



## 2degrees – Cross Submission

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Commerce Commission Draft Report on MTAS

18 August 2009

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# PART I – OVERVIEW

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1. This investigation is to decide whether regulation of termination charges is needed.
2. The incumbents' submissions try hard to suggest they are entitled to charge above cost prices, relying on network externalities, two-sided markets, or the need to cross-subsidise certain customers. They threaten regulation will lead to reduced investment, or say it is not necessary because 2degrees has already entered.
3. New Zealand consumers don't understand why they continue to suffer the consequences of above cost prices – namely high retail prices, low-utilisation and a lack of competition. They do however understand why the incumbents go to such lengths to hang on to their monopoly profits.
4. The incumbents say that the market is competitive. Consumers know that is not true and tell us. High MTRs and closed-net pricing have split New Zealanders into two separate networks, choking off communication between the customers of different operators. Being able to talk and SMS cheaply to a small on-net calling circle but unable to call who you want, when you want is not illustrative of an efficient and competitive market. New Zealand consumers deserve better.
5. The incumbents argue the case for regulation is not made out and that the Commission's benchmarks are too low and unreliable. They suggest that regulation would somehow disadvantage competition, ignoring the fact that the vast majority of our trading partners have enjoyed the benefits of regulation for many years.
6. The Government is currently investigating the merits of establishing a Productivity Commission and is focused on closing the productivity gap with Australia. Australian telecommunications markets have benefited from regulation and special telecommunications competition rules for many years. Telecommunications is a key productivity driver.
7. The incumbents' arguments against the need for regulation are self-interested and flawed. Competition is good for consumers and the need for competition is what this investigation is about:
  - **The New Zealand market is not competitive:** New Zealand consumers suffer from high prices and low utilisation and are becoming increasingly split into two separate networks. High off-net pricing deters communication between customers on different networks in an attempt to make everyone else's network unattractive to subscribe to, significantly reducing the efficiency and utility of telecommunications services in New Zealand.
  - **There are clear barriers to entry and expansion:** We have launched, but barriers to entry and expansion prevent us from fully entering the market and completing our network build. The level of market foreclosure was clearly evidenced in the Concept Economics report *Assessment of the consumer benefits of mobile termination regulation in New Zealand (Concept Economics July Report)*, which concluded the ability of a new entrant to contest all customer segments and expand its network geographically was substantially restricted.

- **High MTRs are a cash cow for incumbents:** The EC has made it clear that high termination rates are a “cash cow” for incumbents, a tax on new entrants, and that closed-net pricing creates consumer harm.<sup>1</sup>
- **Consumers will benefit from lower MTRs:** Ofcom, supported by Vodafone’s own experts, Analysys Mason, recently concluded that “*lower termination rates are likely to benefit consumers overall.*”<sup>2</sup> It is absurd to argue that greater competition will not result in benefits for New Zealand consumers.
- **Threats of higher retail prices from reduced MTRs have not eventuated overseas. This is mere scaremongering for political impact not tolerated elsewhere:** Vodafone made similar threats to the UK regulator in 2002, threatening higher prices, more expensive handsets and customers giving up mobile services in droves if lower MTRs were imposed. In fact, the opposite occurred; prices came down significantly with mobile penetration and total call volumes increasing in the UK since 2002. The same benefits can be expected from increased competition in New Zealand.
- **Investment bribes are unsubstantiated:** Threats of reduced investment are scare tactics and are not borne out by the facts. Vodafone NZ has recently announced further rural investment with the announcement of the Vodafone Farmside partnership to provide rural wireless broadband.<sup>3</sup> Vodafone is also investing heavily in its network build in India, where voice termination rates are very low at \$NZD0.00615. In any event, the New Zealand Herald pointed out this week that Vodafone NZ and Telecom between them earned over \$2.4 billion in the last decade in MTR payments from landline customers alone, ensuring that incumbent infrastructure has been fully “paid for” out of monopoly profits earned from New Zealand consumers. In contrast, we have invested \$250 million dollars of **new money** into New Zealand and have called for the fixed line subsidy (from which we would benefit) to be removed.
- **There is no incentive on incumbents to offer cost based undertakings:** High MTRs subsidise the incumbents and imposes a cost on us. They facilitate closed-net pricing, foreclosing large sections of the market to competition. It is telling that neither Vodafone nor Telecom make any attempt to indicate what their actual costs are, but rather seek to criticise the approach taken by the Commission. The test for regulation requires the Commission to exercise its judgment and expertise and make a *qualitative* and *quantitative* assessment of the relevant factors.
- **New Zealand is years behind international developments:** It is generally accepted that access prices should be cost based. The EC, which already has regulation, recommends an even narrower definition of costs than that proposed by the Commission. In it’s current deliberations Ofcom (supported by Analysys Mason) identified six potential forms of regulation, five of which would result in lower rates (the exception being *de-regulation*). Analysys Mason state that Ofcom “...*is rightly investigating the question of what interconnection charging regime is most appropriate for telecommunications services going forward.*”<sup>4</sup> The Commission must also take a forward looking approach and should not be persuaded to place an over emphasis on historical benchmarks.

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<sup>1</sup> Neelie Kroes, *Cutting the price of phone calls – new termination rules* Brussels, 7 May 2009.

<sup>2</sup> Ofcom, *Wholesale mobile voice call termination: Preliminary consultation on future regulation*, August 2009, para 1.16.

<sup>3</sup> Vodafone, *Farmside partnering to deliver broadband to rural customers*, 12 August 2009, <http://topnews.net.nz/content/2425-vodafone-farmside-partnering-deliver-broadband-rural-customers>.

<sup>4</sup> Analysys Mason, *Case studies of mobile termination regimes in Canada, Hong Kong, Singapore and the USA*, 26 November 2008, p 5.

- **The case for regulation is clearly made out:** This investigation is about putting regulation in place that ensures the incumbents have the right incentives to charge on the basis of cost. That will go some way to alleviating the very high barriers to entry and expansion that we face and bring the benefits of greater competition to New Zealand consumers.

# PART II – OUR SUBMISSION

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## 1. INTRODUCTION

- 1.1 Two Degrees Mobile Limited (**2degrees**) welcomes this opportunity to comment on the submissions which have been made on the Commission's *Draft Report on whether the mobile termination access services (incorporating mobile-to-mobile voice termination, fixed-to-mobile voice termination and short-message-service termination) should become designated or specified services (Draft Report)*.
- 1.2 As part of this cross-submission we have engaged Concept Economics to provide comments on submissions made by Vodafone, Telecom, Covec, Analysys Mason and NERA on specific topics including the state of competition barriers to entry, two sided markets and the waterbed effect, the factual/counterfactual and the Commission's cost-benefit analysis (**CBA**).
- 1.3 We also commissioned Professor Dr Justus Haucap, director of the Dusseldorf Institute of Competition Economics (**DICE**) and Chair of the German Monopolies Commission to critically evaluate and comment on the reports submitted by Concept Economics and Covec following the Draft Report. Dr Haucap has provided detailed comments on the likely effects of mobile termination regulation on competition, the CBA of mobile termination regulation conducted by Concept Economics, and the CBA conducted by Covec.
- 1.4 This cross-submission is therefore accompanied by:
- (a) Concept Economics MTAS Cross-submission (**Concept Economics August Cross-Submission**)
  - (b) Professor Dr Justus Haucap, Short Report on the Assessment of the Expected Costs and Benefits of Lower Mobile Termination Rates in New Zealand, (**Dr Haucap Report**).
- 1.5 We also attach:
- (a) Letter from Communications Venture Partners, 27 July 2009.
  - (b) David Fougere, *Why Closed Network Txt Pricing Creates a Non-Competitive Mobile Market*, July 2009, (**Phoenix Research July Report**)
- 1.6 The structure of the remainder of Part II of this cross-submission develops the key points set out in Part I under the following sections:
- Section 2 - Purpose of investigation
  - Section 3 - Purpose of the Act
  - Section 4 - The market is not competitive
  - Section 5 - Artificial (incumbent created) barriers are uniquely high
  - Section 6 - We have entered but the market is still foreclosed

- Section 7 - The evidence of the distortions caused by closed-net pricing is clear
- Section 8 - Vodafone complain that they will have lower revenue due to reduced MTRs – that should read lower *monopoly profits*
- Section 9 - Competition benefits all consumers, including lower users
- Section 10 - They say 2degrees makes more money without regulation
- Section 11 - Incumbent submissions fail to acknowledge that New Zealand lags far behind the developed world on regulation of termination rates
- Section 12 - A full scale cost model is not required
- Section 13 - Spam is a ridiculous basis to suggest high SMS termination rates
- Section 14 - Vodafone rely selectively on the Analysys Mason July Report
- Section 15 - Undertakings are above cost and should be rejected
- Section 16 - The incumbents make baseless, inappropriate criticisms of the Commission

## 2. PURPOSE OF INVESTIGATION

*This inquiry is to decide if regulation is needed*

- 2.1 This inquiry is about a decision on whether to regulate or not.
- 2.2 It is an unusual question to be asking as New Zealand is so far behind the rest of the world on the issue of regulating mobile termination rates (**MTR**). The debate in most of the world is about fine-tuning multiple operator markets. In New Zealand it is about breaking closed networks and new entry. It is telling that much of the developed world (at least those which do not have BAK or very low rates) is working to reduce rates which have already been determined under regulatory regimes.
- 2.3 The test is whether or not regulation is in the long term interests of end users of telecommunications services.<sup>5</sup> In applying the test the Commission must have regard to efficiencies.<sup>6</sup>
- 2.4 The most obvious efficiency in this context is setting an efficient access price.
- 2.5 Vodafone and Telecom have not provided any evidence that their costs are those of efficient providers. Instead they seek to game benchmarks. And in fact they have argued that they should charge more than the Telecommunications Act 2001 (**Act**) explicitly contemplates.
- 2.6 Nor have they attempted to suggest what their termination costs are. Their silence speaks volumes.
- 2.7 The Commission should, in our view, take into account the high level of market foreclosure resulting from closed-net prices and the *inefficiency* in maintaining the status quo. In fact, if the Commission does not recommend regulation we believe lack of regulation will enable this situation to worsen, as two separate closed groups compete less over time, notwithstanding 2degrees' entry. In our view, this is a factor which the Commission should have regard to as the Act explicitly contemplates the harm of inaction by referring to "*omission*" in section 18(2).
- 2.8 The Commission must have regard to the inefficiency of delay. As noted by the *Ministerial Inquiry into Telecommunications- Final Report* (27 September 2000) (**Final Telco Report**):

*"While the Inquiry has sought to design a relatively expeditious designation process, even in a best-case scenario, a service could only be designated or specified around nine months after the process was initiated. This length of time is necessary in order to run an open, transparent and thorough designation/specification process, and ultimately to allow the Minister to approve any regulatory proposals. **The costs of a market failure over this time could be significant.**"<sup>7</sup>*

<sup>5</sup> Section 18(1) provides that the relevant **purpose** is to "*promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand by regulating, and providing for the regulation of, the supply of certain telecommunications services between service providers*"

<sup>6</sup> Section 18(2) provides that "*In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand, the efficiencies that will result, or will be likely to result, from that act or omission must be considered.*"

<sup>7</sup> *Ministerial Inquiry into Telecommunications Final Report* (27 September 2000) (**Final Telco Report**), <http://www.med.govt.nz/upload/30006/final.pdf>, p 52.

*This inquiry is not about determining a regulated price*

- 2.9 This is not an inquiry to determine what the access price should be.
- 2.10 Regulated access prices will only occur if the access service is designated *and* against that “threat of regulation” (through an STD or bilateral process) the parties cannot agree price terms.

*The ultimate goal is efficient supply prices from incumbents with monopoly bottlenecks*

- 2.11 As noted, the purpose of the regulatory regime is to encourage efficient supply costs, recognising that incumbents with bottleneck monopolies have no incentive to set efficient supply prices. It is as simple as that.

*Benchmarking is part of a broader quantitative and qualitative assessment*

- 2.12 The benchmarking exercise is not nearly as significant as the incumbents make out. It is just part of a number of *qualitative* and *quantitative* measures to be reviewed. The law is clear on this point. Vodafone and Telecom should know that. The Court said exactly this when Vodafone sought to challenge its obligations to fund the TSO (discussed in 16.12 below).

*The incumbents’ focus on benchmarking is misplaced and misses the point*

- 2.13 The incumbents have, in our view quite deliberately, sought to make their arguments principally about challenging the benchmarking process that the Commission has used (throwing in waterbed arguments suggesting they will have to “recoup” their losses elsewhere, which we find unbelievable in the face of competition, despite what their economists say on this). That is a misconceived approach and seeks to divert attention from the issue in hand.
- 2.14 In doing so they miss the points that:
- (a) the Commission’s analysis requires a *qualitative* and *quantitative* assessment as to whether there should be regulation;
  - (b) the CBA modelling is an imperfect process, incapable of the precision that they suggest.

- 2.15 Again these points are well established law. We can only assume that the incumbents’ assertions on these points are directed at parties other than the Commission.

*There are numerous quantitative & qualitative reasons to regulate mobile termination rates*

- 2.16 There are a number of quantitative and qualitative reasons to regulate mobile telecommunication rates:
- (a) as the Commission has noted, prices are high and utilisation is low;
  - (b) there has been no market entry until recently;
  - (c) *there are two closed text networks preventing meaningful new entry into the pre-paid mobile business;*

- (d) there has been a lack of infrastructure investment until we spent NZ\$250 million of *new money* (ie not from cashflow) on our network;
- (e) the harm of high termination rates is well acknowledged, so regardless of views on “actual cost”, there should be a clear timetable to determine a regulated price, with price to be backdated at FPP stage (if required) (as opposed to the far weaker threat of regulation) to encourage incumbents and access seekers to agree prices close to efficient cost;
- (f) regulation has been a feature of most OECD countries for a number of years;
- (g) the harm of closed-net pricing is well acknowledged and New Zealand has a uniquely high incidence of closed-net pricing;
- (h) we have two closed mobile networks rather than any-to-any connectivity – people cannot communicate as freely as expected with the vast majority of traffic being on-net;
- (i) as Concept Economics shows, this situation is worsening over time;
- (j) the EC has said that regulation within the EU should move from TSLRIC, which is too high, to LRIC, ie to include direct costs only;
- (k) Ofcom has identified six possible regulatory options, five of which would clearly reduce termination rates.<sup>8</sup> Ofcom consider that “*lower mobile termination rates are likely to benefit consumers overall*”;<sup>9</sup>
- (l) Analysys Mason (Vodafone’s experts), in a report for Ofcom dated 26 November 2008, has (among other things) concluded that: “*Industry sources ... [in the four BAK countries it studied, Canada, Hong Kong, Singapore and the USA] ... did not consider that the termination regime adopted has had an adverse effect on the ability of mobile operators to invest in their networks*”<sup>10</sup>
- (m) as noted in our last submissions, there is no evidence of harm in low termination rate or BAK countries, whereas there is evidence of harm in countries with excessive MTRs;
- (n) the Commission’s cross-check of average on-net prices is quantitative support for actual costs being much lower than the incumbents suggest;
- (o) as previously submitted, in our view the Australian costs (modelled by WIK for the ACCC) are likely to be significantly above New Zealand’s;
- (p) if the approach of taking the average of the three lowest countries’ rates is followed, the voice benchmark rate would be NZ4.82c in 2009.<sup>11</sup>

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<sup>8</sup> Ofcom, *Wholesale Mobile Voice Call Termination – Preliminary Consultation on Future Regulation*, 20 May 2009, para 6.4. The sixth deregulation may be appropriate given that regulation has been in place for a number of years, and there are four key players and one niche player.

<sup>9</sup> Above, para 1.16

<sup>10</sup> Analysys Mason, *Case studies of mobile termination regimes in Canada, Hong Kong, Singapore and the USA*, 26 November 2008, p 5.

<sup>11</sup> See 2degrees, Submission on Draft Report, 28 July 2009, para 3.33.

*The incumbents mis-state the facts and law and make inappropriate and unfounded criticisms of the Commission*

- 2.17 Vodafone's submissions make a number of comments which, even when literally true, convey an incorrect impression. It also makes a number of inappropriate and unfounded criticisms of the Commission. For example, Vodafone directly or indirectly claim the Commission has failed to do things it was obliged to do (eg "*strangely decided to only construct a cost benefit model*"<sup>12</sup> for MTM which it later describes as a "*critical oversight*".)<sup>13</sup> In fact as discussed in section 16 below, the Commission is the expert body and has a broad discretion. Similarly Vodafone disingenuously suggests that the benchmarking is the "be all and end all" of the process and implies that the Commission has "failed" to "prove" things (admittedly it turns out that Vodafone means "*prove to Vodafone*", a somewhat different test). One of the tactics in Vodafone's submissions is to create erroneous "straw-men" it can easily strike-down or simply just mis-state the facts/law, for example implying the Commission must establish that "*termination rates pose a fatal barrier*". An example is its incorrect argument that the Commission "*has not established that the counterfactual termination rates pose a fatal barrier*". In fact the law on barriers to entry and expansion is quite clear. The test is not a "*fatality*" test, as discussed in section 5 below, nor, contrary to the implication, is the Commission "*put to the proof*".
- 2.18 Vodafone stoop to using an excessive number of adjectives, some of which are derogatory to the Commission and ignore the Commission's role as the expert body in a blatant attempt to appeal to the Minister. By way of example, over just a four page section, Vodafone variously describes the Commission's approach as "*reckless*",<sup>14</sup> that its work is "*embarrassingly exposed*",<sup>15</sup> that it has done an "*even poorer job*",<sup>16</sup> that it makes "*heroic assumptions*"<sup>17</sup> which Vodafone says are "*staggering*",<sup>18</sup> and that the Commission has "*engaged in wishful thinking*".<sup>19</sup> This phoney rhetoric, consistent with its attempts to "set up" the Commission on potential judicial review grounds, seems designed to give an impression of righteous indignation in order to appeal to the Minister.
- 2.19 It is a shame that Vodafone does not simply provide its estimate of its efficient cost of providing the service consistent with the principles in the Act.
- 2.20 Even some of the headings of Vodafone's submissions are incorrect and misleading. An example of its misleading headings is "*International cost benchmarking leads to a rate of 14.3 cpm*".<sup>20</sup> Critically Vodafone is referencing prices not costs. The subsequent text makes it clear that this means that the number changes when it manipulates the "benchmarking methodology".
- 2.21 We do not seek to rebut all those in this submission, but we do highlight some examples, which show that the incumbents' submissions cannot be taken at face value.
- 2.22 To us, such an unprincipled approach suggests that the incumbents understand the weakness in their own case. We hope that the Commission, and ultimately the

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<sup>12</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 54.

<sup>13</sup> Above, para 9.

<sup>14</sup> Above, p 33.

<sup>15</sup> Above, p 34.

<sup>16</sup> Above, p 34.

<sup>17</sup> Above, p 35.

<sup>18</sup> Above, p 35.

<sup>19</sup> Above, p 35.

<sup>20</sup> Above, p 6.

Minister, do not allow regulatory gaming by the incumbents to undermine the regulatory process.

2.23 In fact, contrary to Vodafone's assertions or implications:

- (a) the founding principle of the Act was the recognition that incumbents have monopolies and incentives to price above cost;
- (b) a key goal of the regulatory regime (or the threat of regulation) is to ensure that access prices are set as close as possible to the cost of efficiently supplying them;
- (c) the discussion on whether or not to impose regulation is a qualitative and quantitative one (of which benchmarking and the CBA are but part);
- (d) the Commission is the expert body best placed to exercise this judgment and, while Vodafone is entitled to have a different view, that does not by any stretch amount to establishing an error by the Commission;
- (e) the threshold for regulation is not the Commission proving the fatality of entry barriers. In fact, when establishing the Act regime, it was explicitly recognised that there were barriers to entry **and expansion** and that incumbents often had powerful incentives to game these.

### 3. PURPOSE OF THE ACT

*The Act is designed to ensure efficient supply prices*

- 3.1 The Act and the Telecommunications Amendment Act 2006, together with the Commission's *Review of Cellular Mobile Market Entry Issues* of 2006, recognises that dominant incumbents have monopoly bottlenecks and powerful incentives to restrict or delay market access. They also recognise, contrary to Vodafone's submissions, that there are barriers to entry and expansion.
- 3.2 The philosophy behind the Act is a simple one – to encourage parties to agree a price very close to the efficient cost of supply. Failing that, regulation would occur at the efficient price (then thought to be TSLRIC).
- 3.3 This can be contrasted with Vodafone's and Telecom's submissions that they should somehow charge access prices *exceeding cost* simply because they had the good fortune to be "first to market". On the contrary, the premise of the Act was to address incumbents' incentives to deter, delay or inhibit market entry and expansion.
- 3.4 In section 2 (Introduction) above we discussed section 18 and that the Minister must consider *efficiencies*.
- 3.5 It is telling that nearly 10 years ago the **Final Telco Report recommended for regulation of all interconnection** (admittedly as specified services), and we still have not even got to that stage.<sup>21</sup>
- 3.6 Given the ambiguity created by the incumbents' arguments it is worth reviewing in more detail (1) what problems the Act was designed to fix and (2) how the Act is meant to work. Here we are fortunate as the Final Telco Report provides a very detailed "roadmap".

*The Act is designed to address the bottleneck problem*

- 3.7 Contrary to the incumbents' assertions, the industry is characterised by inefficiency.
- 3.8 First principles suggest that is the case. As noted in the Final Telco Report:

*"Duopolistic and oligopolistic markets can be characterised by collusion (tacit or otherwise) or parallel pricing conduct on the part of the (two or few) players that has an adverse impact on competition. In such cases, prices for consumers are likely to be inefficiently high."*<sup>22</sup>
- 3.9 More specifically, the Final Telco Report recognised:
  - (a) there is a need for all users to connect to get true "any to any" connectivity (ie not just "best mates" or those on the same network);
  - (b) termination is a bottleneck monopoly; and
  - (c) incumbents have a strong incentive to, and likelihood of, overcharging.

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<sup>21</sup> Final Telco report, p 74.

<sup>22</sup> Above, p 13.

3.10 The report noted:

*“An important characteristic of electronic communication markets is the need for networks to interconnect **so that communications can take place between electronic communications users on a real-time basis, irrespective of which network** (e.g. that of Telecom, Clear, Vodafone or Telstra-Saturn) a user is on. **A significant part of the value of each network lies in its ability to connect its users to users on all of the other networks. This is known as ‘any-to-any connectivity’,** and is not a feature of network industries such as electricity and gas. In effect, each electronic communications network is a **‘bottleneck’** to which all other such networks require access.*

*The need for any-to-any connectivity requires new competitors (entrants) to reach agreements with other direct competitors for access to their networks. For this reason there is a **stronger likelihood in the electronic communications sector that new entrants will be delayed or overcharged by incumbent operators.** This is particularly the case in markets where an operator owns a formerly state-owned monopoly network.”<sup>23</sup> [emphasis added]*

3.11 The Final Telco Report also noted that:

*“Over the last decade, most developed countries have reformed their electronic communications sectors by partially or wholly privatising previously Government owned telecommunications companies and **introducing industry-specific regulation. These changes have all been directed at achieving gains in efficiency, lower prices, and increases in quality and diversity of services.***

***For all of these countries, a key regulatory issue has been, and continues to be, how best to minimise barriers to entry and (where entry has already taken place) barriers to market expansion, and to ensure that ‘incumbent’ telecommunication companies ... do not inhibit competition by taking advantage of their market power.”**<sup>24</sup> [emphasis added]*

3.12 The report went on to describe access regulation as *“providing for non-discriminatory access to other networks (essential for ‘any-to-any connectivity’) or to those parts of a network that are difficult or costly to duplicate”*. Termination is, of course, impossible to duplicate. Any-to-any connectivity would require non-discrimination, except where justified on true efficiencies (as acknowledged by the Commission in paragraph 74 of its 2006 mobile market review report).<sup>25</sup> The Commission’s cross-check (on-net average prices) is proof in itself of price discrimination. No further proof is required to show that regulation is needed.

3.13 The report went on to specify what it meant by efficient prices in this exact context:

*“If interconnection prices do not accurately reflect costs, perverse incentives can be created, as has been the case in the 0867 dispute.*

*In the Inquiry’s view, **the efficient costs of call origination and call termination are the costs that would be incurred by an operator using the most efficient means at any point in time to provide the service. This***

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<sup>23</sup> Above, p 14.

<sup>24</sup> Above, p 15.

<sup>25</sup> Commerce Commission, *A Review of Cellular Mobile Market Entry Issues*, 10 October 2006.

*approach, widely supported by leading academic research and best practice regulation, is sometimes referred to as calculating prices on the basis of 'forward-looking costs'. **Such costs would include the direct costs of supplying the services, including a cost of capital return on the capital costs, as well as a share of common costs that are related to supplying the services in the long term (i.e. total service long-run incremental cost-TSLRIC) of an efficient operator.***

*In the most simple and stylised example, this means that when a customer on network 'A' calls someone on network 'B', then network A pays network B a **cost based termination charge.**"<sup>26</sup>*

- 3.14 As the discussion in our past submissions and this one notes, leading academic research and best practice is now moving to LRIC (as proposed by the EC and effectively used in the US), contrary to Vodafone's absurd suggestion that arguments against high MTRs are a "*conceptual theory advanced by 2degrees*"<sup>27</sup> (and *incorrectly* by implication advanced only by 2degrees). This context is hugely significant and compelling.

#### *Conclusion*

- 3.15 The incumbents have tried to cloud the issues. In fact the market has two major problems, above-cost access prices and large discrepancies between on-net and off-net prices (**closed-net** pricing).
- 3.16 The Final Telco Report recognised these problems nearly 10 years ago, and how far behind New Zealand was even then. Little has changed, except that the "best practice" cost standard is now LRIC and the closed net pricing problem is likely far worse than anticipated.
- 3.17 The case for regulation is quite clear. As noted in the Final Telco Report:

*"Underpinning the Inquiry's view on the desirability for **ex-ante regulation** is:*

- the characteristics of the electronic communications sector, in particular the **strong interdependence between networks** and the rapid pace of change, which means markets can easily be distorted;*
- the view that **additional efficient competition between network operators is desirable**, and hence the **desirability of reducing barriers to entry and expansion;***
- the reality that it may be **economically rational for existing network operators to prevent, delay or add cost to the entry or expansion of competitors...**"<sup>28</sup> [emphasis added]*

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<sup>26</sup> Final Telco Report, p 65.

<sup>27</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 55.

<sup>28</sup> Final Telco Report, p 51.

#### 4. THE MARKET IS NOT COMPETITIVE

*Contrary to the incumbents' assertions, there's ample evidence of a lack of competition*

- 4.1 Telecom and Vodafone (including their experts) submit that the New Zealand retail telecommunications markets are competitive. But they don't rely on usual measures of competition (ie price and utilisation) which the Commission has correctly found to be high and low.
- 4.2 More notably the incumbents never attempt to suggest that their past returns are inadequate (for obvious reasons). It is unfortunate that there has not been proper public disclosure of those returns, or capital invested, as regulation would, in our view, inevitably have occurred.
- 4.3 That is the real "secret" which Vodafone should be talking about.
- 4.4 Rather, Telecom/NERA claim that the Commission has taken too narrow a focus and that there has been vigorous competition on technology and quality of coverage.
- 4.5 Contrary to the submissions by Vodafone, Telecom and their experts, Concept Economics note that "...the historic duopoly has not been effectively competitive".<sup>29</sup>
- 4.6 The Commission in its 2008 Telecommunications Market Monitoring Report noted that:

*"While mobile calling volumes continue to grow at a strong rate, they are low by international standards making up only one quarter of total calling minutes compared to at least one third to one half in comparable countries. The growth in mobile usage has likely been driven by restricted on-net calling offers like BestMates given that mobile revenues and list prices have remained largely unchanged."<sup>30</sup>*

- 4.7 Assertions of a competitive market are self-evidently incorrect and an insult to consumers:
  - (a) Voice utilisation rates are low because it is too expensive to make calls to and from mobiles, especially off-net mobile calls;
  - (b) In our view, incumbents' returns are likely well in excess of any reasonable measure;
  - (c) Despite this, even Telstra has been deterred from entering due to the artificially created entry / expansion barriers;
  - (d) Fixed line customers have subsidised the incumbents for a number of years;
  - (e) Networks are closed – there is virtually no cross-net traffic;
  - (f) There is ample anecdotal evidence of inefficient use of dual handsets;
  - (g) Despite NERA's assertions, Telecom clung onto old technology to the frustration of numerous overseas travellers (until our imminent entry). Concept Economics highlight in its August Cross-Submission the lack of dynamic

<sup>29</sup> Concept Economics, MTAS Cross-submission, 18 August 2009, (**Concept Economics August Cross-submission**) section 3.

<sup>30</sup> Commerce Commission, 2008 Telecommunications Market Monitoring Report, 14 April 2009, para 2.

competition, calling this *“the avoidance of competition rather than of rivalrous dynamic change”*<sup>31</sup>

- 4.8 As demonstrated very clearly in the Concept Economics August Cross-Submission, the incumbents’ comparisons with OECD rankings are misleading for many reasons. Among other things, the rankings are very sensitive to the choice of user profile and as noted in figure 1 of their report, New Zealand sits at the “low user” end of the basket. Interestingly this can be contrasted with the US at the other extreme which has 443min per month per subscriber. As Concept Economics also note, with the illustrative example of Vodafone Australia vs Vodafone New Zealand plans, *“...the results will be dependent on the specific profile chosen and do not...properly compare the value mobile subscribers receive in New Zealand relative to consumers overseas”*.<sup>32</sup> The third reason noted by Concept Economics is that it was not clear that the pricing plans were driven by competitive forces, but rather it appears that *“...it was the threat of regulatory intervention...provided an incentive to offer plans that improved the OECD rankings, but which did not necessarily improve consumer wellbeing”*.<sup>33</sup>
- 4.9 Prior to 2degrees’ launch, we were the only OECD country where consumers could choose from only two operators<sup>34</sup> and we are one of only three OECD countries without an appropriate regulatory framework in place.<sup>35</sup>
- 4.10 As noted, real data is not available to us, but we believe that the unusual market structure which has impacted competition in New Zealand is due to the fact that one of the mobile operators was owned by a predominately land line company. Further that company was unusual by international standards as it earned a higher EBITDA margin on fixed line services relative to the mobile services (60% versus 35%) – See graph below.

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<sup>31</sup> Concept Economics August Cross-Submission, section 2.3.

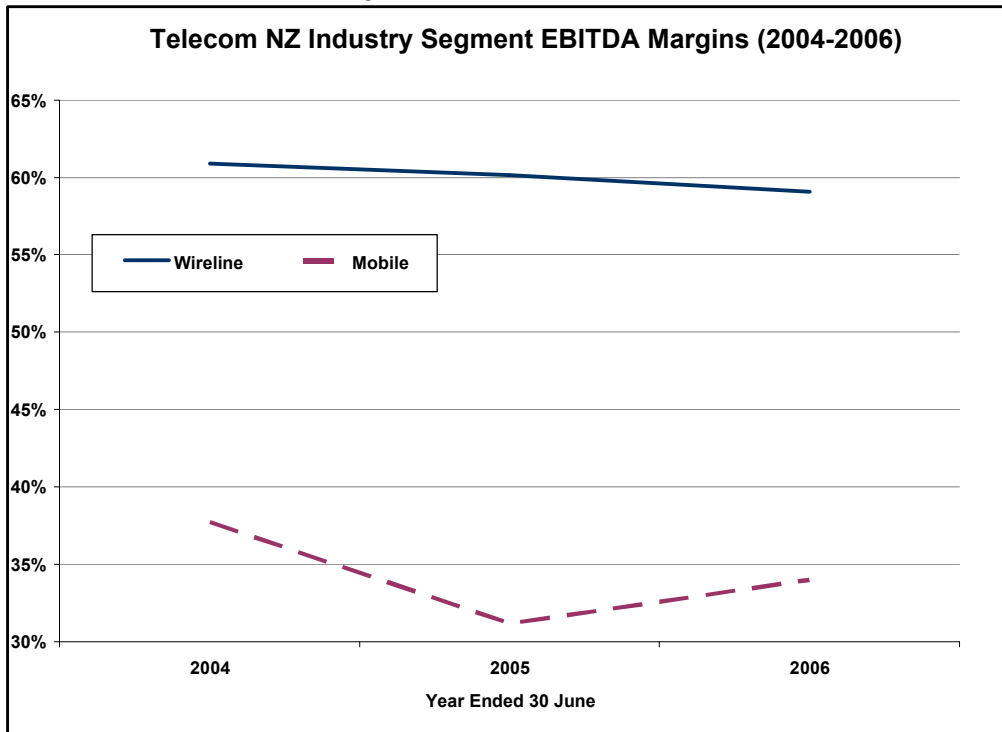
<sup>32</sup> Above, section 2.1.1.

<sup>33</sup> Above, section 2.1.1.

<sup>34</sup> The Commission at paragraph 187 of its Draft Report referred to the 2007 OECD Communications Outlook, which showed New Zealand and Slovakia as the only two OECD countries with only two mobile operators. Telephonic O2 Slovakia entered the Slovakian mobile market as its third operator in February 2007. So for more than two and a half years prior to 2degrees’ entry, New Zealand was the only OECD country with only two mobile operators.

<sup>35</sup> OECD Communications Outlook 2009, Table 2.11.

**Data source: Telecom Corporation NZ Limited**



4.11 By contrast, Vodafone, the largest multinational mobile provider in the world with operations in 35 countries and a market capitalisation worth almost as much as the entire New Zealand economy (GDP), believes that their New Zealand operation is a start performer due to its degree of dominance. We interpret that to mean that profits here are excessive and perhaps unrivalled in any other country.

4.12 We consider that this shows that:

- (a) It appears that the market has evolved so that Vodafone and Telecom don't directly compete with each other. This allows them to earn very high EBITDAs in their respective arenas as noted above.
- (b) Telecom has a group of customers that are relatively well protected from competition in two respects:
  - (i) Telecom's business customers that require voice plus fixed bundles are protected from competition as no one really can compete for those customers by bundling fixed and voice;
  - (ii) Telecom's share of the fixed voice market grants them a large base which they can, and in fact do, use to create an artificial retail-price mediated network effect that softens competition.
- (c) Vodafone has focussed on all other voice customers, again using retail prices to create an artificial network effect for the purposes of softening competition for those customers.

- 4.13 We also note that Telecom has 85% market share in Dunedin and Vodafone has 97% market share in Auckland pre paid markets.<sup>36</sup> The stranglehold on consumers extends not just to a family, or small calling circle, not even to a class at school or the rugby club but is dominated by city and increasingly by Island – North Island on one network, South Island on the other. It's a winner takes all scenario unseen anywhere else in the world.
- 4.14 In our view a key mechanism for softening competition is that on-net prices lead consumers to sort themselves into groups, and this makes it harder and harder for any given customer to switch carriers (because she or he cannot get the people in her or his group to also switch). Such customers in effect become monopolised.
- 4.15 What is particularly concerning is that “we don't know what we don't know”. Vodafone and Telecom do not disclose sufficient information for the Commission, Nominated Counsel and advisors, let alone the public, to know how bad things really are. That's what the real “secret” is. Vodafone's 2008 accounts have no granularity in the \$554.3 million cost of sales or the \$211.8 million ‘other’ item. In all, the majority of revenues are unaccounted for in any reasonable level of detail.
- 4.16 Vodafone sent \$800 million of its profits in 2008 to its British-based parent.<sup>37</sup> Former Vodafone Group CEO Arun Sarin commented that “*New Zealand contributes far more than what the ordinary numbers might suggest – it punches above its weight*” and he wished he could take the New Zealand company and scale it to the rest of the world “*I could say my job's done, I could retire early.*”<sup>38</sup>

*In fact competition of any nature, albeit inefficient, has only appeared to occur with our imminent entry*

- 4.17 The assertions about competition being vigorous are hard to reconcile with the fact that it has only been our imminent arrival that saw:
- (a) The appearance of MVNOs, which can best be characterised as pyrrhic competition from the incumbents' “fighting brands”. Commentators have noted that;
- “Vodafone and Telecom partly introduced the MVNO concept - originally popularised in the UK by Virgin Mobile - partly on the basis that it's better that customers are cannibalised by someone taking your wholesale feed than a competitor. And partly to placate the Commerce Commission – although now that a competitor has arrived with its own actual network, the MVNO model looks less like opening the market, and more like fulfilling 2degrees' fear that the incumbents will try to ring fence it with virtual competitors.”<sup>39</sup>*
- (b) Telecom's belated GSM launch.

- 4.18 Indeed it appears that Telecom have already increased the sums they are spending on subscriber acquisition costs (**SAC**) as a direct result of competition. For example,

<sup>36</sup> Phoenix Research, *Measurement of On Net Mobile Traffic Among Students in Auckland and Dunedin: Key Findings*, May 2009, [http://www.2degreesmobile.co.nz/c/document\\_library/get\\_file?uuid=fff7bd97-ed42-4cce-9b92-70dd46149805&groupId=10128](http://www.2degreesmobile.co.nz/c/document_library/get_file?uuid=fff7bd97-ed42-4cce-9b92-70dd46149805&groupId=10128).

<sup>37</sup> Jenny Keown, Market hero to big bad incumbent – the changing face of Vodafone, *The Independent*, 25 June 2009, p 6.

<sup>38</sup> Deborah Hill Cone, Vodafone head toasts New Zealand success story, *National Business Review*, 8 April 2004.

<sup>39</sup> CallPlus launches mobile service, ‘going where 2degrees can't’, *National Business Review*, <http://www.nbr.co.nz/article/callplus-confirms-mobile-launch-going-where-2degrees-cant-107584>, 17 August 2009.

the Goldman Sachs JBWere *UPDATE* (11 August 2009) on Telecom Corporation of New Zealand Limited illustrates the increase in Cost of Sales (**COS**) as a function of more competition.

***“Handset subsidies.** One area where the impacts of XT should be more explicitly clear is the flow-through of handset subsidies and acquisition costs. We expect TEL's mobile COS to be +63% on pcp and 57% of service revenues in 4Q, with elevated costs to outweigh subscriber revenues for some time to come”<sup>40</sup>*

- 4.19 This can be contrasted with previous research, Telecom's 2004 SEC filing, highlighting COS as 28%<sup>41</sup> of revenues, significantly lower than the current estimate of 63%. This suggests that cost of sales has gone up as a consequence of handset subsidies.

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<sup>40</sup> Goldman Sachs JBWere *UPDATE* (11 August 2009).

<sup>41</sup> See Management Commentary accompanying Telecom's SEC filing for year ended June 2004 showing mobile revenue at p13 and cost of sales for mobile subscription, upgrades and dealer commissions at p 19.

## 5. ARTIFICIAL (INCUMBENT CREATED) BARRIERS ARE UNIQUELY HIGH

*Vodafone makes the spurious suggestion that barriers to entry are not high*

- 5.1 Vodafone and its advisors appear to have abandoned relevant law and economics. They suggest that 2degrees has entered the market, and that the Commission must now demonstrate that there are barriers and that these are “fatal”.<sup>42</sup>

*Vodafone’s unsubstantiated comments ignore reality, law and economics*

- 5.2 We consider Vodafone’s suggestions and implications to be wrong on many levels:

- (a) We have not completely entered the market (we have not completed network build, nor are we by any stretch a full service provider yet).
- (b) More importantly, the costs we faced and continue to face are considerably higher than those faced by the incumbents - the acknowledged test.
- (c) Well-established New Zealand law (based on economic reasoning and evidence) makes it clear that:

*“Anything is capable of being a barrier to entry or expansion if it amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and maintain that entry or expansion in the long run, being a cost or limitation that an established incumbent does not face. The height of the barrier is a function of the degree of the differential.”<sup>43</sup>*

- (d) More importantly, the Courts have recognised the issues new entrants face getting interconnection at an appropriate price.
- (e) Similarly the OECD has recognised a number of barriers to entry / expansion in the telecommunications sector.
- (f) The Final Telco Report recognised these barriers as well – relevantly, incumbent conduct in relation to bottlenecks, such as interconnection.
- (g) Similarly academics and regulators recognise the harm of above-cost termination rates, especially when coupled with high on-net / off-net price differentials.<sup>44</sup>

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<sup>42</sup> Vodafone’s submission dated 28 July 2009 [public version] states (at para 34 and 35): “A larger network does have some advantages over a new entrant, of course. The question is, are these advantages **fatal “barriers”** to a new entrant or merely “hurdles” which properly incentivise the network to grow to achieve similar scale? The Commission has no role in removing simple hurdles to new entrants and **has not established** that the counterfactual termination rates pose a fatal barrier to entrants. If it were, it would be difficult to explain why 2degrees has invested \$250m in its operation and announced it will launch next month. Surely, it cannot have relied on the termination rate” barriers” being removed to meet its business case?” [emphasis added].

<sup>43</sup> *Commerce Commission v Southern Cross* (2001) 10 TCLR 269 at para 73. (CA). While *Southern Cross* referred to a cost that an incumbent “does not face”, the Court in *Air NZ v Commerce Commission* (2004) 11 TCLR 347 (HC) at para 101 have interpreted this as referring to a cost that an incumbent “did not face”. Subsequent cases such as *NZ Bus* (2006) 11 TCLR 679 (HC) have also referred back to the *Southern Cross* definition. The Commission’s Mergers and Acquisitions Guidelines, 1 January 2004 at page 27 refer to “a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face.”

<sup>44</sup> Relevant studies include: Armstrong and Wright (2007) “Mobile call termination in the UK” *UCL* September 2007, Cambini and Valletti (2007) “Information exchange and competition in communications networks” in *Journal of Industrial Economics*, “On-net and off-net pricing on asymmetric telecommunications networks”, *Information Economics and Policy* 19(2),171-188, Cabral (2007) “Dynamic price competition and network effects”, *CEPR*

- 5.3 Given the implication in Vodafone's submission that we are in the market and therefore there must be a sufficient competitive constraint, it is noteworthy that the Commission's Mergers & Acquisitions Guidelines state that:

*"... if the only viable entry occurs at the fringe of the market, and fails to attack the incumbent's core business, then entry cannot be seen as being an effective constraint."*<sup>45</sup>

- 5.4 That quote goes to the heart of this inquiry.
- 5.5 We have previously submitted on these issues, but our comments are supported by the Concept Economics August Cross-Submission, Concept Economics August Data Request Report and the Dr Haucap Report.

*There are considerable barriers to entry and expansion in mobile markets*

- 5.6 The Commission's "A review of cellular mobile market entry issues" 10 October 2006 identified a number of barriers to entry (already discussed in past submissions) including exclusive dealership arrangements, SIM card locking (which Vodafone only stopped doing after the Commission's warning<sup>46</sup>), offering long-term contracts with penalties for early termination, bundling, MTRs, Resource Management Act; spectrum; coverage; closed network pricing, and pocket pricing.<sup>47</sup>
- 5.7 We appreciate that the Commission is well aware of these issues and simply note that we still face costs and obstacles that the incumbents do not. With respect, we consider these factors to still be relevant to this inquiry.

*The New Zealand High Court has recognised these issues*

- 5.8 In the *AMPS-A* case,<sup>48</sup> the High Court commented (in relation to the fixed PSTN) that:

*"Although the legal barrier to network operation was removed in 1989, **barriers to entry to network operation are substantial**. There are known to be **large economies of scale and scope**, with diseconomies, in particular, in duplicating the local loops. Telecom has built up its network gradually but a potential entrant to network operation is faced with very large investments in transmission facilities and rights of way unless, as in the case of Clear, it can gain access to existing facilities such as the New Zealand Railways fibre link.*

*There is **the necessity to obtain interconnection** with the PSTN (and international transmission) on terms that are not unduly disadvantageous. The most daunting of these barriers is the dependency upon Telecom's PSTN"*<sup>49</sup>

- 5.9 While we seek to provide reciprocal network access, we nonetheless face the same dependency on Telecom and Vodafone's monopolies in termination on their networks.

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*Discussion Paper No. 6687*, February 2008, Harbord and Pagnozzi (2008) "On-net/ off-net price discrimination and 'bill and keep' vs 'cost based' mobile termination rates, MPRA Paper 14540, January 2008.

<sup>45</sup> Commerce Commission, Mergers and Acquisitions Guidelines, 1 January 2004, p 28.

<sup>46</sup> See letter from Dr Ross Patterson, Telecommunications Commissioner to Vodafone on locking of mobile handsets, 29 April 2008,

<http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/MonitoringandReporting/ContentFiles/Documents/Letter%20to%20Vodafone%20on%20handset%20locking.pdf>.

<sup>47</sup> Commerce Commission *A review of cellular mobile market entry issues*, 10 October 2006, paras 38-92.

<sup>48</sup> *Telecom v Commerce Commission* (1991) 4 TCLR 473 (**AMPS-A**).

<sup>49</sup> Above, 520.

- 5.10 It is unsurprising then that the Court concluded in relation to the mobile services market that: **“There are formidable barriers to entry to this market.”**<sup>50</sup>
- 5.11 While many, but not all, barriers have been reduced by regulation, we face new substantial barriers; switching barriers; market foreclosure and closed-net pricing, which the incumbents did not. Further, without regulation, the interconnect bottleneck remains a formidable block, especially when prices so manifestly exceed cost.
- 5.12 It is noteworthy that the Court considered interconnection to be the second highest barrier after spectrum. While those comments related to the PSTN (now regulated), the market power now lies in relation to mobile interconnection. The Court commented that **“Telecom is in a position to manipulate terms and conditions to the advantage of Telecom Cellular. Moreover it is inevitable that Telecom will gain access to much useful information regarding the activities of a competitor in the course of its normal business.”**<sup>51</sup>

*The OECD says barriers to entry and expansion are high*

- 5.13 Vodafone and its advisors may struggle to recognise these barriers to entry and expansion, but in its Access Pricing report (2004) the OECD notes that:

*“Throughout this report we have emphasised that call termination to a specific end-user is almost always a non-competitive service. In certain circumstances the terminating network, even though it may have only very few end-users, will, **if unregulated, exercise its monopoly power over termination to raise the termination charges to monopoly levels.**”*<sup>52</sup> [emphasis added]

- 5.14 In an earlier report, *Indicators for the Assessment of Telecommunications Competition* (January 2003)<sup>53</sup> the OECD noted:

*“Characteristics of the telecommunications market*

*The telecommunications industry has some quite distinctive aspects from other commodity industries ... [T]his has implications on the sector specific consideration in **imposing regulatory measures or analysing the state of competition.** An appropriate analytical framework for the evaluation of effective competition **should take into account various factors that characterise the telecommunications industry** or markets. ... The features peculiar and prevalent in the telecommunications sector are:*

- **Bottleneck/essential facility control:** *Telecommunications networks have very high fixed costs that result in bottleneck or core facilities in the provision of access. The **advantage of the incumbent in relation to access provision gives the firm an incentive to use its dominance in order to stifle competitors.***
- **High sunk costs:** *Investment in telecommunication networks entails large sunk costs. Sunk costs are the acquisition of tangible and intangible assets that cannot be recovered through redeployment of the assets outside the relevant market. **Significant sunk costs cannot be recouped in a short period of time after the commencement of the supply of products or***

<sup>50</sup> Above, 522.

<sup>51</sup> Above, 522.

<sup>52</sup> OECD, *Access pricing*, 2004, <http://www.oecd.org/dataoecd/26/6/27767944.pdf>, p 139.

<sup>53</sup> OECD, *Indicators for the Assessment of Telecommunications Competition* (January 2003) <http://www.oecd.org/dataoecd/4/22/2496809.pdf>.

**services. These high sunk costs allow for the incumbent to erect an effective entry barrier to potential entrants into the telecommunications market because it is costly to enter the telecommunications market.**<sup>54</sup> [emphasis added]

5.15 As noted, we have not fully entered the market. Most notably we have not completed our network build. Moreover, as a late entrant we necessarily face barriers to entry and expansion (ie costs) which the incumbents did not face. The OECD notes that the incumbents' possession of essential facilities, economies of scale and scope (only available to a provider of all telecommunications services), early entrant advantages, strategic advantages and exclusionary conduct are barriers to entry.

5.16 The OECD comments:

***“Entry barriers/Ease of entry:***

*As noted above, there are many sources of entry barriers in the telecommunications markets, which could result from certain constraints due to regulation, **possession of essential facilities by an incumbent operator and other factors.** Three sources of entry barriers are absolute advantage, **strategic advantage and exclusionary behaviour.** Absolute barriers may occur owing to technological barriers, economies of scale and economies of scope and regulatory restrictions of market entry, e.g. resulting from the shortage of available radio spectrum for mobile services. Economies of scale exist where the provision of services demands high fixed costs, while economies of scope occur where costs for one product can be reduced through a joint production with another product. These two will act against the entry of potential firms to telecommunications markets. **Strategic barriers have to do with the first mover advantage and the nature of investment in telecommunications networks. Exclusionary barriers are associated with vertical integration of the telecommunications sector.** A vertically integrated firm with market power on an upstream market can lever its position into a downstream market. In the absence of effective regulation, a **firm controlling a network may be able to exclude those firms competing from accessing its network or squeeze their margins by increasing the interconnection prices charged for the conveyance of competitors' services and reduce the firm's retail service prices.**<sup>55</sup> [emphasis added]*

5.17 That well-acknowledged incumbent behaviour is the reason why all OECD countries except for New Zealand, Mexico and Slovakia have regulation. Our closest trading partner, Australia, has had regulation of mobile termination for over 12 years.<sup>56</sup> The first question is whether or not to regulate. That decision has already been made by most economies we compare ourselves with (except for those with BAK or very low termination rates).

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<sup>54</sup> Above, p 9.

<sup>55</sup> Above, p 17.

<sup>56</sup> GSM Terminating access services became a declared service in June 1997 and MTAS became a declared service in June 2004. See Domestic GSM terminating access [no longer in operation since MTAS became a declared service] <http://www.accc.gov.au/content/index.php?id/322643> and pages iii-iv and xix of ACCC, *Final Decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service*, June 2004.

*The potential harm of closed network pricing is acknowledged by the OECD*

5.18 As noted by the OECD in its report, *Competition and Regulation Issues in Telecommunications*, (2002):<sup>57</sup>

*“Another issue which competition authorities have had to address is the question whether networks should be allowed to charge higher prices for calls to other networks (or offer discounts for on network calls). **When such differential pricing is allowed, larger networks have an incentive to insist on high interconnection charges. This raises the price for off-network calls. Since smaller networks have proportionally more off-network calls, the customers of smaller networks suffer proportionally more than those of larger networks, reducing the attractiveness of smaller networks.**”<sup>58</sup>*  
[emphasis added]

*The Final Telco Report noted the incentives to price above cost and the resulting harm*

5.19 As noted above, the inquiry clearly found that:

*“The need for any-to-any connectivity requires new competitors (entrants) to reach agreements with other direct competitors for access to their networks. For this reason there is a **stronger likelihood** in the electronic communications sector that **new entrants will be delayed or overcharged by incumbent operators.**”<sup>59</sup>* [emphasis added]

*The OECD has also discussed the information asymmetry favouring incumbents*

5.20 While a slightly different point, the OECD publication *Predatory Foreclosure* (2004)<sup>60</sup> discusses the issue of “Exploiting Information Asymmetry” in section 4.3, commenting that:

*“Sometimes the incumbent in a market has an **informational advantage** over potential entrants due to its greater experience and established contacts with suppliers and customers. This advantage flows in two directions, i.e. the incumbent might not only have better access to market information, but it might also be viewed as a more reliable source of information than newcomers are. This creates the potential for incumbents to create fear, uncertainty and doubt in the minds of others – including potential entrants, customers, and investors or creditors – regarding the feasibility of profitable entry. For example, an incumbent might send misleading signals about market demand and its own costs to deter competitors or make it harder for them to raise capital. In addition, an incumbent might spread doubt among customers about an entrant’s viability or quality.”* [emphasis added]

5.21 For present purposes we simply note that, in addition to facing competitors who “know all the market data”, in this regulatory process we have faced information disadvantages in relation to pricing and costing which the incumbents do not. By our read of media reports, sometimes it appears that incumbents have demonstrably benefitted from the above effect.

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<sup>57</sup> OECD, *Competition and Regulation Issues in Telecommunications*, 2002  
<http://www.oecd.org/dataoecd/48/39/1834399.pdf>.

<sup>58</sup> Above, p 11. The report goes on to note that one possible response is for new entrants to become call sinks, eg paying customers to receive calls and become “call sinks”, profiting from inbound termination revenues. Needless to say that would not be an efficient solution to the problem at hand.

<sup>59</sup> Final Telco Report, p 14.

<sup>60</sup> OECD, *Predatory Foreclosure*, 2004, <http://www.oecd.org/dataoecd/26/53/34646189.pdf>.

*That harm is very real and exists in NZ as the evidence shows*

5.22 [ ] TRI/VRI

5.23 Concept comments that:

[ ] TRI/VRI

5.24 After discussing market failure in more detail, they conclude that:

[ ] TRI/VRI

5.25 Concept also provide some compelling further observations based on the Vodafone and Telecom data:

[ ] TRI/VRI

*Despite the recent spike of activity, overall the market is getting less competitive, not more.*

5.26 As noted in the Concept Economics *Submission to the Commerce Commission in Relation to Data Reclassified as Restricted Information (Concept Economics August Data Request Report)*:

*“... the manufactured network effect that on-net price discounting creates in combination with above-cost mobile termination rates is a substantial barrier to sustainable entry and expansion in the New Zealand mobile market.”<sup>61</sup>*

5.27 Concept notes how *at best* this restricts even the efficient entrant to small market segments (the “tame dwarf” scenario) and *at worst* leads to the efficient entrants’ market exit.

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<sup>61</sup> Concept Economics *Submission to the Commerce Commission in Relation to Data Reclassified as Restricted Information (Concept Economics August Data Request Report)*, p 1.

5.28 They comment that their findings reinforce their view:

*“... that the relevant counterfactual is one where the ability of the efficient entrant to compete effectively is severely constrained. Instead, an entrant is likely to be limited to small segments of the market, or ultimately forced to exit.”<sup>62</sup>*

5.29 Similarly Concept Economics succinctly explain the entry/expansion barriers resulting from New Zealand’s closed-net pricing noting that the *“entrant provides less benefit to new customers.”<sup>63</sup>*

#### *SMS bundles lock up the market*

5.30 While discussed in more detail below, for present purposes (and in the context of foreclosure), we note that SMS bundling risks foreclosing access to much, if not all, the mobile market by blocking access to many of the “entry level customers”. Below, we describe the New Zealand market and explain the significance of SMS. We also discuss the Phoenix Research on who the “texters” are and how they are “locked in” to the incumbent networks.

5.31 This finding is consistent with the conclusions of Concept Economics.

#### *Attempting to compete results in massive wealth transfers to the incumbents*

5.32 The Concept Economics August Data Request Report provides detailed worked examples of the massive wealth transfers which occur describing excessive termination charges as *“a subsidy for incumbents funded by a tax on the entrant”<sup>64</sup>*.

5.33 It is small wonder then that Vodafone and Telecom fight so hard to set excessive termination charges for SMS and voice:

(a) it sets a barrier to entry; and

(b) it subsidises their business,

while “raising rival’s costs”.

5.34 The OECD knows this problem and has highlighted it, so why does it persist in NZ?

#### *Professor Dr Haucap’s evidence states clearly the harm of closed-net pricing*

5.35 Contrary to the submissions by Vodafone and its experts, Dr Haucap makes it clear that it is not just economic literature that recognises that a combination of high mobile termination rates and on-net discounts can serve as a *strategic barrier to entry*, but that the EC and European Regulators Group have acknowledged this as well.<sup>65</sup>

5.36 Dr Haucap provides a simple example, which demonstrates the necessity for the smaller operator to discount off-net calls which *“most likely also leads to an imbalance”* in traffic flows.<sup>66</sup>

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<sup>62</sup> Concept Economics August Data Request Report, p 1.

<sup>63</sup> Concept Economics August Cross-submission, section 1.

<sup>64</sup> Concept Economics August Data Request report, Restricted Version, p 4.

<sup>65</sup> Professor Dr Justus Haucap, Short Report on the Assessment of the Expected Costs and Benefits of Lower Mobile Termination Rates in New Zealand, 18 August 2009, (**Dr Haucap Report**), para 3.

<sup>66</sup> Above, example begins at para 4, above quote is from para 6.

5.37 He comments that:

*“A reduction in MTRs, therefore, clearly serves to reduce barriers to entry and to limit competition in the retail mobile market.”<sup>67</sup>*

5.38 He goes on to note that:

*“It is important to note that the fact that a lowering of MTRs also reduces barriers to entry is largely ignored in the Covec report.”<sup>68</sup>*

*Concept Economics August Cross-Submission states the harm quite clearly*

5.39 Concept Economics notes that:

*“Perhaps the central problem facing 2degrees is the barrier to entry and expansion created by the combination of above cost termination charges and on-net retail price discounts”.<sup>69</sup>*

5.40 Concept Economics also find that contrary to Vodafone’s assertions that 2degrees is in the market and therefore faces no obstacles “...lower termination charges are critical to an efficient entrant being an effective competitor”<sup>70</sup>

5.41 Concept Economics comment in this regard that a “...a barely surviving entrant would not provide the vigorous competition of a thriving competitor.”<sup>71</sup>

*Summary on barriers to entry*

5.42 In short, it is well-established that even if there has been entry into the market, there may still be barriers to expansion which hinder the effectiveness of entry.

5.43 We are pleased to see that even Vodafone’s experts, Analysys Mason, acknowledged the real competitive harm of on-net / off-net price differentials. In their report for the Israeli Competition Authority, they also commented:

*“Furthermore, the calls from a subscriber to a mobile network, to another subscriber within that same network (‘on-net’ calls) are significantly cheaper than calls to other mobile networks (‘off-net’ calls) indicating that the excess revenues earned from termination could potentially be being used to subsidise on-net calls and price them below cost – behaviour which could be considered anti-competitive.”<sup>72</sup>*

5.44 It is odd then to see Vodafone state the contradictory position that no one is suggesting Vodafone’s on-net prices are anti-competitive.<sup>73</sup>

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<sup>67</sup> Above, para 8.

<sup>68</sup> Above, para 9.

<sup>69</sup> Concept Economics August Cross-Submission, p 15

<sup>70</sup> Above, section 3.

<sup>71</sup> Above, section 3.1.2.

<sup>72</sup> Analysys *A Study of Mobile Termination Charges* Report for the Israel Ministry of Communications and Ministry of Finance, 22 July 2004, attached to submissions from Optus to ACCC in response to Draft MTAS Pricing Principles and Indicative Prices 2009-2011, December 2008  
<http://www.accc.gov.au/content/item.php?itemId=854284&nodeId=24179635d87be82638c3f0affa6179db&fn=Other%20supporting%20documents.zip>

<sup>73</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 263

## 6. WE HAVE ENTERED BUT THE MARKET IS STILL FORECLOSED

*An important means of market entry – SMS – is locked to competition*

- 6.1 A feature of the New Zealand market is the relatively high incidence of SMS relative to voice. Putting aside the fact that this is arguably due to the extremely high cost of voice, SMS has become an accepted and common form of communication. Notably at the more value-based end of the market.
- 6.2 The striking fact in New Zealand is the prevalence of on-net SMS bundles and the foreclosure effect this has had on the market.
- 6.3 This section 6 focuses on SMS, but many of the comments apply equally to voice.

*Anecdotal evidence suggests that SMS packages are a “must have” for some customers*

- 6.4 The significance of SMS bundles has come through strongly in public feedback, via the media, on 2degrees’s initial offerings.
- 6.5 For example, by looking at the comments on the Independent article on line entitled “2degrees slashes mobile pre-pay prices” (4 August 2009).<sup>74</sup> As at 11 August 2009, around one third of the comments expressed the view that 2degrees needed to offer SMS bundles similar to those offered by the incumbents.
- 6.6 Commentary on 2degrees text bundles (or lack of) is widespread on blog sites. As an example, the popular site [www.geekzone.co.nz](http://www.geekzone.co.nz) has a forum discussing whether cheap SIM cards from 2degrees could facilitate text bullying.
- (a) High School teacher ‘Coulson’ wrote “most teenagers I know (I’m a high school teacher) are on text plans anyway and don’t plan to switch to 2D [2degrees]...”
- (b) In response ‘Tardtastic’ wrote “yeh, like Coulson said, everyone of my friends is on text2000 or boosttxt...”
- 6.7 This provides a level of *qualitative* evidence to the Commission on the foreclosure of SMS markets and lack of competition between the incumbent operators.

*Phoenix Research demonstrates that SMS packages are a “must have” for some customers*

- 6.8 Research conducted by Phoenix Research supports the anecdotal evidence above that SMS bundles are a “must have” for some customers.<sup>75</sup>
- 6.9 In short, their research shows:
- (a) The younger market segment is almost entirely pre-paid users.
- (b) This segment has very strong calling circles (Vodafone “owns” 97% of Auckland, Telecom “owns” 85% of Dunedin).<sup>76</sup>

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<sup>74</sup> <http://www.stuff.co.nz/business/industries/2717733/2degrees-slashes-mobile-pre-pay-prices>.

<sup>75</sup> David Fougere *Why Closed Network Txt Pricing Creates a Non-Competitive Mobile Market*, July 2009, [http://www.2degreesmobile.co.nz/c/document\\_library/get\\_file?uuid=286d2207-ec2c-42d5-ba4b-716c541d3a86&groupId=10128](http://www.2degreesmobile.co.nz/c/document_library/get_file?uuid=286d2207-ec2c-42d5-ba4b-716c541d3a86&groupId=10128) (**Phoenix Research July Report**).

<sup>76</sup> Referred to at para 36 and discussed at footnote 17 of our submissions on the Draft Report and in the Commission’s 2008 Telecommunications Market Monitoring Report, 14 April 2009.

- (c) This segment predominantly purchase SMS packages. According to Phoenix Research:

*“77% of all txt traffic from pre-paid phones is from phones with txt bundles”<sup>77</sup>*

*If there was any doubt about the extent of foreclosure, the Concept Economics August Data Request Report clearly demonstrates SMS market failure in New Zealand*

6.10 We refer to the Concept Economics August Data Request Report submitted to the Commission on 11 August 2009 which commented on the reclassified incumbent responses to the Commission’s Data Request and concluded that:

- (a) In 2008 on-net SMS as a proportion of total SMS was [ JVRI ]% for Vodafone and [ JTR ]% for Telecom.<sup>78</sup>
- (b) The New Zealand market is split due to distorting on-net pricing and is not efficient.
- (c) On-net pricing leads customers to sort themselves into separate markets.
- (d) That the market is not competitive, with the basic idea of a telecommunications network – that of any-to-any connectivity – being eroded by artificial price constraints.

6.11 We also refer to the Concept Economics August Cross-Submission where Concept Economics note *“the pricing structures used by Telecom and Vodafone distort competition by discouraging customers from communicating with customers connected to other networks.”<sup>79</sup>*

*The ramifications of market foreclosure are high*

6.12 Mobile market segmentation can be represented diagrammatically as follows, drawing on an analogy with the airline industry where new entry also typically occurs at the low-spend / “economy” end of the market.

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<sup>77</sup> Phoenix Research July Report, p 1.

<sup>78</sup> Concept Economics August Data Request Report, Restricted Version, p 2.

<sup>79</sup> Concept Economics August Cross-submission, section 1.

**Table A: Mobile telephony in New Zealand – value chain & entry**

	“Service level” (Value proposition)	Offering	Comments
High Value ↑↑	First Class	Corporate accounts – bundled offering, term contracts, group deals on data etc.	Normally bundled High SAC
Growth ↑↑	Business Class	On account customers. Relatively price insensitive	Often bundled
Entry level	Economy	Prepay customers.  Relatively price sensitive	↑ growth = FTM  “Hungry Market”, high price elasticity
SMS Bundles		Bundled SMS for prepay locks access to economy segment	SMS bundles block market access. SMS is a barrier to entry

- 6.13 Table A highlights the fact that the price sensitive users we would expect to target with competitive voice packages won’t just be inhibited by the artificial network effect in voice; the effect is arguably even stronger in the SMS market.
- 6.14 We invite the Commission to consider the Phoenix Research slides in more detail, and in particular the evidence on the prevalence of text usage among younger consumers, together with the Concept Economics August Data Request Report.
- 6.15 The fact that there is virtually no cross-net traffic, ie no real “interconnection” between the incumbent networks is hugely inefficient and harmful to New Zealand consumers and clear evidence of a “broken market”.
- 6.16 On-net pricing needs to be employed only by one of the two incumbent to prevent cross network communications. SMS is a useful example. Telecom customers can SMS Vodafone from Telecom’s \$10 SMS bundle but because of Vodafone’s retail pricing strategies, few SMS come back. This results in Telecom customers giving up on Vodafone and prefer to SMS other Telecom users – that way they receive a reply SMS.
- 6.17 The effect is so pronounced as to appear similar to early development of SMS technology which was unable to support cross-net SMS between different operator technology plans. New Zealand has reverted to a point where it is not technology that closes networks but the artificial effects of high MTRs and closed-net pricing.

*As a reality check let’s compare proposed prices to the real cost of terminating SMS*

- 6.18 We have commented on cost elsewhere, but as an indicative benchmark, the likely cost of texting can be estimated by data costs.

6.19 As far as we know, neither the Commission nor the incumbents have attempted to estimate SMS costs by reference to data. An SMS is just data. A 160 character SMS consists of just 140 bytes of data.<sup>80</sup> The Vodafone casual rate for data is \$1 per day for up to 10 megabytes.<sup>81</sup> There are 10485760 bytes of data in 10 megabytes.<sup>82</sup> The cost of one byte of data must be no more than 0.0000095c, so the cost of an SMS cannot exceed 0.0013c. Even if we include some additional level of signalling messaging associated with each SMS and assume that total data required per SMS is as high as 1Kb, then the cost of originating and termination cannot exceed 0.01c when compared to data retail prices. The data costs of Vodafone's 2000 text bundle will therefore not exceed \$0.2. Whereas they propose to charge competitors \$190 for 2000 texts in their Voluntary Undertaking and 2degrees [redacted] 2°AP for 2000 texts under the current interconnect agreement.

*Incumbents know we can't match their retail rates (which are orders of magnitude less than what they charge us)*

6.20 In many jurisdictions charging customers far less than you charge competitors would be viewed as prima facie anti-competitive.

6.21 A recent example of where such wholesale/retail price differentials were held to be illegal was in Base's complaint against Proximus.<sup>83</sup> On 26 May 2009 the Belgian Competition Board confirmed Proximus's abuse of its dominant position on the Belgian market and imposed a €66.3 million fine on Proximus.

6.22 The Competition Board held that Proximus had abused its dominant position on the business market to preclude BASE and other competitors from operating in this market over 2004-2005.

6.23 The facts of the case are similar to pricing differentials prevalent in the New Zealand market: Proximus was offering its business customers extremely low rates, well below the costs other operators were required to pay Proximus for calls to those customers.

6.24 Telecom clearly have no qualms about charging excessive MTRs, recently confirming that their rates to customers are much better than they will give us for half (ie termination only) the service:

*"Telecom spokeswoman Rebecca Earl said the headline rate from 2Degrees were lower but Telecom's bundle offers were better, especially with TXT, which could be between 1.2c and 4c per TXT [including GST]."<sup>84</sup>*

6.25 A recent NZX telecommunications equity analyst review<sup>85</sup> comments among other things:

*"View: Given text termination rates, the focus was always going to be on voice ... [.] The 9c per TXT offer ... will appeal to low text users with high use*

<sup>80</sup> SMS costs more than Hubble, 13 May 2008, *The Inquirer*, <http://www.theinquirer.net/inquirer/news/1046303/sms-costs-hubble>.

<sup>81</sup> Vodafone Media Release, *Vodafone launches \$1 a day mobile broadband*, 16 June 2008, <http://www.vodafone.co.nz/about/media-centre/2008-media-releases/mobile-internet.jsp>

<sup>82</sup> <http://www.convertunits.com/from/megabyte/to/byte>.

<sup>83</sup> Press Release of the Belgian Competition Council, *The Competition Council imposes a fine of 66,3 million euros on mobile operator Proximus for abuse of a dominant position*, 26 May 2009, [http://mineco.fgov.be/organization\\_market/competition/press\\_releases/press\\_release\\_26052009\\_en.pdf](http://mineco.fgov.be/organization_market/competition/press_releases/press_release_26052009_en.pdf)

<sup>84</sup> *Kiwis overcharged for mobiles*, 4 August 2009, [www.stuff.co.nz/business/2719927/Kiwis-overcharged-4-mobiles](http://www.stuff.co.nz/business/2719927/Kiwis-overcharged-4-mobiles).

<sup>85</sup> Name available on request.

*texters better off with the incumbents' text bundles. ..., VOD's on-net voice offer of 49cpm when combined with its other offers for texts and Best Mates means that switching patterns maybe dependent on the services individuals use. This could result in some SIM swapping for different services, which would be a negative for 2Degrees given the asymmetric traffic pattern that would result. ...*

**Outlook:** *2Degrees' success and market impact remain heavily dependent on the regulatory process in the near term and the extent of its eventual network build longer term. The on-net offers of the incumbents and their ability to bundle with fixed line and broadband creates a barrier in the business and high user markets. However, this appears an attractive proposition for voice-oriented consumers and will affect market prices."*

#### *Voice and SMS Services are tied*

6.26 There is much talk about "growth in the voice market", but much of that growth is not available to a new entrant if they can't provide competitive SMS. As noted, for many target customers SMS is a "must have" and we cannot access those potential customers as they use SMS bundles and are tied into closed-net calling circles.

6.27 We cannot compete on price for these customers but it is not due to inefficiency on our behalf or a better offering by incumbents. It's because the market is foreclosed and this investigation by the Commission must open it up to real competition so that consumers can benefit from genuine interconnection.

*Our shareholders did not rely on regulation for the business case; they just thought that the 2006 reforms to the Telecommunications Act would actually have an impact*

6.28 Our shareholders invested after the 2006 Mobile Market Review. Both large investors in 2degrees had been watching the New Zealand regulatory environment for over five years. Capital was only deployed after the Mobile Market Review and Telecommunications Amendment Act 2006.

6.29 Incumbents appear to be suggesting that our shareholders should not rely on the regulatory regime.

6.30 That's a bizarre concept. Most of us would like to think we can rely on the law. That is what our shareholders did. Following the 2006 amendments to the Act they took the reasonable view that New Zealand would no longer be the outlier on regulatory matters and that the Commission and the Government would remove artificial entry barriers. They saw the business opportunity and consumer benefit as clearly linked.

6.31 Please see the attached Investor letter from Andy Scott of CVP.

## 7. THE EVIDENCE OF THE DISTORTIONS CAUSED BY CLOSED-NET PRICING IS CLEAR

*Traffic imbalance is principally a function of retail behaviour*

7.1 Vodafone submit that:

*“The Commission has relied upon submissions from 2degrees to support the view that MTM traffic flows between unequal sized networks will be unequal and in favour of the larger network – all other factors being equal.”<sup>86</sup>*

7.2 The incorrect inference that it is the relative size of networks that causes traffic imbalance mischaracterises our earlier submissions.

7.3 The Mobile Challengers (a large group of late entrant European operators) submitted to the Commerce Commission’s Issues paper on this matter last year and showed that Traffic imbalances occurred and net payments were made to incumbents as a result of high MTRs and on-net / off-net retail price differentials.

7.4 We have argued that traffic imbalance is principally a function of retail behaviour - to be attractive to customers a new entrant’s off-net prices must be sufficiently low so as to compete with the incumbents on-net prices. This results in greater outbound traffic from the new-entrant as its subscribers are not deterred from calling off-net by prohibitive rates. The result is to push up outbound traffic relative to the incumbent network, creating a net outflow of termination charges.

7.5 Concept Economics note the “crucial point” that:

*“A smaller carrier must provide benefits that are at least attractive as the offers of its larger rivals, which can mean offering off-net discounts that create the equivalent of the larger carriers’ on-net discounts. This in turn creates call and text imbalances such that the smaller carrier has a net outflow of traffic, and thus makes net outpayments. If termination charges are high, this can have a significant impact on the smaller carrier’s viability. Indeed, as is well-known in the case of network effects, artificial or natural, a possible equilibrium is market monopolisation.”<sup>87</sup>*

7.6 Dr Haucap similarly notes that “if, however, prices differ between networks then the flow of traffic obviously depends on the respective price for off-net calls”<sup>88</sup>

7.7 As Concept Economics, and indeed Dr Haucap, note, that point appears to have been ignored by Vodafone’s experts. Covec simply argued that the traffic was a result of the mix of customers, a conclusion that Concept Economics comments on as follows:

*“Covec expresses the view that market share does not impact on traffic imbalance, but that it is simply the mix of customers each network has that determines net traffic flows. This is incorrect. It ignores that there is a fundamental relationship between price and demand, and the related impact of asymmetric network sizes when on-net pricing is practised. It also ignores the possibility of customer sorting where there are (in this case, artificial) network effects (created by on-net discounting).”<sup>89</sup>*

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<sup>86</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 28.

<sup>87</sup> Concept Economics August Cross-Submission, section 3.1.5.

<sup>88</sup> Dr Haucap Report, para 6.

<sup>89</sup> Concept Economics August Cross-Submission, section 3.1.5.

7.8 But as Concept Economics and Dr Haucap point out this is not economically feasible.

*The Slovenian case study provides clear evidence of the barriers to entry caused by high MTRs and closed-net pricing*

7.9 Vodafone go on to submit:

*“There is no evidence for this view. Call flows will be roughly equal and if they are not in balance then the explanation is the differing customer mixes of the two networks rather than their size.”<sup>90</sup>*

7.10 Again this is incorrect. We refer to the submission by Trilogy International Partners dated 27 July 2009 which sets out clear evidence of the effects of closed-net pricing based on the experience of new-entrant “Vega” in the Slovenian market.

7.11 We summarise the key points from the Trilogy submission below:

- (a) The Slovenian incumbent restricted competition and retained market share by cross-subsidising on-net calls with high off-net call prices.
- (b) For incumbent subscribers on the carrier’s four most popular calling plans, making a peak call to a new entrant customer cost between two and eight times more than a call another customer of the incumbent.
- (c) The large cost differential discouraged Slovenians from signing up with the new entrant as they knew that incumbent subscribers would be reluctant to call them due to the higher cost that would be incurred.
- (d) In a 2004 paper on Slovenian telecommunications reform, faculty at the University of Ljubljana’s School of Economics agreed that the large price difference between on-net and off-net calling was one of the main causes of concentration in the Slovenian mobile services market, explaining that on-net calls were being subsidised by high off-net charges.
- (e) By structuring tariffs to provide a significant on-net / off-net retail price differential, the incumbent both ensured that subscribers on the incumbent’s network did not migrate to other operators and encouraged migration back to the incumbent from the new entrant.
- (f) As customers expected to be able to both make and receive calls, the full utility of mobile service was not enjoyed by customers of the new entrant as calls were no longer received.
- (g) Calling behaviour was evidenced from on-net / off-net call balances with the proportion of minutes sent by new entrant customers to the incumbents exceeded 155% of the traffic returned.
- (h) Not only was there a huge imbalance of mobile termination payments but the total cross network traffic was a tiny proportion of what might be expected in a fully functioning market.
- (i) No regulatory action was taken and as a direct result the new entrant ceased all investment and exited the market.

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<sup>90</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 29.

- 7.12 Trilogy also noted that on-net / off-net retail pricing differentials in New Zealand are far higher than in Slovenia (up to 40 times higher for texting).

*Early evidence of significant traffic imbalance between 2degrees and the incumbents highlights the similarities between New Zealand and Slovenia*

- 7.13 The level of traffic imbalance between 2degrees and the incumbent operators since the launch of 2degrees provides strong evidence of the real and significant risk of the Slovenian experience repeating itself in New Zealand in the absence of regulatory intervention.
- 7.14 The Voice and SMS Traffic Report<sup>91</sup> attached as Appendix A to this submission sets out the traffic flows experienced by 2degrees for the first 8 days after the launch of the network and provides an early indication of a significant traffic imbalance in favour of the incumbents:

**I**

**2°COI**

*Differing customer mixes is no justification for traffic imbalance*

- 7.15 The traffic flow data above also disproves Vodafone's argument that traffic imbalance is caused by differing customer mixes and not retail incentives.
- 7.16 2degrees has launched initially with a pre-pay offering without text bundles, targeting price sensitive voice customers with competitive on-net and off-net voice calling rate. Vodafone claim that price sensitive pre-pay customers receive more calls than they make, submitting that:

*"It is also commonly understood that the consumers who receive more calls than they make are low spend (especially pre-pay) consumers".<sup>92</sup>*

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<sup>91</sup> We note that the SMS Traffic Report is based on information currently to hand for the period 8-12 August 2009 and may not have captured all traffic. The information is currently being reviewed internally and will be updated as and when required.

<sup>92</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 268.

7.17 If it is correct that low spend pre-pay customers are net receivers of calls it would have been expected that 2degrees would have been a net receiver of calls given its low price pre-pay offer. This has not been the case, and the reason is clear - Vodafone's off-net tariffs are structured to deter off-net calling (by making calls to other networks very expensive with the intent of punishing customers of competitor networks), reinforcing the network effect and creating a high barrier to competition for these monopolised "closed-net" customers.

**8. VODAFONE COMPLAIN THAT THEY WILL HAVE LOWER REVENUE DUE TO REDUCED MTRS – THAT SHOULD READ LOWER MONOPOLY PROFITS**

*By definition regulation reduces monopoly profits – it is a consumer welfare test not a Vodafone or Telecom welfare test*

- 8.1 Throughout their submission Vodafone claim that if MTRs are reduced as proposed by the Commission this will result in lost revenue for Vodafone. For example, at paragraph 46 of their submission Vodafone claim that:

*“In total, the changes to MTAS rates proposed by the Commission in its draft report will put at risk over \$300 million in revenue for our business over 5 years.”<sup>93</sup>*

- 8.2 What Vodafone fails to point out is the revenues they are pointing to are in fact monopoly profits funded by users of telecommunications services in New Zealand.

- 8.3 It is important that the Commission remains focused on the purpose statement in the Act, namely “...to promote competition in telecommunications markets for the long-term benefit of end-users...” and not how to ensure a soft-landing for the incumbent operators.

- 8.4 Vodafone’s submissions infer that the incumbents should be protected from efficient competition, and that the effects of lower termination rates on incumbent revenues must be trivial. There is no basis for this submission.

- 8.5 In any event, if one was to accept Vodafone’s arguments, the effects of lower termination charges on incumbent revenues are likely to be trivial in relation to MTM traffic due to Vodafone’s own argument that MTM traffic is close to balanced between the incumbents. On that basis, the only issue would therefore seem to be the extent to which lower FTM MTRs result in a wealth transfer, or more properly a removal of the fixed line subsidy of mobile, in favour of Telecom or other fixed operators. We can not see any reason why these distortions should not be removed and have previously argued for symmetry between FTM and MTM termination rates. (Although any potential concerns about FTM rates must not impede regulation of MTM rates.)

- 8.6 Dr Haucap comments that:

*“It should also be noted that market competition always involves a shift of rents from one market participant to another. If a market is liberalised and incumbent firms have to lower their prices due to competitive restraints rent is transferred to consumers.”<sup>94</sup>*

- 8.7 He goes on to discuss Covec’s comment to this effect:

*“If the Act serves “to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunication services within New Zealand”, as laid out in section 18 of that Act, then it is inevitable that this involves shifting rents.”<sup>95</sup>*

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<sup>93</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 46.

<sup>94</sup> Dr Haucap Report, para 12.

<sup>95</sup> Dr Haucap Report, para 12.

*Vodafone suggest lower MTRs will lead to less investment – this argument has already been rejected by the EC*

- 8.8 Vodafone state that they have invested in the order of \$500 million in their 3G network<sup>96</sup> and suggest that lower MTRs could discourage future investment decisions.<sup>97</sup>
- 8.9 It is important to note that Vodafone's recent investment has been funded by New Zealand consumers out of Vodafone's monopoly profits whereas 2degrees have invested \$250m of new shareholder funds into the build and launch of the 2degrees network.
- 8.10 Vodafone also refer to the consumer benefits which have flowed from their investments. We note these benefits are not immediately evident from the high prices and low utilisation that characterise the New Zealand mobile market and the length of time Telecom was also able to hold on to its old CDMA technology platform.
- 8.11 In any event, it is the efficiency of investments that is the issue, not how to preserve the comfortable life of the incumbent duopoly.
- 8.12 Investment will be undertaken, at least by *competitive firms*, so long as the expected return of the investment exceeds its expected cost. Consequently, reducing returns that well exceed costs, to levels that still exceed costs, will not harm efficient investment incentives.
- 8.13 It is counterintuitive to suggest that increased competition will lead to less investment. Indeed, NERA have argued for Telecom that competition takes place through technology.
- 8.14 The argument that reducing MTRs harms investment incentives has also been made by a number of incumbent operators in Europe and been similarly rejected by the EC, who considers that the reduction of MTRs:
- “...can be expected to lead to enhanced competition and lower retail tariffs across the range of consumers, while still facilitating efficient cost recovery and appropriate investment incentives.”<sup>98</sup>*
- 8.15 The EC also notes that:
- “...the elimination of the fixed-mobile cross-subsidy provides a more balanced framework for important innovations and investments in fixed networks.”<sup>99</sup>*
- 8.16 The same logic applies to the removal of the cross-subsidy between new entrant mobile operators and the incumbents. We refer to paragraph 7.14 which sets out the traffic imbalance between 2degrees and both Vodafone and Telecom since the launch of the 2degrees network.
- 8.17 Removing the ability of incumbent operators to recover significant proportions of their common costs through call termination revenues will lead to operators needing to

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<sup>96</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 15.

<sup>97</sup> Above, para 134.

<sup>98</sup> European Commission, Explanatory Note Accompanying the Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU, p 16.

<sup>99</sup> European Commission, Commission Staff working document accompanying the Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU *Implications for Industry, Competition and Consumers*, p 27.

justify the return on investment for services other than call termination from the benefits provided to customers of those services. This would seem to be an appropriate and fair incentive to provide.

8.18 Concept Economics make the point: *“...reducing excessive profit will have no negative impacts on efficient investment. Investments will be undertaken, at least by competitive firms, so long as their expected return exceeds their costs.”*<sup>100</sup>

8.19 It should also be noted that an efficient operator should be able to recover a significant proportion of any reduced revenue through efficiency gains and the increased utilisation that will flow from greater competition and lower prices.

*Vodafone’s own experts confirm that industry sources in low termination countries did not consider the termination regime to have an adverse impact on investment*

8.20 We note that Vodafone’s own experts, Analysys Mason, conducted a review of the termination regimes in the low MTR countries Canada, Hong Kong, Singapore and the USA commissioned for Ofcom in 2008. Analysys Mason observed, in relation to the impact of low MTRs on investment levels, that:

*“Industry sources with knowledge of proposed termination regime changes in these countries did not consider that the termination regime adopted has had an adverse impact on the ability of mobile operators to invest in their networks.”*<sup>101</sup>

8.21 So Vodafone’s own experts, commenting on four low MTR markets, noted that industry sources in those markets did not consider low MTRs to have an adverse impact on investment.

8.22 Clearly Vodafone’s submissions on this point should be given very little weight, if any.

*Even Vodafone does not appear to be concerned about low MTRs - investing heavily in India in May 2009*

8.23 We also reiterate our earlier submissions on the Draft Report noting that Vodafone is an aggressive investor in India, which has very low termination rates (\$0.00615 / minute) but was still the target of a USD11.2 billion investment by Vodafone in 2009.<sup>102</sup>

8.24 Vodafone’s website notes that it is deploying around 2,600 new base stations each month and it offers average calling rates of US2 cents per minute.<sup>103</sup>

8.25 Further, Vodafone Group CEO Vittorio Colao has reiterated that *“India is by far the country where we have invested the highest amount of money in the world.”* and *“We will continue to invest more as there are opportunities here.”*<sup>104</sup>

8.26 In April 2009, Vodafone Essar in India raised a loan of around US\$2 billion from the State Bank of India to fund its expansion plans, including bidding for 3G licences.<sup>105</sup>

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<sup>100</sup> Concept Economics August Cross-submission, section 4.3.7.

<sup>101</sup> Analysys Mason, *Case studies of mobile termination regimes in Canada, Hong Kong, Singapore and the USA*, 26 November 2008, para 1.4.1.

<sup>102</sup> Vodafone to invest more in India, wants more spectrum, 19 January 2009, <http://www.zeenews.com/business/ice-economy/2009-01-19/499964news.html>.

<sup>103</sup> Vodafone in India, [http://www.vodafone.com/static/cr\\_report09/issues/india.html](http://www.vodafone.com/static/cr_report09/issues/india.html).

<sup>104</sup> Vodafone to invest more in India, wants more spectrum, 19 January 2009, <http://www.zeenews.com/business/ice-economy/2009-01-19/499964news.html>.

- 8.27 Vodafone's willingness to invest in low MTR jurisdictions casts significant doubt on the investment bribes set out in their submission.

*Concept also conclude that MTRs will not undermine efficient investment*

- 8.28 Concept Economics conclude as a matter of principle that "reducing excessive profits will have no negative impact on efficient investment".<sup>106</sup>
- 8.29 Vodafone argues that "large and unexpected swings in mobile termination pricing cause havoc for business plans."<sup>107</sup> Yet these appear to have already been factored into its plans. Vodafone's Annual SEC filing has warned its shareholders of the potential for regulation:

*The New Zealand NRA has initiated an investigation into mobile and SMS termination rates and proposes an immediate reduction from 15.00 cents to 7.00 cents for voice and 9.50 cents to 1.00 cent for SMS. Vodafone has submitted alternative undertakings and the NRA will consult further before making final recommendations to the Minister by the end of 2009.*

- 8.30 Telecom's SEC filing also contains warnings about potential regulatory change.
- 8.31 Given the lengthy delay in implementation of regulations, the incumbents have plenty of time to adjust its business plans. Further the Court of Appeal in *Telecom v Commerce Commission*<sup>108</sup> noted with approval that

*"Harrison J was also unpersuaded by the argument on behalf of Telecom that retrospective price adjustment would undermine the market with uncertainty. He held that submission to all judicial processes, whether originating or on review, carry an element of uncertainty for the participants. They must adjust their affairs to follow a final result. Further, large corporations employ sophisticated financial mechanisms for reserving against adverse contingencies and a large corporation such as Telecom must itself have the ability and capacity to forecast with accuracy the likely price to be fixed by the Commission on a pricing review determination."<sup>109</sup>*

- 8.32 That decision also confirms the Commission's power to backdate the price determined in a pricing review to the date of the initial determination.<sup>110</sup> This is a key factor in the regulatory regime as the incumbents would be able to pursue a backdated price at the FPP stage if this is ultimately determined to be lower than the IPP.
- 8.33 This must be taken into account by the Commission as the risk in terms of harm to competitors and end users of setting an IPP too high, or failing to regulate, is far greater than an IPP that is too low and can be adjusted at FPP stage in any event.

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<sup>105</sup> Vodafone Essar raises Rs 10,000 cr loan, may part-use it for 3G, 17 April 2009, *The Economic Times*, <http://economictimes.indiatimes.com/News/News-By-Industry/Telecom/Vodafone-Essar-raises-Rs-10000cr-loan-may-part-use-it-for-3G/articleshow/4414563.cms>.

<sup>106</sup> Concept Economics August Cross-submission, section 4.3.7.

<sup>107</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 50.

<sup>108</sup> *Telecom v Commerce Commission*, CA75/05, 25 May 2006.

<sup>109</sup> Above, para 29, the Court of Appeal accepted Harrison J's reasons at para 42.

<sup>110</sup> Above, para 44.

## 9. COMPETITION BENEFITS ALL CONSUMERS, INCLUDING LOWER USERS

*Claims that vulnerable consumers will be worse off are simply Vodafone scare tactics*

- 9.1 Vodafone submit that reducing MTRs will harm “vulnerable” pre-pay consumers and that this must be taken into consideration by the Commission.
- 9.2 The alleged harm to prepay users is grossly overstated by Vodafone who state that 71.5% of their customers are pre-pay users but make no effort to specify the number of actual users who could reasonably be considered “low spend” or “vulnerable”. The implication from Vodafone, which is extremely misleading, is that all pre-pay users are in some way “vulnerable”. This is simply not credible.
- 9.3 If Vodafone are saying that more than 70% of their customers are “low use” or “vulnerable” this simply highlights the extent of market failure in New Zealand.

*Lower usage is more likely to be due to higher prices*

- 9.4 For those customers that are genuinely “low-use” the specific circumstances of the New Zealand market must be taken into consideration, namely high retail prices (especially for off-net calling) and the prevalence of SMS as a voice substitute.
- 9.5 As simply illustrated by one blogger on the 2degrees Facebook fan site high voice prices force New Zealand users to conduct conversations by SMS:

*“The one thing I want over everything else is for calling rates to be brought WAY down from what they are currently at on Vodafone and Telecom. I hate having to rely on text messages to have a ‘conversation’ with somebody, so would really love for it to be feasible to call someone and speak for longer than a minute...”<sup>111</sup>*

*Are Vodafone saying that 70% of their customer base is not profitable without high MTR subsidies?*

- 9.6 Similarly, it would also be astounding if Vodafone was in fact saying that more than 70% of its customers were only profitable as a result of the subsidy paid by fixed and other mobile operators through excessive MTRs especially when one considers that so few SMS and voice calls actually incur a MTR fee due to the prevalence of on-net calling. Again this demonstrates the extent of market distortions in New Zealand.

*It is an insult to common sense to suggest that removing the barrier to entry created by high MTRs will be bad for consumers*

- 9.7 It is an insult to common sense to suggest that removing the barrier to entry created by high MTRs will lead to increased retail prices. The opposite will occur. Lower MTRs will lead to greater competition and benefits for all users of telecommunications services in New Zealand.
- 9.8 This is supported by Dr Haucap’s report. He concludes that the key difference between Covec’s report and Concept’s report is that the latter focuses on first order effects, whereas the former concentrates on second order effects. He states that

*“[t]he key difference is that Covec ignores that positive competition effects of lower MTRs due to additional market entry and fiercer competition from*

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<sup>111</sup> Posted by a New Zealand consumer on the 2degrees Facebook Fan-site.

*entrants. I am sceptical that an approach that would allow market foreclosure in order to find optimal tariffs would be superior to an approach which sets a level-playing field in order to let competitive processes work.*"<sup>112</sup>

9.9 Vodafone quote selectively from the Ofcom 2008 Consultation and the associated Analysys Mason November 2008 Report.

9.10 For example, Vodafone refers to comments in the Analysys Mason report relating to penetration levels in the US and Canada, which they state are "significantly lower" than New Zealand but ignore that they are higher in Singapore and Hong Kong than in New Zealand and:

(a) In relation to Canada, the statement by Analysys Mason that:

*"While there was regulatory concern a few years ago about the dearth of prepaid options, the entry of Virgin Mobile....invigorated the sector, and its success prompted incumbent operators – who had previously shown themselves to be reluctant to offer these services – to compete more vigorously".*<sup>113</sup>

It is reasonable to expect that the full scale competition which will be delivered by 2degrees in the absence of high MTRs and closed-net pricing will similarly invigorate the New Zealand mobile market for the benefit of New Zealand consumers.

(b) In relation to affordability in Hong Kong, conveniently not referred to by Vodafone, but enjoying low MTRs and penetration of 126%,<sup>114</sup> Analysys Mason state:

*"...industry sources expressed the opinion that mobile retail prices continue to be much more affected by the vigorous retail competition in the market today."*<sup>115</sup>

Again the greater significance of competition in delivering benefits for consumers is stressed.

(c) Vodafone also fails to refer to the overall conclusion reached by Ofcom (and Analysys Mason) that:

***"[L]ower mobile termination rates are likely to benefit consumers overall (both fixed and mobile) because operators will have greater retail pricing flexibility. We would expect operators to be able to offer consumers a wider variety of retail packages and tariff structures."***<sup>116</sup>  
[Emphasis added]

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<sup>112</sup> Doctor Haucap Report, para 38.

<sup>113</sup> Analysys Mason, *Case studies of mobile termination regimes in Canada, Hong Kong, Singapore and the USA* November 2008, p 16.

<sup>114</sup> Above, p 8.

<sup>115</sup> Above, p 23.

<sup>116</sup> Ofcom, *Wholesale mobile voice call termination: Preliminary consultation on future regulation*, August 2009, p 3.

- (d) In the US, budget conscious customers are sacrificing landlines rather than mobile phones, with analysts estimating that 25% of households in the US rely entirely on mobile phones.<sup>117</sup>
- (e) As Concept Economics point out, arguing that low termination rates limit subscription and usage and harm low income users “*is at odds with the experience of the United States*”.<sup>118</sup> As Concept Economics points out, “...*the proportion of low income households with a telephone has risen more quickly than that for the population generally.*”<sup>119</sup> This can be contrasted markedly with Vodafone’s scare tactics on these issues. It is also inconsistent with the report which Analysys Mason prepared for Ofcom (26 November 2008), discussed above, in which it included on page 9 that “*SIM penetration measures in the USA and Canada are likely to be closer to the actual user penetration levels given the very low incidence of prepaid subscriptions. Additionally very large bundles of minutes and equal pricing from on-net and off-net pricing also minimise the incentive to maintain multiple subscriptions*”. In fact as Concept Economics point out, the majority of homes who relied solely on mobiles were predominantly “low income households” indicating the level of fixed to mobile substitution in the US.<sup>120</sup>

*There is very little evidence on how low-usage customers would react*

- 9.11 In our view, we also consider it more likely that a vulnerable consumer would decide not to acquire mobile services than an existing user would decide to cease receiving the utility of the service in response to a small increase in price. This is particularly relevant in New Zealand where penetration rates are already very high.
- 9.12 In any event, as noted above, we consider it most likely that the increased benefits of competition would deliver greater benefits and result in lower prices and/or force operators to find alternative and more efficient ways of differentiating price that ensure profitable supply to all users groups.

*Waterbed effects are irrelevant in New Zealand*

- 9.13 The incumbents have suggested that the Commission underestimates the waterbed effect in its cost-benefit analysis.
- 9.14 As Professor Cave has pointed out, the waterbed effect rests on the assumption that  
*“competitive pressures in outgoing services are so acute that, in order to break even, operators will have to recover reduced termination revenues dollar for dollar in the outgoing market.”*<sup>121</sup>
- 9.15 In a perfectly competitive market, termination profits received by network operators might be used to subsidize prices for retail customers, and the waterbed effect might become an issue.

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<sup>117</sup> Cutting the cord, *The Economist*, 13 August 2009, [http://www.economist.com/research/articlesBySubject/displayStory.cfm?story\\_id=14214847&subjectID=349005&fsrc=nwl](http://www.economist.com/research/articlesBySubject/displayStory.cfm?story_id=14214847&subjectID=349005&fsrc=nwl).

<sup>118</sup> Concept Economics August Cross-submission, section 4.2.1.

<sup>119</sup> Above, section 4.2.1

<sup>120</sup> Concept Economics August Cross-Submission, section 4.2.1.

<sup>121</sup> Martin Cave, *Regulatory Policy toward Mobile Termination*, July 2004, <http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/Investigations/MobileTerminationRates/ContentFiles/Documents/TelstraClear%20sub%20on%20%20Mobile%20Termination%20Issues%20Paper%20Sub%20%20Annex%201%20-%20Regulatory%20Policy%20Towards%20Mobile.pdf>, p 8.

9.16 However in a duopoly, such as the one that has persisted in New Zealand for many years, it is far more likely that termination rents have largely been retained by the incumbents as monopoly profits. Cave and Valletti have noted that “...if mobile operators kept termination profits for themselves, there would be no impact on mobile retail rates.”<sup>122</sup> The only real impact is on the incumbent’s monopoly profits.

9.17 The EC have also pointed out that:

*“If more affordable calls are introduced for end-users as a result of the change in wholesale pricing, it may be expected that this would also encourage increased usage and take-up by consumers (the extent of any change in consumption would of course depend on the demand elasticity). This may in turn help offset any reduction in incoming termination revenues and help to continue funding marginal subscribers on their networks.*

*Furthermore, in an environment of high penetration, marginal customers may rely increasingly on second-hand handsets and handset subsidies may become less relevant.”*<sup>123</sup>

9.18 Dr Haucap notes that the Covec argument that the waterbed effect increases with penetration costs “...contrasts with empirical research...which has come to the opposite conclusion ...”<sup>124</sup>

9.19 He also notes that the Genakos and Valletti study referred to by Covec is silent on the interrelationship between the waterbed effect and entry and therefore its results “... should be digested with great caution in the specific New Zealand context.”<sup>125</sup> He says that “...most importantly” the study does “not control for any asymmetry between mobile operators which is likely to affect traffic flows.”<sup>126</sup>

9.20 Most importantly, he concludes that if there were a strong waterbed effect (which he does not expect to be the case – see para 30) “... 2degrees customers would be “cross-subsidising” Vodafone and Telecom customers, which would [under current above cost MTRs] be a significant barrier to entry for newcomers and detrimental to competition. The effect would be similar to a licence fee that must be paid to the incumbents to be allowed into a market.”<sup>127</sup>

9.21 He concludes that given Covec’s estimated pass-through rate of 41% suggests that competition and fixed-line telephony is not working properly and notes that if that is the case, “... it should hardly be used as argument to (also) prevent competition in mobile telecommunications markets”.<sup>128</sup>

9.22 Vodafone in the UK ran the waterbed argument ahead of regulation in 2002, arguing that proposed reductions in termination rates meant prices would increase, total call

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<sup>122</sup> Martin Cave and Tommaso Valletti, *Comments on the Commerce Commission’s Draft Report into Regulation of Mobile Termination: Issues of Market Definition, Market Power and the Application of TSLRIC*, 28 November 2004,

<http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/Investigations/MobileTerminationRates/ContentFiles/Documents/TCL%20MT%20Submission%20-%20CaveValletti%20-%20Issues%20of%20market%20definition%20etc%20-%202004%2011%2028%20-%20PUBLIC.pdf>, para 25.

<sup>123</sup> European Commission, Commission Staff working document accompanying the Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU *Implications for Industry, Competition and Consumers*, 7 May 2009, p 41.

<sup>124</sup> Dr Haucap Report, para 26.

<sup>125</sup> Above, para 27.

<sup>126</sup> Above, para 28.

<sup>127</sup> Above, para 31.

<sup>128</sup> Above, para 34.

volumes would fall, prepay handset prices would increase, and 10 to 15 million customers would leave. On the contrary, retail prices have dropped significantly and mobile penetration and total call volumes have continued to increase since 2002.<sup>129</sup> Here in New Zealand, seven years on and Vodafone are regurgitating old scaremongering tactics without substance, evidence or credibility.

9.23 This is reinforced by the ACCC's conclusion in 2004 that:

*"...reductions in the price of the MTAS in Australian (sic) and the UK over the last five years have actually been accompanied by large overall increases in mobile penetration levels."*<sup>130</sup>

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<sup>129</sup> Kevin Russell, Chief Executive Officer, 3 UK, Presentation to the Competition Commission, 11 July 2008, [http://www.three.co.uk/ThreePortal/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobno\\_cache=false&blobtable=MungoBlobs&blobwhere=1223553540251&ssbinary=true](http://www.three.co.uk/ThreePortal/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobno_cache=false&blobtable=MungoBlobs&blobwhere=1223553540251&ssbinary=true)

<sup>130</sup> ACCC, *Final Decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service*, June 2004, p xiii.

## 10. THEY SAY 2DEGREES MAKES MORE MONEY WITHOUT REGULATION

*Vodafone's submission is self serving and incorrect*

- 10.1 Vodafone submits that the failure by the Commission to complete a quantitative analysis of the impacts of regulation on MTM termination means that it is unclear that "...MTM termination rates will have any net impact on interconnection payments between mobile operators..." and that the Commission has failed to "...consider whether 2degrees will actually be better or worse off under the secret deal than it would be under regulation....."<sup>131</sup>
- 10.2 Vodafone go on to calculate based on a series of "plausible assumptions" that 2degrees should expect to be better off under the current interconnect agreement,<sup>132</sup> implying that regulation of MTM is therefore not required.
- 10.3 Vodafone's submission is quite simply wrong and misses the fundamental point that this investigation is not concerned with the level of net termination payments between the incumbents, or between each of the incumbents and a new entrant. In any event, their "plausible assumptions" are wrong, as discussed below.
- 10.4 This investigation is about competition. Only by removing the artificial barriers to entry created by high MTRs and closed-net pricing will the majority of the market be contestable.
- 10.5 Vodafone's logic assumes that 2degrees is happy being a "tame dwarf", competing for small groups of niche customers, making no real impact on the broader market. We are not.
- 10.6 More importantly, it is not in the interests of consumers for the benefits of competition to be limited to only a small section of the market. We reiterate per our earlier submission that the Concept Economics July Report has clearly modelled the net public benefits of MTM regulation. Net termination payments are a diversion and in no way address the broader competition that is desperately needed in the New Zealand market.

*Vodafone's "plausible assumptions" are wrong - traffic will not be in balance*

- 10.7 Vodafone set out their "plausible assumptions" at paragraph 357 of their submission, saying traffic will be symmetrical because 2degrees will acquire customers from Telecom who will continue to make and receive the same number of calls as they did when they were Telecom users.
- 10.8 This argument completely ignores the retail distortions created by the combination of high MTRs and closed-net pricing. We reiterate our earlier submissions which discussed the bifurcation of the New Zealand market and the very low levels of cross-net traffic as a proportion of total traffic volumes in New Zealand.
- 10.9 We also reiterate that early indications of traffic flows since the launch of 2degrees demonstrate Vodafone's assumption of traffic balance is wrong:



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<sup>131</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 70.

<sup>132</sup> Above, para 72.

**12°C01**

**11. INCUMBENT SUBMISSIONS FAIL TO ACKNOWLEDGE THAT NZ LAGS FAR BEHIND THE DEVELOPED WORLD ON REGULATION OF TERMINATION RATES**

*Any delay in regulation benefits incumbents to the detriment of competition and consumers*

- 11.1 The incumbents submit that the case for regulation of mobile termination rates is not made out and continue to seek to game and delay the regulatory process. For example, Vodafone make a number of submissions criticising the Commission's benchmarking and cost benefit-analysis (which we deal with elsewhere in this cross-submission) but has not sought to demonstrate real cost from information which is readily available to it.
- 11.2 This is not surprising as our view is that real cost remains significantly below Commission benchmarks for the reasons set out in our previous submission and the Concept Economics July Report. It is also clearly in the interests of the incumbents to maintain the status quo for as long as possible.
- 11.3 We do not accept that there is any good reason for Vodafone to delay submitting a revised undertaking and are concerned that Vodafone's submission that the Commission must revise its approach and re-issue a further draft report before revised undertakings can be considered is simply directed at achieving further delay to the benefit of the incumbents.

*NZ identified as being out of step with international best practice regulation 10 years ago*

- 11.4 The table below indicates that in 1999 interconnection charges of operators with substantial market power were subject to authorisations in many trading partner countries.<sup>133</sup>

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<sup>133</sup> Source: Final Telco Report, p 16.

### Telecommunications Regulation, 1999

Country	Regulatory institutions	Approval of merger	Interconnection		Regulations	
			Authorisation of charges of operators with significant market power	Dispute resolution	Pricing	Service quality
Australia	Independent regulator Competition authority	X	X	X	X	X
Canada	Independent regulator Competition authority	X X	X	X	X	X
Finland	Independent regulator Competition authority	X	X	X	X	X
Ireland	Independent regulator Competition authority	X	X	X		X
New Zealand	Ministry Competition authority Other	X	no authorisation	X	X	X
United Kingdom	Independent regulator Competition authority	X X	X	X	X	X
United States	Independent regulator Competition authority Other	X X	X	X	X	X

Source: OECD Secretariat

11.5 In 1999, 24 out of the 29 OECD countries had an independent telecommunications regulator,<sup>134</sup> demonstrating the scrutiny that was applied to telecommunications regulation worldwide 10 years ago.

*In 2009 regulation of mobile termination rates is a feature of almost all OECD jurisdictions*

11.6 It is important to put the lack of regulatory intervention in New Zealand into a global context. The table below sets out how woefully inadequate the regulatory position is in New Zealand when compared to other OECD countries. Only New Zealand, Slovakia and Mexico lack regulation of termination rates.

<sup>134</sup> Final Telco Report, p 16.

## Regulation of Termination Rates in OECD Countries

Country	MTAS Regulated? <sup>135</sup>
Australia	Yes
Austria	Yes
Belgium	Yes
Canada	Yes
Czech Republic	Yes
Denmark	Yes
Finland	Yes
France	Yes
Germany	Yes
Greece	Yes
Hungary	Yes
Iceland	Yes
Ireland	Yes
Italy	Yes
Japan	Yes
Korea	Yes
Luxembourg	Yes
Mexico	No
Netherlands	Yes
New Zealand	Regulation currently under consideration
Norway	Yes
Poland	Yes
Portugal	Yes
Slovak Republic	Regulation currently under consideration
Spain	Yes
Sweden	Yes
Switzerland	Yes
Turkey	Yes
United Kingdom	Yes
United States	Yes

- 11.7 In terms of our closest neighbour, Australia, termination rates have been regulated since 1997<sup>136</sup> putting New Zealand years behind in terms of achieving even the first regulatory step of declaring MTAS a designated service under the Telecommunications Act. As discussed in 11.11 below Australia also has specific competition rules, which we do not.
- 11.8 New Zealand is in fact so far behind that a number of countries, and in particular the EU, are, in the interests of competition and consumers, now moving towards lower cost standards which allow for;

<sup>135</sup> OECD Communications Outlook 2009, Table 2.11.

<sup>136</sup> GSM Terminating access services became a declared service in June 1997 and MTAS became a declared service in June 2004. See Domestic GSM terminating access [no longer in operation] <http://www.accc.gov.au/content/index.phtml/itemId/322643> and pages iii-iv and xix of ACCC *Final Decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service*, June 2004.

*“...recovery only of costs which would be avoided if a wholesale call termination service was no longer provided to third parties.”<sup>137</sup>*

11.9 It is appropriate that the Commission take into account the approach of the EU and use the EC recommended LRIC price as a cross-check against Commission benchmarking.

11.10 To do otherwise ignores the fact that termination rates are tumbling globally and the fact that regulators around the world are moving to even lower termination rates in circumstances where New Zealand consumers have still not seen the benefits of declaration of MTRs as a designated service.

#### *Australia has special Telco competition rules*

11.11 It is also worth noting in this context that Australia doesn't just regulate termination fees, Part XIB of the Trade Practices Act 1974 (TPA) also provides the ACCC with additional powers in relation to anti-competitive conduct in telecommunications markets.

11.12 Some key points of relevance are:

(a) The "Competition Rule" established in Section 151AK which provides:

*"(1) A carrier or carriage service provider must not engage in anti-competitive conduct.*

*(2) For the purposes of this Part, the rule set out in subsection (1) is to be known as the competition rule."*

(b) It is an effects test, rather than a test of purpose, and thus generally much easier to demonstrate than s 46 (TPA) misuse of market power claims (ie, s 36 of the Commerce Act). Section 151AJ(2) provides:

*"(2) A carrier or carriage service provider engages in anti-competitive conduct if the carrier or carriage service provider:*

*(a) has a substantial degree of power in a telecommunications market; and*

*(b) either:*

*(i) takes advantage of that power with the effect, or likely effect, of substantially lessening competition in that or in any other telecommunications market; or*

*(ii) takes advantage of that power, and engages in other conduct on one or more occasions, with the combined effect, or likely combined effect, of substantially lessening competition in that or any other telecommunications market.*

*(3) A carrier or carriage service provider engages in anti-competitive conduct if the carrier or carriage service provider:*

*(a) engages in conduct in contravention of ss 45, 45B, 46, 47 or 48; and*

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<sup>137</sup> European Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU, 7 May 2009, para 14.

*(b) the conduct relates to a telecommunications market."*

- (c) The ACCC is given the power to issue Competition Notices. These allow it to seek orders for an upfront fine of AU\$10m + AU\$1m per day that the anti-competitive conduct continues. A major issue in which Competition Notices were used was in relation to ADSL. Wholesale ADSL is not a regulated service in Australia, but the Competition Notice process has been used as *de facto* regulation by the ACCC of wholesale pricing - ie, to ensure retail minus wholesale ADSL pricing via price squeeze tests.<sup>138</sup>

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<sup>138</sup> A source of further info is: ACCC, *Anti-competitive conduct in telecommunications markets – An information paper*, August 1999  
[http://www.accc.gov.au/content/item.phtml?itemId=756884&nodeId=50ef4efc087ad6a0f2c0869d9123097d&fn=Anti-competitive%20conduct%20in%20telco%20markets%20information%20paper%20\(Aug%2099\).pdf](http://www.accc.gov.au/content/item.phtml?itemId=756884&nodeId=50ef4efc087ad6a0f2c0869d9123097d&fn=Anti-competitive%20conduct%20in%20telco%20markets%20information%20paper%20(Aug%2099).pdf).

## 12. A FULL SCALE COST MODEL IS NOT REQUIRED

*Benchmarking's purpose is to provide a reasonable proxy for the cost of the regulated service*

- 12.1 Vodafone appear to be calling for a full cost model to be developed, which ignores the purpose of conducting a benchmarking exercise. They also suggest that cost modelling should be conducted now, and again if regulation is implemented. This is clearly not the intention of the regulatory regime and would unnecessarily delay and frustrate the process and play into the hands of Vodafone whose interest are best served by delay.
- 12.2 As noted by the Commission, the purpose of benchmarking is to establish a *reasonable* approximation of the cost of supplying the regulated service without having to resort to developing a full cost model.<sup>139</sup>
- 12.3 In the context of the current investigation into whether the MTAS should be regulated or not, it is important to stress that benchmarking is not to determine the level of the IPP but instead to (1) consider whether the proposed prices are close to TSLRIC, and (2) help inform the Commission's assessment of the likely price that would be set under the FPP to assist the Commission's welfare analysis.

*Benchmarking is one part of the Commission's analysis*

- 12.4 Above we discussed the fact that the Commission's quantitative analysis, while important, is only one factor in determining whether regulation of MTAS would be in the long term benefit of end users.
- 12.5 The practicalities of what can be achieved by a benchmarking exercise must also be taken into account. There will necessarily be imperfections. However, it is not required, nor is it necessary, to conduct a full cost model or to determine the actual IPP at this stage.
- 12.6 The difficulty in quantifying costs and benefits was noted in the Final Telco Report:
- 12.7 Referring to the CRNEC report commissioned by the inquiry, the Final Telco Report noted that both qualitative and quantitative assessments are key:

*"The dearth of quantification of costs and benefits in otherwise very thorough submissions illustrates that such **quantification is not always possible, particularly in the context of forward-looking regulatory proposals.**"<sup>140</sup>  
[emphasis added]*

*"On the practical issue of undertaking cost-benefit analysis, CRNEC (2000, 5) note:*

*"[i]t is not possible to quantitatively forecast changes in productive or dynamic efficiency. Productive efficiency improvements can be assessed ex post, and current efficiencies can be compared across suppliers, but **only qualitative predictions can be made on the effect that regulation will have on production costs.** Forecasts of the effect of regulation on dynamic efficiency are even less quantifiable. In*

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<sup>139</sup> Draft Report, para 101.

<sup>140</sup> Final Telco Report, p 53.

*both cases, however, carefully designed **regulation is capable of promoting efficiency gains**. Moreover ... the measures proposed in the Inquiry's Final Report will have the **effect of promoting productive and dynamic efficiency**. Our quantifications, which include no contributions from productive or dynamic efficiency changes, are therefore conservative in their estimation of the benefits of regulation.*<sup>141</sup> [emphasis added]

- 12.8 The Final Telco Report also highlighted the importance of the Commission as an expert body, suggesting a potential approach of ranking benchmark countries and the Commission selecting, using its best estimate where New Zealand should properly sit. In our view, there is clear evidence that a true TSLRIC calculation would result in New Zealand sitting at the lower end, if not the lowest end, of the current benchmarks.

*"The Inquiry notes that a benchmarking approach would give a range of prices **that could be ranked from lowest to highest by country or, as in the United States, by operator/state. A judgement would then be required as to where New Zealand should, at any time, fit within the ranking.** The Inquiry recommends that this **judgement be made by the Commissioner on the basis of his/her best estimate of where New Zealand would fall if a full TSLRIC assessment were undertaken.** This is consistent with the earlier expressed view that the initial pricing principle should be a proxy for the pricing principle to be used in the pricing review determination - see page 47. This is to minimise the difference in resultant prices, both to achieve efficient pricing and to reduce the likelihood of a party seeking a pricing review determination.*<sup>142</sup> [emphasis added]

*It is appropriate to benchmark costs*

- 12.9 One of Vodafone's criticisms of the Commission's benchmarks is that the Commission has benchmarked cost estimates rather than prices, submitting that this is inconsistent with the proposed IPP.
- 12.10 As noted by the Commission in the Draft Report, the Commission must form a view as to the likely price of the service that would be set under the factual scenario of regulation and has typically based its view of the likely factual price on benchmarking as a reasonable estimate of the likely cost of the regulated service.<sup>143</sup>
- 12.11 Vodafone's submission ignores the fact that ultimately the cost of the regulated service is determined by the FPP and not the IPP. The IPP is by definition only an initial estimate of likely prices pending calculation of the regulated price under the FPP.
- 12.12 In our view, it is entirely appropriate for the Commission to benchmark against costs. A benchmark against prices will not provide any indication of the likely cost of the regulated service under the FPP.
- 12.13 We also agree with the Commission's preliminary view at paragraph 482 of the Draft Report that it is appropriate to benchmark against cost modelled rather than regulated rates, as allowing for the adjustments that are made on a country and regulator specific basis prevents consideration of the full benefits that would flow from an immediate move to cost based rates. Taking into consideration decisions taken by a

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<sup>141</sup> Final Telco Report, p 53.

<sup>142</sup> Above, p 68.

<sup>143</sup> Draft Report, para 457.

national regulator to impose prices which are above cost maintains current distortions in the market and prevents the Commission from considering the benefits which would flow from the proposed cost-based FPP.

- 12.14 In relation to glide paths, as Concept Economics point out, a comparison of glidepaths with other countries, while having some value, does not address the long-term benefit to end users of telecommunication services. For example, where there has been a lack of competition in New Zealand an immediate move to cost based MTRs may be more appropriate. As Concept Economics point out in Slovenia where the regulator halved the MTR allowing a new network to enter. *“This did not have a negative effect on the market – rather competition flourished.”*<sup>144</sup>

#### *Benchmark countries apply second plus second billing*

- 12.15 One further point the Commission should also take into account in its benchmarking exercise and the setting of any IPP is the worldwide norm of second plus second billing. As we have previously advised the Commission<sup>145</sup>, second plus second billing is the global standard for termination charges (and national roaming).

- 12.16 In our view, the factual, and any IPP, should clearly be based on second plus second billing.

#### *Many countries are now recommending even lower costs*

- 12.17 If the Commission was to take into consideration prices which are regulated above cost it would risk falling further behind other parts of the world, and in particular the EU, which is moving to even lower costs, namely:

*“...recovery only of costs which would be avoided if a wholesale call termination service was no longer provided to third parties.”*<sup>146</sup>

- 12.18 Vodafone’s own experts support a LRIC approach having *“completed more than 60 assignments in the area of mobile LRIC cost modelling”* since 2000,<sup>147</sup> and commenting in their report for the Israel Ministry of Communications that:

*“LRIC is used because it best resembles the actual economic cost that an operator incurs in providing termination in a competitive market and allows the operator to recover the full cost of its network.”*<sup>148</sup>

#### *Concept identify a number of concerns with the Analysys Mason/Covec Reports*

- 12.19 The accompany report by Concept Economics addresses in detail the submissions made by Vodafone in relation to the Commission’s benchmarking.

- 12.20 Concept Economics key conclusions are:

- (a) In relation to cost drivers and comparability (para 4.3.1), based on discussion with 2degree’s Chief Technology Officer (Mike Goss), that *“...there is no reason to suppose that costs in NZ would be high when compared*

<sup>144</sup> Concept Economics August Cross-submission, section 4.3.7.

<sup>145</sup> Please see our further discussion at para 15.6 below

<sup>146</sup> European Commission *Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU*, 7 May 2009, para 14.

<sup>147</sup> Analysys Mason, *Assessment of the position of the Commerce Commission of New Zealand in determining MTAS prices*, 27 July 2009, (**Analysys July Report**), p 3.

<sup>148</sup> Analysys *A Study of Mobile Termination Charges* Report for the Israel Ministry of Communications and Ministry of Finance, 22 July 2004, para 2.1.

*internationally. Further, Mr Goss considered that the hypothesis set out by WIK– Consult that costs in NZ are likely comparable with, or below, those in Australia, was reasonable”*<sup>149</sup>

- (b) When taking the relevant factors into account looking at Norway (as suggested by Covec) Concept Economics point out Norway has significantly greater geographic coverage than New Zealand, their labour costs are likely substantially higher, and the substantially colder climate of Norway (including much larger snowfall levels) indicate that the costs of Norway would be *“likely to be substantially higher than NZ Costs.”*<sup>150</sup>
- (c) While the reasoning and basis for Covec’s suggestions as to additional countries to be included or excluded are not entirely clear, the Covec/Analysys Mason suggestion that France should be excluded on the basis that the modelling was bottom up, but based on historic costs, turns out to be a misleading one. Concept Economics’ understanding is that because the capital stock in France was of very recent vintage, and the cost varied by only 2%, it was reasonable to use historic costs to populate the model.

It is disappointing that this feature, which surely must have been known by Analysys Mason, was not noted by Analysys Mason or Covec in their reports.

- (d) Concept Economics also query why the US, with a TELRIC methodology, which is consistent with the TSLRIC approach in the Act, should be excluded from the benchmarking exercise.

### *Cross Checks*

12.21 We also note that, when discussing the cross checks on the cost estimates, Concept Economics highlight the fact that while Vodafone and its experts may criticise the cross-checks they have not provided the Commission with the data to do the analysis they themselves suggest. That is a curious approach. Furthermore, as noted by Concept Economics, *“[i]n general, it is not rational for a firm to price a service at less than the incremental cost. Therefore, it could be assumed that an upper band of the incremental costs of termination are roughly half the on-net retail price.”*<sup>151</sup>

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<sup>149</sup> Concept Economics August Cross-submission, section 4.3.1.

<sup>150</sup> Above, section 4.3.1.

<sup>151</sup> Above, section 4.3.6.

### 13. SPAM IS A RIDICULOUS BASIS TO SUGGEST HIGH SMS TERMINATION RATES

*A strong deterrent for SMS SPAM already exists in the form of the UEMA*

- 13.1 Vodafone submit that when determining the appropriate price for SMS termination, the Commission should have regard to the fact that “[h]igh termination rates have a very particular advantage over low SMS termination rates in that they discourage SMS spam.”<sup>152</sup> and that reducing the price of SMS termination will “remove a deterrent to SMS spam.”<sup>153</sup>
- 13.2 Vodafone fail to point out that the risk of SMS spam has already been addressed in New Zealand by the Unsolicited Electronic Messages Act 2007 (**UEMA**) which prohibits SMS spam.
- 13.3 The UEMA prohibits commercial electronic messages, including SMS messages, unless the recipient has first consented to receiving the message.<sup>154</sup>
- 13.4 To argue that high MTRs are needed to somehow “protect” consumers from the harms of SPAM lacks substance in the context of the existing UEMA regime.

*Vodafone is contradicted by its own experts*

- 13.5 Further, Vodafone’s own experts, Analysys Mason, have found that spam is not a concern in many BAK jurisdictions. In its report for Ofcom, Analysys Mason found that spam has not been an issue in Singapore and the USA, and regulations against unsolicited electronic messages have dealt with the spam problem in Hong Kong.<sup>155</sup>

*SMS is different*

- 13.6 In any event Vodafone argues that SMS traffic flows are “roughly balanced”, “symmetrical”, with any differences being “trivial”.<sup>156</sup>
- 13.7 Given that argument, the clearly very low cost and significance of SMS to the New Zealand market, it is self evident that SMS should be regulated on a BAK basis. The final Telco Report explicitly anticipated different pricing principles for different services. Clause 4 of Schedule 1 of the Act does as well.

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<sup>152</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 85.

<sup>153</sup> Above, para 411.

<sup>154</sup> Unsolicited Electronic Messages Act 2007, s 9.

<sup>155</sup> Analysys Mason, *Case studies of mobile termination regimes in Canada, Hong Kong, Singapore and the USA*, 26 November 2008, para 141.

<sup>156</sup> cf Vodafone, Submission on Draft Report, 28 July 2009, paragraphs 29, 79, 82, 86 and 88.

#### 14. VODAFONE RELY SELECTIVELY ON THE ANALYSYS MASON JULY REPORT

- 14.1 Vodafone rely extensively in their submission on the accompanying report by Analysys Mason.
- 14.2 The Analysys Mason July Report is a critique of benchmarking rather than a critique of the Commission's approach.
- 14.3 Analysys Mason appear to be saying benchmarking is so unreliable that it should be discarded in favour of conducting a full cost model. This can not be done within the timeframe available to the Commission and is not appropriate at this stage of the New Zealand process. It does not appear that Analysys Mason have been fully briefed on the New Zealand process.
- 14.4 Notwithstanding the title to the report, in fact what comes through from its commentary is that while it is not a fan of benchmarking it is a strong advocate of access prices based on prices determined by their underlying costs. Analysys Mason conclude in the executive summary that "[w]e suggest that the Commission develops a cost Model with the objective of calculating the actual cost of providing mobile termination services in New Zealand." This fails to recognise that benchmarking is a precursor to a cost modelling approach.
- 14.5 Analysys Mason's clear approval of cost-based models (as opposed to inflated prices) can be seen on pages 12 and 13 of its report where it notes concerns about the glide path but in doing so has taken great care (correctly in our view) to include a number of quotes that make it quite clear that all of the regulators concerned are proponents of reductions in charges so that they reflect true cost.
- 14.6 For example Ofcom states that "*reductions should be achieved sufficiently quickly in order to deliver substantial benefits to consumers, including benefits to be derived by addressing possible competitive distortions.*"<sup>157</sup> Similarly ARCEP (France) "*...the Authority estimates that it would be consistent to consider a regulation of mobile termination rates based on incremental costs...*"<sup>158</sup> and the ACCC comments that "*...the Commission believes that a closer association of the price of mobile termination services and its underlying TSLRIC+ of production would generate a number of substantial benefits...*"<sup>159</sup>
- 14.7 All the criticisms that Analysys Mason makes can, at best, essentially be summarised as its desire to turn a benchmarking process into a *de facto* cost determination. (At worst one might assume they were trying to increase the benchmark.) That would be inconsistent with the New Zealand statutory regime and indeed as they note in paragraph 9, that the Commission "*...did not have access in most of the cases to the actual cost models.*"<sup>160</sup>
- 14.8 It is also unclear whether Analysys Mason has in fact reviewed the Commission's Draft Report. For example, they note "[w]e understand that the Commission uses the median value to eliminate the country-specific bias from the set of benchmark observations."<sup>161</sup>
- 14.9 They clearly have a view that any change should not take place quickly which can be the only logical basis for advancing use of the 75<sup>th</sup> percentile. They advance no

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<sup>157</sup> Analysys July Report, p 12.

<sup>158</sup> Above, p 12.

<sup>159</sup> Above, p 13.

<sup>160</sup> Above, p 6.

<sup>161</sup> Analysys July Report, p 6.

rationale nor do they suggest why, picking a higher number in its self is more “prudent” or “efficient”.

- 14.10 It is difficult to see why Hungary, as an ex communist state, likely with very high cost structures, could be added in. It would seem better to include the US. It is unclear why Analysys Mason suggest excluding France given, we understand, that while based on historical cost the model was bottom up and based on a new build so was regarded as close to efficient cost. Nor, apart from showing how the benchmark can be manipulated, do we understand why. Greece (raised by Covec) should be included. Greece would be expected to have unusually high costs, so not a good benchmark, due to the large number of islands in the Aegean and Ionian Seas, which would create challenging coverage and back haul conditions. Oddly, neither Covec nor Analysys Mason pointed to lower rate countries such as the US or Canada which could easily be included in the benchmark set.
- 14.11 Vodafone go to great lengths to highlight criticisms by Analysys Mason but it should be noted that nowhere does Analysys Mason suggest that actual costs in New Zealand are high. The implication is that Analysys Mason considers the numbers to be lower. Indeed, Analysys Mason recognised that the likely outcome of regulated prices in Europe under the new EC recommendations would be lower than those currently in place. *“It is clear that the termination costs calculated according to the new EC recommendation will be lower than those currently calculated according to the applicable costing standards in EU/EEA member states (including the ones used by the Commission in benchmarking.)”*<sup>162</sup>
- 14.12 Analysys Mason says that there was a cost path available for Israel but that cost path is historic. Note also that the MTAS cost (after deduction of the externality charge) is 0.127 ILS which we understand is around NZ 5 cents.<sup>163</sup>
- 14.13 Analysys Mason alleged that the Commission “selectively omits” three countries from its benchmarking. There is no basis given for this comment.<sup>164</sup>
- 14.14 As noted by Analysys Mason at paragraph 34 (and paragraph 36 and 38) “[t]he fundamental difference between the current EC methodology and the one recommended by the EC for future use lies in the definition of the ‘increment’. In fact, under the new EC Recommendation, the ‘increment’ is defined narrowly in a manner that is different from the current de facto practice in EU member states”, **ie everything you are benchmarking against in the EU is going to drop.**
- 14.15 In paragraph 42 Analysys Mason comment that “[g]iven that the objective of regulation is to allow the recovery of the costs incurred by an efficient operator, the Commission should be ready to consider the costs incurred by an operator that transitions efficiently from 2g to 3g.”
- 14.16 We note here that their suggested approach is inconsistent with the Final Telco Report:

*“In the Inquiry’s view, the efficient costs of call origination and call termination are the costs that would be incurred by an operator using the most efficient means at any point in time to provide the service.”*<sup>165</sup>

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<sup>162</sup> Above, para 38.

<sup>163</sup> Above, para 25.

<sup>164</sup> Above, para 30.

<sup>165</sup> Final Telco Report, p 65.

- 14.17 We believe that the incumbents have more than recovered their investments, so even if one accepted the spurious argument they should recover their investment cost from a new entrant (we self-funded the same costs), the argument would not apply.
- 14.18 In fact, if one were to follow the logic put forward by Analysys Mason there is a good case for arguing that Australian costs are as good a basis for a benchmark as any, and in fact as evidenced in the Concept Economics July Report it is thought that the cost in New Zealand would be lower.

## 15. UNDERTAKINGS ARE ABOVE COST AND SHOULD BE REJECTED

*Undertakings need to be so compelling they address all possible harm.*

- 15.1 Telecom has submitted a revised undertaking based on the regulated *price* set in Australia by the ACCC.<sup>166</sup> Vodafone continue to seek to delay the regulatory process by refusing to submit a further revised undertaking until they have been able to review a cost benefit analysis for MTM.<sup>167</sup> We have committed to a revised undertaking based on either BAK (and now including FTM termination) or the prevailing fixed termination rate of 1cpm.
- 15.2 It is telling that Vodafone seek to delay any revised undertaking on the basis the Commission has not modelled MTM benefits but fails to produce any estimate or calculation of their actual costs, despite having all of the information necessary to do so. We believe this is because actual costs are very low, evidenced (among other things) by comparison to prevailing fixed termination rates, retail prices and (for SMS) data prices (see below).
- 15.3 In our view, undertakings need to be so compelling that they clearly address *all* of the potential harms of high MTRs and closed-net pricing. The revised Telecom undertaking and previous undertakings submitted by Vodafone fail to do this as they remain significantly above cost, seek to target the minimum reduction in MTRs required to avoid regulation (a target which we say they miss) and remain sufficiently high to maintain the barrier to entry created by closed-net pricing.
- 15.4 As noted in the Final Telco Report, access obligations, including pricing principles, were intended to:
- “... guide commercial negotiations and be the basis of any determination by the Commissioner if the parties could not reach a commercial agreement and a regulatory backstop was required.”<sup>168</sup>*
- 15.5 The current undertakings evidence the lack of any real incentive on the incumbents to offer their best commercial deal. In our view, it is not until “access obligations” ie classification of MTAS as a designated service, are in place that there will be real incentive on incumbents to offer efficient (cost based) prices.
- 15.6 It is also important to note that the Telecom undertaking, contrary to standard practice around the world, provides for pricing on a minute plus second basis. This approach significantly increases the real price payable and introduces retail distortions and arbitrage opportunities which ultimately harm consumers. We refer to the letter from Mr Bill McCabe to the Commission dated 17 September 2008 addressing a number of these issues.
- 15.7 It is also noteworthy that the Telecom undertaking purports to be based on the approach taken in Australia but ignores the fact that Australia applies second plus second billing. The net affect is that the Telecom undertaking in fact provides for a much higher price than first appears on its face.

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<sup>166</sup> Telecom, Submission on Draft Report, 28 July 2009, para 112.

<sup>167</sup> Vodafone, Submission on Draft Report, 28 July 2009, para 56.

<sup>168</sup> Final Telco Report, p 42.

*The cost of mobile termination cannot be 10 times higher than fixed termination*

- 15.8 Referring to the MTRs prevailing in Europe, Neelie Kroes (European Commissioner for Competition Policy) recently highlighted the disparity between fixed and mobile termination rates:

*“Mobile termination rates are still ten times higher than fixed line termination rates, and four to five times above the cost of providing the connection.*

*Any justification for this, for example in terms of mobile operators having higher costs because of the need to set up the networks, is long gone.”<sup>169</sup>*

- 15.9 The same disparity remains in New Zealand with the prevailing fixed termination rate being 1 cpm and Telecom’s revised undertaking recommending a MTR of 10 cpm commencing 1 January 2011. An undertaking which suggests that the efficient price for mobile termination is 10 times the prevailing rate for fixed termination is clearly significantly above cost and not in the interests of end users.

*Remember that SMS is just data*

- 15.10 We also reiterate our earlier submission that the likely cost of texting can be estimated by reference to data prices. An SMS is just data and when the retail price of terminating data is compared to SMS the cost of originating and terminating an SMS cannot exceed 0.01c.

*The proposed undertakings lock in high rates when MTRs are tumbling globally*

- 15.11 A static approach based purely on the CBA could result in significant harm to New Zealand consumers as it fails to take into account the qualitative assessment by the Commission of the need for regulation.
- 15.12 Undertakings which are acknowledged to be above cost (we note the Telecom undertaking is based on regulated *price* in Australia, which includes a 55% mark-up on modelled *cost*) also run the risk of locking in high rates where MTRs are tumbling around the world. We reiterate that a number of jurisdictions are moving to a basis for determining cost that will result in much lower MTRs.
- 15.13 If the Commission were to recommend acceptance of the current undertakings offered by the incumbents this would exacerbate the already large degree to which New Zealand lags behind other OECD nations.

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<sup>169</sup> Neelie Kroes “Cutting the price of phone calls – new termination rules” Brussels, 7 May 2009.

## 16. THE INCUMBENTS MAKE BASELESS, INAPPROPRIATE CRITICISMS OF THE COMMISSION

### *The Commission's obligation to quantify costs and benefits*

16.1 The incumbents seek to critique the Commission approach by turning a high level benchmarking exercise into a *de facto* access price calculation. Among their critiques is the argument that the Commission has inadequately conducted its welfare analysis.

16.2 Contrary to incumbent suggestions, the Act does not require the Commission to quantify or model the costs and benefits of regulation.

16.3 The authorisation provisions under the Commerce Act explicitly require the Commission to be satisfied before granting an authorisation that an acquisition or practice will likely result in a benefit to the public.

16.4 In contrast, the Act does not require that the benefits of regulation outweigh the detriments. As noted by the Commission in its FTM reconsideration report "*The [Telecommunications] Act does not require the Commission to refuse to recommend regulation if there are no net public benefits.*"<sup>170</sup>

16.5 Richardson J in the Court of Appeal in *Telecom Corp of NZ Ltd v Commerce Commission*<sup>171</sup> stated in relation to Commerce Act authorisations that:

*"... there is in my view a responsibility on a regulatory body to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits."*<sup>172</sup>

16.6 The approach of the Commission in *Qantas/Air NZ*<sup>173</sup> indicated that this does not necessarily require the use of models, such that while models are useful, they do not produce "proof", nor do they supplant the Commission's exercise of judgement.

*"With respect to the use of models, the Commission considers that these are useful to the degree that they focus the parties' attentions on key assumptions regarding characteristics of the market. The Commission's view is that the value of a model is in its ability not to produce 'proof' of a substantial lessening of competition, nor to supplant the Commission's exercise of judgement, but rather in providing support to the Commission's deliberations by:*

- *focusing parties' attentions on verifiable economic arguments;*
- *making transparent the values of the key parameters and assumptions in the analysis; and*
- *producing quantitative estimates of the results of a given transaction or arrangement."*<sup>174</sup>

16.7 The High Court upon appeal in *Air New Zealand v Commerce Commission (No 6)*,<sup>175</sup> referring to Richardson J's comments in *Telecom v Commerce Commission* and stated:

<sup>170</sup> Commerce Commission, *Schedule 3 investigation into regulation of mobile termination Reconsideration Final Report*, para 47.

<sup>171</sup> *Telecom Corp of NZ Ltd v Commerce Commission* [1992] 3 NZLR 429.

<sup>172</sup> Above, 447.

<sup>173</sup> Commerce Commission Final Determination, *Air New Zealand/Qantas*, 23 October 2003.

<sup>174</sup> Decision 511, *Qantas/Air NZ*, 23 October 2003, para 909.

*"The experts also agreed that the judgments on the key issues should draw on a careful examination of the available evidence. This accords with the approach sanctioned by the Courts. In Telecom Corporation of New Zealand Limited v Commerce Commission (supra), Richardson J emphasised the importance in Commerce Act cases of a careful enquiry into the facts. He said at p 446:*

*"But pure speculation as to the impact of constraints and simple intuition are no substitute for hard data drawn from empirical studies and evidence from participants in the industry. In the end the value judgment should be as informed by practical evidence as possible."*

*"It might then seem paradoxical that in this case there was extensive reference to and reliance on experience in overseas markets. However, as the next section of this judgment will show, only in comparatively recent times have airline markets within Australasia been exposed to the winds of competition. And only in the last few years has the low cost carrier business model, exemplified by Virgin Blue, been present in the region. Studies of overseas markets can help to compensate for this lack of experience."<sup>176</sup>*

16.8 Richardson J's statement indicates that the reasoning underpinning the decision must amount to more than "purely intuitive judgment". But contrary to the incumbents' suggestions, a great deal lies between "purely intuitive judgment" at one end of the spectrum and a perfect numerical rendering of costs and benefits at the other.

16.9 Moreover, while such a perfect rendering is doubtless desirable when it can be achieved, nothing is gained by false accuracy. The emphasis should be on reasoned judgment, rather than on the particular form of the reasoning (as the form of the reasoning must be adapted to what is likely to be most helpful to the task of identifying the truth under the relevant circumstances).

16.10 On the cost-benefit analysis generally Dr Haucap comments that:

*"... as a general statement, that the welfare effect of enhanced competition are notoriously difficult to estimate due to the dynamic nature of competition."<sup>177</sup>*

16.11 He states that this is because it is almost impossible to predict business strategies and the innovations they may come up with so that it is:

*"... often considered a good approach for public policy to concentrate on market liberalisation and safeguarding the competitive process. Hence, the focus should be on removing artificial barriers to entry and preventing incumbent firms from erecting strategic barriers to entry as far as possible in order to let the firms compete on a level-playing field without further Government intervention."<sup>178</sup>*

16.12 The High Court in *Vodafone v Telecom*, 18 December 2007, an appeal from a Commission TSO determination, commented on s 18 as follows:

*"[59] The same applies to questions as to regard paid to s 18 purpose. Under s 84(2) (c) the Commission "must consider" the s 18 purpose. Put briefly, the*

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<sup>175</sup> *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347

<sup>176</sup> Above, para 51.

<sup>177</sup> Dr Haucap Report, para 11.

<sup>178</sup> Above, para 11.

*Commission must consider the need to promote competition for long-term benefit of end users; and in doing so must consider the efficiencies which may result from the act in question. **The construction of s 18 is of course a question of law, but whether the Commission did “consider” those matters ultimately is a question of fact. It did or it did not. It cannot be recast as a question of law by asserting “the law requires consideration; the decision reached does not in fact accord with efficiency and promote competition; so there is an error of law”.** Sometimes, of course, there is room to reason back from a decision reached that no consideration was given to a required factor. That can occur when the decision reached **could not possibly have been reached rationally** if the required factor had been considered. It is a doubly difficult argument when the duty (as here) is no more than to consider, as opposed to implement. One can consider, and then bona fide not apply. However, this is not such a case where reasoning back is available. **The decision to proceed on a scorched node basis, and then on a challenger greenfield basis, is a rationally available approach to achieving s 18 efficiency and competition objectives.** There is no available inference from the decision made. Further, there is evidence pointing to actual consideration of s 18 factors by the Commission. I accept that past studies and documentation, and references in cited paragraphs of the determination (particularly paragraph 67) point in that direction. So do the probabilities. **Whether the approach which the Commission took in fact is the one which best serves s 18 purpose is not a question of law, but of fact, and one for the Commission.***

*[60] Again, it does not help to recast the situation as one in which the Commission asked itself the wrong question; failed to answer the question it was required to decide; or was involved in a so-called “tightly defined” requirement as opposed to some broad policy matter. The Commission directed itself to s 5 and s 18 requirements, and reached a decision – based on a view taken of those requirements – as to “net cost”. It asked and answered the right questions. The fact that from one standpoint the answer is said to be wrong does not in itself necessarily imply error in those process requirements. It is at most error of fact within process. The “tightly defined” question is an oversimplification. There may be some components within the s 5 definition of net cost which could be so characterised, although that is debatable given the usual breadth of economic concepts. **Certainly, however, the need to consider promotion of competition within s 18 introduces a considerable breadth into the vision required. This is not a situation requiring application of a formula. It is more a situation which requires the weighing of a number of factors, and the reaching of an overall judgment.***<sup>179</sup> [emphasis added]

16.13 It appears that Vodafone is attempting to fight battles it has already lost.

*Case law states that the Commission is the expert body with broad discretion*

16.14 This proposition is highlighted in the 2007 Vodafone case discussed in 16.12 above.

16.15 There is further ample judicial support for the argument that the Commission is the competent and appropriate body to determine, taking into account both qualitative and

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<sup>179</sup> *Vodafone v Telecom*, High Court, Wellington, McGechan J, 18 December 2007, CIV-2007-485-826, paras 59-60.

quantitative evidence, and exercising its own expert judgement, whether regulation would be in the long term benefit of end users.

16.16 See for example:

(a) *Air NZ v Commerce Commission* (No 6)

*“Predictions of the likely behaviour of firms in a dynamic market at some point in the future typically involve the application of economic theory, previous experience (in the markets or other markets having shared characteristics) and known facts about the structure of the market and the behaviour of competition and potential competitors. Such predictions have often been referred to as ‘value judgments’...They are judgments which the Commission is especially constituted and qualified to make and, if open to the Commission on the evidence before it, are findings with which an appellate Court will be slow to interfere.”*<sup>180</sup>

(b) *Auckland Bulk Gas Users Group v Commerce Commission*

*“It is important in this case to bear in mind that the Commission is a specialist body with wide powers of consultation and, as well, a staff and resources which give it a particular ability to consider, to investigate and to make decisions on the matters which are in issue here. See the decision of the Court of Appeal, delivered by Cooke P, in *Goodman Fielder Ltd v CC* [1987] 2 NZLR 10, at 16:*

*We agree with the Administrative Division that, although that Division included for the purposes of this case expert members, the Commerce Commission has resources, procedures and staff making it the more appropriate body to conduct the investigation. A fortiori this Court should not attempt to do so. So we rule out the possibility of the Court allowing clearance or authorisation of the varied proposal without any examination of and decision on that proposal by the Commission.”*<sup>181</sup>

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<sup>180</sup> (2004) 11 TCLR 347 at para 117.

<sup>181</sup> [1990] 1 NZLR 448 at 459.

**Appendix A – Voice and SMS Traffic Report – 5 August 2009:12 August 2009**

**I**

**J2°COI**