



2degrees - Submission on

Commerce Commission Draft Report on MTAS

28 July 2009

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PART I – OVERVIEW

Termination prices significantly exceed any measure of cost. This means higher retail prices and lower use. Above-cost termination charges coupled with on-net (closed net) pricing massively raises existing barriers to entry. That in turn sustains the present excessively priced duopoly.¹

The incumbents' submissions are driven by the understandable wish to preserve monopoly profits. The incumbents are threatened by the potential reduction of the artificial barriers to entry which *they* have erected. They should focus on competing with new products, services and prices, not foreclosing most of the market.²

We commend the Commission for an excellent draft report, but submit that:

1. **Costs:** True LRIC is a better measure of actual costs incurred. It should be adopted - it is the US standard and is proposed by the European Commission.
2. **Benchmarking:** Greater consideration should be given to the cost estimation process (especially which costs are truly incremental). The Commission's benchmarking of SMS is "way off the mark" – on WIK's analysis the even the Commission's proposed regulated rate is *eight times higher* than benchmarks. This is a material error given the significance of SMS for market entry. It is inconsistent with the Commission's recognition of the harm from above-cost prices.
3. **Pricing principles:** More consideration must be given to the relative harms of above and below-cost wholesale pricing. The report underestimates the likely harm of above cost pricing and does not rigorously examine the harms (if any) of below-cost pricing, which are small, probably trivial.
4. **Form of regulation – Bill and Keep:** The Commission should re-think how the potential forms of regulation may best meet the purpose of the Telecommunications Act 2001. In particular, the efficiency benefits of regulation which can be implemented immediately and at much lower cost (eg BAK, or the same rate as used for fixed termination). Such considerations cast doubt on TSLRIC benchmarking as an Initial Pricing Principle.
5. **Alternative IPP:** Economic efficiency suggests that MTRs should be determined consistently with other termination charges where possible (to prevent inefficient arbitrage, and distortion of calling patterns and intermodal competition). Presently, a zero access charge is applied to traffic between Vodafone's Homezone (served through the mobile network) customers and Telecom's fixed network, while other fixed-to-fixed, as well as mobile-to-fixed, traffic is terminated at TSLRIC-based prices which exclude access network costs. BAK or the prevailing fixed termination rate would be a more efficient Initial Pricing Principle. At the very least, spectrum, base stations towers and other mobile access network costs should not be included in mobile termination charges.

¹ Closed-net discounts appears to benefit consumers, but are best characterised as a penalty (charging more) for non-best mates and off-net calls.

² Already Vodafone raises arguments to challenge the process politically and judicially. That is ironic given that there have been process delays and indulgent timeframes in the undertakings process, all favouring incumbents.

6. **Retail control:** The Commission should seize the opportunity to specify *ex ante* non-discrimination rules, rather than relying on *ex post* Commerce Act action which will inevitably be too late. Without retail controls, closed net pricing will remain an anticompetitive means of restricting the competitive effects of entry, especially when wholesale access charges exceed costs. Retail controls are exactly what Vodafone sought – and obtained – in the Commission’s *Homezone* decision when Vodafone argued that price discrimination “hobbled” competition before it emerged. Applying Vodafone’s exact argument here, but amending the wording for this situation:

“If Telecom [Vodafone] can require callers to Vodafone local numbers [2degrees mobile numbers] to pay higher rates than callers to other local numbers [Vodafone mobile numbers], there could be a significant disincentive to take up Vodafone’s local service [2degrees mobile services]. Hobbling Vodafone’s local service [2degrees mobile service] before it begins is unlikely to promote competition for the long-term benefit of end-users.”³

Without such measures there is a real risk that efficient competitive outcomes will not be achieved.

7. **Undertakings:** A better form of regulation would be BAK for SMS and voice. An alternative would be an IPP for voice at the current fixed termination rate of 1 cpm, adjustable at Final Pricing Principle stage if it could be demonstrated that costs were higher or lower. (SMS should be at cost which is no greater than NZD 0.1¢.) We would offer undertakings on either basis, available to all access seekers and to include FTM.

Irrespective of the approach adopted by the Commission, non-discrimination at retail is required to achieve the purpose of the Act. Vodafone certainly thought so in relation to their Homezone service and the same applies here. Consumers will benefit from appropriate regulation. Conversely, the consumer suffers if efficient infrastructure competition is thwarted.

Now is the time for the Commission to determine the best fix. The Commission’s current proposals, while clearly an improvement, do not go nearly far enough. The focus must be on what best addresses current regulatory and market distortions. This will be achieved by BAK, or in the alternative regulation at a rate reflective of real cost, not further above-cost regulation of MTRs.

³ Vodafone: *Commission decision to investigate local service application*, 4 April 2006 para 43.

PART II – OUR SUBMISSION

1. Introduction

- 1.1 Two Degrees Mobile Limited (**2degrees**) thanks the Commerce Commission (**Commission**) for the commitment and work it has put into the *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 We found the Draft Report and WIK-Consult's (**WIK**) *Review of Submissions by Operators and Reports by Consultants relating to the NZ Commerce Commission's MTAS Investigation*⁴ (**WIK June Report**) especially helpful and agree with much of the reports.
- 1.3 As part of this response we have engaged independent economic consultants Concept Economics (**Concept**) who have prepared the accompanying report *Analysing the Welfare Effects of Mobile Termination Regulation (Concept July Report)*.

High level comments

- 1.4 The Commission is well aware of 2degrees' views on many of the matters covered in the Draft Report and we do not propose repeating our previous detailed submissions. For clarity, we start this submission by briefly noting our key points in relation to the Draft Report.

The essential problem

- 1.5 The Commission has identified a number of barriers to entry and expansion facing efficient infrastructure entry to the New Zealand mobile telecommunications market, as referred to in our letter responding to the Commission's request for revised undertakings (**2degrees May Letter**).⁵

"As noted by the Commission in its Issues Paper:

- (a) *closed network pricing – is "likely to be a disincentive to entry, and reduces a new entrant's ability to acquire customers"*⁶ and *"closed network pricing can be a barrier to entry where termination rates are systematically above costs"*⁷
- We consider that even the benchmarks suggested by the Commission are well above cost, so the problem of closed net pricing does not diminish, especially in the context of network effects, discussed below.*

⁴ 9 June 2009.

⁵ Letter from 2degrees to Dr Mark Berry MTAS – *Commission's Request for Revised Undertakings*, 6 May 2009.

⁶ *Telecommunications Act 2001: Schedule 3 Investigation into Regulation of Mobile Termination Issues Paper*, 8 August 2008, Commerce Commission, para 35.

⁷ Above, para 35.

- (b) *“pocket pricing” – “A potential effect of such strategic price setting is that entry for competitors is discouraged.”*⁸
- (c) *bundling – “Bundling cases are becoming an increasing concern for competition authorities.”*⁹

1.2 Similarly retail issues had been noted earlier in “A Review of Cellular Mobile Market Entry Issues” 10 October 2006, including:

- (d) *exclusive dealership arrangements – where it was noted that that incumbents “may have better access to customers as a result of existing exclusive dealership arrangements”,*¹⁰
- (e) *offering long-term contracts with penalties for early termination – which may discourage entrants.*¹¹
- (f) *bundling;*¹²
- (g) *closed network pricing;*¹³
- (h) *pocket pricing.”*¹⁴

1.6 One of the most significant barriers – and the subject of the current process – is the combination of:

- (a) high mobile access termination rates; and
- (b) low on-net and high off-net (**closed net**) pricing.

1.7 It is commonly acknowledged that these have two effects:

- (a) creating a high bottleneck input price – as noted by the European Commission (**EC**): *“remember that termination rates are ultimately included in everyone’s phone bill”,*¹⁵ and
- (b) foreclosing market access due to the artificial network effect, which *“can reinforce the network effects of larger networks and increase barriers to smaller operators entering and expanding within markets.”*¹⁶ (the well-documented *“tariff-mediated network externality”*, which as the Phoenix Research shows, is enormously strong in New Zealand).¹⁷

⁸ Above, para 35.

⁹ Above, para 36.

¹⁰ Commerce Commission, *A Review of Cellular Mobile Market Entry Issues*, 10 October 2006, para 67.

¹¹ Above, para 41.

¹² Above, para 78.

¹³ Above, paras 69-74.

¹⁴ Above, paras 75-79.

¹⁵ Viviane Reding, *Ending the Fixed-Mobile-Subsidy: the New Commission Recommendation on Termination Rates in the EU*, Brussels, 7 May 2009.

¹⁶ European Commission, *Staff Working Document accompanying the Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU – Explanatory Note*, 7 May 2009, p16.

¹⁷ Phoenix Research, *Measurement of On Net Mobile Traffic Among Students in Auckland and Dunedin: key Findings*, May 2009 <http://www.2degreesmobile.co.nz/nzc-theme/pdf/phoenix-research-may-09.pdf>. Results showed that Vodafone dominates amongst Auckland students, whilst a large

The Commission's suggested "fix"

- 1.8 The Commission has suggested that access pricing should be cost-based and that this should resolve the retail issues.¹⁸
- 1.9 It has accepted the harm of above cost pricing.¹⁹ Less convincingly – and with little (if any) apparent substantiation – it has suggested harm from pricing “below cost”, suggesting this encourages over-consumption. It includes BAK in this categorisation.²⁰

The Commission has not adequately considered BAK

- 1.10 We do not believe that the Commission has adequately considered the advantages and disadvantages of BAK, including the Concept Economics report *Bill and Keep is the Mobile Termination Option Most in the Long-Term Interests of End-Users (Concept December Report)*.²¹ In particular, it should analyse the benefits of BAK on the SMS market given it is extremely low cost and a key platform to market entry.
- 1.11 We agree that, in the absence of material externalities and regulatory transaction costs, access prices should be cost-based, and in particular should reflect long-run incremental costs.
- 1.12 But we consider that the cost benchmarks used by the Commission in the Draft Report still considerably overstate true cost. We consider the true cost to be very low, meaning the likely harm (if any) of pricing below cost would be very small. Conversely, the Commission has not sufficiently accounted for the considerable harm of adopting above-cost charges.
- 1.13 When considering regulation the Commission must take account of the fact that almost all mobile traffic is on-net – the Commission notes, “...*the increasingly prevalent retail on-net plans (which accounted for in excess of 80% MTM minutes and more than 90% of SMS volumes in 2008)*.”²² This means that these 80/90% volumes effectively take place on a BAK basis already. By the same token, any over-recovery of costs increases the amount the new entrant subsidises the incumbent. As noted in para 3.45 below this could amount to a 300% plus mark-up, further increasing barriers to entry.

Retail distortions must be addressed

- 1.14 Nor we do we accept that setting access prices equal to costs resolves considerable concerns about retail conduct. The Commission noted the retail concerns which exist in the Issues Paper.²³ In the present context, the most relevant is on-net/off-net price discrimination.
- 1.15 In order to achieve the regulatory purpose set out in the Telecommunications Act 2001 (**Act**) the Commission must consider the overall regulatory

proportion of Dunedin students are with Telecom. There is virtually no cross network traffic amongst these students.

¹⁸ Draft Report, para 897.

¹⁹ Draft Report, Executive Summary para xiv-xv and paras 225, 307.

²⁰ Draft Report, para 380.

²¹ 22 December 2008.

²² Draft Report, para 817.

²³ Issues Paper, para 35.

framework, including the ineffectiveness of New Zealand's *ex ante* regime in dealing with retail conduct.

- 1.16 The Commission must take into account the fact that delay has high efficiency costs.
- 1.17 It should therefore consider the benefits of setting an IPP which can take immediate effect and include non-discrimination as part of any determination. The latter is essential if the harms caused by closed net pricing are to be addressed fully.
- 1.18 The Commission will note that Vodafone sought, and obtained, in the Commission's *Homezone* determination, a non-discrimination clause for retail pricing arguing that an ability to charge higher retail rates for calling competitor networks "hobbled" competition before it emerged.

The Significance of SMS

- 1.19 The Draft Report does not, in our view, place sufficient weight on the role of SMS as an essential mechanism for market entry. It is not possible to be a full-service provider from day one. Rather, entry begins at the "value-based" end of the market, with the lowest cost service being SMS.
- 1.20 The Commission's proposed benchmarks for SMS remain significantly above cost. The WIK June Report concluded:

"...the Commission set its benchmark at 0.01NZ\$ per message. This figure appears to be very high. In our previous report to the Commission we had pointed out that according to the standard conversion rule the capacity of one minute of voice calling is sufficient to carry 432 messages[.]...the WIK cost models...determined costs for an SMS that ranged between 0.00025€ and 0.00063€ per message which correspond at most to 1/8 of the figure set by the Commission."²⁴

- 1.21 Under our current commercial agreements we pay []2°COI and []2°COI per SMS to Vodafone and Telecom respectively, around []2°COI the WIK benchmark.
- 1.22 Despite these eye-watering mark-ups, the Commission suggests that "*caution is necessary in establishing a benchmark and it is appropriate to benchmark SMS termination using the upper bound observation of the data set*".²⁵
- 1.23 Given (1) the huge disparity between current SMS termination rates and any measure of costs; (2) the importance of SMS to market entry and competition; and (3) the WIK comments regarding the real cost of SMS, it is clearly inappropriate for SMS benchmarks to be at the "upper bound". BAK would be a far more appropriate IPP for SMS.

²⁴ WIK June Report, p7.

²⁵ Draft Report, para 525.

The Commission has underestimated the benefits of regulation

- 1.24 We agree that regulation can have many benefits but stress that termination costs are much lower than the Commission's benchmarks suggest, so the potential benefits are much greater than suggested in the Draft Report.
- 1.25 We also consider that the Commission has significantly understated the harm of delay and underestimated the harm of regulatory gaming.
- 1.26 The Commission has, in our view, also repeated the common error as highlighted by WIK, of over-estimating costs,²⁶ which as the Commission accepts is harmful to efficient competition.
- 1.27 This means that the Commission has not placed sufficient weight on conduct in retail markets (discussed further at section 7 below) – the benefits under the factual could in fact be much greater if these issues are properly addressed.
- 1.28 We consider that the estimated 5% price reduction in mobile markets considerably underestimates the potential benefits that competition would bring at the proposed regulated MTAS prices, although the benefits could be much greater still if the factual prices were set closer to long run incremental cost. *Please refer to the accompanying Concept July Report on this issue.*
- 1.29 As noted by the European Commission:

“Symmetry at the level of truly cost-oriented (efficient) termination rates would reduce the payments of smaller market players, while rendering them capable of offering tariff packages and price plans with off-net prices comparable to that of the on-net charges of larger operators. This would in turn increase their ability to compete and thus encourage competition in the retail mobile markets to the ultimate benefit of consumers.”²⁷

- 1.30 We appreciate that it is difficult to quantify the benefits of regulated market entry, especially when entry is imminent. But as the Commission has noted there is a vast difference between efficient competitive entry and the situation when the new entrant's capacity to vigorously compete is sharply constrained because mobile termination rates and closed net-pricing mean a new entrant will be a large out-payer of termination charges and restricted in its ability to compete for large parts of the market.

The prevailing fixed termination rate would be a more efficient IPP and resolve concerns regarding distortions and arbitrage

- 1.31 We appreciate the concern raised by the Commission and various submitting parties that separate FTM and MTM termination rates could be viewed as creating potential distortions and arbitrage opportunities.

²⁶ WIK June Report, p3. See also section 3 below.

²⁷ European Commission, Staff Working Document, *Implications for Industry, Competition and Consumers*, 7 May 2009, p 25.

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- 1.32 By the same logic the rates for termination of FTM, MTM and mobile to fixed (MTF) calls should be equivalent (although we maintain our view that BAK remains the best solution).²⁸
- 1.33 We consider that the cost of terminating a voice call on a mobile network is comparable to the cost of termination on a fixed PSTN. For that reason we would be prepared to submit revised undertakings which provide for BAK (including FTM), or a termination rate for FTM and MTM voice calls terminating on the 2degrees network of 1.00 cpm, and a termination rate for SMS terminating on the 2degrees network of 0.1 cents per SMS. Both undertakings would be open to all access seekers, include FTM and incorporate the standard access principles set out in the Act. That approach would be consistent with that of the United States (US), which the Commission does not appear to have considered.²⁹
- 1.34 The proposed FTM and MTM termination rate of 1.00 cpm is based on the interconnection terms determined by the Commission in its *Draft Determination on the Application for Pricing Review for Designated Interconnection Services* dated 11 April 2005 and specifically the cost of termination calculated by the Commission on a TSLRIC basis for calls terminating on the fixed PSTN network of each operator. The 1.00 cpm rate does not represent our view as to the long run incremental cost covering the price of call termination, which we consider to be substantially lower than 1 cpm. However, the 1 cpm rate has two advantages: it is a rate previously estimated by the Commission, and it would bring MTM and FTM rates into line with FTF and MTF rates

Structure of the remainder of this submission

- 1.35 The remainder of Part II of this submission develops the key points set out above and follows the broad format of the Draft Report under the following sections:

²⁸ BAK is the optimal solution recognising the reality that we do not know the optimal rate, that finding and fixing that rate will be costly, including causing material ongoing costs due to rent seeking, that the ideal rate is likely very small, and could even be negative, that a non-zero rate imposes some billing costs that would not otherwise be incurred, and hence, BAK is best in these circumstances. Looking to the future, applying BAK could also become another step toward bringing all termination charges toward similar or identical levels. BAK would place MTM and FTM calls on the same footing as traffic between Telecom's fixed network and Vodafone's Home Zone customers, and is less different from FTF and MTF rates than the Commission's proposed MTAS rates.

²⁹ In the US, prices for local call termination are set to recover the total element long run incremental cost (TELRIC) of the equipment used in supplying the service plus a contribution to common cost (see *In the Matter of High-Cost Universal Service Support, Federal-State Joint Board on Universal Service, Lifeline and Link Up; Universal Service Contribution Methodology; Numbering Resource Optimization; Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Developing a Unified Intercarrier Compensation Regime; Intercarrier Compensation for ISP-Bound Traffic IP-Enabled Services* (WC Docket No. 05-337, CC Docket No. 96-45, WC Docket No. 03-109, WC Docket No. 06-122, CC Docket No. 99-200, CC Docket No. 96-98, CC Docket No. 01-92, CC Docket No. 99-68, WC Docket No. 04-36) Order on remand and report and order and further notice of proposed rulemaking, 5 November 2008 (hereafter **FCC, 2008**), paragraph 238, p.A-106). State public utility commission and other estimates of this are substantially less than 1¢ per minute (*ibid*, paragraphs 253 ff (p.A-114 ff), especially paragraphs 254, 257 and 261). In 2001, the Federal Communications Commission (FCC) set a benchmark rate for local calls of 0.07¢ per minute, though carriers could obtain a higher rate if they demonstrated to the relevant state public utility commission a higher rate was necessary to recover the TELRIC of call termination (*Intercarrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98, 99-68, Order on Remand and Report and Order, 16 FCC Rcd 9151, 9171-72). This default rate also applies to FTM and MTF local rates, and again the relevant parties could appeal to the relevant state public utility commission to have the rate raised. Such appeals are rare, suggesting the TELRIC rate is likely to be lower than the default rate.

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- Section 2 – Cost
- Section 3 – Benchmarking
- Section 4 – Pricing Principles
- Section 5 – Form of Regulation - BAK
- Section 6 – Alternative Initial Pricing Principle
- Section 7 – Retail Control
- Section 8 - Undertakings

1.36 Part III of this submission responds to some of the Commission's specific questions set out in the Draft Report to the extent they are not addressed in Part II or the Concept July Report.

2. Cost

Introduction - relevant cost standard

- 2.1 We agree with the Commission's conclusion that "...the basis for calculating costs for access bottleneck services should be forward-looking, long-run incremental costs (FL-LRIC)".³⁰ As noted by WIK, it is acknowledged that FL-LRIC has become the "standard" for cost determination in telecommunications regulatory practice around the world.³¹
- 2.2 However, we are perplexed that the Commission then opts to depart from the position of the EC³² and the Federal Communications Commission (**FCC**), which recognise that no shared costs should be included in FL-LRIC.³³
- 2.3 The Commission's rationale for preferring an approach which allows for an allocation of common costs appears to be based on the definition of TSLRIC included in the Act, and the fact TSLRIC as defined in the Act has been used for other designated access services (as Vodafone's submission pointed out).³⁴
- 2.4 The Act does **not** require TSLRIC as a default and we note that the Commission has in other circumstances chosen not to adopt a TSLRIC approach, most notably for call termination on Vodafone's mobile "Homezone" service.
- 2.5 The Commission notes that to avoid distortions the same pricing principle (but not necessarily the same price) should be used for MTAS as interconnection with a fixed PSTN.³⁵ If common costs were to be included (and we say they should not be) the Commission should take a consistent approach to the treatment of costs associated with the radio access network (**RAN**) as is commonly taken to the treatment of costs associated with the fixed PSTN customer access network (**CAN**) when determining interconnection prices with a fixed PSTN – ie they should be excluded. Under the EC recommended approach:

"...only that proportion of the radio access network costs which would be avoidable if a wholesale termination service were no longer provided would be allocated to the overall mobile termination cost. Further, that portion of spectrum costs driven by the need to increase capacity, above the spectrum necessary to provide retail services to subscribers, for the purposes of carrying wholesale voice call termination traffic for third parties would be included. General business overheads would also only be included to the extent that

³⁰ Draft Report, para 431.

³¹ WIK June Report, p1.

³² EC Staff Working Document, 7 May 2009, p14.

³³ Above, p14, see also FCC, 2008, paragraphs 240 ff, where the FCC discusses the theory of regulatory pricing. Note, however, that pricing at LRIC only does not represent current FCC policy. For example, as previously noted (see footnote 29 above), a TELRIC standard plus a contribution to shared costs is currently applied to termination of local, including FTM and MTF, calls. However, even with a contribution toward shared costs, these rates are generally substantially less than USD1cpm.

³⁴ Draft Report, para 435 and footnote 217; For that reason the Commission states that it has been mindful of this difference and not used the EC estimates as a primary benchmark, but instead as a cross-check.

³⁵ Draft Report, para 427.

*they are driven by the provision of the wholesale termination service. Unavoidable business overhead costs would be excluded.*³⁶

- 2.6 In the remainder of this section 2 we discuss our view that reliance on TSLRIC with an allocation for common costs does not best meet the purpose test in section 18 of the Act.

Our understanding of the Commissions' approach

- 2.7 When considering the best regulatory tool it is important to start by acknowledging that the underlying business at issue is the provision of retail mobile telephony services. Demand for wholesale access is derived from and entirely dependent on retail demand, rather than being part of the core business model. Indeed, Vodafone argued that there were not separate functional markets because *"...providing termination services to other networks (as well as buying termination services from them) is a crucial component in offering a complete retail service."*³⁷
- 2.8 Accordingly, the Commission acknowledged (as does the EC) that prices which recover FL-LRIC are more efficient than prices which recover more than this amount.³⁸
- 2.9 We understand the Commission's analysis to be:
- (a) Absent externalities, efficient prices would reflect the EU and FCC view of FL-LRIC (ie no allocation for common costs), and not TSLRIC as it is defined in the Act.
 - (b) The calling externality would suggest prices that recover less than FL-LRIC, while the network externality would suggest prices that recover more than FL-LRIC.
 - (c) It is not known whether either externality is important, but to the extent both exist in any form, the Commission's view appears to be that one would at least partially offset the other.
- 2.10 It then appears that the Commission concludes that as an interim measure a termination rate benchmarked against countries that make very generous estimates of TSLRIC charges (including shared costs) would be appropriate, and in the long term, a TSLRIC charge (again including shared costs) would best achieve the purpose of the Act. We disagree with this conclusion.

Very few costs are truly "incremental" to termination

- 2.11 If it is correct that externalities do not play a role then the Commission appears to concur with the EC view that prices that are set to recover FL-LRIC are best.
- 2.12 This strongly suggests that if cost-based prices are to be used, then FL-LRIC prices should be used in the interim and even more so in the long run.

³⁶ European Commission: 7 May 2009, p28.

³⁷ Vodafone *Submission on Schedule 3 Investigation into Regulation of Mobile to Mobile Termination Issues Paper*, September 2008, p45, para 7.

³⁸ Draft Report, paras 431-434.

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- 2.13 FL-LRIC charges, and also charges that recover “pure” TSLRIC (ie with no allocation for common costs and recovery of only those costs associated with the incremental service) would likely be very close to zero.
- 2.14 The reason for this is that “...*the incremental costs of call termination are only those costs that can be avoided if the call termination service were no longer provided*”³⁹ and there are very few costs which would only be incurred by a mobile operator if termination were not supplied.
- 2.15 As noted by WIK, the term “incremental” implies that it is the question of costs of a particular service or bundle of services that arise *in addition* to the costs of other services that are provided by the same provider that are relevant.⁴⁰
- 2.16 For example, the costs of spectrum, towers, base stations, backhaul, etc. would all be incurred if a network was built to provide mobile broadband, SMS, MMS, and voice origination.
- 2.17 Conversely, voice traffic sensitive costs, that is, costs that are incurred only if voice traffic is supplied (which technically are shared with call origination and so are not incremental to call termination) are a relatively small fraction of total costs. These costs essentially relate only to switching and arguably some very minor increments on network capacity (since without terminating traffic the network might be dimensioned slightly differently).

Call externalities apply and are material

- 2.18 There is no question that the calling externality, even without on-net calling prices, is real. This was acknowledged, for example, by CRA (now NERA) in support of Telecom’s submissions on TSLRIC pricing methodology.⁴¹
- 2.19 It is self-evident to any mobile phone-user that there is significant value in the ability to receive calls. Indeed, Vodafone’s submission on market definition made this consumer value quite clear.⁴² This is also implicit in Vodafone’s suggestion that 2degrees should favour high termination rates as we will seek to attract “net receivers” of calls. Further, the receiving party pays system (RPP) could only work if there was a call externality.
- 2.20 The result is that to ensure efficient call usage, the LRIC cost of termination may need to be discounted to reflect some of the valuation receiving parties attach to inbound calls. Thus, it is possible that the efficient termination charge would be less than the real, albeit small, cost of termination, and perhaps may even be zero or negative. In contrast, it is at best unclear as to whether there is a network externality that needs to be internalised, but even if this is so, it is entirely implausible that such a network externality could be internalised by an above cost MTM termination charge. Rather, if anything, such a charge would likely make any market failure due to a network externality worse, not better. This is because, by holding up retail prices, high termination charges would reduce the attractiveness of subscription, and hence increase the probability that marginal customers would not purchase service when it would be socially desirable that they do so.

³⁹ European Commission: 7 May 2009, p25. See also FCC, 2008, paras253 ff (p.A-114 ff).

⁴⁰ WIK June Report, p2.

⁴¹ Charles River Associates, *Interconnection Pricing*, 7 June 2002, p11.

⁴² Vodafone: September 2008, p45, para 7.

Network externalities are not relevant in New Zealand

- 2.21 In contrast, if there is any basis for applying the network externality argument to justify above cost mobile termination rates, and that is debatable, then it is for asymmetric rates that favour new entrants only.
- 2.22 To expand, above cost call termination charges could only be justified by the network externality argument if there was any likelihood that efficient mobile network penetration would not emerge without above cost charges.
- 2.23 The network externality argument is usually applied to justify high and asymmetric fixed-to-mobile charges (relative to MTF charges) when mobile networks are being rolled out.⁴³ In particular, it is argued that fixed subscribers gain positive externalities from a larger mobile network, but as these benefits are not reflected in mobile prices, mobile subscription levels are inefficiently low (or take-up is inefficiently slow).
- 2.24 There are reasons to doubt this argument applies in the present case, eg:
- (a) Mobile penetration is already very high in New Zealand, and certainly above a level that requires subsidisation from any network.
 - (b) Even if further subsidies were required (and that case certainly has not been made out) it is hard to see how above cost *mobile-to-mobile* charges could increase mobile penetration.
- 2.25 If, on the one hand, calling patterns were balanced between mobile operators, as would be expected to be the case absent closed net pricing (at least in the presence of an unconstrained new entrant), a lower termination rate would not affect cash flows between mobile networks and hence would not per se provide an income source that a network could use to subsidise entry.
- 2.26 Moreover, lower termination rates would lead to lower calling prices (because the effective marginal cost firms face in providing calls would fall (noting this is so even if they have substantial market power)), so would increase the attraction of mobile telephony.
- 2.27 This would increase subscribership unless lower calling prices led, via the (assumed) waterbed effect, to increased subscription charges.⁴⁴ However, even with a waterbed effect, which is considered by many commentators to have minimal, if any, impact,⁴⁵ it is still not obvious that the net effect would be lower mobile penetration. That is, benefit from lower calling prices could more than offset subscriber losses due to balancing higher subscriptions. Indeed, this arguably would be the case as calling demand is more elastic than subscription demand, especially for those who already have a mobile phone.

⁴³ Peitz, M (2005) "Asymmetric access price regulation in telecommunications markets" *European Economic Review* 49 (2), pp341-358.

⁴⁴ That is, while net transfers between carriers would approximate zero with and without lower termination charges, retail calling revenues would fall and if total revenues previously had reflected efficient costs, then carriers would have to adjust other prices, for example, by raising subscription charges, to maintain cost-recovery.

⁴⁵ See, Cave, M. and T. 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*, November 2004.

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- 2.28 Further, even if penetration were to fall, this does not establish the resulting levels would be inefficiently low due to a failure to internalise the calling externality. The default presumption must be, if lower penetration were to emerge, that lower penetration was efficient now that prices more accurately reflect costs.
- 2.29 Finally, and most importantly, as a matter of fact lower penetration is entirely implausible. International experience, as illustrated in the welfare analysis presented in the Concept July Report, strongly suggests a third entrant lowers prices and costs, and increases service quality, variety and (not surprisingly) *penetration*.
- 2.30 If, on the other hand, calls between mobile networks were unbalanced, as would most likely arise due to current closed net pricing (especially in the presence of a new entrant), then above cost mobile termination charges merely reduce 2degrees' capacity to compete effectively and expand the market. That is, above cost mobile termination charges would *prevent* 2degrees from *increasing* penetration.
- 2.31 Thus, if anything, the network externality argument is one in favour of asymmetric termination charges that favour a new entrant (as this would improve the new entrant's capacity to enter the market and compete vigorously with the incumbents and as a result expand mobile penetration).

Conclusion

- 2.32 The consequences of the preceding points are clear. First best efficient call charges would reflect FL-LRIC, and such charges would likely be very close to zero as very few costs are incremental to termination.
- 2.33 While there may be a calling externality basis for lowering mobile termination rates below these levels, it is very difficult to argue that the network externality argument, if it applies at all to New Zealand's high level of mobile penetration, could justify above cost mobile-to-mobile rates, unless they asymmetrically favoured a new entrant.
- 2.34 If the network externality argument for asymmetric rates is put aside, the outcome is that efficiency calls for symmetric and very low mobile termination charges intended to recover FL-LRIC or less than this.
- 2.35 This, in turn, suggests BAK would be a good alternative mechanism, especially looking to the long term, where other interconnection charges can also be reformed. As a result, interim rates ought to be set to recover no more than FL-LRIC, and possibly to zero (BAK), while the Commission could recommend either FL-LRIC or BAK as a long term solution.

3. Benchmarking

Overview

- 3.1 We agree with the statement that “[i]f the benchmarked prices are inflated above the cost of supplying the MTAS in other jurisdictions, the results are unlikely to be informative as to the likely costs of supplying the MTAS in New Zealand.”⁴⁶
- 3.2 We also agree with the Commission’s preliminary view on forward-looking cost-based rates that “... it is appropriate to benchmark against cost modelled rather than regulated rates, as allowing for the adjustments that occur in regulated rates would not fully identify the benefits that would flow from an immediate movement to cost-based rates and would create or preserve distortions in the market.”⁴⁷
- 3.3 But:
- (a) In our view, the Commission’s approach to benchmarking SMS is flawed and massively overstates costs.
 - (b) Even if we adopt the benchmark TSLRIC rates for voice used by the Commission, the benchmarked countries include costs as incremental which are not incremental, and also allow for over-allocation of shared costs.
 - (c) Therefore using those benchmarks repeats other countries’ errors and skews the benchmark rates upward.
 - (d) The Commission’s approach should reflect current developments, namely:
 - (i) The European Commission’s requirement that LRIC should be used and how it should be applied; and
 - (ii) The fact that local call prices in the US, which are based on TELRIC plus a contribution to common costs, are generally less than USD0.1cmp,

rather than using as benchmarks countries which purportedly, but do not actually, apply LRIC (as discussed below in this section 3).
 - (e) By our calculation, based on the WIK model prepared for the ACCC, the proper LRIC benchmark is no greater than NZD 1.24 cpm and is likely lower.
- 3.4 Even then there is bias upwards in the Commission’s approach to benchmarking, including the countries chosen, the averaging process, and the approach taken to cost reductions over time.
- 3.5 In this section we discuss:
- (a) The upward bias in the Commission’s benchmarking analysis;

⁴⁶ Draft Report, para 470.

⁴⁷ Above, para 482.

- (b) The WIK June Report;
- (c) An analysis of the outputs of international TSLRIC models demonstrating significant over allocation of common costs;
- (d) The absence of harm in a number of excluded countries where significantly lower termination rates are applied.

Commission benchmarks are biased upwards

3.6 We consider that the Commission has generally done a good, careful job of benchmarking voice costs, but the analysis of SMS is flawed in our view. We believe that the voice selection is biased towards countries which apply an unjustified interpretation of LRIC (as discussed in section 2 above), leading to an overestimation of voice termination costs.

Voice

3.7 In our view, the Commission must scrutinise more closely the way in which LRIC has been applied internationally. In particular:

- (a) Many of the international cost models – including those benchmarked - do not produce a true estimate of LRIC. This is because, amongst other things, they count a substantial amount of shared costs as being incremental.
- (b) For example, in the WIK model prepared for the ACCC around 60-65% of the network costs are base station costs which should be categorised as shared costs, and not incremental to the provision of termination. In particular, base stations are broadly necessary investments if call origination, on-net call termination, mobile broadband, SMS and MMS origination are to be provided.
- (c) As the EC noted in its Recommendation, LRIC should only include traffic-sensitive costs associated with the provision of termination to third parties, the position also adopted by the FCC.⁴⁸
- (d) As a related point, the calculation of fixed termination rates generally excludes costs associated with the CAN, but the mobile equivalent - the RAN - is included in international cost estimates of mobile termination. This creates a great disparity between fixed and mobile rates and leads to distortions, suggesting that a consistent approach should be taken across both technology types.⁴⁹

3.8 The above points are important for two aspects of the current process:

- (a) In the specification of the relevant final pricing principle: The EC has taken the view that it is important to clearly define how LRIC should be calculated. The Commission should do the same for clarity to reduce the uncertainty about what rate a LRIC methodology is likely to result in.

⁴⁸ European Commission: 7 May 2009, para 14. On the US see footnote 33 above.

⁴⁹ Strictly, in New Zealand fixed rates were set by commercial negotiation, but prior to those commercial agreement the Commission had issued a draft determination that for fixed termination charges that specified that CAN costs be excluded which came to this conclusion.

- (b) In the context of benchmarking: It is important for the Commission to recognise that the international benchmarking cost estimates it has derived include substantial allocations of shared costs and as such overestimate LRIC (and the TSLRIC that underlay fixed termination charges).⁵⁰

SMS

- 3.9 The Commission's international benchmarking of SMS termination rates suffers from a number of serious problems.
- 3.10 Firstly, and most obviously, it is not apparent why the Commission adopts the upper bound of the international range, rather than the average, median (which would be the same as the average in this case) or lower bound. The Commission seems to be implying that erring on the side of higher rates (which is described as "*caution*"⁵¹) is somehow less risky or more efficient, but as discussed below that is clearly not the case. The economic costs of overpricing are likely to be greater than those associated with underpricing and hence there is no justification for the Commission opting for the upper bound of the international benchmark range for SMS termination rates.
- 3.11 The Commission may wish to consider the possibility that the small sample size obtained may reflect costs so low as to not be worth modelling.
- 3.12 By choosing the upper bound, the Commission is also implicitly assuming that only Israel is an appropriate benchmark and Malaysia should be ignored, thus reducing its sample size to 1. Yet in its introduction to the benchmarking of SMS termination, the Commission notes that both Israel and Malaysia are comparable countries and appropriate for benchmarking.⁵² If it were to follow its method of benchmarking voice termination rates and take into account both benchmark countries (not just the one with the higher rate), the Commission would take the median (0.56 cents) as a starting point (ie for the 2009 year).
- 3.13 Additionally, as with the voice benchmarking (discussed below), the cost path assumed by the Commission does not properly account for the likely movement in costs over time. Consistent with our views on voice cost paths, we consider it more likely that there will be significant cost reductions in the early years after entry, followed by more gradual reductions (15% reductions in the first two years, 10% reductions in 2012 and 2013 and 5% reductions thereafter).
- 3.14 Finally, it is worth noting that the Commission's SMS termination benchmarks are now quite dated (2004 and 2005) and it is likely that costs may have fallen significantly due to technological progress and because volumes have increased over the past 5 years. In our view this should also be taken into account by the benchmarking.

⁵⁰ The comments in section 3.7 demonstrate why an undertaking from 2degrees at the fixed PSTN rate of 1c rate is consistent with LRIC and therefore efficient. See our discussion of the proposed undertaking at section 8.

⁵¹ Draft Report, para 525.

⁵² Above, para 518.

WIK Consult report – general comments

- 3.15 The benchmarking process undertaken by the Commission in the Draft Report appears to be directed toward minimising regulatory change and softening the impact of reduced MTRs on the incumbent operators.
- 3.16 It must be remembered that the incumbents currently enjoy *monopoly rents* and will of course seek to maintain or delay the status quo at the expense of competition and the end users who are the ultimate funders of the current duopoly. The Commission should not, in our view, be concerned with whether the necessary regulatory change delivers a “soft landing” for incumbents and instead should be focused on the outcomes which will achieve vigorous competition and the purpose of the Act.
- 3.17 For example, the Commission appears to have chosen rates which move toward more efficient levels, but by as little as economic reasoning could justifiably allow. The proposed general benchmarking approach also self-evidently overstates costs as evidenced in this section 3 below.
- 3.18 2degrees considers that such an approach will fail to deliver the full potential efficiency benefits that are available to the New Zealand economy, and would fail to meet the goals of the Act. 2degrees, and indeed any entrant, faces enormous entry barriers that are unrelated to the efficiency of entry even without closed-net pricing and high mobile termination charges. Consequently, it is not the quiet luxury of the incumbents’ position that needs to be protected, but the process by which efficient competition can unfold.
- 3.19 The Draft Report makes it clear that it will make a number of “*conservative*” assumptions, with conservative invariably meaning “higher”.
- 3.20 Similarly, the Commission have stated that: *“The use of benchmarking to determine an initial price for the regulated service avoids the direct costs that would be incurred if the Commission were to develop its own cost model in respect of mobile termination services. Such costs, which were referred to in 2degrees’ submission (see paragraph 74, Appendix 3), would only be actually incurred in the event that parties requested a pricing review.”*⁵³
- 3.21 The implication that the Commission does not expect to get to cost modelling concerns us, particularly given benchmarked rates are well above cost. Yet the incumbents self-evidently benefit from delay,⁵⁴ so have no incentive to settle at any level other than above cost.
- 3.22 The conservative approach and upward bias of the Commission’s approach to benchmarking was highlighted by WIK.⁵⁵
- 3.23 We agree with many of the conclusions of the WIK June Report, which having outlined general observations relating to the application of FL-LRIC highlighted that in practice the standard is often mis-applied by regulatory authorities, stating:

⁵³ Above, para 413.

⁵⁴ The delay in regulatory intervention of interconnection in the Turkish mobile market is cited as one of the main reasons why the two entrant operators failed to survive as independent entities. See Atiyas and Dogan, (2006), “When Good Intentions Are Not Enough: Sequential Entry and Competition in the Turkish Mobile Industry”, *Telecommunications Policy*, 31, Issue 8-9, 502-523.

⁵⁵ WIK June Report.

“If we now turn to the practice of FL-LRIC implementation by regulatory authorities we note that the above principles are not generally strictly adhered to. The following is a list with examples of deviations both as regards results and the very process of the corresponding modelling exercises:

- (1) On the assumption that there is competition on the retail level, costs of operators’ current volumes are determined. It is generally neglected that this competition is of an oligopolistic nature with prices that tend to be still substantially above cost so that volumes are lower than they would be if there were vigorous competition typical for a market with many providers, which in turn implies higher cost.*
- (2) Costs of individual existing operators are used.*
- (3) Costs are determined that they are not those derived for a network according to the most efficient technology.*
- (4) Costs are used that were derived from the so-called top-down costing approach which is based on the cost accounting records of existing operators. This approach is usually not as flexible as bottom-up cost modelling although it is also capable of generating credible results. Since, however, these data are largely under the control of the operators and given the latter’s interest, there is always the risk that inefficiencies and other factors that tend to inflate costs are not identified and compensated for.*
- (5) There is too intensive an interaction between regulatory authority and the operators in the process of cost determination with the risk of allowing operators too large an influence on the result.”⁵⁶*

3.24 WIK goes on to state that *“...there is strong evidence that regulatory authorities have often to too large an extent allowed that these factors influence cost determination with an effect of an upward bias”⁵⁷* and while not agreeing in full with the EC approach, refers to the vigorous reaction, of the EC (which recommends a “pure” LRIC approach to this state of affairs).⁵⁸

3.25 WIK goes on to consider the application of the FL-LRIC standard by the Commission in its benchmarking exercise and highlights the very important point that:

“At least a substantial number of the results on which it is based suffer from the deficiencies noted in our discussion above. All correspond to volumes of service that were realised in oligopolistically structured

⁵⁶ Above, pp2-3.

⁵⁷ Above, p3.

⁵⁸ Note that WIK refers to the comments of the EC that *“...the absolute level for mobile termination rates remains high in a number of Member States compared to those applied in a number of countries outside of the European Union, and also compared to fixed termination rates generally, thus continuing to translate into high, albeit decreasing, prices for end-consumers”*. See European Commission: 7 May 2009.

*markets with retail prices still relatively high and therefore these volumes being still low relative to what they would be in an effectively competitive market. As we have discussed, this translates into lower economies of scale and therefore higher cost. In the case of at least four countries, i.e. the UK, the Netherlands, Norway and Denmark, the modelling exercises were carried out in close cooperation with the regulated operators implying the tendency of an upward bias in the calculated cost.*⁵⁹

- 3.26 The upward bias of the Commission's benchmarking is further highlighted, WIK noting "...the overall bias of this interaction tends to be upwards and **never downwards**"⁶⁰ [emphasis added] concluding that given "...the tendency toward upward biases, the Commission may have been well advised not to use the median value from the range of cost figures surveyed but, say, an average value from the three lowest figures."⁶¹
- 3.27 In our view it is clear from both the points raised by WIK regarding the mis-application of FL-LRIC by benchmark countries and the conservative approach by the Commission to matters such as estimated cost reductions that the Commission benchmarking overstates cost. We reiterate our earlier submissions that, if anything, there is strong argument for termination rates which are below cost (due to the calling externality) whereas corresponding arguments for above cost rates are weak.
- 3.28 We therefore submit that if the Commission is minded to proceed with an IPP based on international benchmarking that it critically reviews the benchmark process which has been undertaken to remove the current upward bias.

WIK Consult approach – revised benchmark rates (voice)

- 3.29 As discussed above, a more appropriate approach to benchmarking and estimated cost reductions would be to take into account both the WIK recommendation and the *actual* cost-paths observed in countries such as Sweden and Denmark.
- 3.30 Approximating the cost-path as a 10% reduction per annum does not properly account for the likely impact of entry in New Zealand and the potential path of costs over the next 5-10 years.
- 3.31 As observed in Sweden, it seems more likely that costs will come down significantly over the next 2-3 years and more gradually thereafter. Thus we propose that the cost-path incorporate 15% reductions over the next two years (in line with the Swedish case), 10% reductions in 2012 and 2013 and 5% reductions thereafter.
- 3.32 Applying this to the nine benchmark countries used by the Commission, we obtain the following results (note in countries where 2008 rates are used by the Commission, a 15% reduction is applied in 2009).

⁵⁹ WIK June Report, pp 6-7.

⁶⁰ *Assuming that regulatory authorities are committed to objectively and have no agenda of actually setting prices below costs, assuming thus that their cost modelling is done in this objective way, errors and mistakes in the modelling discovered later on should also occasionally go in the downward directions. But they actually always never do.* Above p7, Footnote 3.

⁶¹ Above p7.

Table 1: Cost paths in the benchmark countries (NZ cents)

	2008	2009	2010	2011	2012	2013	2014	2015
Australia		6.54	5.56	4.73	4.25	3.83	3.64	3.45
Denmark		11.77	10.00	8.50	7.65	6.89	6.54	6.22
France	4.83	4.11	3.49	2.97	2.67	2.40	2.28	2.17
Israel		7.16	6.09	5.17	4.66	4.19	3.98	3.78
Malaysia	5.23	4.45	3.78	3.21	2.89	2.60	2.47	2.35
Netherlands	10.44	8.87	7.54	6.41	5.77	5.19	4.93	4.69
Norway	9.53	8.10	6.89	5.85	5.27	4.74	4.50	4.28
Sweden	6.96	5.92	5.03	4.27	3.85	3.46	3.29	3.12
UK		12.52	10.64	9.05	8.14	7.33	6.96	6.61

- 3.33 To obtain the benchmark rate, the Commission has proposed taking the median of the individual country rates for each year. However as noted above, we do not consider this approach to be appropriate in light of the likely impact of entry by a third operator in New Zealand. In this respect we agree with the conclusions of the WIK June Report. Thus we have taken the average of the three lowest countries' (France, Malaysia and Sweden) rates to obtain a benchmark rate for each year. In the table below this is compared with the median of the above rates and with the Commission's proposed benchmarks.

Table 2: Benchmark rates under alternative approaches (NZ cents)

	2009	2010	2011	2012	2013	2014	2015
Bottom 3 Average	4.82	4.10	3.48	3.14	2.82	2.68	2.55
Median	7.16	6.09	5.17	4.66	4.19	3.98	3.78
NZCC	7.20	6.50	5.80	5.20	4.70	4.30	3.80

- 3.34 Taking the median of the rates in Table 1 for each year, we obtain a very similar end point to the Commission. However, under this approach rates are reduced more rapidly in the early years, a path that we believe will more closely mimic costs. In our view, however, the median is not appropriate and instead the recommendations of the WIK June Report should be followed and the average of the 3 lowest benchmark rates should be used. This would imply a benchmark rate of 4.1 cents in 2010, falling to 2.55 cents in 2015.

Benchmarking and cost allocation

- 3.35 When using the outputs of international TSLRIC models to determine an appropriate mobile termination charge, it is crucial that the Commission examine whether the contributions to shared/common costs included in those models are reasonable in the NZ context, and to adjust those contributions where necessary.
- 3.36 In this context, it is important to recognise that many of the TSLRIC costs models include very large implicit contributions to shared network costs (that is, in addition to the explicit mark-up for non-network shared costs – ie, overheads). In fact, those models may be better characterised as fully allocated cost (**FAC**) models because they fully allocate shared network costs.

More specifically, the models include in the LRIC calculation network infrastructure which is shared between many services other than termination. WIK describes this approach, which it refers to as a “single traffic increment modelling approach” in the following way:

“A single traffic increment modelling approach does not identify any fixed common costs. These costs, if any, are directly allocated to network elements. The unit costs of the network elements then include all network costs. In this way there are no fixed or common costs that remain at the network level which have to be allocated according to an EPMU or a Ramsey-Boiteux approach.”⁶²

3.37 One particularly large shared cost source is base stations. WIK finds in its analysis of cost drivers that base stations costs account for:

- 91.2% of total costs for a small densely populated country;
- 63.1% of total costs for a medium sized densely populated country; and
- 72.4% of total costs for a large sparsely populated country.⁶³

3.38 WIK also notes that experience suggests the range is generally 60% to 70%. For Australia, the country WIK identifies as having costs that are likely to be most similar to NZ, WIK’s modelling finds 63.4% of annual network costs are accounted for by base station costs.

No harm is evident from countries with significantly low rates

3.39 As discussed in section 4 below there are a number of countries with lower termination rates whose exclusion does not appear to be explained solely by the identified cost drivers. We are not aware of harm arising in these countries as a result of low termination rates.⁶⁴

3.40 It is also important to highlight that in countries such as the US where the stricter (ie more correct) interpretation of LRIC has been applied, cost estimates are dramatically lower.

⁶² WIK-Consult, *Mobile Termination Cost Model for Australia*, January 2007, p14.

⁶³ WIK-Consult, *Cost-Driver Sensitivity Analysis*, 22 December 2008, p11.

⁶⁴ Draft Report, para 466. The Commission noted that according to the sensitivities conducted by WIK-Consult, the most important cost drivers included equipment and facilities prices; volumes of calls and SMS; quality of service; spectrum band; and cost of capital.

Table 3: WIK Australian TSLRIC costs for an operator with 31% market share

Network element	Annual costs (A\$ million)	Proportion of TSLRIC (%)
		(%)
Base Stations	321.5	63.4
BSC	42.6	8.4
MSC (incl. SP, CP and TRAU)	17.2	3.4
HLR	7.9	1.6
SMSC	1.3	0.3
Radio links BTS-BTS hub	26.3	5.2
Radio links BTS hub-BSC	19.5	3.8
Leased lines BTS hub-BSC -	-	0.0
Leased lines BSC-MSC	32.4	6.4
Leased lines MSC-MSC	38.1	7.5
Total annual network costs	506.8	100.0
Common organisational level costs	56.2	
Total cost	563.0	

Source: WIK-Consult (January 2007), Mobile Termination Cost Model for Australia, Table 6-7

- 3.41 Other network costs included in the table above that are very much shared costs, and would not be incremental with respect to the mobile termination service are Base Station Controllers (**BSC**) the Home Location Register (**HLR**), the Mobile Switching Centre (**MSC**) and the Short Message Service Centre (**SMSC**). Together these elements account for approximately 77% of the total network cost, and 69% of the total costs (network plus common organisational costs).
- 3.42 The remainder of the network costs in the WIK Australia model relate to Radio Links and Leased Lines. These costs total \$116.3m which is 21% of the total costs. *This implies that the unit cost is around 1.09 Australian cents (1.24 NZ cents) of the total 5.3 Australian cents (6.02 NZ cents) TSLRIC.*
- 3.43 In our view this is still very much an overestimate of the true LRIC of mobile termination because the impact of terminating traffic on the dimensioning of radio links and leased lines would be very small. This would be even more so for NZ networks because, as market research carried out by Phoenix Research indicates, on-net traffic volumes far outweigh off-net and so mobile termination traffic volumes likely play little role in network dimensioning. This suggests that the true LRIC of mobile termination in New Zealand is likely to be close to zero cents per minute.
- 3.44 WIK itself also concludes that costs in Australia would likely be higher than New Zealand due to different cost drivers.⁶⁵
- 3.45 Even taking this very conservative LRIC estimate of 1.24 NZ cents (derived from the WIK Australian model), shows that the effective mark-up for common costs (network plus organisational) included in the Australian WIK model is in excess of 300%. *The question that then arises is whether 300% is a reasonable and appropriate common cost mark-up.* In our view this is completely excessive, unjustifiable, inconsistent with the methodology applied for fixed termination, and will serve to maintain the major retail pricing distortion and entry barriers that are currently present in NZ's mobile market.

⁶⁵ WIK June 2009 Report, p10.

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- 3.46 In general, economic efficiency principles show that individual services should cover their incremental costs and in sum revenues across all services must cover total costs. For on-net calling, the absence of retail price regulation means that operators themselves are able to determine the amount of common costs that will be recovered by the termination service that they implicitly supply to themselves (ie termination of on-net calls). Low on-net pricing offers by the incumbents indicate that for on-net traffic they seek to recover very low levels of common costs.
- 3.47 Including any non-trivial amount of common costs in the mobile termination rate will: (1) distort common cost recovery patterns; and (2) impose an asymmetric burden of common cost contribution on an entrant, given that it will have a much higher proportion of off-net traffic than incumbents. For example, consider the case where an incumbent has 70% of on-net voice traffic, whereas an entrant has only 20%. In this case, 80% of the entrant's voice minute will be providing (using for example, the Australian costs) a mandatory 300% or more mark-up contribution over incremental termination costs to the incumbent, whereas this is only the case for 20% of the incumbent's traffic. This asymmetric imposition will serve to increase barriers to entry, by making it extremely hard for the entrant to compete.
- 3.48 Consider, in contrast, the case where a zero or small common cost mark-up is applied to the LRIC when determining the mobile termination charge. There are four key outcomes:
- (a) Because the termination rate is set at or close to the LRIC of supplying termination, there should be no concerns about an inefficient overuse of termination occurring (ie because the price is effectively signalling cost of provision).
 - (b) Recovery of total costs will still be achieved – ie there is no reason to believe that setting the price of mobile termination at true LRIC will prevent mobile networks from recovering their costs.
 - (c) The barrier to entry associated with asymmetric common cost recovery is removed.
 - (d) The allocation of common costs across retail services can be determined by competitive forces, resulting in pricing and cost allocation that is more efficient and in the interests of end users.
- 3.49 As the Commission is aware, our view that a rate based on true LRIC being appropriate is not a unique one. Close to such an approach has been applied by the FCC in the US for many years and is the basis of the recent recommendation made by the European Commission. We also stress that it is essential that such an approach be taken in NZ as part of a regulatory environment that will foster sustained efficient entry. The fact that overseas regulators in markets with 3, 4 or 5 established players have chosen to fully allocate network costs does not mean it is reasonable, efficient, or in the long-term interests of consumers to do so in NZ.

4. Pricing principles

- 4.1 The first point is that the Commission cannot determine actual FL-LRIC with 100% accuracy. No one can. Further, regulators generally acknowledge that all past estimates have been too high, in many cases far too high. We believe that trend (ie rapid reductions in termination rates) will continue. We also consider that:
- (a) The cost (harm) of setting the price too high is very great.
 - (b) The cost (harm) of setting the price too low is very low (and no harm from doing so has been demonstrated by the Commission). As a related point, if the Commission accepts that termination costs are low, it follows that the margin of error is much lower too.
 - (c) There is no network effect basis for increasing prices above costs (unless it is to provide 2degrees with asymmetrically high mobile termination rates).
 - (d) Conversely there are very good reasons to reduce the MTAS price to recover less than FL-LRIC due to the calling externality.
- 4.2 When determining an IPP, given that it should be for a short term until the FPP (eg estimated LRIC) is applied, and given the costs of getting this wrong (at its worst preventing competition or inhibiting it severely), then it is clearly better to err on the side of being below cost rather than above cost. Any harm to incumbents would be short term as well as small, whereas the harm to the competitive process under the converse would be high.
- 4.3 Given the imperfections of the regulatory environment discussed above, the clear harm of pricing above cost and the default regulatory stance of erring above cost, it seems self-evident that prices should, if anything, be below cost. As noted, pricing above cost is commonly regarded as raising retail prices and exacerbating the incentives for closed net pricing.
- 4.4 On the other hand the Commission has only indicated that pricing below cost could be inefficient. It has provided no evidence of harm. That's because there is no real harm.
- 4.5 In this regard we note:
- (a) Fixed line wholesale termination rates are currently in the order of 1cpm, yet there is no evidence that mobile network operators are encouraging calls to fixed lines in preference to on-net calls (which they suggest costs them 15cpm to terminate).
 - (b) A number of jurisdictions have very low termination rates and/or BAK and we are not aware of any evidence of "harm", indeed these markets are characterised generally by vibrant, dynamic competition. For example:

Table 4 – Selected termination rates

Jurisdiction	Rate per minute	Approx rate in NZ cpm ⁶⁶	RPP/CPP
Austria ⁶⁷	€2.01cpm by June 2011	4.4	CPP
Bahrain ⁶⁸	0.0073 BHD	3.0	CPP
Bangladesh ⁶⁹	0.40 BDT	0.89	-
Canada ⁷⁰	BAK unless net traffic imbalance		RPP
China ⁷¹	0.06 yuan (as at 2003)	1.3	RPP
Cyprus ⁷²	€2cpm	4.4	CPP
Hong Kong ⁷³	BAK	0	RPP
India ⁷⁴	0.20 INR	0.6	CPP
South Korea ⁷⁵	31.80 KRW	3.9	CPP
Kuwait ⁷⁶	0.006 KWD	3.2	-
Nepal ⁷⁷	54 paisa	1.1	-
Pakistan ⁷⁸	0.9 PKR by January 2010	1.6	CPP
Singapore ⁷⁹	BAK	0	RPP
Thailand ⁸⁰	0.69 THB	3.1	CPP
USA ⁸¹	BAK	0	RRP

- (c) Of the countries listed above, mobile telephony operates on a CPP basis in at least five countries (we are unclear of the system for those countries with no annotations) with no obvious efficiency problems that might arise if such rates were set at inefficiently high rates. Further, while the preceding table focuses on mobile termination rates, at least two jurisdictions have BAK or low interconnection charges for CPP calls on their fixed networks. In the US fixed local calls are terminated at extremely low levels (roughly USD0.07cpm) while even long distance calls are largely terminated at rates that average around USD 0.75cpm. To our knowledge, neither has any efficiency problems that could remotely be attributed to rates that are set to inefficiently low levels. In fact, the FCC (see FCC, 2008, paragraphs 2 ff) has been

⁶⁶ Using exchange rate from xe.com as at 20 July 2009.

⁶⁷ Austrian Regulator Adopts Final Schedule for Mobile Termination Rates that Flattens the Gliding Path, 17 June 2009, <http://www.telekomaustria.com/presse/news/en/0617-termination-rates.php>.

⁶⁸ ictQatar Interconnection and Access Dispute between Vodafone Qatar QSC and Qatar Telecom (Qtel) QSC) 10 February 2009, para 53.

⁶⁹ <http://www.telenor.com/en/investor-relations/company-facts/business-description/grameenphone>

⁷⁰ Analysys Mason, *Case Studies of Mobile Termination Regimes in Canada, Hong Kong, Singapore and the USA* 26 November 2008, p11.

⁷¹ China sets flat mobile phone interconnection fee, 13 November 2003,

<http://www.chinatechnews.com/2003/11/13/120-china-sets-flat-mobile-phone-interconnection-fee/>.

⁷² European Commission, *Lower charges, greater consistency, more competition: Commission consults on bringing down mobile phone tariffs in Europe*, IP/08/1016, 26 June 2008.

⁷³ Office of the Telecommunications Authority, De-regulation of Fixed-Mobile Interconnection Charge to take effect on 27 April 2009, http://www.ofa.gov.hk/en/press_rel/2009/Apr_2009_r3.html 26 April 2009.

⁷⁴ The Telecommunication Interconnection Usage Charges (Tenth Amendment) Regulations, 2009(2 of 2009).

⁷⁵ Commerce Commission, *Comments on undertakings received in relation to the MTAS Investigation*, 25 March 2009, p12.

⁷⁶ See, ictQatar Interconnection and Access Dispute between Vodafone Qatar QSC and Qatar Telecom (Qtel) QSC) 10 February 2009, para 53, where the Kuwaiti termination rates are referenced.

⁷⁷ Nepal Telecommunications Authority, Interconnection Guideline 2065, 9 January 2009.

⁷⁸ Telenor Pakistan Business Description <http://www.telenor.com/en/investor-relations/company-facts/business-description/telenor-pakistan/>

⁷⁹ Analysys Mason *Case Studies of Mobile Termination Regimes in Canada, Hong Kong, Singapore and the USA* 26 November 2008, p24.

⁸⁰ <http://www.itu.int/ituweblogs/treg/Thailand+CAT+Slashes+Proposed+Interconnection+Rates.aspx>

⁸¹ Above, p31.

seeking for close to a decade to lower, rather than raise, existing interconnection rates.

- (d) It is noteworthy that Vodafone is an aggressive investor in many of these markets. According to Vodafone it invested £5.9 billion in 2009 “...including [£]1.4 billion in India to drive growth”.⁸² In addition to its investment, India’s very low termination rates likely helped Vodafone add an additional 24.6 million⁸³ customers in India in the year ended 31 March 2009 - undoubtedly Indian consumers are benefiting from a market characterised by high investment and low termination rates. In the US Vodafone “...remain[s] committed to [its] investment in Verison Wireless” in what it describes as an “...important and attractive market” despite BAK.⁸⁴
- (e) We understand that Vodafone has around 300M customers worldwide, of which around 95M are in India and (on a proportionate basis) around 39M in the US. So, over *one third* of its customers are in BAK or low termination price jurisdictions.
- (f) It is equally noteworthy that Vodafone has sought zero termination rates in Qatar⁸⁵ (and as discussed below, BAK here in NZ, which means that in some situations Telecom already pays Vodafone zero to terminate on its mobile network).
- (g) The default position in the USA is a far better benchmark, and makes it quite clear that the US regulator, the FCC, considers the costs of termination on both fixed and mobile networks to be very low.

⁸² *Vodafone Annual Report For the year ended 31 March 2009*, Chief Executive’s Review, see www.vodafone.com

⁸³ Above.

⁸⁴ *Vodafone Annual Report For the year ended 31 March 2008*, Chief Executive’s Review, see www.vodafone.com

⁸⁵ *ictQatar Interconnection and Access Dispute between Vodafone Qatar QSC and Qatar Telecom (Qtel) QSC* 10 February 2009, para 8.

5. Bill and Keep (BAK)

Overview

- 5.1 We were pleased to see BAK contemplated as an IPP/FPP in the proposed form of regulation. We were, however, disappointed at the lack of *detailed* analysis in the Draft Report on the merits or otherwise of using BAK as the relevant pricing principle (including a lack of detailed discussion of the Concept December Report).
- 5.2 We submit:
- (a) That the termination costs are not materially different to zero, particularly for SMS.
 - (b) Even if we were wrong, that is not a sufficient reason to dismiss BAK.
 - (c) There is no demonstrable harm from BAK, in fact the reverse is true.
 - (d) There is “real world” support for our position.
 - (e) There is “real world” adoption of BAK domestically and abroad.
 - (f) Our arguments have been accepted by the Commission and advocated by the incumbents and their experts.

Introduction

- 5.3 We do not consider that it is appropriate to so summarily dismiss a pricing principle which is widely used both domestically and abroad, and in fact has been used for mobile telephony interconnection in New Zealand, including for Homezone arrangements, which utilise Vodafone’s mobile network.
- 5.4 It appears that BAK has been dismissed as a pricing principle because it has been viewed as “*below cost*”. With respect that is, in our view, flawed analysis. Even following that logic, it is premature to reject BAK in this way until the appropriate pricing principle has been determined and applied. Until that time, the Commission should assess the merits of BAK, with a particular focus on the s18 purpose.
- 5.5 In fact, if the Commission does not to take its “one chance” to regulate retail conduct, it must adopt a pricing principle which mitigates the very high level of harm flowing from New Zealand’s extraordinarily high proportion of discounted on-net pricing. Its choice of pricing principle must take account of the imperfections of our regulatory regime (discussed in section 7 below), so that regulation actually delivers the outcomes anticipated by the s18 purpose.
- 5.6 Contrary to the Commission’s apparent view, even setting termination charges at cost (assuming this can be done) will not stop on-net / off-net pricing differentials. Given network size and switching barriers, even a small distinction in relative on-net/off-net differentials will ensure that most of the market remains foreclosed. In fact, the current market is best characterised by a series of discrete monopolies owned by one or the other of the incumbents as the Phoenix research makes clear. The limited level of porting demonstrates the limited level of switching between networks. In any event,

even accepting the materially below cost argument (which we do not), BAK still has demonstrable net benefits.

5.7 Below we expand on some of these points and discuss how:

- (a) Vodafone and Telecom and their experts CRA/ NERA and Covec have argued for BAK;
- (b) the Commission has accepted these arguments;
- (c) BAK is used internationally;
- (d) BAK is used in many commercial arrangements;
- (e) The Commission should not worry about *how* this might impact retail plans.

BAK is not materially below cost

5.8 As noted we do not consider that BAK is materially below cost and in our view when the cost-benefit analysis is applied BAK comes out as the most effective option for regulation in New Zealand.

5.9 We believe that if LRIC is adopted as in the US, and proposed in the EU, then the gap between the LRIC “cost” and BAK is a very small one. We appreciate that at this stage the Commission has a different perspective, but we consider that it has, for now at least, adopted the wrong cost standard and/or applied benchmarks which skew the numbers upwards.

Harm not identified

5.10 But even if we are not correct, ie even assuming that BAK was “below cost” in a material way, the Commission has failed to identify any “harm” from this because there is none.

5.11 It has simply asserted that this would be “inefficient” (and alluded to concerns about a move to RPP). With respect, in light of our comments about the inability to determine true cost and the significant ongoing harm of closed net pricing, this warrants a far more detailed analysis.

5.12 The Commission has, in our view, also taken the wrong approach to the “default” position. Following on from our submissions above that the Commission has failed to point to any real theory of harm or evidence that this is likely; we note that even if the cost is materially above zero, then this could in fact be recovered at the retail level.

5.13 We do not consider it correct that BAK necessarily leads to a RPP system. Indeed even an RPP system based on BAK can evolve so that there are no direct charges to receive calls.⁸⁶ As noted by Littlechild: *“Some mobile operators in RPP countries are now offering customers the options of plans with free incoming calls. Changing to a ‘bill and keep’ regime would avoid the*

⁸⁶ For example, in the US Nextel/Sprint nationally, US Cellular in Midwest, Cellular South in southeast and in Canada Fido/Rogers and Telus Mobility and all 3 mobile operators in Singapore have offered free incoming calls despite BAK, see http://www.encore.nl/documents/Hague22Apr08_Littlechild_def.ppt

*bottleneck monopoly and associated distortions of conventional CPP regimes, yet enable operators and customers themselves to chose how to pay for calls...*⁸⁷

- 5.14 He notes that: “A ‘bill and keep’ regime has traditionally led to RPP. However it is also consistent with free incoming calls as have emerged in several RPP countries.”⁸⁸ In any case, near zero and zero local fixed call termination rates respectively in the US and Canada have in no way led to RPP for fixed calls.
- 5.15 But in any event, we do not consider that the Commission should worry about *how* this might impact retail plans, as its focus should be on competition to drive efficiency, not whether or not retail plans might change.
- 5.16 Its job is to regulate to facilitate competition, not dictate how that competition might manifest itself.

BAK is a feature of many dynamic markets

- 5.17 It appears that the Commission discussion commencing at paragraph 410 of the Draft Report includes a number of misconceptions regarding BAK.
- 5.18 For the avoidance of doubt, we consider that BAK means zero rate termination. It is not dependent on traffic volumes. Regimes that simply “net-off” termination charges are not BAK. We believe that a balance of traffic should emerge under BAK because it allows operators to compete on retail price to an efficient level. Given that that BAK should not be confused with “netting”, we do not consider that BAK within a range of +/- 10% is true BAK, or an appropriate option.
- 5.19 Further, the comments relating to the risk of “hot potato routing” are ill-founded. As noted we do not consider the cost of mobile termination to be material. However, to the extent costs could be avoided by transferring traffic to a terminating mobile operator at the earliest possible point, incentives to do so exist *irrespective of the access price methodology*. Such incentives are not specific to BAK. Indeed, Ofcom rejected concerns regarding this issue as noted by the Commission’s own summary.⁸⁹
- 5.20 We have previously submitted on the jurisdictions which have adopted BAK regimes and noted that these are characterised by dynamic and vigorous competition. The same can be said for other low MTR regimes.
- 5.21 As noted, Vodafone has in fact made significant investments in a number of these jurisdictions suggesting that it is not overly concerned about those costs.
- 5.22 Further, Vodafone has argued for a “zero” access price in Qatar:

*“On 23 November 2008, Vodafone...reiterated its request for ictQATAR to set interconnection service charges at zero.”*⁹⁰

⁸⁷ *Mobile termination charges: Calling Party Pays versus Receiving Party Pays*, SC Littlechild, Telecommunications Policy 30 (2006) 242-277, abstract.

⁸⁸ Above, p242, (section 4.5); he then comments on optional free incoming calls in North America and free incoming calls in Asian RPP countries (sections 4.6-4.7).

⁸⁹ Draft Report, para 416.

⁹⁰ ictQatar *Interconnection and Access Dispute between Vodafone Qatar QSC and Qatar Telecom (Qtel) QSC* 10 February 2009

- 5.23 As noted in our discussion on the lack of harm and pricing below cost in the present situation, we reiterate that this is not a situation of infrastructure investment where adequate returns are required in order to ensure continued investment. In this case the adequate returns (which in the New Zealand market are far more than adequate) are, and should be, obtained through the retail markets.
- 5.24 Putting those submissions aside, if indeed it was possible to encourage calling onto another player's network (ie by encouraging some form of subscriber who is a net call originator, which we do not understand), then it seems to us that this option would be equally available to all networks.

The role of traffic symmetry

- 5.25 The actual level of the interconnect price would be irrelevant if traffic is symmetrical, as Vodafone has previously indicated should be the case.
- 5.26 Given that Vodafone has stated that traffic is generally balanced, the introduction of BAK should not change the net flow of payments between networks and hence this should not impact on investor returns. That lays bare Vodafone's real concern, that entry by a third player will reduce retail prices, because it will increase competition. That would harm Vodafone if it was earning monopoly rents, or was inefficient or both.
- 5.27 In fact traffic is unlikely to be symmetrical because of the retail price distortions. It is those distortions which affect competition and even if one were to accept that the termination cost was material (which we do not), incumbents should not be further rewarded for this distortion.
- 5.28 It is for this reason that it is often argued that retail price discrimination should be regulated. See for example, Stenneck and Tangerås.⁹¹

BAK has a number of supporters both domestically and abroad

- 5.29 Telecom's experts, CRA, stated during the TelstraClear Determination⁹² that "[w]e have demonstrated that many of the costs that the Commission have associated with [BAK] pricing are without foundation, and that the efficiency benefits of adopting [BAK] pricing are larger than the Commission had recognised."⁹³ We entirely agree with this sentiment. Those submissions are discussed below, together with Vodafone's and the Commission's past comments.

[http://www.ict.gov.qa/files/images/Determination_on_Interconnection_Charges_bw_Voda_and_QTel_10_Feb_2009_\(Non_Confidential_Version\).pdf](http://www.ict.gov.qa/files/images/Determination_on_Interconnection_Charges_bw_Voda_and_QTel_10_Feb_2009_(Non_Confidential_Version).pdf), para 8.

⁹¹ Johan Stenneck & Thomas P. Tangerås, *Intense Network Competition*, October 20, 2008, Working Paper #08-36, Net Institute, www.NETinst.org.

⁹² Commerce Commission: Final Determination on the application for determination for 'Interconnection with Telecom's fixed PSTN', 28 September 2006.

⁹³ Charles River Associates' *Final Report, Comments on the Draft Access Determination: Interconnection Pricing*, 9 September 2002 para 49, p15.

New Zealand precedent

- 5.30 The Commission's dismissal of BAK is particularly perplexing when there is NZ precedent including:
- (a) in the *Homezone*⁹⁴ context, as sought and obtained by Vodafone;
 - (b) Telecom/TelstraClear for Fixed line & Local calls, as sought and obtained by Telecom via agreement with TelstraClear;⁹⁵
 - (c) Telecom/Vodafone for MMS traffic;
 - (d) Telecom/Vodafone for MTM calls; and
 - (e) Vodafone/"Another fixed carrier", apparently for Fixed Line calls.
- 5.31 Further, among other things BAK is already employed by Vodafone (and Telecom) for its on-net calls. Vodafone does not receive a terminating fee for calls that are made from one of their customers to another person on its network and they recover the full cost from the originating customer – even though these calls are often charged at heavily discounted rates.

An international precedent - interconnection agreements

- 5.32 International roaming agreements facilitate inbound SMS termination on the Vodafone, Telecom and 2degrees networks. 2degrees has over 150 agreements with overseas operators which facilitate SMS traffic between both sets of customers. All of these agreements, without exception, charge for SMS termination on a BAK basis.
- 5.33 2degrees understands that both Vodafone and Telecom have in the region of 220 countries / territories where international roaming agreements are in place. Each country may include multiple operators. If these agreements are based on standard GSM arrangements then they will also facilitate SMS termination services and like 2degrees the vast majority of these agreements, if not all, will charge for SMS termination on a BAK basis.
- 5.34 This means that the only operator in the world which will pay the SMS termination rates which are the subject of the MTAS investigation will be the local mobile operators (ie direct local competitors, 2degrees, Telecom and Vodafone NZ).
- 5.35 2degrees therefore considers interconnection arrangements (in the form of roaming agreements) with overseas mobile operators to be relevant as they clearly go to both the real cost of SMS and the appropriate pricing principle. 2degrees considers the Commission should at least seek confirmation from Vodafone and Telecom what proportion of their international agreements with foreign mobile operators provide for termination of SMS on a BAK basis as described above.
- 5.36 BAK is not limited in its application. These varied examples illustrate BAK's versatility and have been endorsed by the incumbents as an efficient means

⁹⁴ Commerce Commission: 28 September 2006.

⁹⁵ Commerce Commission: *Determination on the TelstraClear Application for Determination for Designated Access Services*, Decision 477, 5 November 2002.

of receiving compensation for their termination services, where costs are minimal in any case.

International precedent – BAK jurisdictions for MTAS

5.37 We have noted some of these jurisdictions in table 4 above. As discussed these countries are in many cases characterised by dynamic mobile markets.

BAK endorsed by Telecom, Vodafone, their experts & the Commission

5.38 Both Telecom and Vodafone have recognised BAK's inherent benefits and endorsed its adoption. They have acknowledged that BAK offers a simple, innocuous and efficient solution to the competitive harm caused by high termination rates without distorting competition.

1) Telecom's support for BAK

5.39 CRA (in substance now NERA locally) has concluded in submission, on behalf of Telecom, that:

"The efficiency of [BAK] is that it:

- (i) Is a pricing regime in which each carrier bears its fixed costs for interconnection, and the payment for out of balance termination is set at zero. In this sense the prices that are set under [BAK] approximate those that are incurred by carriers – large fixed costs and very small marginal costs for both origination and termination of local calls;*
- (ii) Is the only regime that is robust to large and asymmetric changes in traffic volumes, and which neither penalises nor (sic) provides efficient incentives to promote out of balance traffic volumes (ie there is no incentive for a party to attract customers who are net receivers of calls);*
- (iii) Provides each carrier with incentives to reduce their costs of providing local interconnection services (since each carrier bears their own costs) and to develop efficient pricing regimes for any customers on their networks; and*
- (iv) Has much lower transaction costs than a TSLRIC regime with origination and termination payments. The industry avoids the costs of having the Commission undertake benchmarking and/or calculate the TSLRIC for both the origination of interconnecting calls and the termination of interconnecting calls."⁹⁶*

5.40 We agree with CRA's expert analysis and its conclusions that:

- *"[BAK] interconnection for example can be highly efficient."⁹⁷*
- *"...the greatest long term benefits to end users will result from a pure [BAK] interconnection regime for the voice and data tails."⁹⁸*

⁹⁶ Charles River Associates', 9 September 2002, para 18, p7.

⁹⁷ Charles River Associates: *Economic Advice on Aspects of Vodafone's Application for Interconnection with Telecom's Fixed PSTN*, 3 July 2003, p4.

- “[t]he reduction in termination payments associated with the adoption of a [BAK] regime will thus increase consumer welfare in respect of net terminators of the calls.”;⁹⁹ and
- “[i]n our view the adoption of a [BAK] pricing regime is therefore likely to result in a material increase in welfare in respect of net originators of the calls.”¹⁰⁰

2) Covec’s support for BAK

5.41 Vodafone experts, Covec, has similarly concluded that:

- “In general, from the perspective of the TSO, there seems to be no particular reason to favour a small positive interconnection charge over [BAK].”;¹⁰¹
- “In our opinion, there is no advantage to having the net cost of the TSO linked to any relative traffic imbalance between Telecom’s local access network and VLS.”;¹⁰² and
- “In our view it would be very poor public policy to allow TSO-related arguments to stand in the way of new competitive initiatives”.¹⁰³

3) Vodafone’s support for BAK

5.42 In support of BAK Vodafone submitted that:

- “[BAK] is the most efficient pricing principle for local interconnection in the presence of the TSO obligations regardless of the technology used to deliver a local calling service.”;¹⁰⁴
- “In our view the Commission is correct to conclude that [BAK] is preferable to a cost-based regime when other local operators are using [BAK].”;¹⁰⁵
- “This is not the full picture. [BAK] was not adopted in [NZ] solely to address callsink scenarios”.¹⁰⁶ (We agree, Vodafone provided confidential examples of when it has used BAK);
- “The Act specifically recognises [BAK] as an alternative pricing principle, available where the Commission considers that a forward-looking cost-based pricing principles does not give effect to the Act’s section 18 objective.

....

- “[BAK] is not restricted to fixed networks either.”;¹⁰⁷

⁹⁸ Charles River Associates: 7 June 2002 p2.

⁹⁹ Charles River Associates: 9 September 2002, para 38, p11.

¹⁰⁰ Above, para 36, p10.

¹⁰¹ Covec: *Vodafone Local Service TSO and Cost Recovery Issues*, 11 July 2006, p8.

¹⁰² Above.

¹⁰³ Above, p9.

¹⁰⁴ Vodafone: *Cross submission on Vodafone’s interconnection application*, 11 July 2006, para 6.

¹⁰⁵ Above, para 12.

¹⁰⁶ Above, para14.

- [BAK] and the non-discrimination condition remain the most efficient course the Commission can adopt to promote competition in service markets.”;¹⁰⁸
- “Such an asymmetry in retail pricing is obviously a major concern for the provision of local services by Vodafone and is likely to retard competition.
 - As we explained in the application, the ability for callers to ring a Vodafone local number at the price of a local call is likely to be important to the success of our local service initiative.”;¹⁰⁹
 - If Telecom can require callers to Vodafone local numbers to pay higher rates than callers to other local numbers, there could be a significant disincentive to take up Vodafone’s local service. Hobbiling Vodafone’s local service before it begins is unlikely to promote competition for the long-term benefit of end-users.”¹¹⁰
- Vodafone also endorsed Telecom’s/CRA’s support of BAK.¹¹¹

5.43 Again, we would agree with Vodafone’s conclusions; BAK is very well suited for mobile networks and promotes the purpose of section 18 of the Act. We submit that there is no valid basis to conclude that Telecom and Vodafone’s conclusions do not equally apply to MTM, FTM, MTF and SMS termination services.

5.44 Vodafone’s conclusion seems to recognise the harm of maintaining low on-net and high off-net pricing in telecommunications. Its recognition of the competitive obstacle, it, and consumers, would face if Telecom could essentially implement “on-net” pricing for local calls between Telecom customers and “off-net” pricing between Telecom and Vodafone customers is striking. We submit that there is a direct analogy with mobile termination rates and on/off net pricing and consider that a non-discrimination condition in conjunction with BAK provides for a competitive market environment.

5.45 Vodafone also does not consider that the use of BAK in *Decision 477* was an “exception” and notes that in the past Vodafone and Telecom had interconnected mobile-to-mobile calls on a BAK basis and that Vodafone and Telecom currently use bill and keep to exchange MMS traffic on their mobile networks.”¹¹²

4) CRA argued that BAK is not below cost

5.46 It is confusing that the Commission now states that BAK is below cost and therefore inefficient, when it accepted the opposite position, advanced by CRA previously.

¹⁰⁷ Above, para 15.

¹⁰⁸ Above, para 64.

¹⁰⁹ Vodafone: 4 April 2006, para 36.

¹¹⁰ Above, para 43.

¹¹¹ Above, para 39.

¹¹² Vodafone: 4 April 2006, para 83.

5) *The Commission's support for BAK*

5.47 In the *Homezone* context the Commission adopted arguments by CRA in 2002 that the price under BAK was not, in fact, zero.¹¹³

*"...like in barter, the absence of an explicit price does "not mean the price is zero" and that [BAK] did provide a price."*¹¹⁴

*"This perspective implies that the net price of interconnection is zero, but it does not imply that firms view the cost of interconnection as being zero".*¹¹⁵

*"In neither case [hybrid BAK or pure BAK], however is the price of interconnection (as opposed to the net payment) set to zero."*¹¹⁶

*"In the earlier paper CRA argued that "it is inappropriate to assume that [BAK] prices interconnection at less than its true cost"¹¹⁷ or that [BAK] sets prices "below cost".*¹¹⁸

5.48 The Commission's Draft Report seems to ignore its previous position on this issue. Its current position is that BAK "...result[s] in below cost pricing of termination"¹¹⁹ is hard to reconcile with its conclusion in *Homezone* that it "...considers that as Telecom and Vodafone will originate and terminate significant numbers of local voice calls, [BAK] will provide each party with **valuable form of compensation**, for the costs which they incur in terminating the other carrier's calls".¹²⁰ (emphasis added).

Conclusion

5.49 We still consider BAK to be the MTR regime which best meets the purpose set out in section 18 of the Act (namely promoting competition in telecommunications markets for the long-term benefits of end-users).

5.50 We request that the Commission reconsider the merits of BAK given existing precedent and previous endorsement by the incumbents.

5.51 We ask that the Commission reconsider in more detail our past submissions, namely:

- (a) paragraphs 1.4 – 1.17 of the 2degrees (NZ Comms) letter of 6 May 2009 (on revised undertakings);

¹¹³ Commerce Commission: *Final Determination on the application for determination for 'Interconnection with Telecom's fixed PSTN'*, 28 September 2006, para 116.

¹¹⁴ CRA, *Interconnection Pricing*, 7 June 2002, pp7,16.

¹¹⁵ Above, p7.

¹¹⁶ Above, p16.

¹¹⁷ Above, p7.

¹¹⁸ The Commission in *The Commerce Commission Final Determination on the application for determination for 'Interconnection with Telecom's fixed PSTN'*, 28 September 2006, para 116, quoting CRA *Economic Advice on Aspects of Vodafone's Application for Interconnection with Telecom's Fixed PSTN*, 3 July 2006, p4. This comment was made with reference to the paper by Quigley and Vogelsang *Interconnection Pricing: bill and keep Compared to TSLRIC*, CRA Report for Telecom New Zealand, 7 April 2003.

¹¹⁹ Draft Report, para 406.

¹²⁰ Commerce Commission: 28 September 2006, para 120.

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- (b) paragraphs 4.6 – 4.21 and Schedule C of the 2degrees (NZ Comms) undertaking submission of 13 February 2009; and
- (c) paragraphs 5.15 – 6.17 of 2degrees (NZ Comms) submission of 5 September 2008.

5.52 We also ask the Commission to review in more detail the Concept December 2008 Report.

6. Alternative Initial Pricing Principle

Comments on proposed IPP and FPP

6.1 In this section we comment on the IPP proposed by the Commission and suggest an alternative option for voice termination which:

- (a) addresses the Commission's concerns regarding distortions caused by differences between fixed and mobile termination rates; and
- (b) provides for an IPP which avoids the economic harm which will flow from significantly above cost termination rates determined on the basis of the Commission's proposed benchmarking.

Option – IPP based on the current fixed termination rate

6.2 The IPP proposed by the Commission in the Draft Report is set out below.¹²¹

“Initial pricing principle:

Benchmarking against MTAS prices in comparable countries that result from the application to networks that are similar to the access provider's mobile network of –

- (a) *a forward-looking cost-based pricing method; or*
- (b) *if the Commission considers that a forward-looking cost-based pricing method does not best give effect to the purpose set out in section 18, whichever of the following methods that the Commission considers best gives effect to that purpose:*
 - (i) *a pure bill and keep method; or*
 - (ii) *a pure bill and keep method applied to two-way traffic in balance (or to a specific margin of out-of-balance traffic) and a forward-looking cost-based pricing method applied to out-of-balance (or traffic beyond a specific out-of-balance margin).”*

6.3 The Commission states that as a general principle the form of the IPP should reflect that of the FPP and should therefore be in the form of benchmarking against a similar cost standard in other jurisdictions which apply the proposed FPP.¹²²

6.4 We have sympathy for this approach in theory but are deeply concerned that in practice this will lead to delays and significant costs which may ultimately frustrate the purpose of this process and section 18 of the Act.

6.5 We are also concerned that given the rapid movement downward in the EU of benchmark cost standards and the already very low rates and/or application of BAK in a number of overseas jurisdictions any international benchmarking exercise is seeking a “moving target” and that the Commission will inevitably reach an outcome that is significantly above actual cost. We refer to our

¹²¹ Draft Report, para 959.

¹²² Draft Report, paras 360-362.

detailed submissions on Commission benchmarking and the likely harm from above cost MTRs earlier in this submission.

- 6.6 The Commission also stated that a common theme in submissions from parties on 2degrees' proposed use of BAK for MTM and SMS traffic was that our proposal would distort competition between fixed and mobile network operators because MTM calls would be terminated at no cost to the originating mobile network whereas FTM calls would be terminated at a non-zero cost to the originating fixed network.¹²³
- 6.7 On that basis the Commission expressed its view that the MTAS should be subject to a pricing principle that is similar to that for the fixed PSTN origination and termination service and that:

*"To adopt a different pricing principle could result in a distortion of prices that would favour either fixed network operators or mobile network operators. A consistent pricing principle is likely to minimise the risk of such a distortion and hence be consistent with section 18 of the Act."*¹²⁴

- 6.8 The footnote to the above extract went on to state that this was not to say that the resulting prices for the MTAS would be the same as the price for the fixed PSTN interconnection services, but that the same pricing principle should be applied.¹²⁵
- 6.9 2degrees disagrees with the above footnote. In order to achieve the Commission's stated objective of no distortion between fixed and mobile operators the price for MTAS must be the same as the price for fixed PSTN interconnection services.
- 6.10 2degrees considers that the cost of termination on a mobile network and the cost of termination on a fixed PSTN are comparable and that the cost of termination on a fixed PSTN is a good benchmark for mobile termination costs. There is international precedent for this approach:

United States Reciprocal Compensation Arrangements:

- 6.11 In the US reciprocal compensation arrangements apply between mobile operators and local fixed operating companies. Broadly, FCC orders provide for a rebuttable presumption that fixed and mobile termination rates should be reciprocal and based on the fixed operator's termination costs. It is presumed that fixed termination costs are a reasonable proxy for mobile termination costs.¹²⁶ The regulatory regime allows mobile operators to bring forward-looking cost studies to rebut this presumption.¹²⁷ We understand that in practice this rarely occurs (if at all), suggesting that it is unlikely that mobile termination costs are materially higher than fixed termination costs. As a result, symmetry between fixed and mobile termination rates is common in the US.

¹²³ Draft Report, para 426.

¹²⁴ Draft Report, para 427.

¹²⁵ Draft Report, footnote 209.

¹²⁶ As noted by Ofcom on its recent consultation *Mobile citizens, mobile consumers – Adapting regulation for a mobile, wireless world*; 28 August 2008, footnote 187, this is a simplification and the US regime is complex.

¹²⁷ *Local Competition Order*, 11 FCC Rcd. at 1085; 47 C.F.R 51.711.

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6.12 We strongly recommend that the Commission consider the US approach.

India:

6.13 We also understand that the regulatory regime in India provides for a termination rate of less than NZD1cpm calculated on a fully allocated cost basis and for symmetry of termination prices relating to FTM, MTM and MTF calls.¹²⁸

6.14 In the New Zealand context, the Commission has already calculated the price of interconnection with Telecom's fixed PSTN using a TSLRIC methodology in connection with the application by Telecom and TelstraClear for a determination on the price of interconnection between their respective fixed PSTNs in 2002, with the Commission's draft report concluding a price of NZD 1 cpm.¹²⁹

6.15 2degrees considers that this price, calculated by the Commission on a TSLRIC basis, is a more efficient benchmark for the actual cost of MTAS than the international benchmarking currently proposed in the Draft Report. Using the existing fixed termination rate also avoids the considerable risks associated with the Commission setting MTRs above cost, which will clearly be the case under the current proposal.

6.16 In its discussion of efficient costs the Commission comments that:

"As submitting parties have noted, any departure from the economically efficient price is likely to create distortions. Submissions have noted that below cost pricing of termination such as BAK, will incentivise mobile network operators (sic) ('MNOs') to attract customers who tend to make more calls than they receive, in order to replace the lost termination revenues on inbound calls with higher revenues on outbound services. Off-net calls may also be encouraged, as the MNO faces no cost for termination of calls on another network under BAK, whereas it incurs its own termination costs in respect of on-net calls that remain on its own network."¹³⁰

6.17 The Commission comments that this is likely to be inefficient.¹³¹

6.18 We do not accept that a mobile termination rate for voice calls of 1 cpm would be below cost. If this was the case, and per the Commission's rationale above, there should be clear evidence of MNOs encouraging calling to Telecom's fixed PSTN because the cost of termination on the fixed PSTN would be less, and on the Commission's current analysis, significantly less, than the cost of terminating a call on their own mobile network.¹³²

6.19 We are not aware of any evidence of this occurring. To the contrary, Vodafone has heavily promoted on-net calling and discouraged off-net and mobile to fixed calls through its retail pricing plans. We also reiterate that we

¹²⁸ The Telecommunication Interconnection Usage Charges (Tenth Amendment) Regulations, 2009 (2 Of 2009).

¹²⁹ Commerce Commission: *Draft Determination on the Application for Pricing Review for Designated Interconnection Services*, 11 April 2005.

¹³⁰ Draft Report, para 380.

¹³¹ Draft Report, para 381.

¹³² 2degrees understands that the prevailing rate for termination on Telecom's fixed PSTN is 1 cpm.

are not aware of any instances in the US where a mobile operator has sought to take advantage of the rebuttable presumption regime and seek to establish that the cost of termination on a mobile network is higher than the cost of termination on a fixed PSTN. *Nor do we know of examples where it is cheaper to call off-net than on-net anywhere under BAK regimes.*

- 6.20 We therefore propose an initial pricing principle benchmarked against the prevailing rate for the designated access service: Interconnection with Telecom's PSTN, or a pure BAK method.

Summary

- 6.21 If the Commission is to achieve, over the long term, economically efficient and consistent termination rates, then it must start somewhere. MTAS is a good place to start as efficient rates will also allow 2degrees to effectively apply competitive constraints on Vodafone and Telecom.
- 6.22 Several obvious efficient alternative rates suggest themselves:
- (a) An IPP of the current fixed termination rate (ie 1cpm), adjustable at FPP stage if it could be demonstrated that true LRIC costs were higher or lower. (We offer an undertaking for fixed-to-mobile calling on this basis.)
 - (b) Forward-looking LRIC or pure TSLRIC (that is, without a contribution to shared costs): the Commission (like the FCC) accepts that long run efficiency calls for forward-looking LRIC rates. Such rates would likely be extremely low, as would a pure TSLRIC rate, so would be very close to the *Homezone* BAK rates and would be closer to other fixed-to-fixed and mobile-to-fixed rates than the Commission's presently proposed interim rates.
 - (c) Looking to a future with universal application of forward-looking LRIC or pure TSLRIC rates suggests application of BAK may be best (since LRIC or pure TSLRIC rates are very low and BAK, which closely approximates such prices, is a considerably less costly to implement than universally set termination charges). (We offer an undertaking for fixed-to-mobile calling on this basis.)

7. Retail Control

The relevance of imperfections in NZ's regulatory regime

7.1 The Commission is clearly not responsible for any imperfections with the New Zealand regulatory regime, but when applying the s18 test it should be mindful of the imperfections in the Act, and the way that the Act and Commerce Act 1986 (**CA**) inter-relate.

7.2 Put more simply, an entrant in New Zealand is subject to substantial risk from anticompetitive harm which will not be rectified by the current system and, if anything, this should influence the Commission's choice of pricing principles, especially when (as submitted above):

- (a) the harm of above-cost pricing is self-evident;
- (b) there is no evidence of any harm from low termination rates or BAK (in fact the opposite);
- (c) these issues cannot be addressed in an efficient way under the CA.

7.3 As noted by Stenneck & Tangerås:

"Companies and regulators often have divergent views of most issues, for the competitive situation to the level of cost, and the decisions are usually appealed. Legal proceedings are known to drag on for years. In addition, companies have great difficulties in predicting the eventual decisions by regulatory agencies and courts."¹³³

7.4 Most obviously, the Commission must take into account the Act's purpose when recommending an appropriate form of regulation.

7.5 The s 18 purpose test provides:

"(a) The purpose of this Part and Schedules 1 to 3 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.

(b) 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."

Our submission

7.6 Accordingly, we consider that the Commission must take the following matters into account:

¹³³ Stenneck & Tangerås, *Intense Network Competition*, Working paper #08-36, Net Institute, 20 October 2008.

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- (a) delay has high efficiency costs, it is therefore critical the Commission does all that it can to expedite the process without threatening due process;
 - (b) an IPP which takes immediate effect has considerable impact, especially in the vulnerable start- up phase; and
 - (c) similarly *ex ante* regulation of retail conduct is ineffective, so the Commission should as part of any determinations, require that each Access Provider does not impose any charge on its retail customers that would discriminate between calls and SMS messages to customers of any Access Seekers, and calls and SMS messages to its own customers.¹³⁴ As submitted by Vodafone without this new competition would be “hobbled”¹³⁵ before it emerged.
- 7.7 The Commission should not be concerned about retail market disruption where this is a by-product of efficient competition. The Commission must decide if it is worrying more about the shock to the quiet luxurious lives of the incumbents, or about the viability of efficient competition. Certainly, consumers will not be upset about disruptive price falls and the availability of new packages that help break the inefficient constraints they currently face when they wish to access off-net subscribers.
- 7.8 More significantly, we consider it most remiss for the Commission not to take these regulatory imperfections into account. The delays and associated cost and harm are not in the long term interests of end-users.

What we want

- 7.9 We appreciate that much of this is outside the Commission’s control. But it is within the Commission’s power to enable immediate implementation (ie early in 2010), by mandating BAK. That has considerable benefit in timing and effectiveness.
- 7.10 But even BAK still does not resolve on-net pricing differentials unless the Commission prohibits off-net price discrimination. Put another way: *even with BAK what is to stop Vodafone from maintaining its closed networks by charging more for off-net calls?*
- 7.11 As noted by Vodafone, non-discrimination rules are essential:
- “If Telecom require callers to Vodafone local numbers to pay higher rates than callers to other local numbers, there could be a significant disincentive to take up Vodafone’s local service. Hobbling Vodafone’s local service before it begins is unlikely to promote competition for the long-term benefit of end-users.”¹³⁶*
- 7.12 In short, we request non-discrimination prohibitions as sought and obtained by Vodafone in *Homezone*.

¹³⁴ As the Commission required in *Homezone*, see Commerce Commission: 28 September 2006, para 172.

¹³⁵ Vodafone: *Commission decision to investigate local service application*, 4 April 2006, para 43.

¹³⁶ Above, para 43

Regulatory “toolkit”

- 7.13 The regulatory “toolkit” available comprises the Act and the CA.
- 7.14 The Act focuses on wholesale (access) issues, but enables the Commission to set rules in advance (*ex ante*) and permits the Commission to address retail issues (as in *Homezone*).¹³⁷
- 7.15 However, the CA gives the Commission no direct regulatory powers – the courts set the rules and breach is only determined after the event (*ex post*), in most cases many years after the event. That means that policing anti-competitive conduct is necessarily subject to the inherent delays, cost and uncertainty of the court system.
- 7.16 The Commission has, however, acknowledged that it has the power to require non-discrimination for retail pricing,¹³⁸ as is consistent with **Vodafone** having sought and obtained non-discrimination in the *Homezone* determination. Vodafone also sought, and obtained, BAK pricing in that determination. (That decision was characterised as a “fixed line” decision, although Vodafone was, of course, providing (and is continuing to provide) its “fixed” service via its mobile network.)
- 7.17 2degrees has recently [REDACTED] **2°COI**.
- 7.18 We have a history of telecommunication cases which have taken years to “go through the system” (the 0867 case is still going through the Courts, 10 years after the relevant conduct took place, and there is strong disagreement between the NZ courts and the Privy Council (*Telecom v CLEAR* [1995] 1 NZLR 385 (PC); *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* [2006] 1 NZLR 145) - the two leading s36 CA (abuse of market power) cases; and only 4 ultimately successful s36 cases in the 23 year history of the CA.¹³⁹
- 7.19 We note that CA telecommunications cases and investigations include:
- *Telecom Corporation of New Zealand Ltd V Clear Communications Ltd* [1992] 3 NZLR 247
 - *Telecom v Clear* [1995] 1 NZLR 385 (PC)
 - *Commerce Commission Report : Telecom Xtra (20 May 1997)*
 - *Telecom New Zealand Limited v Clear Communications Limited*, CA 206/97, 9/12/1997
 - *Commerce Commission Report : Telecom/Saturn* (30 July 1998)
 - *Commerce Commission Report: Telecom Bundling of Broadband Services* (21 December 2007)

¹³⁷ Above.

¹³⁸ Above, para 155.

¹³⁹ *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554. *Union Shipping NZ Ltd v Port Nelson Ltd* [1990] 2 NZLR 662. *New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd* [1990] 1 NZLR 731. *Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd* [1987] 2 NZLR 649.

- *Commerce Commission v Telecom Corporate of New Zealand Ltd* CIV2004-404-1333 (Data tails)
- *Commerce Commission v Telecom Corporation of New Zealand Ltd* (2008) 12 TCLR 168

7.20 The Ministerial Inquiry into Telecommunications¹⁴⁰ noted that,

“...there is considerable scope for Telecom and, in some cases, other network operators, to...inhibit...competition, without necessarily breaching the Commerce Act”¹⁴¹

“Moreover, even if liability under the Act can be proven, it may take a number of years before all appeal rights are exhausted, and the range of remedies that the Courts can impose is very limited. It follows that action under the Commerce Act may be suited to dealing with past wrongs, but can be ineffective when it comes to nipping problems in the bud.”¹⁴²

7.21 A second problem comes from regulatory delays. The process under the Act is necessarily time-consuming. While the Commission’s conscientious approach is admirable its timing is well in excess of the timelines prescribed in the Act. (Indeed we are staggered at Vodafone’s and to a lesser degree Telecom’s complaints about process when they have been the beneficiaries of major indulgences around timing generally, most notably on the Undertakings process.) While there is *“a reasonable opportunity to amend [an undertaking] in light of any submissions received by the Commission”*, the incumbents have been granted requests for extensions and more opportunities to submit revised undertakings.

7.22 A linked delay comes partly from the regulatory process which can have a prolonged IPP/FPP process. The Commission timetable suggests that it staggered and potentially could be 18 months before implementation. This process began around 14 months ago and the issues were identified at least as early as the Commission’s 2006 market monitoring report.

7.23 Again most of this is outside the Commission’s control **except** it can recommend (and ultimately adopt) IPPs and FPPs more readily geared to quick implementation. That is an efficiency which the Commission should have regard to.

Comparison to other jurisdictions

7.24 This is to be contrasted with the majority of the jurisdictions the Commission has focussed on, where the regulator can determine breach of the antitrust laws and impose penalties, eg the EC, Denmark, France, The Netherlands, Norway, and the UK.¹⁴³

7.25 Many jurisdictions also have specific ex ante rules, in recognition of the fact that policing antitrust violations after the event is ineffective, it’s “ambulance at the bottom of the cliff”.

¹⁴⁰ Ministerial Inquiry into Telecommunications, 27 September 2000.

¹⁴¹ Above, p24.

¹⁴² Above, p21.

¹⁴³ Global Competition Review, *Handbook of Competition Enforcement Agencies 2009*.

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7.26 National Regulatory Authorities in the EU may impose a number of obligations on operators designated as having Significant Market Power (**SMP**), such as transparency, non-discrimination and accounting separation. The Act indirectly recognises some of these issues by setting some IPP and FPP by reference to retail bundles.

Closing comments

7.27 In summary we submit that the NZ regulatory outcome must:

- (a) take account of the flaws in the regulatory process, notably the manner in which it is skewed to favour incumbents;
- (b) consider other jurisdictions where MTRs are much lower;
- (c) consider s18 of the Act as its primary goal; and
- (d) give more consideration to other, better, forms of regulation, including BAK.

7.28 We consider that the Draft Report has failed to do the above.

8. Undertakings

- 8.1 We refer to the undertaking submitted by 2degrees on 22 December 2008 (**Initial Undertaking**) and the comments of the Commission on the Initial Undertaking set out in the Draft Report.
- 8.2 2degrees has considered the comments made by the Commission and confirms that it would be prepared submit a revised BAK undertaking which:
- (a) Includes termination of FTM and MTM voice calls;
 - (b) Is open to all access seekers, including wholesalers and re-sellers of mobile services; and
 - (c) Incorporates the standard access principles and limits on the application of the standard access principles set out in Schedule 1 of the Act.
- 8.3 2degrees would also be prepared to offer an alternative (non BAK) undertaking that specifically addressed the concern raised by the Commission that having separate FTM and MTM termination rates creates potential distortions and arbitrage opportunities. By the same logic, and while we maintain that BAK remains the best solution, rates for termination of FTM, MTM and MTF calls should be equivalent.
- 8.4 As submitted, we also consider that the cost of terminating a voice call on a mobile network is comparable, and certainly no greater than, the cost of termination on a fixed PSTN. Accordingly, we would be prepared to offer a revised undertaking providing for:
- (a) A termination rate for FTM and MTM voice calls of NZD 1 cpm; and
 - (b) A termination rate for SMS of NZD 0.1 cents per SMS.
- 8.5 The proposed FTM and MTM termination rate is based on the cost of termination on Telecom's fixed PSTN calculated by the Commission in connection with the application by Telecom and TelstraClear for a determination on the price of interconnection between their respective fixed PSTNs set out in the Commission's Draft Determination on the Application for Pricing Review for Designated Interconnection Services dated 11 April 2005.
- 8.6 *Please refer to the Concept July Report for the welfare analysis applicable to a termination rate of NZD1cpm.*
- 8.7 The Commission has indicated that it considers a conditional undertaking lacks sufficient certainty to enable recommendation to the Minister. We would be happy to discuss with the Commission the most practical way to implement either of the proposed undertakings.

PART III – RESPONSE TO COMMISSION QUESTIONS

1. Framework

Consultation questions:

454. The Commission is seeking the views of interested parties on the appropriate counterfactual scenario against which to assess regulation.

455. The Commission is seeking the views of interested parties on the appropriate factual scenario, including the form of regulation, and the relevant pricing principle and cost standard. The Commission is particularly interested in parties' comments on the Commission's preliminary assessment of cost-based pricing compared to BAK as the pricing principle for the regulated service that would best give effect to section 18 of the Act.

456. The Commission is interested in parties' views on the proposed assessment of the impact of regulation.

Appropriate counterfactual

- 1.1 We note that the Commission's analysis focuses on impacts in the fixed line markets. We consider that:
 - (a) the benefits of regulation are considerably greater in mobile; and
 - (b) these benefits in mobile *alone* justify **effective** regulation.
- 1.2 The counterfactual is analysed in the separate Concept July Report. That report discusses two potential counterfactuals: (1) entry that fails and (2) ineffective entry, that is, entry confined to a limited scale of operations. Here we focus on how restricted competition would likely be in the counterfactual.
- 1.3 There are a number of barriers to entry and expansion in the mobile market, and as a result material portions, if not the vast bulk, of the market is non-contestable. For example, in both the factual and counterfactual, a significant share of the "business" segment is not available to a new entrant due to the need for a bundled fixed plus mobile offering. However, 2degrees could only make such an offer through a vertical arrangement with a credible provider of business communication services. The most obvious potential candidate being [REDACTED] 2°COI. However, [REDACTED] 2°COI.¹⁴⁴ Commercially there would be no advantage offering this with [REDACTED] 2°COI
- 1.4 In contrast, in a more competitive environment, which would not include [REDACTED] 2°COI effective business competition would have a much higher probability of emerging. In particular, an entrant would be more likely to have

¹⁴⁴ As an aside, 2degrees notes that it considers the terms of the [REDACTED] 2°COI services.

access to the funds necessary for the substantial investment required to provide the level of service that many businesses would generally require. However, even absent [REDACTED] 2°COI, that scenario would be stymied by on-net retail calling prices and high mobile termination charges in the counterfactual.

- 1.5 Thus, returning to the main focus, in the counterfactual a significant share of the business and residential market will not be contestable because of the incumbents' (most notably Vodafone's) on-net retail prices. In this context, Vodafone's claim that new entrants can use on-net pricing to gain market share is wrong.¹⁴⁵
- 1.6 In fact, as outlined in the Mobile Challengers position paper submitted to the European Commission, new entrants such as Bouygues Telecom, Base and E-Plus have used on-net pricing without success:

“Even when Challengers provide on-net offers, they do not succeed in competing with larger operators. Each time, the conclusion is the same: due to a large customer base and the network effect this creates, larger operators are better placed to provide on-net offers and Challengers are unable to effectively compete against this pricing strategy and to react commercially with the provision of this kind of offers.”¹⁴⁶

- 1.7 The example of Slovenia, discussed in our past submissions, provides a particularly poignant case study of the difficulty entrants face in this context (see the welfare analysis in Concept July Report. The mechanism for this effect is discussed immediately below).
- 1.8 We agree with the Commission that in the counterfactual, the existing commercial agreement with Vodafone would apply. [REDACTED] 2°COI
- 1.9 So, under the counterfactual we would see the existing customer base would be largely non-contestable, because:
- (a) termination charges would be more than double the Commission's estimate of costs – (and, as noted above, we consider that the Commission has considerably understated the harm of such rates);
 - (b) closed net pricing would continue.
- 1.10 The direct effect of the preceding is that 2degrees would face strong incentives to set above cost off-net retail prices in order to at least recover the high rates charged by the incumbents for termination. But this will significantly reduce 2degrees ability to compete as such rates would be

¹⁴⁵ “It is because of this tendency to have small calling circles that on-net pricing is actually used in many markets by smaller operators to gain market share. A new entrant could use on-net pricing to target those groups such as families and businesses if they chose to do so. The experience across European markets is that many small operators have used this strategy effectively for gaining market share.” Vodafone, Submissions on Issues paper, para 7.

¹⁴⁶ The Mobile Challengers call for a regulation that takes into account the anticompetitive effect of larger operators' on-net offers, December 2007, [http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/Investigations/MobiletoMobileTermination/ContentFiles/Documents/challenger_statement_onnet%20\(2\).pdf](http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/Investigations/MobiletoMobileTermination/ContentFiles/Documents/challenger_statement_onnet%20(2).pdf), pp 3-4.

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unattractive to the customers of the incumbents who benefit from closed-net pricing.

- 1.11 The alternative would be to price off-net calls below the rates charged by the incumbents for termination, resulting in a loss, and again limiting the ability of 2degrees to compete.

Appropriate factual

Form of regulation: Designation or Specification

- 1.12 We agree that regulation should be designated. There is a clear need to determine both price and non-price terms. We agree that the main issue is price, but consider that non-price terms are material. We consider that the Commission has failed to recognise that closed net pricing will continue. We submit that the Commission should impose retail controls to address this significant barrier to entry and expansion as it did in *Homezone*.

Pricing principle

- 1.13 We agree in *theory* with cost-based pricing, but for reasons outlined above, we believe in practice BAK provides the appropriate second best approach.

BAK

- 1.14 We are pleased to see that the Commission has acknowledged BAK's potential role in its recommended regulation and consider that BAK as the pricing principle for the regulated service that would best give effect to section 18 of the Act.

Cost standard

- 1.15 As submitted above:
- (a) we consider LRIC to be the appropriate cost standard;
 - (b) there is no basis for implying that TSLRIC should be the "default" cost standard;
 - (c) even if there were such a default, that is clearly rebutted by the fact that LRIC is clearly more appropriate, as adopted, in essence by the US and the EC has directed the national regulatory authorities to adopt.

Impact of regulation

- 1.16 Clearly the impact of regulation will depend on the ultimate recommendation. We consider that regulation, even on the basis proposed by the Commission, has considerable benefits – and in fact in excess of those modelled by the Commission. This is because the Commission has understated the barriers to entry and expansion under the counterfactual, and not sufficiently accounted for less favourable counterfactuals.
- 1.17 We do not consider that the counterfactual goes nearly far enough to deliver the full benefits of regulation as it:
- (a) involves MTAS rates which greatly exceed termination costs;

(b) does not prevent closed net pricing.

1.18 If mobile termination charges reflected LRIC this would level the playing field by a significant degree, reducing the incumbents' capacity to create network externalities as means of preventing entry. 2degrees would be able to price on the basis of actual costs, and hence could compete on the basis of merits. This would not only lead to lower prices over the most of the market's breadth, but would lead to calling plans that do not artificially distort calling patterns and lead to customers holding more than one handset merely to provide contacts with an on-net way of reaching them, or so as to minimise costs when communicating off-net.

1.19 *Please see the Concept July Report.*

2. Factual Price

Consultation questions:

621. The Commission is seeking the views of parties on the proposed approach to determining a regulated price for the MTAS under a factual of cost-based regulation.

622. The Commission is seeking information about whether there are any additional cost-modelled MTRs, to those discussed in paragraph 506, that should be used in benchmarking a cost-based factual price for the MTAS.

623. The Commission is seeking the views of parties on how cost-based MTRs are expected to change over time, including whether the Commission's approach to a downward cost-path over time described in paragraphs 516 and 517.

624. The Commission is seeking the parties' views on what significance should be placed on the cross-checks discussed in paragraphs 528 to 543 above.

625. The Commission is seeking the parties' views on the extent to which the Commission's benchmarks are likely to be comparable for the MTAS in New Zealand.

Proposed approach to determining regulated price

2.1 Subject to our reservation about determining costs, and the need to critically examine "over-allocation" of costs, we note:

- (a) Costs vs. price: For the purpose of benchmarking, it is correct to focus on regulator's estimates of the cost concept adopted by the Commission, and not on present regulated rates or prices. Quite simply, if regulation is to be cost-based, that is what it should be.
- (b) Median pricing: Given the downward trend, we agree with WIK that a better approach is to average the bottom three. Taking the average biases the benchmark towards pricing above cost (the perils of which have been observed by the Commission). We note that the Commission has followed the "Median Approach" based on its practice in the UCLL and sub-loop unbundling, on the "*two-way nature of interconnection assess services*"¹⁴⁷. With respect that analogy is inapt. Whether to regulate access to MTAS is not a question about whether to regulate access to an incumbent monopolist's facility so as to allow intra-facility retail competition. That question raises concerns about whether regulated rates would inefficiently discourage entrant investment in facilities, and instead lead to entrants "free-riding" on the incumbent's investments. Rather, we will be providing reciprocal access. We are an infrastructure service player. So the same concerns about erring on the side of caution with respect to

¹⁴⁷ Draft Report, para 478.

underpricing simply do not apply. See our comments on benchmarking in Part II above.

- (c) Relevant costs: In our view, the costs of any service are the costs that are only incurred with provision of the service and which otherwise are not incurred. The cost of providing mobile termination to third party carriers are those costs that are incurred with the provision of off-net mobile termination.

Additional cost-modelled MTRs

2.2 As noted:

- (a) LRIC is the appropriate measure;
- (b) but in any event the identified jurisdictions “*over-allocate*”.

How cost-based MTRs are expected to change over time

- 2.3 We note the Commission’s reference to “*cost-paths*”¹⁴⁸, whereby cost-based MTRs change to reflect increased traffic volumes etc. We agree with WIK that this is hugely significant. The NZ duopoly has severely restricted use. We expect costs to drop dramatically as volumes increase.
- 2.4 The Commission’s choice of *10% reduction* seems *highly flawed*: For Sweden, the numbers drop by 16%, then 11% for the first two years.¹⁴⁹ For Denmark the reduction is 13%.¹⁵⁰ We see no basis for artificially inflating the benchmark rate in this way. Especially given implementation lags, this just starts the process with inflated numbers. We fail to see how this could be “*reductions of 10% per annum... based on the...Swedish benchmark*”¹⁵¹. By our calculation, using the Commission approach (i.e. 10% reduction per annum) the end point for 2012/2013 for Sweden would result in 0.241SEK for 2012/2013, when in fact it is 0.237SEK.
- 2.5 Moreover, applying the average reduction is also inappropriate, and again postpones cost reductions for no obvious reason. It would be more appropriate to follow the Swedish example of higher reductions early, but we would expect reductions in New Zealand to be higher and to occur over a longer period given the present low usage volumes in New Zealand.
- 2.6 See also our discussion on benchmarking in Part II above.
- 2.7 Looking forward, mobile telecommunications costs can be expected to fall due to general productivity growth, gains from scale, due to lower prices and higher incomes leading to more intensive use of existing services, and gains in economies of scope due to innovation that leads to more services being provided over the same infrastructure. All three of these effects are likely to be intensified by 2degrees’ entry, which will encourage, and indeed already has forced, all incumbents to seek greater efficiencies, but which will also encourage competition on price and quality, and innovation in service provision.

¹⁴⁸ Draft Report, para 472.

¹⁴⁹ Draft Report, para 514.

¹⁵⁰ Draft Report, para 515.

¹⁵¹ Draft Report, para 576.

Our view on the significance to be placed on the cross-checks

- 2.8 The Commission's cross-checks are (1) the EC estimated LRIC numbers, which it suggests should be lower than TSLRIC, and (2) implied retail on-net prices.
- 2.9 The first point is that we believe the EC LRIC number to be "back of envelope" calculations – for example - the EC Staff Working paper¹⁵² does not show how the underlying assumption of 70% reduction was derived so it is difficult to use it as a meaningful cross check. As noted above, using the WIK model for Australian termination rates produces LRIC (as defined by the EC) of in the order of about NZD1.24cpm. However, as we note elsewhere, even this is not consistent with the LRIC methodology, which implies only costs incremental to provision of the MTAS should be included.
- 2.10 The on-net approach is also highly likely to result in excessive estimates of the appropriate MTAS rate. It is done on averages, not best customers, so by definition is above the real "best rates". This immediately implies that either (1) the carrier's lowest rates are below LRIC, which seems implausible if those rates are not temporary promotional rates, unless the carrier is setting rates anticompetitively, or (2) the true LRIC rate is no higher than the lowest price less avoided retail costs. In short, while it is hard to comment meaningfully without seeing the data, we agree that in principle applying a retail minus approach to on-net discounted retail prices is a very useful basis for determining a ceiling MTAS price. We also consider that the Commission's allowances for costs etc are too low.
- 2.11 In summary, the **lowest** (not average) on-net rates are surely the best indicator of the **upper limit** of underlying costs. If this were not so, then the firm would be pricing below actual incremental cost, which would not appear to be profit-maximising behaviour unless there was an anticompetitive purpose.)

Extent to the benchmarks are likely to be comparable for the MTAS in NZ

- 2.12 We comment on the cost drivers below:
- (a) **Data limitations** – We agree with the Commission. It is difficult to have confidence in the results of a regression that has only 16 observations.
 - (b) **Dependent variable** – We agree with the Commission.
 - (c) **Independent variables** – See (d) and (e) below.
 - (d) **Urbanisation** – We generally agree with the Commission, but wonder if coverage on highways and towns outside of main centres is better in Australia as compared with NZ which would, at least to some extent, counter the effects of the different urbanisation levels. This may reflect greater political pressure on Telstra to ensure good rural coverage than there is in NZ, plus the Resource Management Act makes things more difficult in New Zealand. (According to Telecom that is a key reason for coverage limitations.)

¹⁵² Draft Report p529.

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- (e) **Population/subscribers per cell site** – The Commission has addressed this well.
- (f) **Comments from WIK on Covec** – We agree with WIK's comments.
- (g) **Currency conversion** – We agree that Covec's approach was flawed.
- (h) **2G/3G** – New entrants should not have to fund the incumbents transition cost from the move from 2G to 3G.

3. **Cost benefits of regulation**

Consultation questions:

880. The Commission is seeking the views of interested parties on the proposed approach to assessing the extent to which regulation, when compared to the counterfactual, will promote competition for the long-term benefit of end-users.

881. In particular, the Commission is interested in submissions on the following (including reasons):

- the relevant timeframe over which to assess the impact of regulation;
- the extent to which reductions in MTRs will be passed through in some form to end-users – what retail prices are likely to change, and by how much;
- the extent to which regulation will address barriers to entry and/or expansion in the relevant downstream markets (the retail FTM/tolls market, and the retail mobile services market), compared to the counterfactual;
- the extent to which regulation will affect efficiencies (and in what direction) in each of the relevant downstream markets;
- the extent to which reductions in MTRs are likely to lead to higher retail mobile subscription prices (and if so, the strength of such an effect), and any evidence of this; and
- any other likely consequences of regulation in each of the relevant downstream markets.

Regulation promotes competition for the long-term benefit of end-users.

- 3.1 2degrees notes that its majority shareholders only subscribed for share capital *after* the regulatory regime was improved by the Telecommunications Amendment Act 2006. Moreover, as is evident from these and earlier submissions, the effectiveness of regulation is critical to the long term benefits that end-users are likely to obtain.
- 3.2 Regulation goes directly to the quality and extent of competition. While 2degrees is entering the market with or without regulation, regulation will have a direct impact on:
- (a) the level of market foreclosure due to closed net pricing;
 - (b) retail rates;
 - (c) the level of calling activity;
 - (d) the level of investment undertaken by 2degrees (and its rivals).
- 3.3 These matters are covered in more detail in the Concept July Report.

- 3.4 Regulation has enabled new entrants to introduce innovative products and become price leaders in many markets. For example:¹⁵³
- (a) Avea, following its entry in Turkey in 2004, introduced innovative offerings and retail rates suddenly decreased including the incumbents decreasing the rate of on-net calls so as to entrench their dominant position.
 - (b) After Play, entered as Poland's fourth entrant in March of 2007, retail prices fell by over 60%.
 - (c) BASE, who entered the Belgian mobile market in 1999 as the third entrant, managed to secure around 23% of the market. BASE's success and the accompanying competition has resulted in falling retail rates and the emergence of innovative offerings. BASE considers that its success and competitive impact could have been even greater if it had received more regulatory assistance.
 - (d) Bouygues Telecom entered the French mobile market in 1994 bringing with it "market changing" offerings. In 1996 it stimulated customer demand by introducing the call plan concept and free voicemail at a time when only business executives on company phones could afford mobile services. Bouygues Telecom continues to be an innovator introducing the first plan providing free calling after 8:00pm to all networks. Other players followed this lead.
 - (e) E-Plus Group, Germany's third largest mobile operator with 18 million customers links its growth to major reductions in wholesale call and data charges towards costs and meeting the specific needs of customers. This includes developing the first mobile brand for an ethnic minority (the Turkish community).
 - (f) The 3 brand operates in a number of jurisdictions leading the way in innovative offerings. In 2007 3 offered customers a deal allowing them to use 3 networks abroad while only paying their local 3 call rates. It has "*slashed*" tariffs in Europe, embraced the EU's cap on roaming charges, and has teamed up with Skype to offer customers free calls to Skype users "*...demonstrating what a mobile operator committed to customer value can do in an environment without termination charges*".
 - (g) WIND entered the Italian mobile market in 1997 and is the third largest player. It considers that its success is due to being a price leader, boosting competition in Italy and billing by the second.
 - (h) Tasmobil successfully entered the Slovenian mobile market in 2007 after substantial regulatory reform that had previously maintained a duopoly against a previous entrant. It has brought "*fresh*" competition to the market and is offering bundles of voice minutes from as little as USD7.35 a month.

Extent reductions in MTRs will be passed through / retail price changes

- 3.5 As noted, competition will lead to lower prices. See the Concept July Report

¹⁵³ Mobile Challengers Company Profiles
http://www.mobilechallengers.eu/index.php?option=com_content&view=article&id=39&Itemid=40

Extent regulation will address barriers to entry and/or expansion

3.6 Please refer to the Concept July Report and our comments above.

Extent regulation will affect efficiencies (and in what direction)

3.7 Please refer to the Concept July Report and our comments above.

Extent reductions in MTRs lead to higher retail subscription prices

3.8 We do not consider that there will be any average increase - competition will prevent duopolists maintaining their rents elsewhere. This is consistent with examples of entry the world over.

3.9 Vodafone CEO Russell Stanners agrees. He recently stated on the Sunday program (12 July 2009) that termination rates do not affect retail prices:

Reporter: But Vodafone and Telecom says, these wholesale rates don't affect what they charge customers.

Russell Stanners: Well they certainly don't factor in retail pricing, because these are the rates between the networks, so it doesn't actually factor in the retail pricing.

Reporter: Not at all?

Russell Stanners: Not from a perspective of how we set retail prices. We set them based on how we look at customers, how we can deliver value.

3.10 This directly contradicts what Vodafone have asserted throughout their various submissions.

"Put simply, you can't instantly take [] VNZCOI of cash flow out of a business's hands and expect it will have no effects on retail pricing..."¹⁵⁴

"Clearly, if one major source of revenue is suddenly unavailable to MNOs, this will greatly alter the profitability of existing retail pricing arrangements for almost all categories of consumers. A change in the mobile termination rate will also affect the incentives of MNOs to compete for customers. Almost certainly, this will lead to a change in the prices offered in the retail mobile market."¹⁵⁵

3.11 In fact, regulation leading to enhanced competition would reduce the monopoly rents Vodafone currently is able to extract and passing these on in the form of consumer benefits.

3.12 TUANZ Chief Ernie Newman has also pointed out that Stanners' comments are inconsistent with Vodafone's submissions during the current investigation.

¹⁵⁴ Vodafone Submissions accompanying Revised Undertaking, 6 May 2009, para 34.

¹⁵⁵ Vodafone Submissions on Undertakings, 13 February 2009, para 71.

"Fascinating! In the numerous wearying Commerce Commission conferences I've been to on this topic, the incumbents' argument has been based solidly on the exact opposite of this argument. Their premise has been that if termination rates are reduced, retail [subscription or handset] prices will rise and the customer will be no better off. It's known in academia as "two sided markets and the waterbed effect." Learned international economists make a living pushing that piece of theory.

Take for example, this excerpt from one of Vodafone's most recent submissions to the Commission on this topic - dated May 2009 and on line on the Commission's site here. Check the following quote for yourself at paragraph 25:

"Mobile operators base their retail pricing and capital investment plans, in part, on revenue they expect to receive from providing mobile termination services. The link between retail prices and mobile termination rates has previously been recognised by the Commission and is referred to as the "Waterbed Effect." In short, reductions in termination rates mean mobile operators will find it profitable to raise the retail prices for some mobile consumers - especially low-spend pre-pay consumers whose profitability to serve is highly dependent on mobile termination revenues received from calls made to these consumers."

So much for the credibility of that argument - which has been recycled over and over and over at conferences and in submissions. Mobile termination rates "don't factor in retail pricing." Said by Russell, with emphasis, twice. Adios, waterbed!"¹⁵⁶

¹⁵⁶ Ernie Newman, *Adios Waterbed Effect – Vodafone*, 13 July 2009
<http://www.tuanz.org.nz/blog/e379f711-b2b6-4423-9e32-4a8bf9f301db/08847903-a050-444b-8c8c-4b9ebefee8bf.html>.

4. Non-core prices and terms etc

Consultation questions:

949. The Commission is seeking the views of interested parties on the significance and magnitude of call set up charges for mobile networks and parties preferred approach to recovering call set up costs.

950. The Commission is seeking any evidence of differing cost structures for different operators which could be grounds for asymmetric pricing, and the views of interested parties over the timeframe for any asymmetric pricing to be phased out.

General comments

- 4.1 We are happy to discuss non price terms if matters progress.
- 4.2 We confirm that per second wholesale billing is the international norm and must be adopted as previously outlined.
- 4.3 We refer the Commission to the 2degrees May Letter, section 3 of which dealt with Asymmetric Pricing. In addition to the cost-based points noted there, network externalities could also justify asymmetry in our favour as discussed above.
- 4.4 On timeframe, we note that the European Commission has acknowledged in its *Recommendation on termination rates*¹⁵⁷ that asymmetric pricing for termination may be used but should be phased out within four years of entry. It could be argued that given the NZ context where 2degrees' expansion (and thus ability to achieve scale) will be restricted in (at least) the first 1-2 years of entry, the maximum timeframe should be longer in NZ – say 5 years.

¹⁵⁷ p8.