



**OPENING SUBMISSIONS - COMMERCE COMMISSION CONFERENCE IN RELATION  
TO MTAS SCHEDULE 3 DRAFT REPORT**

**31 August 2009**

**Public Version  
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### 1. Executive Summary

#### Introduction

- 1.1 This paper summarises key points on which we rely, from our various submissions, starting with our submissions on the initial Issues Paper.<sup>1</sup> We do not cover all points, but seek to make this a useful summary of our position.
- 1.2 References to TSLRIC are to TSLRIC as applied in New Zealand (or its equivalent elsewhere). LRIC refers to the model adopted by the EU.

#### Severity of the market failure requires robust action

- 1.3 There is severe market failure. This has substantial implications not only for mobile services, but also for fixed line services, convergence, and investment such as in the fixed and mobile NGN. The severe market failure calls for robust action. Tinkering with termination rates won't be enough.
- 1.4 Incumbents note that regulators should be conservative as to the level of regulatory intrusion (such as in relation to rates and glide paths). What emerges is that these statements come from the perspective of the negative impact on incumbents. There is a tendency to ignore the risks of under-regulation, leading wrongly, particularly in current adverse market conditions, to outcomes such as higher MTRs, long glide paths, etc.
- 1.5 Little account is taken of the negative impacts of reduced regulation on other stakeholders. However, in this market, the risk of overly intrusive regulation (from an incumbent's perspective) is much less than the risk of inadequate regulation. The Commission can balance the benefits of robust regulation against the impact on incumbents. However, the latter should be considered only insofar as those impacts in turn demonstrably negatively impact end users.

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<sup>1</sup> As noted in the Woosh and Kordia submissions on the draft report, we rely on all submissions made in relation to this investigation.

- 1.6 If the unique New Zealand market conditions call for a departure from the historical approach of New Zealand and other regulators, that is appropriate. Robust action is needed for tough problems. However, New Zealand in fact does not have to strike out on its own path. This is illustrated by the EU's adoption of LRIC, driven by similar (but lesser) market failure problems.

**Key Point: Strong Impact beyond mobile services**

- 1.7 A key consideration is the impact of excessive termination rates beyond mobile services.

**Bundling and cross-subsidisation**

- 1.8 Telecommunications is rapidly becoming a market where the differences between mobile and fixed services are eroding, and bundles dominate. Services over mobile are becoming complements, or even substitutes, for services over fixed. Integrated fixed/mobile operators can bundle products over both platforms. In this environment, excessive termination charges distort market-place competition. This is achieved through various practices such as bundling and cross-subsidisation. We have given examples in earlier submissions, as has the Commission in its draft report. For example the Commission notes:

Vodafone currently offers a business landline and calling package called Business Tolls Plus. Under this plan, the retail price for FTM calls to a Vodafone mobile subscriber is 13 cpm. Under Vodafone's Deed, Vodafone currently charges 15 cpm for terminating FTM calls on its mobile network.

- 1.9 Regulation of termination rates, with symmetry between MTM and FTM rates will reduce the problem of bundling and cross-subsidisation.
- 1.10 Significantly, and picking up the point at the start of this submission – that the severe market failure calls for robust action – bundling and cross-subsidisation confirms that there should be a substantial drop in termination rates, and consideration of options such as LRIC and margin squeeze tests.

**Negative impact on NGN and other investment**

- 1.11 It is also recognised that the distortions caused by artificially high termination rates erode incentives to invest in, and migrate to, NGN, whether fixed or mobile. The EU, Ofcom, and WIK-Consult, in a major report to the EU, all recognise this problem.

**Dynamic efficiencies**

- 1.12 Incumbents have, when addressing dynamic efficiencies, focused upon their own incentives to invest, or, at best, incentives to invest in mobile networks. This is too limited. While incentives to invest in mobile networks are important, of major significance is the impact of termination rates on the incentives to invest beyond mobile networks. This is identified above by, for example, WIK-Consult and Ofcom.
- 1.13 Incumbents' concerns about what they say are problems with the cost benefit analysis are substantially outweighed by these wider dynamic efficiency considerations.

### **On-net and off-net pricing, and other discrimination**

1.14 Along with the negative effects of bundling, on/off-net pricing is one of the most problematic features of mobile services. In turn, this has substantial implications beyond mobile services, mobile users and new entrant MNOs.

1.15 Reducing SMS and MTM termination rates will:

- (a) reduce the problem (the more the reduction, the less the problem); and
- (b) make it significantly more likely that any on-net/off-net pricing strategy is pro- rather than anti-competitive.

1.16 To illustrate the ability of pricing to deal with this problem, Ofcom note that LRIC:

.....would most likely to lead to a reduction, if not elimination, of the on/off net differential in mobile call charges, addressing any potential concerns about competitive distortions between mobile operators..."

### **FTM/MTM termination rate asymmetry**

1.17 Excessive termination rates also lead to FTM and MTM termination rate asymmetry.

1.18 This is illustrated by the Vodafone/2degrees ICA. Under that agreement, there is now a difference between FTM and MTM rates.

1.19 Even if the regulated rates are symmetric, if they are set too high, commercially lower MTM rates are a real prospect. This creates market distortion.

### **TSLRIC v LRIC**

1.20 While our preference is for the Commission to follow the EU's lead now and move to LRIC, we recognise that this may require more thorough review, and therefore delay. We have proposed a pragmatic solution to this: expand the description of the service, beyond the BAK and TSLRIC options, to include, at least, LRIC, as an option to be considered.

1.21 A key benefit of this approach is that there is no downside as the Commission is not committed at this stage to that pricing model. There can be gain from what is learned from regulatory activity such as by European NRAs.

### **The Counterfactual**

1.22 We support use of cost modelling to more accurately determine the factual. This better enables a more accurate assessment of what the factual should be, which is the best estimate of the likely regulated price at the FPP stage, at the relevant times.

1.23 However, to meet incumbents' concerns, we recognise that cost models, prices and other information should be applied pragmatically to achieve that goal (that is, to best estimate the likely regulated price at the FPP stage at the relevant times).

1.24 It is for that reason that we have also suggested that the description of the MTAS service, to be added to Schedule 1, should be made flexible enough to accommodate cost models, price benchmarks, and other information.

- 1.25 Telecom's revised undertaking is only effective if also accepted by Vodafone and 2degrees. We therefore conclude that it cannot be used as a counterfactual. Therefore the counterfactual for Telecom terminations is (a) the Ministerial undertakings for FTM and (b) no regulation or other control for MTM and SMS.
- 1.26 If however the Telecom draft undertaking applies, it must be adjusted for minute plus second.
- 1.27 We confirm why the Vodafone/2 degrees ICA should not be used as a counterfactual.
- 1.28 As to retail pass-through, this cannot be assessed simply by looking at retail FTM charges. That is unrealistic. We agree with TelstraClear's submission on this. Services are sold in bundles, and reduced termination rates can and are passed through in a variety of ways, of which a pass-through into retail FTM prices is only one of many options.

#### **Margin squeeze**

- 1.29 We confirm that the market failure is such, that an imputation test is necessary. Reduced termination rates will not solve the problems unless the Commission applies an option similar to LRIC. The test would deal with vertical and horizontal margin squeeze.
- 1.30 If we assume that the regulated rate is 7cpm, or even 4cpm, the market problems will largely remain. On/net pricing will continue, as will bundling practices, which will leave in place similar problems to what currently exist. Simply getting to some figure described as efficient cost, unless it is low, such as with LRIC, will still leave the problem in place. In particular, pricing based on TSLRIC will not solve the problem and would need to be supplemented by other measures.

#### **Second + second**

- 1.31 Benchmarks are fully or predominantly second + second. Therefore, to be consistent in the counterfactual and in the initial price, second + second is required. The detail of set up costs is for the FPP, not sooner. Rather than leaving open the issue to deal with on the determination, the issue can be closed out in the definition of the service.

#### **Internationally originated traffic**

- 1.32 Similarly the benchmarks (predominantly GATS signatories as well) treat this traffic in the same way as domestically originated traffic. Therefore the domestic rate should apply.
- 1.33 We confirm other reasons why this service should be regulated.

## **2. Severity of the market failure requires robust action**

- 2.1 Our submissions, and those of 2degrees and Concept,<sup>2</sup> outline a picture of severe market failure. Many of those submissions are, of necessity, made confidentially.
- 2.2 This has substantial implications not only for mobile services, but also for fixed line services, convergence, and investment such as in the fixed and mobile NGN.
- 2.3 Severe market failure calls for robust action. Tinkering with termination rates won't be enough. The extent of the market failure should drive the way the Commission approaches all issues in this investigation.
- 2.4 In our submission, the extent of the market failure should drive the way the Commission approaches all issues in this investigation: everything from selecting price points for benchmarking, to considering new pricing models (such as LRIC) and the proposed margin squeeze imputation test.
- 2.5 Incumbents note that regulators should be conservative as to the level of regulatory intrusion (such as in relation to rates and glide paths). They say this in view of the potential negative impact on networks and consumers.
- 2.6 What firmly emerges is that these statements come from the perspective of the negative impact on incumbents. There is a tendency to ignore the risks of under-regulation, leading wrongly, particularly in current adverse market conditions, to outcomes such as higher MTRs, long glide paths, etc.
- 2.7 Little account is taken of the negative impacts of reduced regulation on other stakeholders. However, in this market, with its severe failure, the risk of overly intrusive regulation (from an incumbent's perspective) is much less than the risk of inadequate regulation.
- 2.8 The severe market failure calls for robust regulation, and for the Commission to take into account the adverse impacts if this does not happen. In doing so, it can balance the benefits of robust regulation against the impact on incumbents. However, the negative impacts on incumbents should be considered only insofar as those impacts in turn demonstrably negatively impact end users.<sup>3</sup> General assertion is not enough.
- 2.9 In the New Zealand market conditions, the risk of under-regulation is far greater than the risk of over-regulation. If the unique New Zealand market conditions (significantly more severe market failure than elsewhere internationally) call for a departure from the historical approach of New Zealand and other regulators, that is appropriate. Robust action is needed for tough problems.
- 2.10 However, New Zealand in fact does not have to strike out on its own path. This is illustrated by the EU's departure from long standing pricing principles (TSLRIC) and adoption of LRIC, driven by similar (but lesser) market failure problems.

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<sup>2</sup> Para 2 Woosh CallPlus and Kordia cross-submissions (18 August 2009); Wigley submission on Restricted Information questionnaires (12 August 2009); Concept Economics Reports (11 August and 18 August 2009); Wigley submission on Domestic ICAs (20 August 2009)

<sup>3</sup> For further detail see Para 3 of the Woosh, CallPlus and Kordia cross-submissions dated 18 August 2009

### 3. Key Point: Strong Impact beyond mobile services

- 3.1 A key consideration is the impact of excessive termination rates beyond mobile services. We show this in a number of ways, as follows.

### 4. Bundling and cross-subsidisation

- 4.1 Telecommunications is rapidly becoming a market where the differences between mobile and fixed services are eroding, and bundles dominate. Services over mobile are becoming complements, or even substitutes, for services over fixed. Consumers are increasingly seeing less difference between the two. Even the distinction between the two platforms (fixed and mobile) is eroding with PSTN-lookalike services based on Homezone, the introduction of femtocells, etc. Integrated fixed/mobile operators can bundle products over both platforms. In this environment, excessive termination charges distort market-place competition. For example, there can be fixed-to-mobile substitution driven largely by distortions (excessive MTRs), when such substitution should be driven instead by an efficient market.

- 4.2 As Callplus submitted:<sup>4</sup>

Mobile & Fixed telecommunications is rapidly converging and there is a high degree of inter-relationship. If mobile operators are able to leverage significant market power & charge artificially high mobile termination rates then they are able to undertake predatory pricing practices in other markets which efficient rivals cannot match. This is achieved through bundling and cross subsidising into the fixed line calling, broadband & access market or through on-net mobile pricing.

CallPlus does not suggest that Bundling & On-net pricing per se is anti-competitive. Simply that it is critical that mobile termination rates are set at an appropriate level (where monopoly profits are not extracted by a dominant player) in order that competition in the mobile, fixed line access, broadband and fixed line calling markets is on a „level playing“ field.

- 4.3 CallPlus gave several examples<sup>5</sup> such as:

“- Vodafone business toll packages offering tolls packages with calls from a fixed line to on-net mobiles at 15c per minute (2c below the interconnect rate at that time)

- Vodafone’s “talk 0” plan offering unlimited calls to Vodafone mobiles for \$6 per month (incl GST). The retail price would cover a competitor’s interconnect costs for a mere one minute per day.”

- 4.4 In its draft MTAS Report the Commission notes:

690. In its annual monitoring report for 2007, the Commission observed that both Telecom and Vodafone were offering retail packages to business customers with retail FTM prices close to or below the wholesale MTR. The Commission noted that this suggests that integrated fixed and mobile operators enjoy a significant premium on the termination of mobile traffic that is not available to other carriers.

<sup>4</sup> Para 3 CallPlus submission on the Issues Paper (5 September 2008)

<sup>5</sup> Para 3 CallPlus submission on the Issues Paper (5 September 2008)

691. This continues to be the case. For example, Vodafone currently offers a business landline and calling package called Business Tolls Plus. Under this plan, the retail price for FTM calls to a Vodafone mobile subscriber is 13 cpm. Under Vodafone's Deed, Vodafone currently charges 15 cpm for terminating FTM calls on its mobile network. Once the additional costs associated with call origination and other costs are included, Vodafone's retail FTM price for business customers appears to be even lower, relative to the costs that would be incurred by a competitor in supplying such a call.

692. Under the factual scenario of regulation, non-integrated competitors would be able to efficiently compete with Telecom (and Vodafone) in the supply of FTM calls from a similar cost base, and would allow them to increase competitive pressures in the supply of such calls.

- 4.5 As we have submitted, including elsewhere in this submission, regulation of termination rates, with symmetry between MTM and FTM rates, will reduce the problem of bundling and cross-subsidisation.
- 4.6 Significantly, and picking up the point at the start of this submission – that the severe market failure calls for robust action – bundling and cross-subsidisation confirms that there should be a substantial drop in termination rates, and consideration of options such as LRIC.
- 4.7 However, reduced rates alone are not sufficient, as we have outlined in detail.<sup>6</sup> Hence there is our submission that the Commission should augment price regulation with vertical and horizontal margin squeeze imputation tests (see below).

## **5. Fixed and mobile distortions**

- 5.1 The European Commission summarises the problem, in the process that led to the adoption of LRIC instead of a TSLRIC model:<sup>7</sup>

Significant divergences in the regulatory treatment of fixed and mobile termination rates create a fundamental distortion between fixed and mobile markets and consumers. ....

...[Regulators must] promote competition by, amongst other things, ensuring that all users derive maximum benefit in terms of choice, price and quality of service and that there is no distortion or restriction of competition. In order to achieve these objectives, the regulated termination rates should be brought down to the costs of an efficient operator.

## **6. Negative impact on NGN and other investment**

- 6.1 It is also recognised that the distortions caused by artificially high termination rates erode incentives to invest in, and migrate to, NGN, whether fixed or

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<sup>6</sup> See for example Paras 8 and 9 of the Woosh, Kordia, CallPlus and Orcon submission on the Issues Paper (5 September 2009)

<sup>7</sup> Draft Recommendation on the Regulatory Treatment of Fixed and Mobile Termination at Pages 4 and 7

mobile. For example, in its mobile services review commenced in 2008, Ofcom notes:<sup>8</sup>

The extent of convergence will also play a role, since any analysis of options for mobile call termination may also need to consider ongoing changes affecting fixed services, particularly the shift to next-generation networks. Any change to the interconnection regime in one part of the sector may have implications elsewhere and reform is likely to be best considered in light of all of the issues in the round (including questions about transitional issues).

- 6.2 In their major report for the EU, *The Future of IP Interconnection*, WIK-Consult concluded that high mobile termination rates in a CPP/CPNP world stand in the way of evolution to, and investment in, NGN. For example, at Page XI of that report:

If [mobile] termination fees were to remain at current levels, we anticipate that many mobile operators and some fixed operators might choose not to evolve their networks to IP based interconnection. They might perceive the migration as an unacceptable regulatory risk. Alternatively, they might choose an IP interconnection strategy that attempts to lock in the current inefficient arrangements [CPNP], or a modernized version of them, rather than enabling IP-based interconnection arrangements to evolve in a healthy and natural way. These concerns suggest that waiting for the migration to IP based NGNs to implement changes might be a self-defeating strategy.

## **7. Dynamic efficiencies/Incentives to invest**

- 7.1 As we noted in our cross-submissions<sup>9</sup>, incumbents have, when addressing dynamic efficiencies, focused upon their own incentives to invest, or, at best, incentives to invest in mobile networks. This is too limited. While incentives to invest in mobile networks are important, of major significance is the impact of termination rates on the incentives to invest beyond mobile networks. This is identified above by, for example, WIK-Consult and Ofcom.
- 7.2 In our Cross-Submission, we provided a case study about CallPlus, in relation to the wider impacts of excessive termination rates, and how telecommunication services and welfare benefits need to be viewed in the round. The CallPlus case study shows how excessive mobile termination rates can hinder infrastructure-based competition beyond mobile services.
- 7.3 Incumbents' concerns about what they say are problems with the static efficiency aspects of the cost benefit analysis are substantially outweighed by these wider dynamic efficiency considerations.

## **8. On-net and off-net pricing, and other discrimination**

- 8.1 Excessive MTM and SMS termination rates enable the severe market failure identified in submissions including the confidential Concept reports and Wigley submissions on the RI information and the ICAs.

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<sup>8</sup> Ofcom, *Mobile citizens, mobile consumers – Adapting regulation for a mobile, wireless world* at para 8.45 (20 August 2008)

<sup>9</sup> At Para 6

- 8.2 Along with the negative effects of bundling this is one of the most critical features of mobile services. In turn, as summarised above, this has substantial implications beyond mobile services, mobile users and new entrant MNOs.
- 8.3 As both 2degrees and Vodafone acknowledge, reducing or even eliminating termination rates may not eliminate on-net and off-net pricing. But reducing SMS and MTM termination rates will:
- (a) reduce the problem (depending on the degree of reduction); and
  - (b) make it significantly more likely that any on-net/off-net pricing strategy is pro- rather than anti-competitive.
- 8.4 The Vodafone cross-submission maintains that, as reduced MTRs will not eliminate on/off-net pricing, such pricing is not a justification for reducing rates. This overlooks the points just made. Reduced pricing will reduce the problem. The greater the reduction, the lower the problem.
- 8.5 This is illustrated by Ofcom's May 2009 observations<sup>10</sup> about the positive effects of introducing LRIC pricing (which would substantially reduce rates). LRIC pricing (called LRMC by Ofcom):

....would most likely to lead to a reduction, if not elimination, of the on/off net differential in mobile call charges, addressing any potential concerns about competitive distortions between mobile operators..."

....It would reduce the absolute difference between fixed and mobile termination rates. This would be consistent with the anticipated general travel over the longer term and provide industry greater flexibility to adapt to ongoing market developments (e.g. fixed/mobile convergence....

....It would also remove potential concerns about competitive distortions between fixed and mobile operators that are related to common cost recovery...

## 9. FTM/MTM termination rate asymmetry

- 9.1 Excessive termination rates also lead to FTM and MTM termination rate asymmetry.
- 9.2 This is illustrated by the Vodafone/2degrees ICA. Under that agreement, there is now a difference (which cannot be quantified in public submissions due to confidentiality restraints) between FTM and MTM rates.<sup>11</sup>
- 9.3 As was said on our behalf, in relation to the Vodafone/2degrees ICA:<sup>12</sup>

"8.1 While the ICA cannot be used, my clients submit, in the counterfactual analysis, it can be used to show the problems with setting the rates too high, and the allied problems of bundling and on/off net pricing, etc.

<sup>10</sup> Para 6.114, Ofcom MCT consultation paper (May 2009)

<sup>11</sup> This is extracted from Para 3.2 of the Wigley submission on ICAs dated 20 August 2009

<sup>12</sup> This is extracted from the Public Version of the Wigley Submission on ICAs dated 20 August 2009

8.2 As Telecom and our clients note, FTM and MTM rates need to be linked. The regulated rates should be the same.

8.3 However, that of course does not stop parties from agreeing rates commercially, provided, where the service is regulated, the price and non-price terms are no less favourable than the terms of the determination or registered undertaking.

8.4 That's subject to compliance with the Commerce Act. However, that legislation is close to irrelevant due to its limited application and the several years to achieve outcomes. It is useful to note in this regard that Ofcom came to a similar view even in relation to the more intrusive EU-based ex post regime in the UK. See its May Mobile Termination consultation paper at Paras 6.88 to 6.91.

8.5 What the ICA demonstrates is that such commercial agreements can create severe regulatory distortions if the regulated price for a related service is set too high. In this instance, if the regulated price for FTM is set too high (for this service over which MNOs have a monopoly), MNOs can gain substantial benefit

8.6 MNOs, individually or collectively, can benefit from [ **VNZAPI/2DAPI** using off/on net strategies and the like against FNOs.

8.7 For example, the outcome will be increased substitution of mobile phones for fixed caused by the regulatory distortion. In this example, which can apply in other ways, the regulated price (FTM or FTM/MTM) is set too high, enabling MNOs to agree terms that undercut FNOs in the marketplace.

8.8 Having fixed to mobile substitution driven by genuine efficiencies is one thing. Having substitution driven by regulatory distortion is quite another.

8.9 All this highlights the importance of the Commission taking robust action in light of the severe market conditions and that a so-called "conservative" approach will not sort the market failure. The Commission now has clear evidence of what can happen in the mix of regulatory action and commercial agreements. The commercial agreements cannot be stopped (they may be "efficient" agreements but the Commerce Act will not stop them anyway): the key challenge is to get the right regulatory settings to reduce the potential problems."

9.4 Ultimately, symmetric MTM and FTM rates (however set: by regulation or commercially) are key. As CallPlus submitted:<sup>13</sup>

There is a high degree of substitutability between the fixed and mobile markets, there are more mobiles than people and every house has a phone. In the event that Mobile-to-mobile termination rates become out of line with Fixed-to-Mobile rates (and particularly where only mobile network operators have bill & keep) this could create a huge substitution of calling away from fixed to mobile calls. A mobile network operator who is also a fixed line operators would have a huge competitive advantage over „fixed line only“ competitors through bundling, on-net calling and other means of cross subsidisation.

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<sup>13</sup> Para 8 CallPlus submission on the Undertakings (13 February 2009)

## 10. Full pricing model review, and pragmatic options

- 10.1 We have in several submissions<sup>14</sup> noted that the Commission should do a full review of the possible pricing models, just as Ofcom is reviewing 6 options including TSLRIC and LRIC<sup>15</sup>
- 10.2 Vodafone's expert, AnalysysMason, for example, supports such a review for the UK where, as Ofcom notes, the on/off-net pricing issue is not particularly problematic (i.e. there is even more reason to do this here). Having identified trends such as fixed-mobile convergence, and IP-based technology, AnalysysMason note in their mobile services report to Ofcom, appended to the latter's report, *Wholesale mobile voice call termination*:<sup>16</sup>
- Therefore, Ofcom is rightly investigating the question of what interconnection charging regime is most appropriate for telecommunications services going forward.
- 10.3 The period under review for regulation during this investigation is for the period up to 2016 (the normal 5 year period starting in 2011). Decisions are being made now for a long period. We firmly submit that the Commission should consider options in more detail, as Ofcom is doing, in light of the long term ambit of the regulatory period.
- 10.4 While our preference is for the Commission to follow the EU's lead now and move to LRIC, we recognise that this may require more thorough review, and therefore delay. We have proposed a pragmatic solution to this: expand the description of the service, beyond the BAK and TSLRIC options, to include, at least, LRIC, as an option to be considered.
- 10.5 A key benefit of this approach is that there is no downside as the Commission is not committed at this stage to that pricing model. Based on more work it can choose to accept or reject that model. By that stage it may have the benefit of experience in Europe with application of the LRIC model. As was said on our behalf:<sup>17</sup>

### A workable solution

9.3 While my client seeks a review of pricing methodology options in the investigation (as noted in earlier submissions), it is recognised that this will delay the investigation.

9.4 As a pragmatic solution, an option is suggested which achieves both:

- (a) Expedition; and
- (b) Review of price methodology options.

9.5 The Commission's draft pricing principles allow consideration of the options of TSLRIC and BAK. We propose that the Commission add the option of consideration of the EU LRIC option as well. Ideally, mandated

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<sup>14</sup> Our submissions and cross submissions on the draft Report and the Wigley submissions of 12 and 20 August 2009

<sup>15</sup> Which is labelled LRMC by Ofcom

<sup>16</sup> Annex 8.1 to that report

<sup>17</sup> Wigley Submission on ICAs (20 August 2009)

reciprocity is included, recognising that CBC is unlikely in the near term. It is easy enough to frame short wording around these options.

9.6 This also has the benefit of alerting the parties, and the Minister, to the possibility of, for example, an EU LRIC outcome, during the likely negotiations for Ministerial undertakings.

- 10.6 LRIC provides a robust answer to the severity of the market failure. This is illustrated by the Ofcom statement noted above.<sup>18</sup> LRIC pricing (called LRMC by Ofcom):

.....would most likely to lead to a reduction, if not elimination, of the on/off net differential in mobile call charges, addressing any potential concerns about competitive distortions between mobile operators...”

....It would reduce the absolute difference between fixed and mobile termination rates. This would be consistent with the anticipated general travel over the longer term and provide industry greater flexibility to adapt to ongoing market developments (e.g. fixed/mobile convergence....

....It would also remove potential concerns about competitive distortions between fixed and mobile operators that are related to common cost recovery...

## 11. The Counterfactual

### Use of cost models

- 11.1 We support use of cost modelling to more accurately determine the factual, for the reasons noted in our submissions.<sup>19</sup> This better enables a more accurate assessment of what the factual should be, which is the best estimate of the likely regulated price at the FPP stage at the relevant time.
- 11.2 However, to meet incumbents’ concerns, we recognise that cost models, prices and other information should be applied pragmatically to achieve that goal (that is, to best estimate the likely regulated price at the FPP stage at the relevant time).
- 11.3 It is for that reason that we have also suggested that the description of the MTAS service, to be added to Schedule 1 (which errs in not incorporating cost modelling as benchmark information) should be made flexible enough to accommodate cost models, price benchmarks, and other information. This can be achieved by economical wording.<sup>20</sup>
- 11.4 Incumbents make generalised references to reasons why cost models and prices diverge, and therefore why the price not the cost model should be applied. They do so without providing detail. That is not surprising as this is often not explained by regulators. (An uplift by 50% by ACCC, in a single sentence or two in a determination, hardly qualifies as a reliable indicator for New Zealand, for example).

<sup>18</sup> Para 6.114, Ofcom MCT consultation paper (May 2009)

<sup>19</sup> Kordia, Orcon and Woosh submissions on draft undertakings (13 February 2009); Kordia and Woosh submissions on the draft report (28 July 2009); Kordia, Woosh and CallPlus cross submissions on draft report (18 August 2009)

<sup>20</sup> Para 3, Woosh and Kordia submissions on draft report (28 July 2009)

- 11.5 This reflects the conservative approach noted at the start of this submission. As we noted above, the severity of the market failure requires:
- (a) robust action;
  - (b) consideration of the negative effects if such a conservative approach is taken; and
  - (c) clear identification of the negative impacts on end users of a conservative approach, not negative effects on incumbent MNOs insofar as that does not impact end user benefits.
- 11.6 The ACCC approach also illustrates why using only price benchmarks is wrong. As we have noted, in its 2004 MTAS determination, ACCC accepted that WIK's modelled price, applying TSLRIC<sup>21</sup>, was correct. Nonetheless they applied an uplift to that figure for different reasons. In comparable circumstances here, the Commission could not apply such an uplift: the price must be TSLRIC, without uplift. If the Commerce Commission benchmarked off the price rather than the modelled cost, the wrong benchmark would be used, as the benchmark must be the TSLRIC figure, not "TSLRIC plus a discretionary uplift". Benchmarking only from regulated prices falls into error.

#### Vodafone/2degrees ICA

- 11.7 This should not be used as part of the counterfactual for a number of reasons<sup>22</sup> including:
- (a) Vodafone has chosen not to make it a formal draft undertaking, which it was able to do instead of adopting the tactic of talking about what it repeatedly characterises as a "secret deal". The ICA, to use Vodafone's words "*has terms far more favourable than those set out in our undertaking*"<sup>23</sup>. So why has Vodafone not made that the draft undertaking instead of the one it put forward? It had choices. The confidentiality of the ICA did not preclude putting forward an undertaking on the same terms (without stating that it is the same). That Vodafone has not used the terms of the ICA in its formal draft undertaking is telling and indicates a tactical play;
  - (b) Draft Undertakings make for a clear and easy mechanism for counterfactuals, which should not be eroded (in this instance by use of tactics by Vodafone); and
  - (c) The so-called "secret deal", said to be available to others, in reality would not be accepted by any other party. Nor, in view of its duration relative to the regulatory period under review, can it be an appropriate counterfactual;
  - (d) There are a number of issues with the ICA, referred to in the Wigley report of 20 August 2009, much of which is confidential. Issues include the asymmetry between FTM and MTM termination rates.

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<sup>21</sup> As adjusted by ACCC. More correctly, this is TSLRIC+, the equivalent of TSLRIC here

<sup>22</sup> See in particular Para 4 of the Kordia and Woosh submissions on the draft report (28 July 2009) and the Wigley submission on ICAs (20 August 2009)

<sup>23</sup> Para 248 Vodafone submission on draft report dated 28 July 2009

### **Retail Pass-Through**

- 11.8 Vodafone, in its cross submission<sup>24</sup>, takes an inaccurately simplistic approach to this. Pass-through cannot be assessed simply by looking at retail FTM charges. That is unrealistic. We agree with TelstraClear's submission on this.<sup>25</sup> Services are sold in bundles, and reduced termination rates can and are passed through in a variety of ways, of which a pass-through into retail FTM prices is only one of many options. The market is increasingly competitive, and includes not only FNOs but also integrated fixed/mobile operators and pure MNOs (which provide, if not services that are substitutes, services that are complimentary in nature). Therefore competitive pressure continues to increase as fixed and mobile markets converge. See also the Draft Report on MTAS, Paras 685-702.
- 11.9 In any event, even if there are the pass-through problems claimed by Vodafone, that does not justify above-cost mobile termination rates. As Professor Haucap notes,<sup>26</sup> a problem in one market (FTM retail) does not justify continuation of problems in another (that is, excessive termination rates).

### **Reciprocity**

- 11.10 The Commission raises this at Agenda Item 8.<sup>27</sup> As the Telecom Revised Undertaking only applies if there is reciprocity (that is, 2degrees and Vodafone execute the same undertaking<sup>28</sup>) its terms (in particular, the prices) cannot be used in the counterfactual. 2degrees and Vodafone have not clearly stated that they would enter such an undertaking, which at minimum would be necessary for the Commission to use this as a counterfactual. (In that event it would be a counterfactual as to termination of all calls on mobile networks<sup>29</sup>). Further, it is most unlikely that both 2degrees and Vodafone would execute such an undertaking. For example the price terms of the undertakings differ irreconcilably from 2degrees' approach.
- 11.11 Under Clause 16(3) of Schedule 3A, this revised Undertaking replaces the original undertaking. The original therefore is no longer an effective draft undertaking. Therefore there is no draft undertaking provided by Telecom that is capable of being part of the counterfactual.
- 11.12 That being so, in relation to termination of calls on the Telecom network, the counterfactual can only be (a) the Ministerial undertakings as to FTM and (b) no regulation or other controls as to MTM and SMS. An updated CBA should be amended accordingly
- 11.13 If, like the 2degrees draft undertaking, Telecom's revised undertaking cannot be considered, the same result is reached.

### **Minute plus second**

- 11.14 If, contrary to our submission, the Telecom undertaking is to be used as a counterfactual, then, as the draft report identifies, and as we have noted, there needs to be an adjustment to enable correct benchmarking.

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<sup>24</sup> Paras 222-257 Vodafone cross-submission dated 18 August 2009

<sup>25</sup> Para 5-25 Telstra submission date 28 July 2009

<sup>26</sup> Para 34 of Professor Haucap's report on behalf of 2degrees filed 18 August 2009

<sup>27</sup> Para 12 of the Agenda

<sup>28</sup> Clause 3 Revised Draft Undertaking and Para 113 Telecom Submission on Draft Report (28 July 2009)

<sup>29</sup> Subject to adjustment if, contrary to our submission, the Vodafone/2degrees ICA can be used as part of the counterfactual

## 12. Margin Squeeze

- 12.1 We have submitted that the severity of the market failure is such that moving the termination rates alone will not solve the failure.<sup>30</sup>
- 12.2 If we assume that the regulated rate is 7cpm, or even 4cpm, the market problems will largely remain. On/net pricing will continue, as will bundling practices, which will leave in place similar problems to what currently exist. Simply getting to some figure described as efficient cost, unless it is low, such as with LRIC, will still leave the problem in place. In particular, pricing based on TSLRIC will not solve the problem and would need to be supplemented by other measures. IPP pricing will not get there, and even if FPP pricing would solve the problem (that is unlikely with TSLRIC), this would happen years later (if at all, given that there has never yet been a final decision on a price review).
- 12.3 At the end of its Agenda, the Commission has ruled out remedies that amount to retail regulation. Margin squeeze therefore takes on more significance.
- 12.4 It is of course not a remedy that is retail regulation. It is wholesale regulation. Although it is about the margin involving (a) a wholesale input (the MTAS) and (b) retail prices, it is the size of the *margin* that is material not the *absolute* prices at each end (such as the retail price).
- 12.5 We do not suggest that the Commission fully designs an imputation test to include in the definition for Schedule 1. Rather, Schedule 1 should have a short description of an imputation test to be designed at the determination stage. Alternatively, the description includes the option of incorporating an imputation test.
- 12.6 Although margin squeeze can be the basis of an anti-trust remedy, in this context, it is sought as a regulatory remedy, particularly because anti-trust cannot solve for the problem. While margin squeeze principles in an anti-trust context provide guidance, the test can be designed to meet the specific circumstances.
- 12.7 In telecommunications, as with other sectors, regulation is designed to step in where competition law is inadequate to deal with the problem. Here there is severe market failure which will not be solved by merely dropping termination rates. Tough problems call for tough measures. Commerce Act remedies cannot handle the problems (due to time delays and the limited effect of Section 36).
- 12.8 The Commission is able to work from precedents overseas such as Ireland and Australia. The imputation test can be designed to enable pro-competitive on/off net discrimination. There are complexities, but the seriousness of the problem justifies this. We consider that merely reducing termination rates will leave severe problems in the telecommunications markets. The Commission and New Zealand will still have a problem on their hands.
- 12.9 The severity of the bundling problem also justifies horizontal margin squeeze imputation tests as well. There is an added level of complexity but the circumstances justify this. There really is no other realistic solution to this serious problem, given anti-trust remedies are virtually irrelevant

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<sup>30</sup> Paras 8 and 9 Woosh, Kordia, CallPlus and Orcon submission on Issues Paper (5 September 2008) and Paras 15-17 of Wigley submission on the RI Information dated 12 August 2009)

### **13. Minute + Second/ Second + Second**

- 13.1 Vodafone provides a number of reasons for retention of minute + second. We have dealt with those reasons.<sup>31</sup>
- 13.2 But the real issue is clear and simple. For the factual (on the investigation) and for the initial price (under the IPP), the approach is benchmarking. All or most of the countries being benchmarked use second + second. To benchmark correctly, New Zealand must apply second + second too, both for the factual and for the IPP. The granularity of set up costs is immaterial. They only become relevant on a final pricing review under the FPP (that is not an issue until after an Initial pricing determination.)
- 13.3 This international outlier of a debate (resolved years ago elsewhere) seems endless and costly. Costly for providers, the stretched resources of the Commission (which has more important things to do), for consumers presented with limited competition due to the minute-minimum, and for certainty going forward.
- 13.4 Rather than leaving open the issue to deal with on the determination, the issue can be closed out in the definition of the service.

### **14. International origination of traffic<sup>32</sup>**

- 14.1 This also comes down to a benchmarking issue. The countries being benchmarked do not differentiate internationally originated (IO) traffic from domestically originated (DO) traffic. Therefore, on a benchmark basis, IO termination on mobile networks should be regulated and priced just as termination of DO traffic is priced. Additionally, benchmarked countries generally are GATS signatories which further indicates this approach is correct.
- 14.2 There is a very small incremental cost of IO traffic compared to DO. This cost is close to immaterial. But this is a level of granularity that is not relevant until a final pricing review. It is not relevant to the investigation or the initial pricing.
- 14.3 We have provided a detailed analysis of GATS, and concluded that the GATS instruments require:
- (a) non-discriminatory supply of IO and DO termination services by NZ mobile providers (i.e. the terms and conditions must be the same or similar);
  - (b) supply of IO termination services at cost-oriented rates; and
  - (c) that governments must ensure that this happens, and the Commission must have regard to those GATS obligations, under Section 19A of the Telecommunications Act.
- 14.4 Using CallPlus as a case study we also show that regulation of IO termination rates encourages NZ facilities-based competition beyond mobile services, and fosters wholesale and retail competition for the benefit of NZ end users. Therefore there are New Zealand public welfare benefits (and NZ wealth transfers between carriers which is relevant). That is so, even if it is relevant that some benefits from reduced termination rates go offshore. The case for regulation is made out.

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<sup>31</sup> Further detail is at Para 9 of the Woosh, CallPlus and Kordia Cross-submission dated 18 August 2009

<sup>32</sup> Further detail is at Para 10 of the Woosh, CallPlus and Kordia Cross-submission dated 18 August 2009

## 15. Ministerial Undertakings

15.1 We have outlined a number of reasons why it is not premature to revisit termination rates before the undertakings expire.<sup>33</sup> One reason is that it is time to be carrying out another MTAS review cycle anyway. That is so, given the long periods between commencement and completion of the review cycle. This comes close to coinciding with the end of the Ministerial undertakings. In any event, for the reasons we have given, there should be change anyway.

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<sup>33</sup> See for example Para 2 CallPlus, Kordia, Woosh and Orcon submissions on Issues Paper of 5 September 2008.