail in this submission, including the constant renewal of handsets and the transition of customers from Telecom’s TDMA network to its CDMA network, this is most likely to result in handset prices being more expensive than they otherwise would have been.
- 12 The likely impacts of this price adjustment are discussed in detail below. The likely losers will be low income consumers, who will react to the price adjustment by ceasing or not renewing their mobile subscription, mobile customers that pay the higher prices, and fixed line callers who will have fewer mobile consumers to call. Professor Hausman calculates that approximately 95% of the “benefits” of regulation perceived by the Commission in fact would comprise a transfer from these customers to other customers who would gain from reduced fixed to mobile prices. A significant proportion of this transfer will be from low income consumers to corporate customers. Given current penetration rates of about 75%, some of this transfer will be within businesses, families, or individual accounts.
- 13 When regard is had to these real world impacts, it is clear that the proposed regulation would have the effect of advantaging one group of consumers over another, and destroying value overall.

- 14 The draft report is also mistaken in its assertion that regulation will not impact on investment decisions in the mobile services market. Given the large sums of money involved, the fierce contest, and high degree of uncertainty as to what services will be delivered at what prices over what technology in even two years' time, it lacks credibility to assert the precedent proposed by the draft report would simply be ignored by Telecom and Vodafone in the future. The draft report implies a real risk that once a mobile technology has been proven to be successful (and ignoring the risks taken and losses made on unsuccessful technology), and a couple of years old, the Commission will second-guess the pricing structure and technology migration plans of Telecom and Vodafone and significantly reduce revenue streams. Telecom would be negligent not to factor in this risk, and major investment decisions will be delayed as a result.
- 15 The compressed life cycle of mobile network technologies, and the scale of the investment uncertainties faced by mobile operators, can be observed from the fact that this year Telecom has written off \$110m of its TDMA investment, and has commenced its roll out of 3G. All of this investment is driven by (and put at risk by) the contest with Vodafone. If the Commission intervenes in this dynamic by regulating a 4 year old network, it must expect - and take responsibility for - the on-going distortion to investment decision-making its intervention would create.
- 16 Finally, but importantly, the decisions of OFTEL and ACCC do not translate to New Zealand markets. The question whether the competitive conditions in New Zealand are different, or the decisions are incorrect, is interesting but secondary. The facts remain that no excess profits are earned in the mobile services market in New Zealand, a robust competitive process sets prices unconstrained by termination rates in fixed line toll calling markets, and the regulation proposed in the Commission's draft report will result in price rebalancing, a transfer between consumers and a net welfare loss.

Competition in the market place

- 17 In Sections 3 and 4 of this submission Telecom provides a comprehensive analysis and market evidence of the robust competition in the mobile services and fixed line toll calling markets. This analysis clearly demonstrates the following:
- 18 First, the mobile services market is effectively competitive. This means:
- 18.1 regulation will not promote competition for the purposes of section 18;
 - 18.2 price rebalancing will occur in response to regulation; and
 - 18.3 customers will drop off the mobile network in response to price rebalancing. Negative welfare effects will occur in both the mobile services market and the fixed line toll calling market.
- 19 Second, mobile termination is part of the mobile services market. This means regulation will not promote competition for mobile termination services. Even on the

Commission's analysis of a separate market, regulation will not promote competition in that market.

20 Third, the retail tolls and F2M market is competitive. This means:

20.1 regulation will not promote competition for the purposes of section 18;

20.2 as prices are currently set by the competitive process unconstrained by mobile termination rates, regulation will not result in "benefits" in this market.

The Commission's draft report

21 In this submission Telecom emphasises that the Commission bears the onus of proving regulation is needed. The Commission cannot make a series of estimates and assumptions, and require Telecom and Vodafone to "prove otherwise". Every uncertainty counts against regulation. Where uncertainty exists, the Commission must make a conservative assumption.

22 To recommend regulation, the Commission must prove every one of the following:

22.1 there is a separate market for termination on each network;

22.2 the mobile services market is not effectively competitive;

22.3 a regulated reduction in mobile termination rates would not result in price rebalancing (as compared to the counterfactual);

22.4 the retail fixed line toll calling market is not effectively competitive;

22.5 a regulated reduction in mobile termination rates would result in a reduction in retail tolls and F2M prices (as compared to the counterfactual);

22.6 regulation would not have a material impact on investment decisions in the future.

23 The following gives an overview of the arguments made in the draft report in support of these propositions, and the market evidence Telecom has put before the Commission in rebuttal.

There is a separate market for termination on each network

24 The draft report argues the following supports this proposition:

24.1 while mobile operators supply termination, subscription and calling services together, there is a discontinuity on the demand-side between wholesale and retail customers;

- 24.2 the two-sided market analysis proposed by Telecom and Vodafone is not consistent with studies showing prices in the mobile services market to be high, and the UK data showing a lack of price rebalancing following regulation.
- 25 Telecom has informed the Commission:
- 25.1 termination, subscription and calling services are jointly supplied, and treated by mobile operators as being in the same market;
- 25.2 the two-sided market analysis is appropriate, as Telecom and Vodafone must adjust the balance of prices between both sides of the market to maximise mobile service volumes and revenues, and to recover very large joint production costs;
- 25.3 the Commission's analysis of pricing in the mobile services market is incorrect, and its reliance on the MED analysis of OECD data drives erroneous conclusions. The mobile services market is manifestly competitive, and the prices resulting from this competitive process are at the competitive level. Telecom includes with this submission studies demonstrating that Telecom Mobile makes only a normal return, and New Zealand mobile operators earn a low return on investment.
- 25.4 the attached report from Charles River Associates (Annex B) corrects the Commission's interpretation of UK data and highlights the impact of regulation.
- 26 Telecom submits the Commission has not proven that there is a separate market for termination on each network. The Commission must adopt a market definition that accords with commercial commonsense and the experience of participants. In the current context, where the onus is on the Commission to make out the case for regulation, any uncertainty should result in a conservatively wide market definition being adopted (consistent with the use of conservative assumptions in the Commission's competition law analysis). The Commission should proceed on the basis that termination is part of the mobile services market.
- The mobile services market is not competitive***
- 27 The draft report refers to the MED / OECD study which purports to show high and static retail prices in the mobile services market. The Commission argues this supports the proposition that the mobile services market is not competitive.
- 28 Telecom has informed the Commission:
- 28.1 the mobile services market is effectively competitive. Competition in the mobile services market is a high stakes, high risk contest where Telecom and Vodafone compete fiercely for every customer. Competition takes place on the basis of competing network technologies that have a dramatically compressed

life cycle, rapid evolution of handset technologies, and pricing innovations such as Telecom's \$10 text deal;

- 28.2 the Commission concedes that the data on market growth and penetration, changes in market share, decreasing revenue per minute, the expected introduction of number portability in 2007 and the potential for new entry all support the conclusion that the mobile services market is competitive;
- 28.3 Deutsche Bank and Citigroup both comment on the low return on investment earned by New Zealand mobile operators. Telecom's EVA analysis is attached to this submission (Annex E), the robustness of which is confirmed by Professor Trow (Annex F);
- 28.4 There are significant flaws with the MED analysis of the OECD data.
- 29 Telecom submits the Commission has not proven that the mobile services market is not competitive (and the Commission concedes this). The MED analysis of OECD data is not a sufficient basis to dismiss the evidence of competitively set prices and low returns earned by mobile operators, particularly given the flaws in the MED analysis highlighted in this submission. In fact, the market evidence clearly demonstrates the mobile services market meets the workably competitive standard. The Commission should proceed on the basis that the mobile services market is competitive.

A regulated reduction in MTRs would not result in price rebalancing

- 30 The draft report argues the following supports this proposition:
- 30.1 UK data does not support the waterbed effect;
- 30.2 Telecom and Vodafone say there are no cross-subsidies. This means mobile prices will not rise following regulation;
- 30.3 Prepay customers will be unaffected by subscription rises. Marginal customers make few calls;
- 30.4 the Commission's not convinced there is sufficient competition to drive price rebalancing.
- 31 Telecom has informed the Commission:
- 31.1 termination revenue is used to contribute to the costs of producing mobile services. If this revenue stream is reduced, the marginal cost of providing mobile services will increase. In any market, prices will rise in response to an industry-wide increase in marginal costs.
- 31.2 the market is effectively competitive, although even a market subject to limited competition would be driven to rebalance following regulation;

- 31.3 cross-subsidies are not necessary for a price rebalance to occur;
- 31.4 although cross-subsidisation does not occur when Telecom's entire customer base is taken into account, for marginal customers handset subsidies are calculated by reference to expected revenue streams from signing up a customer, including termination revenue. The commercial challenge for mobile operators is to earn a return over the lifetime of the handset, which is renewed at a rapid rate – currently approximately [*JTCNZRI*] months. If termination revenues are regulated, other prices will rise – most likely, handset prices;
- 31.5 this sort of price rebalancing has occurred in New Zealand mobile markets in the past, most recently in response to the move in global capital markets away from valuing absolute customers numbers to an emphasis on ARPU. The constant renewal of handsets means there may be commercial opportunities to rebalance handset subsidies;
- 31.6 the attached report from Charles River Associates (Annex B) corrects the Commission's interpretation of UK data and highlights the impact of regulation. While it is the case in New Zealand that mobile services markets are competitive and New Zealand mobile operators earn only a normal return, the attached reports from Professor Hausman and Professor Katz explain this is not a necessary condition for any price increases – rational, profit-driven firms will always increase prices if marginal revenue drops.
- 32 Telecom submits the Commission has not proven that rebalancing would not occur. The mobile operators in the New Zealand market have informed the Commission, and the available evidence supports the conclusion, that price rebalancing will occur.

The fixed line toll calling market is not competitive

- 33 The draft report argues the following supports this proposition:
- 33.1 the margin available on retail business F2M calls is low;
- 33.2 this may explain the higher margins on tolls;
- 33.3 Telecom's vertical integration is a barrier to entry, as it can raise rivals costs / price squeeze;
- 33.4 Price discrimination between residential and business occurs.
- 34 Telecom has informed the Commission:
- 34.1 a large number of firms contest the fixed line toll calling market. Barriers to entry, and to expansion between national, international and fixed to mobile calling, are low. Competitors fight hard for brand recognition and market share;

- 34.2 the Commission concedes the data on the large number of competitors in the market, the decline in prices, the decline in Telecom's market share, the evidence of new entry and expansion, and the impact of preselection all support the assessment that this market is competitive;
- 34.3 the prices that result from this competitive process are set at the competitive level. Comparisons with rough estimates of cost are not a safe basis upon which to declare manifestly competitive markets to be lacking in competition – a number of competitive factors will inform margins over time;
- 34.4 only a very few fixed to mobile prices offered to large corporates approach the level of mobile termination rates. The draft report is misleading in apparently relying on TelstraClear's characterisation of this as a constraint on competition. Prices offered to corporates are the result of a process of robust competition and the buyer power of corporates. All other fixed to mobile prices (residential, and business) are set by a competitive process at a margin above termination rates.
- 35 The question at issue is whether the fixed line toll calling market, encompassing international, national and fixed to mobile calling by residential, business and corporate customers, is effectively competitive. Telecom submits the Commission has not proven that the fixed line toll calling market is not competitive. In fact, the market evidence available to the Commission clearly shows this toll calling market to be competitive, and the Commission should conduct its analysis on this basis.

A regulated reduction in MTRs would result in a reduction in retail tolls and F2M prices

- 36 The draft report argues the following supports this proposition:
- 36.1 F2M prices and mobile termination rates both declined in the 1997 – 2004 period (but the Commission concedes this does not demonstrate causality).
- 37 Telecom has informed the Commission:
- 37.1 Telecom's market experience is that there are significantly different degrees of pass through for residential, business and corporate segments;
- 37.2 this accords with the different features of competition in these segments.
- 38 The draft report does not grapple with the different competition dynamics around each customer segment. While all prices are competitively set, and expected to fall in the foreseeable future due to competitive activity, only corporate prices would be materially influenced by a reduction in termination rates. The assumptions made by the Commission in its CBA do not reflect these real world dynamics, and significantly overstate pass through.

Regulation would not have a material impact on investment decisions in the future.

- 39 The draft report argues the following supports this proposition:
- 39.1 there is likely to be little incremental investment unrelated to the 3G rollout. If the Commission excludes 3G, this eliminates dynamic efficiency impacts;
 - 39.2 by drawing a clear line between 2G and 3G, the Commission demonstrates it is aware of dynamic efficiency considerations and does not set a poor precedent;
 - 39.3 regulation has the potential to stimulate investment in F2M infrastructure.
- 40 Telecom has informed the Commission:
- 40.1 the Commission fails to recognise the compressed life cycle of mobile technologies – the precedent of regulating a 4 year old mobile network technology, which is very early on in its asset lifecycle, will be factored into decision-making and result in delayed investments;
 - 40.2 the Commission is regulating the timing of transition from one technology to another, which is a very risky thing for the Commission to be doing.
- 41 Telecom submits the Commission has not proven that regulation would not have a material impact on investment decisions in the future. The Commission should proceed on the basis that regulation will have material dynamic efficiency impacts.

Cost benefit analysis

- 42 The Commission's cost benefit analysis is fatally undermined by the errors discussed above.
- 43 Telecom makes the following points about the cost benefit analysis appropriate to this inquiry:
- 43.1 the cost-benefit analysis should include the impacts of price rebalancing in the mobile market. This will take into account the reduction in the welfare of consumers that drop off the mobile network, the reduction in the welfare of consumers that remain on the network but pay higher prices, and the reduction in the welfare of fixed line consumers who have less mobile customers they can call. This means that most of the producer to consumer wealth transfer proposed by the Commission will in practice be a consumer to consumer wealth transfer. Professor Hausman calculates that when these negative consumer welfare impacts are added to the positive impacts identified by the Commission, the net consumer surplus in 2006 is -\$8m to -\$43m, and in 2010 -\$8m to -\$44m;

- 43.2 the Commission's assumption of fixed to mobile price elasticity of -0.6 has scant support. A more robust estimate of -0.4 would, of itself, result in the Commission's model calculating that regulation results in negative net welfare;
- 43.3 how the Commission calculates the indirect costs of regulation varies between the consumer welfare and net welfare calculations. This is wrong - the costs of regulation are real, and do not vary depending on whether the Commission counts transfers as a benefit. Using the indirect costs calculated by the Commission for the consumer welfare calculation consistently in the net welfare calculation results in, of itself, the Commission's model calculating that regulation results in negative net welfare;
- 43.4 the Commission's assumptions of pass-through are unrealistic – in factual 1 retail prices are assumed to trend down to cost, and in factual 2, an effective pass-through of over 100% is assumed;
- 43.5 a wealth transfer from producers to consumers is neutral in efficiency terms, and should not be counted in any cost benefit analysis. For this reason a net public benefits test, and not a consumer welfare test, is appropriate;
- 43.6 when the Commission's model, which focuses solely on the effect of regulation in the fixed line toll calling market, and excludes the negative welfare effects of price rebalancing in the mobile services market, is corrected for the price elasticity, price path and indirect cost estimates noted above, the net public benefits of regulation are $-\$56\text{m}$ (factual 1) and $-\$29\text{m}$ (factual 2).

B LEGAL FRAMEWORK

COMMISSION BEARS THE ONUS AND BURDEN OF PROOF

- 44 The Telecommunications Act puts the onus on the Commission to demonstrate that any proposed regulatory intervention in telecommunications markets is warranted, and meets the standard required by sections 18 and 19. Section 19(c) provides that:

the Commission ... must make the recommendation ... that the Commissioner considers best gives, or is likely to best give, effect to the purpose set out in section 18.

- 45 That the onus stays on the Commission is consistent with the primacy given by the Telecommunications Act to commercial negotiation and the operation of workably competitive markets. Minister Swain summed up the regulatory framework as:

we need as much market as possible, as much government as necessary

- 46 This is particularly critical, and the burden on the Commission is at its highest, when the decision being considered is a new regulatory intervention. The uncertainties and risks of any regulatory intervention mean that the section 18 standard, requiring confidence that an intervention will be to the long term benefit of end-users, is a demanding one.

- 47 Telecom submits the Commission has not properly incorporated these aspects of the legal framework into its draft report. In response to Telecom's previous submission the Commission, at paragraphs 53 and 54 of the draft report, refers to the section 19(c) wording and to the Commission's cost benefit analysis.

- 48 The deficiency in the Commission's analysis remains, however. The onus is on the Commission to be confident that any decision "best gives, or is likely to best give" effect to the section 18 purpose, and when the decision being considered is a regulatory intervention this burden on the Commission is particularly acute.

- 49 As a practical matter, this means that every uncertainty counts against intervention. While the role of the draft report is to test propositions, the Telecommunications Act requires that the onus stay with those proposing regulatory intervention, and that the Commission weigh every uncertainty as counting against intervention.

- 50 As discussed later in this submission, the analysis in the draft report in favour of regulatory intervention does not meet this standard. The chain of reasoning in favour of regulation is beset by uncertainties and assumptions. For example:

- 50.1 the two current market participants have expressed a consistent view on the mobile services market, and yet the Commission has taken a contrary view. Further, the Commission has adopted an overly narrow market definition, rather

than a conservative assumption (which is the Commission's usual practice) of a wider market definition;

- 50.2 the Commission has concluded it is not sufficiently certain the mobile services market is competitive. As discussed further below, measured against the commercial commonsense standard, this view is extraordinary. As importantly, the Commission errs in the implications it draws from this view. If the Commission cannot confidently form a view that the mobile services market is not competitive, then this counts against regulatory intervention and the Commission should proceed on the conservative basis the market is competitive.
- 50.3 the uncertainties associated with the assumptions in the Commission's cost benefit analysis must be weighed as counting against intervention. It would be inconsistent with the Telecommunications Act for the Commission to construct a series of "best guess" assumptions and place the onus on participants to "prove otherwise". The onus remains on the Commission to have confidence that the section 18 standard is met, which, when conducting a cost benefit analysis, means the proper response to any uncertainty is to use a conservative assumption. The Commission's cost benefit analysis currently contains no discussion of the uncertainties associated with each assumption, and no consideration of the accumulated uncertainty generated by the series of judgements and assumptions that must be made in order to conclude regulatory intervention is required.
- 51 In the present process every uncertainty counts directly and clearly against intervention. While Telecom accepts the purpose of the draft report is to test propositions, the Commission has failed to work within this important aspect of the legal framework.

THE COMMISSION'S APPROACH TO SECTION 18

- 52 The Commission has correctly identified that sections 18 and 19 of the Telecommunications Act set the standard for decision-making in a Schedule 3 investigation. This means that the Commission must make its recommendation on whether to designate a mobile termination service, or not, based on the outcome that best gives, or its likely to best give, effect to section 18 – the promotion of competition in telecommunications markets, for the long term benefit of end-users of telecommunications services in New Zealand.
- 53 Telecom submits that the Commission's application of sections 18 and 19 in the draft report is fundamentally flawed in a number of important respects.
- Wealth transfers**
- 54 Key amongst them is the Commission's attempt to manufacture a "consumer welfare approach" from the wording of section 18. The Commission has suggested that the

section 18 reference to the promotion of competition “for the long term benefit of end-users” requires it to address distributive issues to ensure appropriate treatment of inefficiencies and excess profits in limited competition markets. That is, the Commission can count a transfer of producer surplus (through regulation) as a benefit to end-users.

- 55 That is simply wrong. There have been innumerable Commission and court decisions establishing the neutrality of producer surplus to a net benefits test in the Commerce Act merger context. That same reasoning must apply equally in a Telecommunications Act context, because the legal framework is the same and the Commission is faced with the same limited competition environment in both instances. The economic aspects of this issue are addressed in the attached report by Professor Katz (Annex D).

The accepted analysis

- 56 Telecom submits the Commission is erring in law and economics by treating transfers from producers to consumers as a welfare gain. The settled approach to conducting cost benefit analyses under New Zealand competition law (applied many times by the Commission) is to treat transfers as welfare neutral (Commission’s “Guidelines to the Analysis of Public Benefits and Detriments”, page 14 (1997 – Telecom notes the Guidelines are currently under revision):

Distributional issues are subjective and the Commission's views on them may have no greater validity than anyone else's. For example, there is no a priori reason why the status quo should be favoured over a new distribution of wealth; nor why a large group of the population (e.g., consumers) should be more deserving than a small group of the population (e.g., producers).

- 57 The Telecommunications Act does not mandate a different approach to wealth transfers. The purpose statements in the Commerce Act and Telecommunications Act are materially identical. This is the result of a clear policy and legislative intention to align the framework and objectives of the Telecommunications Act with the Commerce Act (discussed further below). The current form of the Commerce Act purpose statement - “The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand” – was enacted in May 2001. There has been no suggestion in any of the Commission decisions since May 2001 that the change in the insertion of a purpose statement referring to the “long-term benefit of consumers within New Zealand” requires a change from the settled approach to the treatment of wealth transfers.

Affirmation from the High Court

- 58 The High Court has recently affirmed that the reference to long-term consumer benefit does not mandate a change in approach to wealth transfers by the Commission. In the Air NZ/Qantas appeal decision (Auckland High Court, Rodney Hansen J and Kerrin Vautier, 17 September 2004) the Court held:

[238] For the purpose of determining both detriments and benefits, the longstanding practice has been to ignore wealth transfers from New Zealand consumers to producers that result from higher prices. The underlying principle is that the welfare effect of changes in the distribution of income, where one group within the public of New Zealand gains while another group simultaneously loses, is neutral.

[239] Mr Land, for Gullivers, submitted that the introduction in 2001 of s 1A of the Act required a change in approach. Section 1A provides:

“The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand.”

It was submitted that the reference to consumers signalled a shift in the balance which the Act seeks to achieve between the interests of consumers and economic efficiencies. Mr Land submitted that s 3A which requires the Commission to have regard to any efficiencies in determining whether conduct will result or will be likely to result in a benefit to the public, should be read subject to s 1A so as to exclude benefits which do not flow directly to consumers.

....

[241] We are satisfied that the introduction of s 1A should not disturb the Commission’s established practice of treating as neutral any wealth transfers between New Zealand consumers and producers. Determinations of authorisation applications under the Act are properly concerned with balancing any efficiency detriments associated with breaches of the statutory competition standard, against any efficiency gains that may result from the business acquisition or contractual arrangement in question. It is the balancing of these real resource impacts on the economy that best serves the long-term interests of consumers. The inclusion of ad hoc wealth transfers, which are not losses to society, would distort the efficiency assessment by assuming additional economic harm to the public of New Zealand. In any event, consumers might well be the ultimate beneficiaries. [emphasis added]

- 59 In Telecom’s submission, regardless of whether the Commission is assessing the net public benefit under the Commerce Act or assessing which recommendation will best promote competition in telecommunications markets under the Telecommunications Act, the essential question is one of efficiency and the “real resource impacts on the economy”. The High Court has confirmed this is the outcome of the phrases “long-term interests of consumers” in the Commerce Act and, therefore, the phrase “long-term benefit of end-users” in the Telecommunications Act. When such issues are addressed under the Commerce Act, the legal position is that transfers are to be treated as welfare neutral. There are simply no grounds for the Commission to depart

from this approach under the Telecommunications Act. The Commission must reconsider its position in light of this recent statement by the High Court confirming distributional concerns are not relevant to the promotion of the purpose of the Telecommunications Act.

The Commission’s proposed “regulatory exception”

60 The Commission’s explanation for the inconsistency in its approach to distributive effects under the Commerce Act and the Telecommunications Act is that (paragraph 60):

Control as a regulatory mechanism has a different philosophical base from competition as a regulatory mechanism. It is precisely because there is a concern about monopoly profits, and a lack of competition to drive them out, that control must be justified. In such an environment, the Commission considers that the scheme and context of the Act means it must explicitly address distributive effect.

61 There are two difficulties with the Commission’s proposed regulatory exception. The first is that it is inconsistent with the legal framework, as recently affirmed by the High Court in *Air NZ/Qantas* (discussed above). The High Court has confirmed that the purpose statements of the Commerce Act and Telecommunications Act relate to efficiency considerations and “real resource impacts on the economy”. The legal framework implements a net welfare standard, and distributional concerns are not relevant. Importantly, the statements of the court in *Air NZ/Qantas* cannot be read as predicated on an assumption or condition that competitive forces be likely to drive any producer surplus to consumers over time. The court held the purpose statement required a consideration of real resource impacts only, and distributional concerns were not relevant. While the court noted consumers might be the ultimate beneficiaries, this (i) is explicit confirmation that a transfer to consumers is not a precondition to concluding wealth transfers are neutral, and (ii) can be taken to refer to the dynamic view that consumers benefit when providers are incentivised to compete for the market. There is no legal foundation for the Commission’s claimed “different philosophical base”.

62 Second, the distinction the Commission purports to make is illusory. The settled treatment of wealth transfers is that the purpose of the Commerce Act, and now the Telecommunications Act, is best advanced by the Commission treating wealth transfers as mutually offsetting and therefore welfare neutral. This position was established in competition law at a time when the merger threshold was one of dominance, so that the post merger environment for which authorisation was sought would have been one of limited competition. That is, there is no difference between the post merger environment in an authorisation context (particularly under the dominance test), and the current environment where the Commission is making decisions to impose regulation in circumstances of limited competition. The distinction the Commission proposes does not exist.

- 63 Authorisations for mergers/acquisitions and restrictive trade practices under the Commerce Act are, by definition, applied for where there is a significant "competition problem". The High Court decision in Air NZ/Qantas is plainly inconsistent with the distinction proposed by the Commission. The airlines proposed a merger to monopoly on some routes and a substantial lessening of competition on others, but there was no suggestion the lack of post-merger competition was relevant to the treatment of wealth transfers. Instead, the High Court has affirmed that, even in that context, the purpose of the Commerce Act (and therefore the Telecommunications Act) requires that the Commission consider only "real resource impacts on the economy", and explicitly ruled against the relevance of wealth transfers or distributional concerns.
- 64 The Commission cannot ignore the fact that wealth transfers were irrelevant to the authorisation analysis conducted under the dominance threshold, and remain irrelevant to any consideration of merger to monopoly, and that these mergers result in the situations the Commission now describes in its draft report as meeting the threshold test for intervention under the Telecommunications Act: where there is a concern about possible monopoly profits, and a lack of competition to drive them out.
- 65 The implications of the Commission's proposal also highlight how far outside the legal framework and economic orthodoxy the Commission proposes to stray. The Commission's "consumer welfare" approach implies:
- 65.1 the Commission would recommend a regulatory intervention that reduced New Zealand's net welfare, as long as the transfer from producers (and their shareholders) to consumers was sufficiently large.
- 65.2 the Commission is prepared to count a transfer from Telecom and Vodafone to other corporates and businesses as a benefit, potentially outweighing a net welfare loss to New Zealand.
- 66 In fact, as demonstrated in the attached report from Professor Katz (Annex D), in a situation where fixed line customers are also mobile customers, it is possible for the Commission's proposed consumer welfare test to recommend regulation where this would harm every consumer. Given current mobile penetration levels (approximately 75%) this is a serious possibility.
- 67 Professor Katz and CRA (Annex B) expose the political value judgments inherent in the Commission's proposed wealth transfer. Before the Commission recommends wealth transfers it must articulate why consumers in their roles as owners, customers and employees of companies purchasing telecommunications services are more deserving than consumers in their roles as owners, employees and customers of New Zealand's mobile service providers. These are patently difficult political judgements. As discussed by Professor Katz, the prevailing policy consensus is that competition and market regulation is a poor vehicle for addressing these issues, which should focus on efficiency and "growing the pie", and redistributive and social policy goals should be addressed in specific measures designed for the purpose.

The statutory and decision-making framework

- 68 The Commission relies on clauses 2 and 3 of Part 1 of Schedule 1 (with their focus on discounting any inefficiencies and excess profits in cost based pricing) in support of its position that wealth transfers should be counted in the cost benefit analysis in a Schedule 3 investigation. However, in doing so, the Commission neglects the decision it is actually tasked to make: whether or not regulation of a particular service should occur at all, not how to price a service that the Act already regulates.
- 69 The distinction is important, both as a matter of law and logic – discounting inefficiencies and monopoly profits makes sense in cost based pricing calculations, and has been specifically recognised in that context in the Telecommunications Act. Counting the transfer of perceived monopoly profits from producers to consumers as a benefit does not make sense in the context of assessing the costs and benefits to all end-users of regulating a service precisely because transfers are welfare neutral and distribution issues are political, and it is for this reason the legal framework treats distributional concerns as irrelevant and focuses on efficiency outcomes and real resource impacts.
- 70 The Telecommunications Act directs only that the decision of whether to recommend regulation of a service is to be based on section 18 considerations. In the Issues Paper the Commission referred to section 19(b), which refers to additional matters set out in Schedule 1 “if applicable”. The Commission has properly dropped the reference to section 19(b) in the draft report, as clauses 2 and 3 of Schedule 1 do not apply in this context. The Commission has instead refined its reference to one of “statutory context”. As discussed above, however, this overlooks the nature of the decision being considered, which is of a different nature and context to the application of Schedule 1 service descriptions, and is contrary to the explicit directions from the High Court to treat distribution concerns as irrelevant to any net benefit analysis.

Legislative history

- 71 That the same approach to wealth transfers was intended to apply under the Commerce Act and the Telecommunications Act is supported in the legislative history of the Telecommunications Act. Both Parliament's choice of words and the history of the legislation plainly show that the "long-term benefit of end-users of telecommunications users" under the Telecommunications Act was intended to be equivalent to a net economic benefit test under the Commerce Act.
- 72 As Telecom has previously submitted to the Commission in the LLU investigation, the enacted form of the section 18 purpose statement in the Telecommunications Act was introduced in Supplementary Order Paper No 216 ("**SOP 216**"). David Cunliffe, the Chairman of the Commerce Committee, provided the substantive Government explanation of the purpose clause (Hansard, 27 November 2001, 13245):

Most important, the purpose clause in Part 2 , clause 18, has been brought into line with the purpose of the Commerce Act and that is a very, very important streamlining of this bill. 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.

- 73 Further, in their briefing to the Commerce Committee on the Telecommunications Bill, Ministry of Economic Development officials stated that clause 15 (as drafted) required consideration of net benefits to the whole of New Zealand (Telecommunications Bill, Detailed Briefing for the Commerce Committee, p 15). In so doing, officials rejected submissions from Telecom, the New Zealand Law Society and United Networks Ltd that the clause should be redrafted to make this clear, stating that (Clause by Clause Analysis, p 13):

"Efficient telecommunications markets for the long term benefit of end users" (used in cl 15) is equivalent to "net economic benefits".

and (Clause by Clause Analysis, p16):

The current purpose statement is intended to be a robust proxy for the whole of society. Consequently, efficiency gains would be measured for the whole of society.

- 74 In their specific briefing paper on the purpose clause dated 15 August 2001, MED officials reiterated that (Telecommunications Bill - Purpose Clause, para 6):

The Telecommunications Bill uses the phrase "long term benefit of end-users of telecommunications services". The [phrase is] commonly accepted as a proxy for net benefit to New Zealand.

Affirmation of the settled approach by Treasury

- 75 The settled approach that the Commission must treat wealth transfers as mutually offsetting and therefore welfare neutral was endorsed by the New Zealand Treasury in the LLU context, in their advice to the Minister of Communications following the Commission's recommendation (Cabinet Policy Committee paper from the Minister of Communications, "Local loop and fixed public data network unbundling in New Zealand", 12 May 2004, para 56):

The Commission's assessment framework for its determination includes both efficiency gains and wealth transfers. Treasury considers that the assessment framework should only include efficiency gains, as this is the actual gain to New Zealand. Moreover, the Commission's assessment framework is inconsistent with its assessment framework for clearing mergers and takeovers under the Commerce Act. The purpose statement in the Commerce Act (under which the Commission clears takeovers and mergers) is similar to the purpose statement in the Telecommunications Act, and it therefore follows that the assessment frameworks should be similar.

- 76 Treasury identified the following policy concerns with the Commission's treatment of distributive effects (Treasury Report, "Briefing for EDC Local Loop Unbundling and Fixed PDN in New Zealand", 10 May 2004, para 18):

*Treasury disagrees with the approach the Commission has taken, as including distribution effects in a cost benefit analysis could justify regulation where there is an inefficient outcome, but offsetting wealth transfers... We consider regulation is best used to improve the efficiency of markets. The Government has other policy instruments to address concerns about distribution of income. **An efficiency based approach is best aligned with the purpose of the Act, as the long run interests of consumers is served by allowing producer surplus to incentivise innovation and entry into the market.***

- 77 Having reviewed the Commission's treatment of efficiency and distribution effects, Treasury recommended that (Treasury Report: "Briefing for Meeting with the Minister of Communications on Local Loop Unbundling", 19 April 2004, para 33):

*...if the Government is to ask the Commission to reconsider its decision [to regulate only a limited bitstream access service] then it should also **asked the Commission to reconsider its assessment framework.***

Affirmation of the settled approach by the Government

- 78 The settled treatment of producer surplus as irrelevant to the cost benefit analysis of regulatory intervention has also recently been endorsed by the Minister of Energy in the Gas Pipelines Inquiry. As Telecom has already submitted, for the purposes of that Inquiry the Minister specifically requested that the Commission report on a net welfare basis. This is also consistent with the approach taken by the government to the Airfields Inquiry, where the government's decision was made on the basis of a net welfare analysis.
- 79 The Commission's paragraph 69 does not address this issue. The "interests of acquirers" threshold in section 52 has *never* carried the day in the government's decision-making. The difficulty for the Commission's approach remains – the Commission's role is to advise the Minister, and the government consistently responds to the Commission's reports and makes decisions on regulatory intervention on the basis of a net welfare test.
- 80 It is the government (via the Minister of Communications), not the Commission, who must ultimately make the decision of whether to regulate the mobile termination service. In Telecom's submission, the approach taken by the Treasury and the Minister, as the ultimate audience for Commission recommendations, cannot be ignored. If the government uses the net welfare standard in its decision-making, the Commission has no mandate to do otherwise.

Commission’s treatment of wealth transfers not supported by “AMPS-A” case

- 81 The Commission has referred to High Court dicta in the decision of *Telecom Corporation of New Zealand v Commerce Commission* (1991) 4 TCLR 473 (the “AMPS-A” case) in support of its approach to wealth transfers. The Commission seems to be relying on AMPS-A to give legitimacy to its assertion that it may count wealth transfers as a benefit to end-users in its cost-benefit-analysis. In doing so, the Commission must equate “distributive issues” as referred to in AMPS-A, with wealth transfers (from producer to consumer).
- 82 However, in Telecom’s submission, AMPS-A does not provide the Commission with any judicial support for its position. The court in AMPS-A was addressing the debate that had developed as to the *scope* of a recognisable public benefit – that is, whether the size of the segment of the public that a benefit attaches to is relevant, and whether that segment of the public is New Zealand or overseas based. AMPS-A does not, under any reading, address wealth transfers from producers to consumers.
- 83 It is clear from the section of AMPS-A cited by the Commission that the High Court was not considering wealth transfers from one section of the public (producers) to another (consumers). Rather, the Court was discussing the possible distinction between “public” and “private” benefit in the sense of whether a benefit accrued to a wide cross section of the New Zealand public or a narrow group, and whether this was relevant to the weighting of the public benefit. The court’s use of the words “distributive values” cannot be read as an endorsement of weighting wealth transfers from producers to consumers.
- 84 The Commission cannot continue to dismiss this issue without proper consideration or analysis of Telecom’s view, a view that is shared by the High Court and the government. Telecom again repeats the submissions it made in the LLU process regarding the proper approach to wealth transfers.

Regulation will not promote competition in this case

- 85 Telecom submits (and understands the Commission to agree) that proposed regulation will only meet the benchmark set by section 18 if it promotes competition. That is, for the Commission to recommend regulation it must first be confident the proposed regulation will promote competition in telecommunication markets. As a further and separate matter, this competition must be for the long-term benefit of end-users.
- 86 As detailed in this submission, the mobile services market and the retail tolls and fixed to mobile calling market are competitive. In this context regulation is unlikely to promote competition for the purposes of section 18.

Importance of dynamic efficiency

- 87 In terms of weighing efficiencies, Telecom agrees with the Commission that dynamic efficiency is of greatest importance in its regulatory decision-making, all the more so in relation to services at the cutting edge of new (and developing) technology – as is the case for mobile telephony.

Potential “end-users”

- 88 Telecom agrees with the Commission that the term “end-users” includes potential end-users of the relevant service. That “end-users” includes potential end-users has significant implications in the mobile services market, as many low income customers opt *into* the market only on the basis of low handset and subscription (access, rental and calling) charges. If subscription prices were to rise (or, equivalently, not drop over time at the same rate as they might otherwise) – as is highly likely to be the case in Telecom’s view following regulatory imposition of lower termination rates – Telecom believes this would lead to many existing customers dropping off the network, and *potential* customers simply opting out of the mobile market altogether. Professor Hausman estimates over 100,000 customers will opt out of the mobile services market, as compared to the counterfactual. This is consistent with the evidence from receiving party pays countries (where subscription prices are higher), such as the USA, where mobile penetration is as low as 50%.
- 89 Telecom submits that the Commission is charged via section 18 with making a decision that best promotes competition for the long term benefit of *all* (current and potential) end-users, not just some, not just ongoing, and not just current users of the service in question.

THE COMMISSION’S APPROACH TO MARKET DEFINITION

- 90 Telecom agrees with the Commission that the legal framework requires that markets should be defined “in a way that best assists the analysis of the competitive impact”, using a “common sense, pragmatic approach” (draft report, para 73). The Commission has not followed this framework, however, and has defined markets for termination on particular mobile networks that are commercially unrealistic, and determinative of the substantive competition issue.
- 91 The Commission accepts that there are complementarities in production and concedes that firms will supply mobile termination, subscription and calling services together (draft report, para 119). Telecom and Vodafone have informed the Commission that the prices of mobile termination, subscription and calling services are related, reflecting the two-sided nature of the market. The Commission has not refuted this (although the Commission’s claim regulation will not result in price rebalancing is addressed later in this submission). The Commission nevertheless suggests that the inter-relationships between termination and other services should be “considered outside of the market definition process”, in assessing the likely consequences of regulation (draft report, paras 82, 118, and 128).
- 92 Telecom submits that the Commission’s approach is erroneous. Before beginning the cost-benefit analysis, the Commission must be sure that competition in the relevant market is limited. The legal framework requires that the Commission must define the relevant New Zealand market correctly as a first step, such that the market definition enables a proper consideration of all competitive forces and linkages. The Commission’s mobile termination markets are instead commercially unrealistic,

exclude significant competitive forces and linkages, and are directly determinative of the competition assessment.

Proper approach to market definition

- 93 Telecom submits that the proper and required approach is to define markets realistically rather than technically. This is required in terms of section 3(1A) of the Commerce Act, is well established by the New Zealand case-law; and is reflected in the Commission's Merger Guidelines.

Section 3(1A)

- 94 The starting point for market definition under the Commerce Act is section 3(1A), amended in 1990. Section 3(1A) defines a "market" as:

*...a market in New Zealand for goods or services as well as other goods or services that, as **a matter of fact and commercial common sense**, are substitutable for them.*

- 95 The Commission has not defined markets in accordance with commercial common sense. As explained further below in Section C, the Commission's markets do not properly expose the play of market forces. Instead, they are unrealistic and determinative of the ultimate issue.

Court decisions on market definition

- 96 The role of market definition in a regulatory inquiry was first explained by the Australian Trade Practices Tribunal in *Re QCMA* (1976) 8 ALR 481, at 516:

*We stress that market definition can be but a first step...mere specification of markets **cannot be determinative** by itself of some ultimate issue.*

- 97 The Tribunal went on to give the classic judicial exposition of what a market is (at 517):

*We take the concept of a market to be basically a very simple idea. A market is the area of **close competition between firms** or, putting it a little differently, the field of rivalry between them (if there is no close competition there is of course a monopolistic market).*

- 98 That emphasis on factual competition between firms came through in the New Zealand High Court's first consideration of the amended section 3(1A), in *Telecom v CC* (1991) 4 TCLR 473 (the "**AMPS-A**" case). The Court said of the recently amended s3(1A) (at 499):

*The retention of the reference to 'commercial common sense', a term that first appeared in *Edmonds Food Industries Ltd/W F Tucker Co Ltd CC*, Decision No 84, affirms the traditional New Zealand emphasis upon the need for a **commercially realistic factual base**. We see no source of conflict or tension*

in the juxtaposition of the two elements, substitutability and commercial common sense, in this formulation.

99 The High Court also explained (at 502):

*If we ask what functional divisions are appropriate in any market definition exercise the answer, plainly enough, must be whatever will **best expose the play of market forces**, actual and potential, upon buyers and sellers.*

100 The Court of Appeal did not disturb the High Court's comments on market definition on appeal in *Telecom v CC* (1992) 4 TCLR 648. Rather, the Court subsequently reiterated this emphasis on competition between firms in *Port Nelson Ltd v CC* [1996] 3 NZLR 554, at 560:

*Generally a market will be identified by reference to the activities of those engaged in commerce, the structures underlying their activities and the perceived susceptibility to change in the medium term future. In other words **what competitors are doing or might reasonably be expected to do** indicates the market in which they are participants.*

101 The High Court expressed a strong preference for defining markets by reference to the activities of firms in *Power NZ v CC* [1996] 1 NZLR 686. The Court observed (at 705):

*The crucial consideration should be that market definition, in association with the identification and assessment of sources of market power, gives rise to a **true assessment of liability**. It follows that something more is required of market definition than that it merely be "reasonable".*

102 The Court went on to expressly criticise the Commission's unrealistic approach (at 705):

*There is one feature of the commission's approach which we ourselves have found less than satisfactory. This is what we shall term its "disembodied" quality, ie its focus upon markets as collections of substitute products (including services), quite **unrelated to the business firms** that undertake their production and marketing. The ultimate subject-matter of the Act is the conduct of business firms.*

103 The Court then concluded that the proper approach was to balance both substitutability and actual competition (at 706):

*The merger calls for an appropriate set of market definitions which will **accommodate both** (i) the services/products and their substitutes; and (ii) all the firms in rivalrous conduct.*

- 104 That view was approved by the Court of Appeal in *Power NZ v CC* [1997] 2 NZLR 669, at 678-679:

*We respectfully agree that the approach adopted by the High Court, as summarised above, was appropriate in the circumstances of this case. The identification of the appropriate market or markets must **accord with the commercial realities**, and take account of the **activities of the parties** involved. It must expose the constraints on the individual firms.*

- 105 The High Court made a simple but accurate observation in *Shell v Kapuni* (1997) 7 TCLR 463, at 526:

A precise approach to market definition is not required... We have to choose a market or markets which is or are most suitable to our task.

- 106 The High Court considered market definition at length in *Brambles v CC* (2003) 10 TCLR 868. The Court first stressed that the ssnip test for substitutability is no more than an analytical tool (at 883):

*[81] The Commission or Court should always be alive to other evidence which can assist in identifying the appropriate market **in accordance with commercial common sense**.*

- 107 The Court ultimately accepted the Commission's market definition, but not its assessment of competitive constraints. In reaching that conclusion, the Court noted (at 892):

*[137] It is important to recognise that market definition is **a tool** for competition analysis rather than an end in itself.*

Merger Guidelines

- 108 In addition to the passage quoted in the draft report (para 73), the Commission's own Guidelines also comment (at page 15):

*Where a number of relevant markets exhibit **similar competitive characteristics**, they may, for ease of reference, be referred to as a single class of market for the purposes of the inquiry.*

- 109 This point was illustrated in the Commission's previous Practice Note 4:

The Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. Where a number of relevant markets exhibit similar competitive characteristics they may, for ease of reference, be referred to as a single class. For example, although air travel on different city-pair routes may not be substitutes in the eyes of travellers, they may be on the part of suppliers, and so it may be

appropriate – and aid the subsequent competition analysis – to classify them in a single product market such as an “air services market”.¹

Commission’s market definition is artificial

- 110 In the submission below, Telecom demonstrates that the Commission’s definition of a termination market on each network is not in accordance with commonsense (*Brambles*), does not accord with the commercial realities and the activities of the parties involved (*Power NZ*) and is not based on a commercially realistic factual base (*AMPS-A*). Both market participants have informed the Commission that mobile termination, subscription and calling are supplied together from a common cost base, and priced to maximise “buy in” on both sides of the market.

The Commission determines the competition issue by defining monopoly markets

- 111 The Commission’s approach to market definition leads inexorably to the conclusion that there will be a “termination bottleneck” on each network (draft report, para 140). That conclusion makes it inevitable that mobile network operators face limited competition in the wholesale market for termination services on their respective networks (draft report, para 190).
- 112 Telecom submits that such a rigid approach is not consistent with proper legal process. The Telecommunications Act requires the Commission to consider whether competition is, or is not, limited. As already noted, *Re QCMA* establishes that market definition is a “first step”. It cannot be “determinative”. Yet the Commission has chosen to define a monopoly market, in which competition is necessarily limited.

Importing market definitions from abroad

- 113 In addition to the Commission’s failure to define markets in accordance with commercial common sense, it refers extensively to market definitions favoured by other regulators (draft report, paras 102-116). The Commission effectively adopts the market definitions preferred by the EC (108) and ACCC (116).
- 114 Section 3(1A) of the Commerce Act defines a market as “a market **in New Zealand...**”. This confirms that the Commission is obliged to define markets that are realistic in the New Zealand context. It cannot simply defer to the decisions of regulators in quite different legal and commercial contexts.

COMPETITION ASSESSMENT

- 115 Telecom agrees that the Commission must make a competition assessment of each relevant market. Section 18 puts the onus on the Commission to be confident that its

¹ See Commerce Commission, *Decision No. 278: Air New Zealand/Ansett Holdings/Bodas*, 3 April 1996, especially paragraphs 137, 140, and 145-46.

decision will, or would be likely to, promote competition in a telecommunications market. This means that if a market is already workably competitive, regulation would be unlikely to promote competition for the purposes of section 18.

- 116 The Commission applies its “limited competition” test in Chapter 4 of the draft report. The Commission has previously defined the limited competition test as follows.²

As noted above, the Commission has previously considered the meaning of “limited competition” in the context of airports:

- 2.24 *The Commission must determine whether competition in the markets for airfield activities supplied by AIAI, WIAL and CIAL is limited or is likely to be lessened. The Commission focuses on the higher test of limited, and considers it need only look at the test of “likely to be lessened” in circumstances where competition is not found to be limited.*
- 2.25 *The ordinary meaning of the word limited applies as the term is not defined in the Commerce Act. Competition will be “limited” where it is restricted. Consequently, the Commission views limited competition as denoting a restriction or impairment to workable or effective competition.*
- 2.26 *In applying the test of limited competition, the Commission considers the purpose of the Commerce Act, which is to promote competition in markets (for the long-term benefit of consumers within New Zealand). The control provisions of the Commerce Act are interpreted in the light of the objective of maintaining competitive and efficient markets, and also having regard to the meaning of competition in the Commerce Act as being workable or effective, but not perfect, competition.*
- 2.27 *The Commission’s view is that a nominal or de minimis restriction or impairment of competition in a market is not sufficient to satisfy the limited competition requirement. There needs to be more than a nominal or de minimis restriction or impairment of competition.*
- 2.28 *In determining whether workable or effective competition is limited in the relevant markets for airfield activities, the Commission considers the structural and behavioural elements exhibited. This involves taking into account all of the relevant factors, including the following: the number and relative sizes of competitors in the market; the nature of entry and of any barriers to entry that may exist, the behaviour of incumbents, and the competitive constraint that one airport may have upon another, the*

² Decision 497, paragraphs 298 to 300.

existence of countervailing power of the airlines; and the regulatory environment within which market participants operate.

For the avoidance of doubt, the Commission adopts the interpretation of “limited competition” used in the Commission’s Airports decision; it is the Commission’s intent to use the same “limited competition, testing here as that used in the Airports decision. As in the Airports decision, the Commission test for assessment of competition in the relevant markets involves an analysis and weighting of other relevant factors, and is not a “bright line” test.

The Commission is not persuaded by Telecom’s arguments that a bright line test would be appropriate in this context because assessment of competition in a market should not turn on a single determining factor. The Commission therefore finds that Telecom’s proposed bright line test for interpreting or defining limited competition is not an appropriate “stand alone” test. However, it is appropriate to consider this as one of the factors to be used in assessing competition.

- 117 The “bright line” test referred to by the Commission was a test proposed by Telecom.³

At the conference Telecom proposed a “bright line” test that could be used to determine whether there is limited competition in a market. This test is based upon the concept of “critical loss”, which refers to the extent to which customer switching may constrain an incumbent from exercising any market power. Telecom argued that where there are high fixed costs, an incumbent is unlikely to be able to profitably exercise market power unless it can accurately identify those customers likely to switch to an alternative supplier.

- 118 Telecom has submitted on the Commission’s limited competition test previously. In particular, the formulation “more than a nominal or de minimis restriction or impairment of [workable] competition” leaves unanswered the question “how much more?”, and so fails to articulate a “test” as that concept is commonly understood. The Commission’s refusal to adopt a clear rule or bright line test in favour of an opaque weighing of factors is also a disappointing abdication of the function of providing guidance to market participants.
- 119 However, in this context the Commission bears the burden of positively proving that workable competition does not exist in a market. If this cannot be affirmatively demonstrated, then the analysis should proceed on the conservative assumption that the market is competitive.

³ Decision 497; paragraph 285

120 The High Court has approved the following definition of workable competition:⁴

*Workable competition means a market framework in which the pressures of other participants (or the existence of potential new entrants) is sufficient to ensure that each participant is constrained to act efficiently and in its planning to take account of those other participants or likely entrants as unknown quantities. To that end there must be an opportunity for each participant or new entrant to achieve an equal footing with the efficient participants in the market by having equivalent access to the means of entry, sources of supply, outlets for product, information, expertise and finance. This is not to say that particular instances of the items on that list must be available to all. That would be impossible. For example, a particular customer is not at any one time freely available to all suppliers. Workable competition exists when there is an opportunity for sufficient influences to exist in any one market which must be taken into account by each participant and which constraint its behaviour.*⁵

121 In QCMA, the Australian Trade Practices Tribunal made the following statements about the workable or effective competition standard:⁶

*“The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more” and that “the antithesis of competition is undue market power in the sense of the power to raise price and exclude entry”.*⁷

Competition expresses itself as rivalrous market behaviour.

...

In our view effective competition requires both that prices should be flexible reflecting the forces of demand and supply and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.

Competition is a process rather than a situation.

⁴ *ARA v Mutual Rental Cars (Auckland Airport) Ltd* (1987) 2 TCLR 141, at 166; *Fisher and Paykel Ltd v Commerce Commission* (1990) 2 NZLR 731, at 757.

⁵ Contained in Heydon, *Trade Practices Law* Vol. 1 (2nd Ed.) Sydney, Law Book Co., 1989 page 1548, paragraph 3.2.10.

⁶ (1976) 8 ALR 481, 514-517. Endorsed by the High Court in *Fisher and Paykel Ltd v CC* (1990) 2 NZLR 731, 759, and the Court of Appeal in *Tru Tone Ltd v Festival Records Retail Marketing Ltd* (1988) 2 NZLR 352.

⁷ Citing the Report of the National Committee to Study the Anti-Trust Laws (1955).

- 122 The Commission must assess the relevant markets against this workable or effective competition standard. If a market cannot be demonstrated to be less than workably competitive, then the analysis must proceed on the basis that the market is workably competitive. Telecom submits below that the position is in fact clear, and the market evidence supplied to the Commission demonstrates to any reasonable standard the relevant markets are competitive.

OTHER ASPECTS OF THE LEGAL FRAMEWORK

Commission's power to regulate retail prices

- 123 It should go without saying that the Commission has no role to regulate retail prices under the Telecommunications Act. Section 18 is plain in this regard: the Commission can only regulate services and prices between service providers i.e. at the wholesale level.

C MARKET ASSESSMENT

THE MOBILE MARKET

Introduction

- 124 Telecom submits that the Commerce Commission has incorrectly defined separate ‘wholesale’ markets for mobile termination services on each mobile network, and a separate retail mobile market that excludes termination services.
- 125 A wider mobile services market is appropriate for analysing whether to regulate mobile termination rates because competition occurs and pricing decisions are always made jointly for mobile termination, origination and subscription services rather than mobile termination services alone.
- 126 As discussed above in *Section B: Legal Framework*, the market definition used for the purposes of the Commission’s inquiry must accord with commercial commonsense (*Brambles*), the commercial realities and the activities of the parties involved (*PowerNZ*), and must be based on a commercially realistic factual base (*AMPS-A*). Further, given the onus on the Commission when proposing regulatory intervention, and the considerable uncertainties involved in the Commission’s analysis, the market definition used by the Commission should be conservative, meaning if there is any doubt a wider market definition should be used.
- 127 Telecom submits a wider mobile market of mobile termination and ‘retail mobile services’ (mobile-originated calls and subscription charges) is appropriate for the following reasons:
- 127.1 a two-sided market framework is applicable to this factual context;
- 127.2 the dynamics of supplying these services together highlight the strong incentives mobile network operators face to strike the right balance of charges between mobile termination and retail mobile services (i.e. the price structure matters); and
- 127.3 the competition assessment will therefore be flawed if it does not take into account both ‘sides’ of the market at issue: termination and retail mobile services.

Applicability of a two-sided market framework

This problem is different from those analysed using standard ‘one-sided’ market frameworks

- 128 Telecom submits that the Commission must modify its approach to market definition to account for the ‘two-sided’ nature of the supply of mobile termination and retail mobile services (mobile-originated calls and subscription services).

- 129 In essence, the 'two-sided' nature of the market arises because both the calling and called parties need and benefit from each other: without both callers to mobiles and mobile subscribers the market for mobile services wouldn't exist. Callers and people being called benefit (receive more utility or consumer surplus) from having increasing numbers of people they can call and who can call them.
- 130 The Commission has based its theory of the way the relevant markets work on the conventional 'vertical view' of markets. This is a fundamental economic error in the present market context. With the 'vertical view'; the wholesaler sells an input to a retailer, for example, who then sells the end-product to the consumer. In this standard upstream/downstream markets framework, the retailer's incentive is to keep the price down as far as possible when buying inputs from the wholesaler, with the aim of maximising profits when selling its end-product to the consumer.
- 131 This framework is clearly not applicable in the case of telecommunications platforms because they are catering to both retailers and consumers simultaneously: Telecom's mobile termination services are sold to other telecommunications carriers, and retail mobile services (mobile-originated calls and subscription) are sold to end-consumers.
- 132 In this instance, Telecom has to set output prices to both retailers and consumers, which differs entirely from the usual vertical analysis of markets. Telecom Mobile must perform a 'juggling act' in terms of the balance of prices across mobile termination and retail mobile services, because of the joint demand by the retailers and consumers for the products produced by Telecom's mobile network. This leads to quite different pricing behaviour than if the platform were only interacting with either wholesalers or end-consumers.
- 133 These differences have led to a body of economic literature that attempts to describe the dynamics of what are now known as 'two-sided markets'. The literature has developed quite significantly since overseas regulators conducted their investigations into mobile termination rates. For example, a roadmap of the "burgeoning literature" on two-sided markets was only written in March this year by Rochet and Tirole and is yet to be published in a forthcoming edition of the Journal of Economic Literature.

Two-sided market definition and implications for the "SSNIP" test

- 134 The standard definition of a two-sided market is expressed by Rochet & Tirole(2004)⁸ :

A market is two-sided if the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and platforms must design it so as to bring both sides on board

⁸ J-C Rochet & J. Tirole, "Two-Sided Markets: An Overview", *forthcoming Journal of Economic Literature*

- 135 A classic example of a two-sided market is the provision of dating services, as discussed by Evans (2002). Dating clubs only work if they attract enough members of the opposite sex to make a match likely. Enough men must participate to attract women, and enough women to attract men. Thus, in Japan, one bar does this by charging \$100 for membership, plus \$20 a visit, and letting women in for free. As Evans notes, the pricing structure obtains a disproportionate share of the revenues from men but the bar presumably believes that at equal prices it would attract too many men, or too few women.
- 136 As just highlighted in the preceding example, an essential feature of this two-sided market structure is that the cost of the platform is a joint cost: prices do not and cannot follow marginal costs in each side of the market⁹. This is partly because the products have joint costs of production that make it difficult to distinguish the production costs of the individual products, but it is mainly because products are priced in order to maximise demand for the services of the platform. Platforms price to one side of the market to 'get it on board' with the knowledge that the other side will follow.
- 137 The Commission implied in its draft determination that cross-subsidies are necessary for a two-sided market to be present (paras 124-5 draft determination). Telecom disagrees – the economic literature clearly demonstrates that two-sided markets do not necessarily involve cross-subsidisation: that is, pricing below incremental cost on one side and using revenue from services on the other side to cover the remaining incremental cost. Instead, products can be priced to cover their incremental costs on both sides of the market with differing proportional contributions to the joint and common costs of their production. This is Telecom's experience in the mobile services market.
- 138 The Commission noted that it considers a credible constraint on the pricing of the cluster of services must be observed to support an argument for a two-sided market (para 120).
- 139 However, Telecom submits that the Commission has seriously erred in its proposal to apply the "SSNIP" test to only one side of a two-sided market. As noted by Evans (2002) page 64:

There is no particular reason to focus on price effects on one side (of the market) or the other – both groups of consumers matter. That is especially true in matching markets in which both sides must buy for there even to be a product. Generally, it is not possible to examine price effects on one side of a market without considering the effects on the other side and the feedback effects between them.

⁹ Evans, D. (2002), *The Antitrust Economics of Two-Sided Markets*, Mimeo.

140 For example, if mobile termination were to rise ten per cent, callers to the mobile network would make fewer or shorter calls, assuming a downwards sloping demand curve. This reduces the value of the service to mobile subscribers (who derive a benefit from receiving calls on the network). Therefore it is not possible to hold the subscriber side of the market constant. On the other side of the market, if retail mobile prices are too high, a mobile operator will fail to attract new subscribers' retail revenue and the mobile termination revenue from those inbound calls they would have received.

141 Charles River Associates outline their review of the two-sided market literature in Annex A. CRA neatly summarise the risks associated with ignoring the other 'side' of a two-sided market:

On market definition, the (two-sided market) literature is unequivocal: it is essential that both sides of a two-sided market be included in the competition analysis. There are three reasons for this.

First, failure to do so carries an assumption that the other side of the two-sided market will be constant between a regulation factual and counterfactual which is not plausible in a two-sided market.

Second, while the rules of competition analysis hold for a two-sided market with both sides considered in aggregate, they break down on each side considered independently because cost and demand is intrinsically joint. This means that in merger and market power analyses, markup of price over cost on one side of a two-sided market is by itself unrelated to market power or efficiency.

Third, where network effects are important, as they undoubtedly are in mobile telephony, a one-sided market definition will fail to take account of these despite their obvious relevance to a cost benefit analysis. Evans (2002) provides useful examples of the problems caused by narrow market definition at 64-5 and 81.

142 For the reasons above, Telecom submits that only a price test applied to both sides of the market will give effect to the purpose of market definition in this case: providing a context for examining whether mobile operators have market power and thus whether our behaviour will have ultimately harmful effects on competition and consumers.

143 Telecom's economic research on the market economics of mobile termination has advanced substantially since our Issues paper Submission (19 July 2004). Telecom now consider the ssnip proposed at paragraph 44 of its Issues paper Submission is incorrect, as it was applied to the "termination" side of the market only.

144 The Commission is incorrect in its attempt to apply a ssnip to the mobile termination side of the market (paragraph 127 of its draft determination). The Commission's

consideration of a competitive reaction by market operators in a response to a ssnip is a seriously flawed application of the ssnip or 'hypothetical monopolist' test. The ssnip test is designed to define the market and, as stated by the Commission:

The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce those goods and services.

145 This quote demonstrates that the Commission recognises that the focus is not on the competitive reaction by suppliers to an increase in the price of one good. The SSNIP test is designed to consider demand and supply-side substitution in order to define a product market which then enables the competition assessment to take place.

146 Telecom refers the Commission to the attached paper by Professor Jerry Hausman (Annex C) for further analysis of the economics of a two-sided market problem and its implication for the regulation of mobile termination rates. At paragraph 45-6 of this paper Prof Hausman demonstrates the flaws in applying the hypothetical monopolist test is to 'one side' of a two-sided market:

In terms of the hypothetical monopolist test, according to the CC Report (¶ 143) both VOD and Telecom are already monopolists in two separate markets for terminating mobile services. Thus, they should already be charging the profit maximizing price. Now consider the following hypothetical outcome: suppose that the Telecom marginal cost of originating calls decreased because of a technological advance in CDMA networks. From equation (1) when c_1 decreases the price of a_1 decreases so that originating call price would decrease. How much the originating call price decreases depends on the derivative $\frac{\partial q_1}{\partial a_1}$, the Telecom own price elasticity of originating calls, which in part depends on how much competition there is between Telecom and VOD.¹⁰ But when a_1 decreases Telecom will gain customers and it will typically find it profit maximizing to increase its terminating price a_2 . How much a_2 changes will be in part determined by how much a_1 changes which depends on the degree of competition between Telecom and VOD. Thus, Telecom cannot be a monopolist in its own termination service.

147 The Commission will be departing from contemporary economic wisdom if it does not apply a two-sided market framework to the mobile termination rates problem. As discussed above, the growing economic literature on the setting of mobile termination charges is now analysed within a clear two-sided market framework.

¹⁰ In technical economic terms, by the Slutsky equation the own price elasticity depends on the cross price elasticities between competitors. I assume here that the marginal cost of originating calls does not change for VOD.

- 148 Relevant to this point is the Australian Competition and Consumer Commission (ACCC) market definition decision in its mobile termination rates inquiry. In finding a narrow market for mobile termination, the ACCC noted that Laffont & Tirole consider all network operators to have market power, irrespective of their size¹¹.
- 149 The Commission should note that this is an incorrect characterisation of Laffont and Tirole's views. Laffont & Tirole were considering the fixed line problem (where penetration is near 100%), and thus implicitly assuming subscription is not affected. This distinction is key to the ACCC's mistake: a "one sided view" is more applicable when subscription is not affected but is clearly incorrect with a two-sided view. Further, Laffont & Tirole's Handbook of Telecommunications was published in 2000, prior to the development of the "burgeoning literature on two-sided markets"¹².
- Incentive to balance charges to the two sides in order to maximise services traded*
- 150 Telecom needs to set the balance of prices between both sides of the market (mobile termination and retail mobile services) in such a way as to maximise the volume of services traded in the market whilst recovering joint and common costs across all products in order to maximise profit. If the balance is wrong, Telecom will be counting the cost of getting it wrong through lower call volumes. This gives Telecom a strong economic incentive to get the price structure right.
- 151 The two-sided market literature clearly points out the dangers of changing a price structure in a two-sided market for the worse. Any sub-optimal change (such as a lowering of mobile termination rates and an increase in retail mobile service charges) will depress the overall volume of calls traded in the mobile market. It was also have a negative flow on to the calling market, as discussed further below.
- 152 The key implication of these dynamics is that the Commission must be very certain that its posited price structure will deliver a more efficient outcome than the current commercial price structure. This sets a high standard for the Commission to meet, given that mobile operators have made judgements based on better information, and a strong incentive to put in place the correct price structure, given the high cost of getting it wrong.
- 153 Telecom considers it is very clear that regulatory intervention to alter the prevailing market price structure will lead to a reduction in society's overall net welfare. Section F sets out Telecom's view of the distortions and costs that will be caused through regulation.

¹¹ ACCC, *Mobile Services Review – Mobile Terminating Access Service*, June 2004, p. 50.

¹² Rochet & Tirole, 2004:op. cit.

THE COMMISSION'S PROPOSED MARKET FOR FIXED-TO-MOBILE AND TOLLS CALLING SERVICES

- 154 Telecom agrees with the Commission's proposal to define a relevant market of fixed-to-mobile (FTM) and toll calling services but Telecom does not agree this is an example of a cluster market. This would imply, incorrectly in Telecom's view, that stand-alone providers, and their single calling services (such as national tolls alone), do not form part of this market. That is, they are unable to compete against providers who supply all services together.
- 155 Telecom does not consider the demand-side 'economies of scope' argument for a cluster market is definitive in this case. The Commission noted Telecom's evidence on the fact that most of our customers buy all three calling services together. This, the Commission said, implied that economies of scope on the demand-side lead to a reluctance by consumers to 'unbundle' calls and purchase from different providers.
- 156 However, it is important to note that not all customers buy our calling services together, and Telecom has no information on the customer purchasing patterns for those New Zealanders who choose to buy calling services from alternative providers to TelstraClear or ourselves.
- 157 The Commission appears to share Telecom's doubts as to whether there is definitive evidence of a cluster market (para 170). Telecom is unclear as to why the Commission expresses a view on this when there is a clear-cut case for a wider "standard" product market based on supply-side factors. Telecom reiterates that ease of supply-side substitutability is the definitive factor creating a wider calling market of FTM and toll calling services.
- 158 The Commission noted Telecom's submission on this issue at paragraph 157¹³ of its draft determination, however it did not express a view on supply-side substitutability and its implications for defining the product market. This appears inconsistent with the Commission's Merger and Acquisitions Guidelines which set out that supply-side substitutability will be considered when the product market is defined.
- 159 In Telecom's view the product market clearly includes international and toll call services when supply-side substitution dynamics are included. Toll carriers can easily switch to the production of FTM calls using existing assets in the event of a "SSNIP" of FTM prices by a hypothetical monopolist. Telecom reiterates the points set out at paragraphs 69 – 70 of Telecom's Issues Paper submission:

¹³ Note however the draft report characterised Telecom's submission incorrectly by stating that Telecom argued "supply-side factors reinforce a broader retail market". Telecom in fact stated that the supply-side argument for a wider market was definitive (paragraph 66 of Telecom's submission on the Issues paper).

The Commission has previously suggested that the supply-side substitution test for tolls and FTM services is not met on the basis that the move by toll bypass carriers into FTM calls services is 'more of a discrete step', because of high termination charges prevailing in the mobile market¹⁴.

Telecom disagrees. Termination charges (whatever the level) do not represent a cost that prevents FTM and tolls from being close substitutes on the supply-side. The supply-side test is based on whether firms can shift production easily and in the short-run, using largely unchanged production facilities and little or no additional investment. Mobile termination charges do not represent an investment cost that prevents firms from switching in the short term – rather, they are a variable production cost (i.e. dependent on units sold) – not an investment (i.e. fixed costs of acquiring income-producing assets).

- 160 For the reasons set out above, Telecom submits that this ease of supply-side switching by toll carriers demonstrated above leads to a relevant market for FTM, national and international toll calls. This includes the services provided by single-service calling providers.
- 161 Telecom notes that with the presence of a vertically-integrated operator such as Telecom, the two-sided market framework can imply that FTM calling services should be included in the wider mobile market. That is, Telecom would aim to set FTM calling prices to optimise mobile and FTM call volumes so as to maximise retail and termination revenue.
- 162 However this dynamic does not apply because of the entry of competing stand-alone suppliers of calling services. Aggressive competition by standalone calling suppliers (e.g. TCL, WordxChange, Slingshot) has led to FTM calls being, in effect, “unbundled” into the separate fixed line toll calling market .
- 163 This means that Telecom’s FTM prices are set in relation to competitive conditions in this calling market, rather than with a view to fully internalising mobile caller’s externalities in receiving calls. Thus, Telecom must price mobile termination services to ensure its mobile subscribers find it attractive to remain on Telecom’s network.

¹⁴ TelstraClear Wholesale Application Draft Determination, 24 November 2002, para. 133.

D COMPETITION ASSESSMENT OF THE MARKETS

FIXED LINE TOLL CALLING MARKET

The retail fixed line toll calling market is clearly competitive

- 164 The Commission has been provided with market evidence that clearly demonstrates that the retail fixed line toll calling market is competitive.
- 165 The key features of the market reflect its competitive nature. The Commission has noted there are a large number of competitors in the market. Further, Telecom's market share is declining. The Commission also records the market evidence that industry toll prices have fallen by 15% over the period 2000 – 2004 and FTM prices have fallen by 12 per cent over the same period. At paragraph 195 of the Draft Report, the Commission records the average decrease in toll prices since 2000 (this is Commission Designated Restricted Information).
- 166 These drops in calling prices have a real effect on Telecom's revenue. For example, Telecom's first quarter financial result for 2005 shows a drop of \$21 million (8.5%) in calling revenue from the same time last year. Of this, national calling revenue was down by 3.6% and international calling revenue by 19.7%.
- 167 The market evidence demonstrates an effectively competitive market where customers have benefited and continue to benefit from declining prices and a large range of competitive offers from the many firms in the market. Any skim of the websites of competitors further demonstrates the healthy interfirm rivalry: posted retail prices demonstrate a wide variation of price points for services available to customers.
- 168 Yet, despite the clear evidence of healthy inter-firm rivalry and low barriers to entry and expansion into national, international and fixed to mobile calling, the Commission has provisionally concluded that the calling market is subject to limited competition.
- 169 This provisional finding is in direct contrast to the Commission's findings in its Draft Determination 497 where it provisionally found effectively competitive national and international toll services markets. Telecom considers it is clear that the competitive pressures in the calling market remain at least as strong as when the Commission noted them in its Draft Determination¹⁵.

¹⁵ Telecom refers to the Draft Determination because the Commission was not required to make a final decision on these services.

The reasoning in the draft report in favour of limited competition

Prices not declining fast enough

- 170 The draft report argues that Telecom's prices are not declining at a fast enough rate (paragraph 211 and 237). Despite the competitive nature of the market, discussed above, the claim in the draft report is that the outcomes are not what would be expected to be observed in a competitive market.
- 171 The Commission has no basis upon which to make such a judgment. The prices observed in the retail fixed line toll calling market are the result of a robust competitive process, and set at the competitive level. There is no basis in principle or practice for the Commission to second-guess the price level or rate of price decline.
- 172 The Commission's approach is particularly flawed given that it compares calling prices to the estimated marginal costs of providing those services. It is a fundamental feature of this industry that telecommunications is a business involving very large fixed and common costs, and so marginal costs are a particularly misleading measure of "competitive price".
- 173 Further, the price figures discussed by the Commission at paragraphs 211 and 205 of its Draft Report were average revenue per minute trends. Average figures do not do justice to the increasingly competitive calling offers Telecom has launched to market in the past few years. Some recent examples include:
- 173.1 Reducing Telecom's average price for international "0161" per minute calling rates by an average of 33% (30-20 cpm) in August 2003¹⁶
- 173.2 Dropping Telecom's headline price by 25% (\$8 to \$6) in June 2004 for our "All you can Talk" International Off-Peak Calling deal to the UK, USA, Canada and Ireland
- 173.3 Cutting the price of Telecom's "All you can Talk" deal (for up to 2 hours) for calling Australia off-peak by 25% (\$4 to \$3) in July 2004
- 173.4 Extending Telecom's "Talkathons" (as many calls as you like to Australia and in NZ for up to \$10 on nominated weekends) to include the UK & Ireland or the USA & Canada; and

¹⁶ 0161 is dialled instead of the standard international dialling code (00XX) to make international calls to all countries. 0161 represents about [JTCNZRI of our international calling traffic.

173.5 The recent launch of “Anytime”, an integrated peak/off peak homeline, National and Home to Mobile calling plan which offers customers significantly cheaper calls than previously available. Home to Mobile calling prices have been cut by 30%, peak national toll call per minute prices reduced by 60% and the plan offers capped calls at anytime for \$2.75 for 2 hours anywhere in NZ (down from \$3).

Telecom’s vertical integration in fixed to mobile reduces competition across the fixed calling market

174 The second argument in the draft report in support of the Commission’s proposition that, despite market evidence, the fixed toll calling market is not competitive is the assertion that Telecom may derive some form of competitive advantage from vertical integration, and that this is of such magnitude as to reduce competition in the fixed line toll calling market. At paragraph 217 and paragraph 239, the Commission states:

In summary, the ability of existing rivals to compete with Telecom appears to be constrained in the case of fixed-to-mobile calls, due to the reliance of non-vertically integrated competitors on the mobile networks for termination.

Comparison of Telecom’s retail pricing for fixed-to-mobile calling with mobile termination rates charged by Telecom to its retail competitors, suggests that competitors are constrained in their ability to compete by the differential impact of the cost of mobile termination.

175 The nature and implications of pricing in the fixed line toll calling market are misrepresented in the draft report.

176 Retail prices for fixed to mobile calls approach mobile termination rates only in the top end of the market. When they do, it is the result of fierce competition between the major telcos competing on the basis of a wide bundle of telecommunications and value-added services, and the market power of corporates. In other words, the thin margins available at the high corporate end of the market are the result of intense competition, not a distortion to competition.

177 More importantly, the issue before the Commission is a competition assessment of the fixed line toll calling market as a whole. The vast majority of prices to residential, business and corporate customers are set at a level that allows efficient competitors to compete. Crucially, these prices are the result of a robust competitive process, and are at the competitive level.

178 The draft report is wrong to reason from the thin margins at the super-competitive end of the corporate market to a conclusion the entire fixed toll calling market, covering national, international and fixed to mobile calls made by residential, business and corporate customers, is not competitive. This simply does not accord with the market evidence, or the standard of workable competition discussed in Section B. The Commission has clearly not proven the fixed toll calling market is not competitive.

- 179 The ACCC notes that there are three necessary conditions for an anti-competitive price-squeeze to be a rational and viable strategy for an integrated firm¹⁷:
- 179.1 Two markets must be vertically integrated and the upstream product must be a necessary input into producing the downstream product;
- 179.2 At least one firm must be vertically-integrated and possess market power in both the upstream and downstream markets; and
- 179.3 The downstream market must be open to competition from rival, non-vertically-integrated firms.
- 180 The second condition is clearly not met in the affected downstream market: the calling market is effectively competitive for the reasons discussed above.¹⁸
- 181 Telecom's lack of market power in the calling market means it would not be able to recoup profits foregone when selling FTM services at a lower than competitive price. In fact, the market evidence illustrates that the opposite has been occurring: Telecom is losing market share and the number of competitors has increased in the calling market.
- 182 Market evidence shows that firms are making healthy margins on FTM services sold in the calling market. This is completely inconsistent with the type of price-squeeze alleged: i.e. competitors earning insufficient margins to enable effective competition.
- 183 Telecom considers the healthy FTM margins are evidence of the dynamics of the calling market discussed in our *Issues Paper* submission: competition in the calling market has largely been driven by residential customers being most price-sensitive to the cost of national and international tolls services. Thus, Telecom and other competitors have focussed upon price reductions for national and international toll calls when competing to retain residential calling customers and to stimulate calling demand.
- There is no evidence competition has been constrained in the fixed calling market***
- 184 There is simply no factual foundation for the suggestion that competition is constrained in the fixed calling market. In fact the opposite has occurred: the calling market has seen sustained new entry and aggressive competition since the early 1990s. Shortly after deregulation, Clear invested in a national backbone and entered the retail market

¹⁷ ACCC, Final Decision, Mobile Terminating Access Service, June 2004 p 107

¹⁸ Note the ACCC Final Decision contains an error when considering this issue. The ACCC defines the relevant downstream market in the same way as the Commission, as being a fixed line toll calling market. When considering this aspect of the report, however, the ACCC uses an inconsistent FTM market.

for calling services. During the first half of the 1990s, the market was contested by Telecom and Clear, and the competitive process focused on price points and innovative discounting features. At times, price gaps as large as 10% existed in the market and churn was significant.

- 185 In the mid-1990s, “third tier” carriers (WorldxChange, Compass and Newcall) entered the calling market. These operators mostly focused on providing international toll services, but with the development of national transport wholesale services, the operators were able to easily expand to providing national toll and F2M calling services.
- 186 The late 1990s was characterised by an explosion of Internet Service Providers (ISPs) diversifying into calling. This was driven by the consolidation of the ISP industry and the need for ISPs to grow their revenue in alternative ways. Examples of ISPs entering the calling market in the late 1990s are: CallPlus (later re-branded as Slingshot), QuickSilver, NetTel and iHug. These companies are able to use their ISP customer base as leverage to target new calling customers.
- 187 The large number of calling competitors, falling prices and our falling market share demonstrates that competition has actually increased, rather than lessened, in the calling market.

The wider mobile services market is effectively competitive

Introduction

- 188 Telecom submits that the wider mobile market is clearly effectively competitive. Telecom considers a robust analysis of the structure and features of the wider mobile market demonstrates this conclusion and note that the Commission’s own competition analysis fails to reveal features of the market that lead to limited competition.
- 189 Telecom disputes the Commission’s tentative conclusion at paragraph 305 of its *Draft Determination* where it states:

The Commission has not formed a definitive view on whether the retail mobile services market is subject to limited competition. However, the Commission is not persuaded that competition in that market is sufficient to ensure that profits being earned in respect of mobile termination are being dispersed through competition at the retail level. ...

- 190 The Commission has considered the wrong competition issue. The Commission considered whether “competition at the retail level is sufficient to disperse profits earned in respect of mobile termination” (para 305). This question is flawed for two key reasons:

190.1 it implies a vertical view of the markets that simply does not apply in this case, where the mobile operator is selling to both retailers and consumers simultaneously;

190.2 mobile operators must price to both sides of the market so as to maximise demand for both retail mobile and mobile termination services. It is wrong to expect prices to follow costs on either side of a two-sided market, and it would lead to inefficient market outcomes if they did.

191 Telecom submits that the correct competition issue is as follows:

Is the wider mobile market of mobile termination, origination¹⁹ and retail mobile services effectively competitive²⁰?

192 A rigorous analysis of the competitive constraints acting on Telecom and Vodafone in this market clearly show that the answer to this question is yes – neither supplier is able to exert market power thus regulatory intervention is unwarranted. Telecom outlines why below.

Inter-firm rivalry is an effective competitive constraint

193 The Commission (paragraph 250) comments that the degree of market concentration is one indicator used to assess the likely level of competition. However, the Herfindahl-Hirschman Index (HHI) is simply a measure of industry concentration and in this case it is poor indicator of the level of competition in this market.

194 The market shares analysis alone negates the HHI proxy result in this case: rapidly changing market shares demonstrate that aggressive inter-firm rivalry is effectively preventing any exercise of market power by either Telecom or Vodafone.

195 Mobile market shares have changed dramatically since Vodafone acquired BellSouth in 1998. As the Commission notes at paragraph 246, Vodafone has successfully taken market share from Telecom Mobile, to the extent that Telecom now supplies less than 50 per cent of the market.

196 This pressure alone would be enough to ensure Telecom competes as aggressively as possible to pull back market share. But Telecom faces a further impetus – in 2003 Telecom actually suffered a net loss in subscribers. Even though 2004 has been more promising, Telecom continues to add fewer than half of all new subscribers to our network, whilst the majority choose our rival.

¹⁹ Mobile origination services are not covered in the Commission's investigation, however Telecom provisionally considers origination would be part of a wider mobile market.

²⁰ The standard of workable or effective competition is discussed in Section B.

- 197 As Telecom emphasised in its first submission, the mobile industry is one that is characterised by large lumpy, sunk and risky infrastructure investments. In order to match our competition and continue to attract and retain subscribers, Telecom must continually invest very large amounts in upgrading Telecom services and the mobile network. The risky nature of this dynamic competition ensures that Telecom has a strong incentive to compete aggressively with Vodafone to grow market share.
- 198 The healthy state of inter-firm rivalry between Telecom and Vodafone is evidenced by the rapid pace of mobile product innovation. Telecom refers the Commission to paragraphs 86 – 98 of our Issues Paper submission, which describes in detail the history of the rapid pace of technological and mobile service development in NZ as a result of competition between ourselves and Vodafone.
- 199 This dynamic nature of competition and improving nature of mobile services available to NZ customers has been recognised by the Commission in its assessment of competition in the NZ mobile market at paragraph 302 of its Draft Report.
- 200 Telecom considers the Commission should apply appropriate weight to this evidence when concluding upon the competition in the mobile industry in NZ. In a dynamic economy, the acknowledged strong evidence of competition in product innovation contributes just as much to improving welfare as pure price competition.

The threat of entry is another effective competitive constraint

- 201 Telecom considers the Commission's assessment of likelihood of new entry (paragraphs 289 – 300) must take into account the mounting evidence of TelstraClear's plans in this regard.
- 202 TelstraClear's statements on its intent to enter the mobile market in NZ clearly demonstrate that entry barriers are not material for the market under analysis. TelstraClear has issued a number of media statements recently on its intent to enter the NZ mobile market: The most recent one outlines Telstra board approval for TCL to deploy a UMTS mobile network in NZ (see The Line, "TelstraClear all go on 3G mobile", 15 November 2004).
- 203 As summarised by Professor Hausman in his attached paper:

Telstra-Clear's (TC) market actions tend to demonstrate that effective competition exists. No barriers to entry exist for TC to enter the market. TC has the necessary spectrum and its corporate parent, Telstra, is the largest mobile provider in Australia and is returning over A\$4 billion in special dividends to its shareholders, indicating more than sufficient surplus cash flow to easily fund a new network in NZ.

Note that since both Telecom and VOD will be required to construct 3G networks, no significant barrier to entry exists from the requirement that TC would need to construct a 3G network. Thus, the Commission conclusion

regarding barriers to entry arising from sunk costs (¶ 290) is incorrect, because barriers to entry arise from asymmetries in required sunk investment costs, which does not exist here. Also, Hutchison has recently entered both the UK and Italy (among other countries) with 3G networks, demonstrating the absence of barriers to entry so long as spectrum is available. Given the absence of barriers to entry the mobile market in New Zealand is and will be effectively competitive.

The Commission's concern with 'high' mobile prices

204 The Commission is concerned with what it views as 'high' mobile prices in NZ and considers it may indicate "less competitive pressure" (paragraph 303).

205 Telecom disagrees that mobile prices are anything above the competitive level. Further, Telecom considers that when quality measures and the constraints imposed by free local calling are taken into account, New Zealand performs well with its mobile pricing. This has become more apparent with the mobile market offers witnessed in the past few months. Telecom details these below.

206 Telecom has launched increasingly attractive mobile pricing offers to market such as:

206.1 \$10 Text- send up to 500 messages and pay no more than \$10 a month – saving of up to \$90 per month. This offer has now been extended until the end of 2005. \$10TXT has been the single largest driver for achieving the sales uplift experienced for Telecom mobile over the last 12 months, aiding an overall reduction in customer churn. \$10TXT has changed the competitive landscape in New Zealand and with the introduction of the 500 message cap, has offered Telecom a key point of differentiation over Vodafone;

206.2 Mates Rates – a new play for 49 cents per minute anytime for calls to national landlines and other Telecom mobiles. Reduced international pricing is included, down to as low as 49 cents per minute;

206.3 Anytime pricing plans – price reductions on peak per minute pricing of up to 38%, and up to 12.4% reductions on access price. International rates are also reduced;

206.4 Data pricing for mobile Jetstream was reduced in early 2004; loyalty data pricing has reduced prices for eligible customers by between 20 and 100+% (eg. a casual rate user who used 100 MB would face a new price of \$159.50 rather than \$800). Recent T3G pricing has reduced prices even further, with savings of up to 60% on the loyalty pricing;

206.5 Handset and device prices have tended to fall, while handset functionality has been increasing. For example, the Nokia 2280 handset has fallen from \$249 to \$149;

- 206.6 Free picture messaging is currently being offered (normally 20 cents per message);
- 206.7 In August 2003 many price reductions occurred:
- (a) reduced access prices by up to 14% on some CDMA plans and airtime prices reduced by up to 23%;
 - (b) several free minute bundles increased in size by up to 100% (eg. Mytime 50 was upgraded to Mytime 100);
 - (c) Voicemail pricing reduced significantly (reduced from airtime rates to 20 cents per retrieval, which is at least a 60% saving).
- 207 Vodafone's approach to price in the mobile services market has become increasingly aggressive of recent times, forcing a series of responses from Telecom. In particular, the following promotions by Vodafone have included substantial price reductions as well as the introduction of various innovations such as further differentiated on-net/off-net pricing and peak/off-peak pricing. In particular:
- 207.1 Vodafone's "Motormouth" campaigns (for both "pre-pay" and on account") have involved a combination of significant price reductions and the introduction of significantly more aggressive differentiation of off-net/on-net call prices. Telecom has responded to provide similar offers in every case;
- 207.2 Vodafone's multiconnection "Talkzone" campaign in the business segment is a very aggressive pricing initiative. It provides for the ability for a "circle" of callers to be nominated with calling among that circle fixed on a monthly basis. Telecom's new "Team Builder" plans in response to Talkzone were launched on 26 November 2004; and
- 207.3 Vodafone's "Mobilise 100" and "Mobile 200" plans have also been significantly sharpened at all relevant price points requiring a direct response from Telecom with its equivalent "Anytime Go 100" and "Anytime Go 200" plans.
- 208 In addition, on 25 November 2004, Woosh led the mobile data market with an industry first, 256 Kbps service with a one gigabyte cap for only \$19.95 (for the first 6 months of a 12 month contract, the remaining 6 months reverting to the standard \$39.95 price point). As reported in the New Zealand Herald, this is less than the cost of an average dial-up connection. Coupled with an offer of a Woosh PC card for only \$499.00, this is the latest and sharpest yet of what have been increasingly competitive offers.
- 209 The Commission relied upon a single Ministry of Economic Development (MED)'s telecommunications benchmarking study to draw its conclusions on the relative level of NZ mobile prices. However Telecom considers that this report is seriously flawed for a number of reasons.

- 210 First, the MED report has not adapted the generic OECD baskets of goods to take into account the unique purchasing patterns of New Zealanders. New Zealanders mobile usage patterns are significantly different from the OECD “representative baskets” which inflates New Zealand’s prices relative to the OECD norm.
- 211 Telecom considers that the figures produced by the Teligen profiles (applied by the MED in its report) are not representative of New Zealand usage patterns. New Zealand mobile usage is significantly lower than the standard “medium” and “high” OECD mobile baskets. Telecom’s analysis of the Teligen model demonstrates that Telecom mobile users cannot be paying the prices implied by the Teligen model.
- 212 The table below compares the average OECD Average Revenue Per User (ARPU) with the implied Telecom ARPU produced by the Teligen model. If these profiles are correct, a significant proportion of Telecom’s mobile customer base would exhibit ARPU above NZ\$[JTCNZRI (ie. all medium and high users). Instead, over [JTCNZRP% of Telecom’s 027 base and [JTCNZRP% of its 025 base have ARPU below \$[JTCNZRI. Further, over [JTCNZRI % of Telecom’s 027 Corporate base have ARPU below NZ\$[JTCNZRI, yet this would be where the bulk of medium to high users would be expected to be found.

Teligen User Profile	OECD average monthly ARPU (Average Revenue Per User) (\$NZ)	Teligen model: implied Telecom actual monthly ARPU (\$NZ):*
Low User	\$24.52	\$29.85
Medium User	\$62.82	\$104.97
High User	\$109.77	\$178.03

* Telecom ARPU was calculated by taking the Teligen-selected Telecom plan for each user profile and multiplying the plan price per minute by the typical user profile of a certain number of minutes and texts per month.

Source: Teligen and Telecom NZ.

- 213 Text usage and capped text pricing are also key differences. The Teligen model is unable to take into account text price capping, which is offered by Telecom Mobile.
- 214 Taking these usage differences into account, Telecom ran the Teligen model using a more typical New Zealand mobile user profile. This involved assuming (per year) volumes of:

Calls = [JTCNZRI

Call minutes = [JTCNZRI (approximately [JTCNZRI minutes per month)

Texts = [*JTCNZRI*

Other settings = [*JTCNZRI.*

- 215 The raw results of the model for this profile put the price of Telecom's Mate's Rates prepaid plan as \$280.21 (PPP, or NZ\$383.10). The model, however, ignored the impact of the text price capping, which reduces the price to \$[*JTCNZRI* (NZ\$[*JTCNZRI*).
- 216 Incorporating text price capping and changing the user profile moved Telecom's price ranking from around 40th (out of 60) to around 14th.
- 217 Telecom considers this unique pattern of usage is due to free local calling and extremely competitive text pricing not available in other countries. Landline penetration is nearly 100 per cent, demonstrating the extent of competition New Zealand mobile operators face in trying to attract customers to use their services whilst recovering high fixed and common costs of service production.
- 218 Our second key concern with the MED report is that it fails to take into account Telecom's high level of mobile service coverage, despite this having a significant impact upon the prices faced by customers. New Zealand has an excellent record in this regard. The OECD Telecommunications Outlook 2003 noted that New Zealand provided mobile coverage to 97% of population in 2001. This is higher than the United States, which reports 97% coverage only in counties where mobile network coverage is provided.
- 219 Third, the MED report fails to measure the extent of penetration of mobile phones and makes no attempt to link penetration to pricing, as undertaken in its Broadband report. New Zealand is outperforming the latest OECD statistics in this regard. The OECD Telecommunications Outlook 2003 reports that New Zealand's cellular penetration was 62.9 per 100 population, with an OECD average of only 53.9 per 100.
- 220 Telecom also considers that the OECD Purchasing Power Parity (PPP) conversion rate applied by the MED is likely to result in the systematic overestimation of prices in New Zealand relative to the rest of the OECD.
- 221 Telecom submitted on this point to the Commission during the interconnection pricing hearings, and the Commission accepted this point and modified its pricing methodology as a result in a subsequent benchmarking study for interconnection. If the Commission's revised methodology were to be applied to modify the OECD's PPP exchange rate for New Zealand, services in New Zealand would be about 20 per cent

cheaper than currently presented in the benchmarking report²¹. The significance of this revision highlights the need for the MED to review its PPP methodology to eliminate what is likely to address these and any other issues.

- 222 Not only is the OECD benchmarking study seriously flawed, other studies reveal contradictory results to those shown by the OECD. For example, the table below summarises mobile price comparison results from Citigroup's Australia/New Zealand Mobile Study of 22 November 2004. Citigroup's study demonstrates New Zealand mobile voice pricing is on average similar or significantly better than the other 10 countries included in this study:

Citigroup Global comparison of mobile voice pricing and mobility premium

Country / Data Year	Mobility Premium	In local currency		In US\$		Annual % mob price to reach US pricing
		Mob voice yield	Fixed voice yield	Mobile voice yield	Fixed voice yield	
US	2.4	0.222	0.093	0.222	0.093	0%
France	2.8	0.196	0.070	0.237	0.085	-2%
NZ	3.2	0.427	0.132	0.278	0.086	-7%
Spain	3.4	0.208	0.62	0.252	0.075	-4%
Portugal	3.5	0.231	0.066	0.280	0.080	-7%
Norway	3.8	1.824	0.481	0.264	0.070	-6%
Australia	4.1	0.497	0.122	0.348	0.086	-14%
UK	4.3	0.152	0.036	0.271	0.064	-7%
Switzerland	6.0	0.697	0.117	0.550	0.092	-26%
Sweden	6.1	2.293	0.376	0.305	0.050	-10%
Germany	7.1	0.335	0.047	0.406	0.057	-18%

- 223 Telecom disagrees with the Commission's implication that its price levels are indicative of a problem with competition in the market where mobile prices are above the competitive level – i.e. at a point where supernormal profits are being made. Rather,

²¹ Telecom is not claiming that the interconnection methodology is necessarily the correct methodology, but rather that some modifications to the PPP methodology are likely to be required in this case.

the evidence presented (below) demonstrates Telecom Mobile is not making an excessive rate of economic return from its mobile business.

- 224 Telecom has relied upon accounting profits information because an economic profitability study of the mobile industry is not available. Performing an economic profitability study of the mobile sector in New Zealand would be a major undertaking²². Telecom has not performed such a study for the purpose of this review and we understand that neither has the Commission (nor does the Commission appear to have the intention of performing such a study).
- 225 Despite the lack of an economic profitability study, the accounting evidence presented below provides a robust indication that Telecom Mobile is not earning excessive economic profits.
- 226 This is because the accounting measures of profit presented are likely to overestimate economic profits in the mobile sector. The accounting measures do not make any allowance for the particularly high “asset stranding” risk associated with the mobile industry and also put a zero value on intangible capital (such as the value of retail brand presence and the value of internal business ‘knowledge capital’ that has been built up over time). In the mobile sector these omissions are all likely to inflate the accounting measure of profits relative to the true economic measure of profits.
- 227 The first part of the accounting profits evidence presented below demonstrates the mobile industry in New Zealand shows a very modest return on invested capital (ROIC):

Post tax Return on Invested Capital (ROIC)

	Post tax ROIC (%)
	2003 est.
Australia	24.5
New Zealand	11.6

Source: Australian/NZ Telecommunications Review, Deutsche Bank, 15 June 2004

²² Difficulties would include the valuation of intangibles, disentangling monopoly profits from returns to past innovation and accounting for different levels of gearing. There are also the ‘hidden’ costs associated with the risk of obsolescence due to technological change or market entry, the beta adjusted market risk associated with the industry (eg, the CAPM WACC), and the economic (rather than accounting) valuation of costs including depreciation.

- 228 A return on invested capital of 11.6% is, if anything, prima facie evidence of less than normal profits being earned in the mobile services market (given the factors identified above with respect to accounting measures of profit). It is certainly not evidence of super normal profits.
- 229 The difference between Australian mobile operators and New Zealand mobile operators is also quite striking. ROIC figures in New Zealand are only half of the mobile industry return in Australia.
- 230 Telecom believes that the ACCC erred in relying on its finding that profit levels in Australia were abnormally large based on the available accounting data. In Telecom's view such a strong finding, critical to its decision to regulate termination, should not have been based on such a weak level of evidence provided (sourced entirely on accounting measures of profitability). Nonetheless, it is clear that even if the Commission were to adopt the ACCC's approach, the same decision should not be carried over to a New Zealand context.
- 231 The second part of Telecom's accounting evidence presents Economic Value Added (EVA) results for Telecom's Mobile business. Telecom's EVA model (attached as Appendix D) was developed at a time when Telecom's mobile business was largely separated out within the Telecom Group. In addition, at the time Telecom was considering divesting the mobile business by way of a float or otherwise. For that reason, the intention was that the model should be comprehensive and robust, including all relevant costs and revenues appropriate in any EVA on a wireless business.
- 232 Telecom considers that the EVA results (a measure of wealth created above the capital cost of investment) further demonstrate that its mobile business is not earning monopoly rents. The analysis demonstrates that the EVA of Telecom's mobile business has [
- JTCNZRI** for the past four years:

Telecom Mobile: Economic Value Added/ROIC
[

JCOI

- 233 Telecom refers the Commission to Annex F where Professor Trow reviews the EVA methodology employed by Telecom. [

234

JCOI

235 The OECD Telecommunications Outlook 2003 report that shows New Zealand mobile market ARPU is amongst the lowest in the OECD: In 2001, average cellular revenue per customer was reported at US\$253 which is less than 60% of the OECD average (US\$433)²³.

236 Telecom is aware of no evidence, even based on accounting data, that suggests super normal profits are being earned in New Zealand. Telecom therefore submits that it would be unreasonable to reach the view that one generic OECD price study indicates returns in excess of competitive levels.

237 Rather, Telecom submits that the evidence above supports a finding by the Commission of an effectively competitive mobile market. The returns being made by mobile operators are no more than normal, which is consistent with the majority of the Commission's competition analysis, which noted:

*Significant and ongoing movements in market shares, increasing market penetration and the development of competing technologies and upgrades (including major investments in 3G networks)*²⁴

²³ OECD. 2003. *Communications Outlook 2003*. Paris: OECD p 105.

²⁴ paragraph 273 of the Commission's *Draft Determination*

E THE IMPACT OF REGULATION AND COST BENEFIT ANALYSIS

238 In this section Telecom addresses the discussion in the draft report of the impact of regulation (as compared to an unregulated counterfactual) and the Commission's cost benefit analysis.

239 Telecom addresses:

239.1 the estimates in the draft report of the "factual" – market performance following regulatory intervention – in the mobile services and fixed line toll calling markets;

239.2 the estimates in the draft report of the counterfactual – the likely future performance of the mobile services and fixed line toll calling markets in the absence of regulation; and

239.3 the cost benefit analysis in the draft report where these impacts are quantified.

THE FACTUAL - MARKET PERFORMANCE FOLLOWING REGULATION

The mobile services market

240 The key assumption made in the draft report is that regulation of termination rates will have no impact in the mobile services market. The Commission has discussed the submissions of Telecom and Vodafone that prices in the mobile services market will rise (which the Commission terms the "waterbed effect"), and excluded any consideration of the mobile services market from its cost benefit analysis.

241 In the face of contrary submissions from both market participants, the Commission has made an abstract assessment that price rebalancing will not occur. The Commission's assessment is inconsistent with the economic framework of the mobile services market, and Telecom's commercial experience in this market. These are addressed in detail below.

The economic framework of the mobile services market: prices increase if production costs rise

242 The Commission's economic analysis as to why the "waterbed" effect will not occur in the mobile market is fundamentally flawed. Telecom refers the Commission to Professor Hausman's analysis (Annex C) and Professor Katz's analysis (Annex D), that clearly show the Commission is incorrect in concluding that a waterbed effect "relies on competition at the retail or subscription end to be sufficient to compete away the economic profits earned on termination" (paragraph 340 of the draft report).

243 Telecom interprets the Commission's dismissal of the "waterbed effect" at paragraph 336 of its draft report as follows:

243.1 a waterbed effect is the removal of connection subsidies (paragraph 336);

- 243.2 connection subsidies have to be present and Telecom and Vodafone have said they are not (paragraphs 336-337); and
- 243.3 in any case, competition at the retail end is necessary before the waterbed effect would occur as competition would create the “cross-subsidies” in the form of connection subsidies.
- 244 This reasoning does not reflect the economics of the mobile market. Rather, as explained in Section C above, cross-subsidies are not a necessary condition of a two-sided market. Further, competition does not occur at the “retail end” as characterised by the Commission. Rather, competition and prices-setting takes place across both sides of the market given the joint demand and supply of the services in question.
- 245 Mobile termination revenue contributes to the large joint costs of producing retail mobile services, thus reducing the mobile service provider’s costs of providing retail mobile services. A regulated decrease in mobile termination rates is equivalent to increasing the marginal cost of producing retail mobile services. This is explained fully in the attached papers by Professor Hausman and Professor Katz. As emphasised in those papers, firms must be assumed to maximise profit. It is fundamental economics that an industry-wide increase in the marginal cost of producing mobile services will lead to an increase in the equilibrium price of retail mobile services sold in a market. This result applies whether monopoly or perfect competition is modelled, and Professor Hausman and Professor Katz make the point that the Commission has no principled basis for relying on doubt as to the state of competition in the market to reason prices will not adjust following regulation. Moreover, Telecom has presented the Commission with robust evidence that mobile services are provided in an effectively competitive market.
- 246 The Commission’s remaining reasons for its proposition that prices will not increase following regulation are also addressed in the attached reports. The draft report posits a “cancelling out” effect for mobile to mobile calling, but this does not address the likely response to an industry-wide drop in fixed to mobile compensation. Further, as discussed above, the discussion in the draft report of cross-subsidies misses the point – whether or not mobile service termination revenue subsidises the incremental cost of mobile connection services, prices can be expected to rise in response to an industry-wide increase in marginal costs of the services.

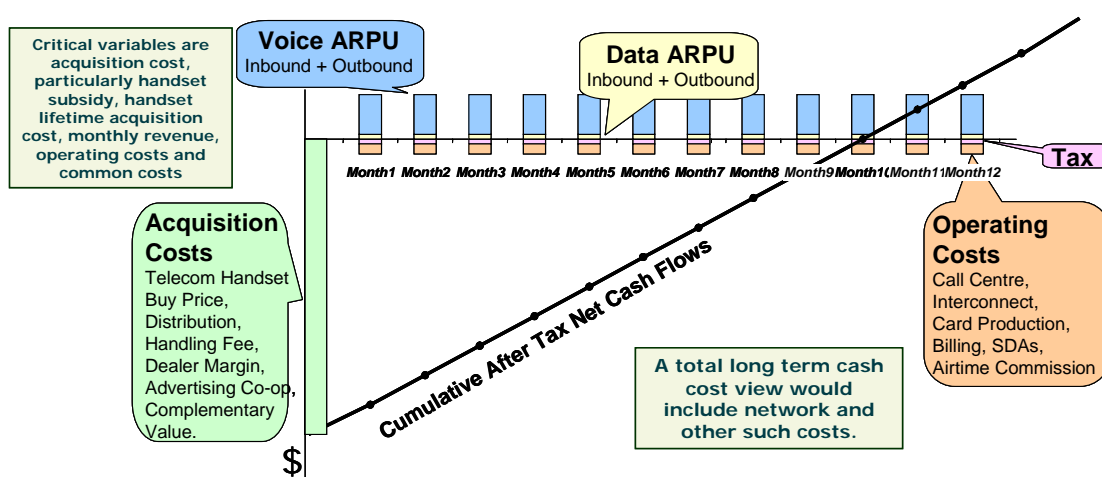
Market evidence of price setting and price rebalancing

- 247 As discussed above, the Commission’s reasoning for discounting the waterbed effect is contrary to the accepted economic framework applicable to the mobile services market. Just as importantly, it also ignores the commercial reality of how Telecom and other mobile operators price mobile services, and handset prices in particular.
- 248 As set out below, commercial reality dictates that Telecom will seek to increase retail mobile prices in response to termination rate regulation going forward.

Pricing of mobile services

- 249 As discussed in Section C, the mobile business involves providing customers with a set of closely related services. Because customers are generally more price sensitive to the potentially large upfront cost of purchasing handsets, and less price sensitive about ongoing monthly subscription and calling bills, competition in the mobile services market is characterised by mobile operators:
- 249.1 investing in the customer upfront (new to mobile or churned from competitors). Cash flow is initially negative due to acquisition costs (handset subsidy, dealer margin etc);
 - 249.2 getting a return on the up front investment by earning monthly operating returns from customers' usage of services (Voice & Data ARPU, Termination revenue etc); and
 - 249.3 attempting to manage operating costs (eg advertising, call centre, interconnect, card production), overheads and common costs better than competitors.
- 250 When mobile operators price a handset (or more particularly, the handset subsidy) they take into account the expected revenues they will realise as a result of a customer who purchases the handset being on their network. The objective is to ensure that customers who do purchase a handset will, over the expected lifetime of the handset, be profitable for the operator, as represented in the simplified diagram below (note this diagram is indicative only):

Figure E1: Critical Factors in Mobile Economics



- 251 For an integrated fixed and mobile operator such as Telecom, this requires that a notional transfer value for calls made from Telecom's PSTN to a Telecom mobile customer should be included (with, for example, a termination rate equal to the market rate).

252 The objective is for the mobile operator to get a return over the expected lifetime of the handset. As the diagram above shows however, pricing this way requires that mobile operators carefully set handset prices so as to ensure that:

252.1 They are not too high as to affect customers' choice of mobile services provider (ie attract connections); and

252.2 they are not too low such that the mobile operator does not get a return over time from customers' usage of services (ie ensure connections are profitable).

253 If mobile operators get this balance wrong, it can result either in loss of market share or masses of uneconomic customers. Indeed, mobile operators worldwide have very recent experience with the latter outcome.

254 Between 1999 and 2001, global capital markets ascribed value to the sheer number of connections on particular mobile networks – ie the focus was on the first variable above. In New Zealand, this precipitated a “race” between Telecom and Vodafone to sign up as many connections to their networks as possible. This was driven by perceptions that a large amount of wireless data revenue would materialise from these connections. Significant handset subsidies became “normal” in the market, drawing a number of very low value customers with a monthly ARPU below \$5. These customers were not economic for Telecom once the handset subsidy was taken into account.

255 As the markets began to ascribe less and less value to connections alone and more value to ARPU, and as Telecom became aware of the increasing number of uneconomic connections on its mobile networks, it instituted a review of its pricing policies. This review showed that, for many of its handsets, it could not expect a payoff from customers using them even over 24 months – when the average handset lifetime is approximately []TCNZRI months. The following are examples of what the review found:

Expected handset NPVs

Handset	Sale price	12month NPV	18month NPV	24month NPV
Nokia 5120i	[] TCNZRI	[] TCNZRI	[] TCNZRI	[] TCNZRI
Nokia 6120i	[] TCNZRI	[] TCNZRI	[] TCNZRI	[] TCNZRI

256 As a result of this review, in early 2002, Telecom changed its pricing policies, and started looking at customers from a “lifecycle value” perspective, represented in the table above, to assess what, if any, subsidy should be put on handsets. The effect can

be seen in the following graph of Telecom's prepaid subscriber acquisition costs over the past three financial years.

I

JTCNZRI

- 257 When mobile pricing is viewed at this customer lifetime value level, and in the context of New Zealand mobile operators' recent experience with the effect of reducing one price (for handsets) on overall customer profitability, it becomes apparent that regulating lower termination rates must affect the tariffs mobile operators offer for other services.
- 258 In fact, capital markets globally have now shifted their focus with respect to mobile operators to return on invested capital. As discussed earlier in Section D, the average ROIC for New Zealand mobile operators does not compare favourably with Australia's, even without termination regulation. This is simply one further reason commercial reality will prevent Telecom simply absorbing the impact of any termination rate regulation.

Effect of termination rate regulation on a customer's lifetime value

- 259 Reduced termination rates will result in reduced termination revenues, which are represented in Figure E1 as "Voice ARPU inbound". Reduced termination revenues will therefore reduce the return Telecom can expect from any particular connection over the handset lifetime. At a customer level, and with limited exceptions, each of Telecom's 1.3million mobile connections will become less economic for Telecom. As a

result, the lifetime value analysis undertaken for every handset put out to market will have to be amended.

- 260 For example, Telecom currently has a large number of customers who are already uneconomic, largely as a result of the handset subsidies that were available in the market in the 1999-2001 period. In the year July 2003 to July 2004, [**JTCNZRI** of Telecom's prepaid customers returned less than \$10 ARPU per month, most of whom it can be assumed are uneconomic or only very marginally economic for Telecom. At such low levels of ARPU, every bit of revenue is important, and removing a proportion of the termination revenue Telecom received for these connections will make them even more uneconomic for Telecom, increasing the necessity for Telecom to address the issue.
- 261 Termination rate regulation will also make a significant number of connections or customers who are currently profitable on a lifetime value view, unprofitable as in many cases the return Telecom gets from a connection is heavily dependent on termination revenue.
- 262 An initial review of Telecom's prepaid customer base for example has identified close to [**JTCNZRI** prepaid customers for whom more than [**JTCNZRI** % of monthly ARPU comes from 021/029 termination revenues alone (this is without even considering fixed to mobile termination revenue). Many of these customers keep phones only for emergencies, or where they cannot afford a fixed line phone, and want others to be able to contact them.
- 263 The average lifetime value of these [**JTCNZRI** prepaid connections, before termination rate regulation, shows that they are marginally profitable for Telecom provided it retains them through two handset upgrades (based on an average of a handset lifetime of approximately [**JTCNZRI** months²⁵).

²⁵ Note for this group of customers, mobile termination revenue is cross-subsidising the incremental costs of handsets and connection. However, across all mobile customers, Telecom reiterates that cross-subsidisation is not occurring.

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JTCNZRI

264 However, when termination rates are reduced from 27 cents per minute to 16 cents per minute, these [**JTCNZRI** connections become on average immediately cash flow negative for Telecom not including common costs/overheads.

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JTCNZRI

265 The key cash flows in this model are actual customer spend drawn from calling data for mobile origination and voice termination revenues from 021/029. The model includes estimates of revenues received by Telecom's fixed business from customers calling these prepaid mobile customers (necessary to create a customer lifetime value for the Telecom Group as a whole. Similar analysis of Vodafone's customer base would not include this fixed revenue component but could find a similar number of affected customers). The estimates are discounted. The model also assumes all of these customers are in the middle of their handset lifecycle, thus if customers replace handsets more quickly their value falls as Telecom invests more in them for the same amount of net calling revenue earned. The nearer the end of the handset lifetime a connection is, the worse the picture will look.

266 Where, as illustrated above by Telecom's EVA model for its mobile business, overall profitability is already strained, these types of results will force Telecom to seek to recover lost termination revenue by countervailing actions such as price rises for outbound voice or text (or a decline in the fall in such prices over time) or reductions in handset subsidies and therefore increases in the retail price of handsets.

267 Given the conservative nature of this model, Vodafone's position as a mobile-only operator, and Vodafone's larger customer base and larger percentage of prepaid customers, Telecom expects that regulation would have a similar effect on an even larger number of Vodafone's customers, forcing Vodafone into similar rebalancing.

How might rebalancing occur?

268 The question then becomes what form any such rebalancing might take. Both Telecom and Vodafone would obviously wish to carry out any such rebalancing in a way that minimises any adverse market reaction from their existing or potential customer bases. Telecom believes that, in practice, prices will rise in a manner which is less visible to the market.

269 There are various customer segments from which Telecom could attempt to balance any reduction in mobile termination revenues, namely: consumer prepaid; consumer post-paid; small enterprise; and medium enterprise/corporates. Of these segments, the consumer prepaid customers may be the primary target of any rebalancing initiative. In particular, and as discussed above, there are a large number of Telecom consumer prepaid customers who, while currently being economically viable, would become uneconomic if the proposed regulation were instituted in its current form. Many other Telecom prepaid mobile customers would become only marginally economic. While on average these customers are currently valuable to Telecom (and actively competed for on that basis) these customers will become less so.

270 Telecom has identified three broad ways in which it could increase its existing mobile revenue streams (other than termination) if necessary, those being: raising current access and calling prices; not reducing future access and calling prices as it otherwise would; and/or reducing the current level of handset subsidisation.

- 271 However, if termination rates are reduced from 27 cents per minute to 16 cents per minute, these [JTCNZRI connections become on average immediately uneconomic for Telecom.
- 272 Possible methods for raising calling prices – or facilitating more gradual price reduction – would be to explore further:
- 272.1 “on-net/off-net” pricing options with price increases effectively being imbedded in off-net calling tariffs; and
- 272.2 peak/off peak pricing with price increases imbedded in peak tariffs;
- 272.3 reduced handset subsidies; or
- 272.4 a mix of two or more of the above.
- 273 Vodafone has already initiated a move in the direction of on-net/off-net pricing with its “Motormouth” campaign. Telecom responded immediately in kind with its “Mates Rates” plan. These plans drive brand loyalty and communities of interest on mobile networks, by creating a margin between the cost of on-net and off-net calls. Therefore, on the one hand, Telecom and Vodafone could increase the off-net calling prices in response to a reduction in the termination rate, in order to both:
- 273.1 Rebalance termination revenues; and
- 273.2 Further drive brand preference and on-net calling.
- 274 On the other hand, a decrease in the current rate of handset subsidisation would have low visibility to the market and could be fine tuned with relative ease. In fact, if applied only to new handsets to the market, and not to handsets already released, it would be wholly invisible.
- 275 Telecom expects to sell [JCOI prepaid cellular handsets in the 04/05 financial year. Of those, [JCOI will be “low tier” (under \$[JCOI) handsets and [JCOI “low to mid tier” (under \$[JCOI) handsets. If Telecom were to target just “low tier” handsets for rebalancing and charge customers an additional, say, \$50 for them, Telecom would be able to collect an additional \$[JCOI per annum (it is important to note however that this number excludes demand effects – ie the loss in revenue caused by these customers dropping of the network). Telecom sees such an approach, coupled with a policy of not reducing future mobile calling prices in line with current expectations, as the most likely approach to be adopted in the factual. If Telecom were to target both “low tier” and “low to mid tier” handsets, the figure would increase to \$[JCOI per annum.
- 276 Telecom sees such an approach, coupled with a policy of not reducing future mobile calling prices as may otherwise have been the case, as the most likely approach to be

adopted by Telecom and Vodafone in the factual. Targeting this demographic would most likely hit users who can barely afford mobile phones as it is, such as the elderly and low-income earners. As Professor Hausman discusses, there is considerable utility and benefit to society in having these people connected to mobile networks, but commercial realities would dictate that these customers would be the first to feel the direct consequences of termination rate regulation.

- 277 Telecom also notes that the regulation of mobile termination rates may in fact cause the current pricing of (in particular) pre-paid handsets to fail its commercial approvals process. Telecom requires that each handset on each plan becomes profitable within the average customer handset lifecycle (approximately [JTCNZRI months) (i.e. that the pricing of the handset will be EVA positive over the lifetime of the handset). This is not a surprising threshold.
- 278 Currently many pre-paid handsets are approved at prices that, even allowing for termination revenue, run close to the approximate [JTCNZRI month cut-off. Telecom expects that, should regulation be introduced and mobile termination revenue reduced, many of those handsets would fail this current commercial threshold. For example, substituting the Commission's proposed 16c/min regulated termination rate into Telecom's commercial approval model, its current consumer offer relating to the Samsung N361 (on a prepaid plan) – currently on sale for \$149 - would be uneconomic. In particular, Telecom would expect to lose \$[JTCNZRI over the (approximate [JTCNZRI month) life of each such handset.
- 279 The promotion of the Samsung N361 was in direct response to a Vodafone pre-pay offer in connection with an equivalent Panasonic handset, which was effective in the market at \$149. Telecom's expectation is that if Vodafone had not been able to account for current levels of termination revenue, its Panasonic handset would have more likely been priced at, say, \$199. The result of all this is that consumers would have had to have paid an additional \$50 for either the Telecom or Vodafone version of a phone in that particular market segment.

When will Telecom rebalancing occur?

- 280 Given the dramatic impact regulation will have on Telecom's mobile revenue streams, Telecom would obviously want to make any necessary adjustment to its other revenue streams as soon as possible following any regulation of mobile termination rates. As Charles River Associates note, this has certainly been the response in the UK.
- 281 As discussed above, rebalancing can occur on handsets as soon as new handsets come to market. This will enable rebalancing to gradually occur as more and more current and new customers upgrade or purchase new handsets.
- 282 The impending retirement of Telecom's TDMA Network will also ensure that the impact of higher "low-end" handset prices will not be able to be avoided by a large constituency of customers. Approximately 600,000 Telecom customers currently

remain on the TDMA network. Many of these customers are the “low tier” customers discussed above. Given the marginal economics of many of these customers in a regulated market, [

JTCNZRI.

This would have the additional effect of weaning off those customers who, but for having paid the increased handset price, would have become uneconomic by virtue of any regulation.

Effect of rebalancing on the level of competition in the market.

- 283 While economic and commercial realities will require Telecom and Vodafone to rebalance in response to reduced termination rates, this is not to say that competition within the mobile services market will become any less aggressive. Rather, regulation will simply result in a step change in the base competitive price level.

Overseas evidence of the “waterbed” effect

- 284 The Commission dismissed the strong relationship between the two sides of the mobile services market by reporting very limited extracts of information from the UK that reports rising mobile penetration and static retail prices in the aftermath of mobile termination regulation in July 2003.
- 285 Telecom submits that the evidence from the United Kingdom clearly shows that mobile prices are increasing in the UK. This evidence is discussed by Charles River Associates in Annex B, section 3.
- 286 Telecom also refers to paragraph 57 of its *Issues Paper* submission. The US Federal Communications Commission (FCC) has identified low US mobile termination charges as a key factor in explaining low US mobile penetration rates, as compared with other countries in which higher termination rates keep down prices to mobile subscribers, particularly marginal customers. Despite high US incomes, US mobile penetration at around 50 per cent is substantially below the leading European countries with penetration around 90 per cent.

The fixed calling market

- 287 The Commission claims in its draft report that “pass through” of mobile termination rate reductions will increase in the factual as compared with the counterfactual. For the reasons set out in this section, that is in fact unlikely to be the case.
- 288 The following patterns can be observed in relevant market segments with respect to the particular fixed to mobile component of relevant calling markets:
- 288.1 in the corporate segment, the retail price of fixed to mobile calls has tended towards the termination rate;

- 288.2 in the SME segment, the average retail price of fixed to mobile calls is slightly higher than in corporate as SME customers exert less countervailing power over calling providers; and
- 288.3 in the consumer segment, fixed to mobile prices have traditionally been higher than prices offered to SME and corporate customers.
- 289 Retail consumer fixed to mobile prices have been higher than those available to business or corporate customers for a number of reasons. Most significantly:
- 289.1 demand has been and remains to a significant extent, inelastic. Fixed to mobile calls have been viewed by consumers primarily as “functional” where the caller effectively values the convenience of accessing a person immediately, wherever that person happens to be; and
- 289.2 National and international calling have been identified as the key components of consumer calling pricing and as such have been the primary focus of competitive offerings while fixed to mobile calling effectively being an “incidental”.
- 290 While the demand (in)elasticity of fixed to mobile calls has been an important factor, Telecom considers that mobile-to-mobile calls and other forms of communication (eg email) are now a real alternative for most fixed calling customers²⁶. Thus the price of fixed to mobile calls is becoming a more important component (relative to, say, national calling) of the overall fixed calling offering. Accordingly, significant market pressure is anticipated on the consumer retail fixed to mobile price. For that reason, Telecom has recently introduced calling initiatives with substantial movements in the consumer retail fixed to mobile price. So, for example, Telecom’s new “Anytime Plus” bundles include (albeit in conjunction with an increased “upfront” subscription price of \$10) fixed to mobile rates of:
- 290.1 \$0.39 per minute for calls to Telecom mobile; and
- 290.2 \$0.45 per minute for calls to Vodafone.
- 291 In addition, the “standalone” fixed to mobile retail price is also under review. Still, even the Anytime Plans fixed to mobile prices (especially allowing for the additional \$10 up front payment) significantly exceed the mobile termination rate. And the recent reduction of the mobile termination rate to 27 cents per minute was not material to the change in the retail price. This highlights how the general competitive dynamics of the

²⁶ This indicates an argument for the fixed calling market being widened to include mobile-to-mobile calls, which could well be the case.

- consumer segment of the calling market are unchanged by variations in the mobile termination rate.
- 292 For the fixed to mobile component in the corporate segment of the calling markets, Telecom considers that the factual likely involves significant “pass-through” of the termination rate reduction in response to the exercise of the countervailing power by corporate customers. Ultimately, the market retail price will likely settle at some small margin above the (regulated) mobile termination rate, just as it has currently settled a small margin above the (unregulated) mobile termination rate. Of course, this changes the absolute price, but not the strong intensity of competition delivering that price. Also as discussed in Part C above, competition occurs across the group of calling services, thus any FTM price near the wholesale price cannot be interpreted to be a “price squeeze”.
- 293 The factual for the consumer and SME segments of the fixed calling market would involve fixed to mobile prices continuing to be set according to the prevailing competitive forces - an identical scenario to that which would occur in the counterfactual. Initially, in the factual, Telecom envisages that its Anytime Plus bundles (and Businesstime bundles in SME) will remain competitive for a significant period going forward.
- 294 But as already noted, competition (not only from TelstraClear but also from Vodafone looking to drive mobile to mobile substitution) is pushing the price of fixed to mobile calls down. So looking longer term into the factual, some “pass through” is possible. But the only point at which genuine “pass through” could confidently be said to have occurred under the factual would be when the retail fixed to mobile prices in consumer and/or SME markets fall below the effective price “floor” of the relevant mobile termination rate under the counterfactual. Until that point, no material distinction can be identified as between prices under the factual and the counterfactual. In that case, the likely decline in the price of fixed to mobile calls could only be said to be coincidental with, but not to result from, the imposition of a reduced regulated mobile termination rate.
- 295 In any case, it is not anticipated that fixed to mobile consumer or SME retail fixed to mobile prices will track so low as to mirror the reduced price likely to occur for corporate customers under the factual. The Commission has claimed a reduced ability under the factual for Telecom to use retail fixed to mobile prices to “squeeze” its competitors. This would not be the case. Further, a price squeeze does not even enter the realm of possibility unless and until the margin between the retail fixed to mobile price and the mobile termination rate are significantly converged. As we have noted above, this would not be the case for consumer and SME market segments in the factual.

THE COUNTERFACTUAL – IN THE ABSENCE OF REGULATION

296 The Commission’s analysis requires it to assess the counterfactual – the likely performance of the relevant markets absent regulation. Telecom discusses below the likely unregulated performance of mobile termination rates, the mobile services market, and the fixed line toll calling market.

Mobile termination rates

297 Telecom refers the Commission to the analysis set out in Table 5 of Charles River Associates’ report attached as Annex B, where the following trend is predicted:

	2004	2005	2006	2007	2008	2009	2010
Counterfactual MT rate	0.280	0.262	0.250	0.239	0.228	0.219	0.210

Mobile services market

298 It is very difficult for Telecom to gauge with any certainty the likely developments within mobile services markets in the counterfactual. This is primarily because Telecom’s ability to define that counterfactual is limited given its brand position. Obviously, Telecom has no visibility of Vodafone’s strategy going forward to which Telecom will be required to respond.

299 Adding to the uncertainty is the differing nature of Vodafone’s operations worldwide. In particular, Vodafone in Australia is a vigorous competitor which is renowned for providing aggressive pricing and market innovation. By comparison, Vodafone UK has been relatively benign, seemingly preferring to retain value in existing customers rather than necessarily aggressively pursue risky strategies around growth.

300 However, if current trends are any indication, it is likely that Vodafone will become increasingly aggressive around price in both consumer and business markets. In that case, Telecom will, as we have outlined above, respond in kind. Recent Vodafone initiatives indicating an increasingly aggressive marketing approach around price include:

300.1 the “Motormouth” campaign in the consumer segment – this offer involved a significant overhaul of consumer pricing for both “pre-pay” and “on account”. The campaign includes aggressive on-net/off-net pricing and much more aggressive international calling rates. Telecom has responded with its “Mates Rates” prepaid plan and also revised part-paid rates to match this initiative;

300.2 the “Talkzone” campaign in the business segment – this offer provides for business customers to nominate a “circle” of callers (of 10 callers or more) with a fixed monthly fee allowing unlimited calling among members of the circle. This initiative is considered to be the most aggressive yet from Vodafone in any

segment of the market and Telecom's (necessary and inevitable) response – "Team Builder Zero" - was launched on 26 November.

- 301 If initiatives such as these continue from Vodafone in the counterfactual – and obviously there is a limited extent to which Telecom can predict that they will or will not – Telecom will look to respond directly to Vodafone on specific "standalone" calling plans. In addition, Telecom may further examine integrated solutions involving "seamless" fixed and mobile calling.
- 302 With respect to data and other 3G services, it is virtually impossible for Telecom – or the Commission - to predict with any degree of certainty the precise manner in which the market will behave in the counterfactual. There are numerous permutations and possibilities as to what particular 3G services customers will value in the New Zealand market or what market prices may be sustainable going forward. For example, 3G deployment in Italy has resulted in stable returns and reliable margins for mobile service providers. In the UK on the other hand, 3G deployment has been highly competitive with profitability as yet unproven. Nonetheless Telecom and Vodafone will continue to invest heavily (taking substantial risks in the process) to ensure each remains competitive on a holistic basis.

Fixed line toll calling market

- 303 Telecom's approach to fixed to mobile pricing in the counterfactual is implied in our comments above regarding the factual. In particular, Telecom envisages that fixed to mobile retail calling prices in the corporate segment of the overall calling market will continue to hover at some thin margin above the prevailing mobile termination rate.
- 304 For consumer and SME markets, however, Telecom's pricing strategy around fixed to mobile calls will continue as outlined in the factual above. In other words, Telecom will continue to respond to the prevailing competitive forces. Obviously, to some extent, any drop in the retail price will be subject to an effective floor at the price enjoyed by corporate customers. Given the highly competitive nature of Telecom's various existing offerings (such as the Anytime bundles), and Telecom's view of the likely glide path for mobile termination rates in the counterfactual, it is not envisaged that fixed to mobile retail pricing will approach this floor in either consumer or SME markets.

THE COMMISSION'S COST BENEFIT ANALYSIS

- 305 The preceding legal and competition analysis criticise the Commission's analysis of/competition in the fixed line toll calling and mobile services markets, and the Commission's proposed benefits of regulation. These issues in turn affect the quantification of the costs and benefits of regulating mobile termination. This section takes the preceding critique and draws on the expert advice of Professor Katz, Professor Hausman and Charles River Associates (CRA). The experts' reports are attached.

306 Of particular concern are the Commission's propositions that transfers can be treated as a benefit of regulation and that there will be no "waterbed effect". The first proposition leads the Commission to emphasise consumer surplus as the appropriate measure of benefits of regulation. The second proposition leads the Commission to focus its analysis on fixed to mobile calls in isolation of any change in the mobile services market.

307 As discussed above Telecom does not agree that consumer surplus is the appropriate standard when considering regulatory intervention, and a public benefits test should be used. Even if consumer surplus is considered in isolation, however, the attached reports from CRA and Professor Hausman demonstrate that regulation will reduce consumer surplus once the effect of regulation on mobile services is included in the analysis.

308 In addition, even if it is assumed that regulation will not affect the market for mobile services (an assumption Telecom does not agree with), the attached reports demonstrate that regulation of mobile termination will be detrimental to economic efficiency.

Transfers as a benefit of regulation

309 In its draft report the Commerce Commission states (paragraph 60):

"Control as a regulatory mechanism has a different philosophical base from competition as a regulatory mechanism. It is precisely because there is a concern about monopoly profits, and a lack of competition to drive them out, that control might be justified. In such an environment, the Commission considers that the scheme and the context of the Act means that it must explicitly address distributive issues. The Commission considers that to the extent which the erosion of producer surplus may have a negative impact on efficiency, it can be considered in the context of dynamic efficiency.

310 In response to the Commission's statement, Professor Katz notes the virtue of competition is that it promotes economic efficiency. Furthermore, most economists would reason that regulation should replicate this virtue in promoting efficiency, and if this is the Commission's policy objective "then this statement badly misses the mark" (paragraph 50).

311 It is a concern regarding monopoly profits, rather than efficiency, that leads the Commission to adopt consumer surplus as a measure of the benefits of regulation. The difficulty with this can be highlighted by considering a change in consumer surplus, due to regulation, that is positive even though there is a loss in overall economic efficiency. On the framework set out in its draft report, the Commission would recommend regulations.

312 An additional issue, highlighted by Professor Katz, which follows from the adoption of the consumer surplus measure, is the inconsistent treatment of the incidence of surplus. The Commission appears to value the surplus for both business and consumer end users of the fixed to mobile service the same. CRA calculates that 62% of the total fixed to mobile call minutes are made by business callers, and that approximately 70% of surplus due to the decrease in fixed to mobile prices would go to

business fixed to mobile calls. The implicit assumption the Commission is making is that all the business operate in competitive markets and therefore they will pass all of this surplus onto their own customers, however this is not necessarily the case. Further, the Commission treats the same people differently in their roles as shareholders and consumers.

Consumer surplus and the “waterbed effect”

- 313 To argue there is no waterbed effect is to argue that the mobile service providers are not behaving rationally. In his report, Professor Hausman explains that the waterbed does not depend on the state of competition in the market, nor is it the result of some sort of Ramsey pricing rule. Professor Hausman shows that the waterbed effect is the economic outcome of a rational service provider taking into account the interrelationship between subscriptions for mobile services and the value of terminating off-net call on their network. As discussed above, empirical evidence from the UK market supports this conclusion.
- 314 This economic effect implies that a regulated decrease in the mobile termination price will result in an increase in the price for mobile services. Higher prices will decrease the consumer surplus for all consumers of mobile services. Further, for some consumers the decrease in consumer welfare will mean that they are no longer willing to subscribe to the service resulting in a decrease in the number of subscribers. Professor Hausman calculates the decrease in the number of subscribers to be over 100,000 or about 4.1% of mobile subscribers if the mobile termination price is regulated at \$0.16/min²⁷.
- 315 With respect to the fixed calling market, regulation is expected to decrease the price of fixed to mobile calls as mobile termination is an input for this service. However, even though fixed line callers will see this as a benefit of regulation, a detriment for this group is that they will have less mobile customers to call. Since a calling party cannot typically substitute a call from one person to another person who continues to subscribe to mobile, the loss in consumer surplus for the calling party can be substantial.
- 316 The following table gives Professor Hausman’s estimate of the effect of regulation on the annual consumer surplus, for 2 years:

(\$m)	2006	2010
FTM price decrease	65	66

²⁷ It might be argued this group would not cease to subscribe as they have already have a handset, and therefore the cost of remaining connected is marginal. However, as noted above, customers constantly reconsider their subscription decision. The average mobile handset life is approximately [JTCNZRI months. Just as significantly, future penetration will be less (as compared to the counterfactual).

Mobile price increase	-61	-63
FTM calling less mobile customers	-12 to -47	-11 to -47
Net Consumer Surplus	-8 to -43	-8 to -44

- 317 The “FTM price decrease” consumer surplus is from the Commission draft report and assumes that there is no waterbed effect. The waterbed effect has two consequences. First, the price for mobile services will increase. The “Mobile price increase” consumer surplus gives the reduction in consumer surplus due to this price increase. Second, as already mentioned, there is expected to be a decrease in the number of mobile subscribers. The “FTM calling less mobile customers” consumer surplus gives the decrease in consumer surplus for fixed to mobile callers. The range is determined by demand curves with different shapes. The lower bound (in absolute value) for the range is based on a linear demand function, and the upper bound for the range is based on a constant elasticity demand function.
- 318 Two conclusions can be made from these results. First, approximately 95% of the gain in consumer surplus calculated by the Commission is a straight transfer from mobile subscribers to fixed to mobile callers. Second, the remaining 5% of the gain for FTM callers will be swamped by the loss of not being able to call 4% of the current mobile subscribers. The result of regulation will be an overall reduction in the consumer surplus.
- 319 As expressed by CRA, the reduction in demand for FTM calls need only be small, less than 2%, for the Commission’s estimates of social gains from regulation to be eliminated.
- 320 These results are based on the proposition that the mobile service providers are rational and as a result there is a price increase for mobile services. Even if it is assumed that the Commission’s proposition holds - that there is no price rise overall - regulation is likely to result in a loss in economic efficiency, for the reasons set out by CRA.
- Fixed to mobile price elasticity***
- 321 The size of the consumer surplus and public benefit increases with the price elasticity for fixed to mobile calls. The Commission proposes the fixed to mobile price elasticity is -0.6. However, as CRA note, the Commission bases its conclusion on an estimate by Access Economics that is incorrectly represented as -0.8, when it should -0.08. Also, the Commission places significant weight on a elasticity figure of [JTCNZRI provided by Telecom in response to a Section 98 notice. In its response to the Section 98 notice, Telecom pointed out this estimate is not robust. The calculation was provided because it was caught by the terms of the section 98 notice, not because it is reliable or has been used by Telecom. As explained in the CRA report, the available evidence suggests a more appropriate baseline elasticity of -0.4, and a range from -0.2 to -0.6 for sensitivity testing.

322 This issue is important. CRA demonstrate the Commission has no solid foundation for its estimate of -0.6 . If a more appropriate estimate of -0.4 is used, this adjustment alone halves the net public benefits of regulation identified by the Commission.

Pass through, Factual 1 and Factual 2

323 The Commission proposes two factuials with different methodologies for modelling future price trends. "Factual 1" assumes that fixed to mobile prices under the factual will simply trend down to cost in 2010. CRA notes this approach implicitly assumes "dramatically different competitive dynamics between the factual and counterfactual". Further, they show that the available data does not support the Commission's reasoning for the different competitive dynamics. For these reasons they conclude that Factual 1 is not a reasonable methodology for the cost benefit analysis.

324 Although Factual 2 offers a better framework than Factual 1, Factual 2 has a number of shortcomings, too. Inconsistencies in the price paths chosen by the Commission result in implausibly high implied pass-through rates of MT prices to FTM prices (over 100%). CRA provides corrected estimates of the price paths based on the data provided in the Commission's report.

Indirect Cost of regulation

325 As with the Local Loop Unbundling investigation, the Commission assumes that the indirect costs of regulation can be modelled as a proportional - i.e. 25% - reduction in the benefit of regulation. The problem with of this approach is that it assumes the indirect costs of regulation can never be greater than the benefits of regulation. In the real world it is entirely conceivable that the indirect costs of regulation will be at least greater than the Commission's 25%. As Professor Hausman's estimate of consumer surplus illustrates, the indirect cost of regulation could well be in excess of 100% of the Commission's perceived benefits of regulation. As CRA points out, there is no reason to assume that the indirect costs of regulation will have any relationship to the perceived benefits of regulation.

326 CRA also corrects an inconsistency in the Commission's treatment of indirect costs. When applying the consumer surplus test the draft report calculates the indirect costs of regulation as 25% of one base, when applying a public benefits test another base is used. As noted by CRA, the costs of regulation are real, and unrelated to whether the Commission counts transfers as a benefit or not. If the indirect costs calculated in the consumer surplus context is used consistently, the net surplus of regulation is significantly negative.

Summary Public Benefits Test

327 CRA make a number of corrections to the Commission's Net Public Benefit analysis are arrive at the following net present values for the public benefit with the Commission's values:

(\$m)	Commission Values	Corrected Values
Factual 1	28	-56
Factual 2	27	-29

328 The corrections includes:

328.1 Estimating price paths and pass through based on independent historical data

328.2 Consistently applying estimates of indirect costs

328.3 Benchmark FTM price elasticity only on economic literature publicly available consultant reports.

329 The corrected values indicate that the Commission's efficiency gain is actually an efficiency loss. It is important to note that this estimate of the expected efficiency loss is extremely conservative, as it does not include the negative welfare impacts in the mobile services market, and the additional loss in welfare to fixed line customers due to a decrease in mobile customers. An indication of this additional cost is calculated by Professor Hausman and reported above.

F DYNAMIC EFFICIENCY

The draft report

- 330 The draft report claims the proposed regulation would have very few dynamic efficiency impacts. The Commission makes a very strong claim – the Commission’s cost benefit analysis includes no dynamic efficiency effects at all. The reasoning in the draft report is that there is likely to be little investment by Telecom and Vodafone in the future unrelated to 3G roll out. By drawing a line between 2G and 3G, the draft report claims, immediate investment decision-making would be unaffected. Further, the Commission will have demonstrated it is aware of dynamic efficiency considerations, and so avoided setting a poor precedent.
- 331 The Commission is right to be concerned about dynamic efficiency impacts in the mobile services market, and the particular vulnerability of the roll out of 3G technology to distortions caused by regulation. Telecom recognises the Commission has attempted to avoid creating these distortions in the mobile services market. For the reasons discussed below, however, regulating current 2G networks will affect investment behaviour. If the Commission were to regulate 2G networks, some of which are still relatively new and yet to return Telecom’s investment, this would set a precedent that must be factored into future investment decision-making. Regulation at this time would also influence the timing and technology choices in the migration from 2G to 3G networks.

Market Dynamics

- 332 The mobile telephony markets are demonstrably competitive and dynamic. Price competition between Telecom and Vodafone has been strong and at times unconventional. Telecom’s revolutionary “\$10 text” pricing initiative is unique worldwide and was borne out of an urgent need to keep pace with Vodafone. At the time of its implementation (1 August 2003), Telecom was losing approximately 1.5 market share points a quarter to Vodafone. The “\$10 text” initiative enabled Telecom to slow this trend. At the same time, consumers benefited greatly from this initiative (which delivers each customer a potential \$90 saving), as indicated by the significant increase of text messaging since its launch.
- 333 Even more significant, however, has been the competition between Telecom and Vodafone on the basis of an ever-increasing range of services and technology and ever-improving quality of service and geographic coverage. This dynamic has resulted in the evolution of Telecom’s mobile service progressively from TDMA (both AMPS-A and D-AMPS), CDMA IS95, CDMA 1X and now EVDO. Ongoing incremental enhancements have been made to Telecom’s mobile networks. The most recent example has been the \$40 million network investment in “T3G” mobile broadband services delivered over EVDO capable PDAs or mobile data cards. In time – when the market dictates - these services may be offered over a new range of EVDO capable handsets. In addition, Telecom is proposing a new “Push to Talk” service and is even exploring the possibility of an even more substantial investment in future technology.

- 334 This type of competition has delivered to end-users the choice of two highly sophisticated and comprehensive mobile networks. But not without cost. The innovations and developments delivered to New Zealand end-users by Telecom and Vodafone have required significant investment – hundreds of millions of dollars of investment involving significant levels of risk. Those levels of risk can be illustrated by Telecom’s recent (June 2004) \$110 million impairment write-down of its TDMA network. This was necessary because Telecom had underestimated the rate at which its TDMA network would depreciate. The technology life cycle had been shorter than Telecom had originally appreciated. Although the picture is not yet clear, a similar “shock” may be in store with respect to Telecom’s CDMA network, or even the EVDO network.
- 335 Anyone proposing regulation of mobile termination rates must account for this pace of change, and the scale of investment and risk. The current market environment is particularly fluid. Indeed, the 2004/2005 period is possibly the least appropriate time to be considering regulation of mobile termination rates. Telecom has just written off \$110m of its investment in TDMA, and is making a \$40m investment in T3G Services – all prior to its investment in excess of [*JTCNZRI*] in the preceding technology, CDMA, having complete its life cycle. These investments are driven by, and put at risk by, competition with Vodafone.
- 336 The narrow point is that it is simply incorrect to say the regulation proposed in the draft report would not impact on investment decision-making. The draft report signals that if Telecom and Vodafone make successful technology choices (they must, of course, bear the risk of unsuccessful investments) then the Commission will regulate after a couple of years. Given the very short life cycles of mobile technologies, Telecom management would be negligent not to factor this risk into their decision-making. The result will be a reduced probability of pay back, and therefore delayed investment.
- 337 More generally, the Commission cannot confidently predict the impact of regulation in the current environment. The transition to 3G technology, and future competition, involves Telecom and Vodafone making a constant series of significant investment decisions in the face of real uncertainty. Technology choices, timing and extent of roll out, pricing and handset offers are uncertain, even two years from now. The impacts of regulation are similarly uncertain.
- 338 As noted above, Telecom recognises the draft report attempts to manage the risk of discouraging investment in 3G technology. But if regulation were to occur in this context, that consequence is inevitable. Regulation will be viewed as a pervasive industry risk, causing a technological lag for New Zealand consumers. The “stay of execution” for 3G has to be treated as temporary, with a real risk of subsequent intervention when the next transition looks likely to occur. The prospect of non-voice services being regulated is also obviously something investors in mobile networks will need to contemplate.

339 In addition, the Commission's proposal to regulate 2G (and not 3G) interferes with the market-based network life-cycle competition from which telecommunications end-users of mobile service have enjoyed in New Zealand continuously over the past decade. In particular, Telecom would be incentivised to migrate its customers prematurely to unregulated technology to mitigate the overall commercial impact of regulation. The draft report effectively proposes that the Commission regulate technology choices and migration paths and timing, when the Commission (or anyone else) simply does not have the information to improve outcomes.

G SERVICE DESCRIPTION

340 In this section Telecom comments on the service description proposed in the draft report. As discussed below, in some material respects it is uncertain what the Commission is proposing. Telecom has identified where the Commission's proposal is unclear, and reserves the right to comment in further detail on a clarified service description, if one is needed.

340.1 **Regulation of 2G, or exclusion of 3G?** The service description in the draft report regulates all mobile network technologies, excluding only 3G. This would result in the regulation of future technologies – 4G, for example.

340.2 **Voice calls.** The term “voice calls” in the Commission's proposed service description could give rise to material uncertainty. Given the rapid emergence of IP-based voice services, “voice calls” is not sufficiently unambiguous to provide industry participants with certainty as to the intended scope of the service.

340.3 **Telecom and Vodafone should be able to apply.** In response to the Commission's question 7.4(d), excluding Telecom and Vodafone from the access seeker definition would create harmful distortions in downstream markets and in industry dynamics. In the fixed calling market, Telecom could face higher input costs than its rivals for calls to Vodafone customers, and in the mobile services market the entry of a new entrant into the market could result in that operator facing a lower cost for terminations on the existing networks than Telecom and Vodafone.

340.4 **Uncertainty in proposed scope of “access seeker”.** The Commission's proposed insert into Schedule 1 contains an inconsistency between the wording of the “description of the service” and of the “access seeker” definition which creates a real uncertainty as to the intended scope of the proposed service. While the “description of service” wording covers termination of all voice calls (ie mobile to mobile and fixed to mobile calls), the “access seeker” wording limits the availability of this service to persons who “provide or potentially will provide fixed to mobile services”, which implies that only fixed to mobile call terminations are intended to be covered by the service.

Definition of 3G

341 A key difficulty with the proposed service description is the term “third generation cellular mobile telephone network”, which creates considerable uncertainty. The thrust of the Commission's report would seem to be that the Commission is drawing a line between current networks (assumed to be 2G) and yet to be built networks (assumed to be 3G). .

342 In fact no such neat bright line can be drawn. Telecom has already invested in 3G networks in New Zealand. Telecom's 1XRTT network and EVDO network both meet

the Telecommunications Act's definition of 3G. If these networks were to be included then the Commission would be regulating 3G.

- 343 Telecom requests that the Commission clarify it is not proposing regulation of Telecom's entire current CDMA network. We suggest that the Commission exclude existing and future 3G networks from regulation and be specific that voice traffic carried over the 1XRTT network meets the definition of 3G. The need for clarification arises out of the Commission's cost benefit analysis, which assumes all existing voice traffic would be regulated.
- 344 To regulate all current voice traffic would involve regulation of Telecom's 3G network, as a significant proportion of current voice traffic is carried over Telecom's 3G network. This is contrary to the Commission's stated intention to distinguish between 2G and 3G mobile network technologies, and raises the significant risks of dynamic efficiency impacts discussed in the previous section.
- 345 In particular, Telecom submits a distinction between "current" and "future" 3G technologies would have a serious distortionary effect. In selecting the CDMA technology path Telecom was motivated by the technology advantages over GSM, including the superior migratory path to new functionality. Telecom saw an opportunity to deliver 3G well ahead of Vodafone with 1XRTT and EVDO technologies, and this strategy is currently yielding benefits for Telecom (and customers) with the company having a clear technology advantage over Vodafone in some areas. If the Commission were to regulate "current" but not "future" 3G networks, this would distort competition between Telecom and Vodafone and penalise Telecom for innovating and investing first.
- 346 In conclusion, the substance of the proposed service description is uncertain, and in parts confusing. This has made a detailed response difficult, and Telecom requests that the Commission clarify its proposal prior to conference.