

**MOBILE TERMINATION ACCESS SERVICES CONFERENCE  
3 SEPTEMBER 2009**

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**FACTUAL AND BENCHMARKING ISSUES (CONTINUED)**

**CHAIR:** Good morning and welcome to the second day of the mobile termination conference.

A revised agenda has been circulated and we will be starting off with continuing factual and benchmarking issues just a couple of matters that were left over from yesterday. Before we do that just a couple of issues. I'd like to remind experts of the code under which they are operating. For three quarters of yesterday it worked perfectly and towards the end of the day there was a bit of straying into advocacy and robust interaction which verged on being outside the code, so we just ask that you remember that.

1 I've been asked that everybody turn their cellphones off, don't have them on silent  
2 because the interference that comes through the system is caused by, we've now  
3 discovered - and if you think that's loud imagine what it's like for the stenographer, so if  
4 you can turn all phones off. And yesterday we just asked about Telecom's position on its  
5 undertaking, we'll come back to that when we deal with undertakings.

6 So some outstanding issues on the factual and benchmarking issues.

7 **MS MAZZOLENI:** Just in relation to glide paths we wanted to come back to you, and an open  
8 question really for the economists then we'll go to all of the parties. Is there any reason  
9 for glide paths in this situation, and if so how in this situation that we may be faced with  
10 here where we end up with regulated rates that may be significantly different from current  
11 prevailing conditions, how glide paths would work in this sort of situation. James do you  
12 want to start?

13 **MR MELLISOP:** Sure. I think there is a role for glide paths. It seems to me to be fairly  
14 standard regulatory practise. I don't know about - I haven't studied the detail so in terms  
15 of your second question, Anita, I probably can't give a particularly good answer, but just  
16 as a matter of principle I see a role for them. And it is to do with sort of transitional  
17 issues and shocks. A couple of observations, I mean I've already pointed out in an earlier  
18 report the use of glide paths by other Regulators for MTRs so I won't repeat that.

19 I do note the FCC 2008 report that raises the LRIC issue, it refers to a ten year  
20 transitional period as I read the document to deal with, I've forgotten the exact quotes, but  
21 it's things like market disruptions. I'll see if I can find it afterwards. So I think that's just  
22 another indication of regulatory practise.

23 The other issue I just wanted to raise was out of the telco area I've referred  
24 yesterday to CPI-X regulation in electricity and gas, for example, where when Regulators  
25 apply CPI-X they estimate the revenue for each year of the regulatory period, say a  
26 five year period and often they'll find that it goes up and down, Regulators typically  
27 smooth the revenue path to avoid shocks. That's at the retail level so it's different to here  
28 but nevertheless it seems to be suggestive of regulatory practise in these areas to avoid  
29 shocks.

30 **MS MAZZOLENI:** Can you just expand on your comment in relation to the ten years, because  
31 I would have thought the period would be quite relevant to the circumstances?

32 **MR MELLISOP:** Indeed, I'm not advocating ten years necessarily for here, it's just an example  
33 of a Regulator being conscious of the impact on the market, and I guess in that case it's

1 indicative of the FCC seeing a change from TELRIC to LRIC being quite a big issue. So  
2 they refer to market disruptions and potential effects, so a ten year period, ten year  
3 transition period. That's as I read the document, it's admittedly a very long, 400 pages,  
4 document, and it may be Eric has a better understanding of it, but that's my interpretation  
5 of it. So not advocating ten years here, just the principle.

6 **MS MAZZOLENI:** If we could just turn to 2degrees.

7 **DR HAUCAP:** I think there are three issues I want to briefly raise in this context. One refers to  
8 the CPI-X that James just referred to. I think one has to distinguish between the future  
9 cost savings that we expect and how they are passed on to consumers, and the efficient  
10 cost that we think can already be achieved today and how we get from a monopoly price  
11 to this price as of today not taking into account any future cost savings.

12 So the CPI-X in my understanding sort of tries to anticipate what future cost  
13 savings there may be and then agree on some sharing between consumers and producers  
14 which is the X factor how to pass this on to consumers. The question that seems to be  
15 more relevant here is how we get from a, let's say, too high price whether that's a  
16 monopoly price, to an efficient price that can be achieved today and there the - initially  
17 my understanding of the philosophy that I have seen in many European mobile markets  
18 was that the glide path was, or at least in some European markets that I'm aware of, was  
19 that the initial idea was to reduce the asymmetry between entrants and incumbents in their  
20 mobile termination rates because in, well, the vast majority of European countries  
21 entrants were allowed to charge higher mobile termination rates in the beginning.

22 And the idea - we didn't get into this discussion yesterday about asymmetric rates,  
23 but the idea there was that even a very efficient entrant, let's say the most efficient entrant  
24 in the world wouldn't be able to reach the same efficiency level as the incumbent on the  
25 first day of operation because they didn't have the same number of customers so they  
26 were allowed to charge a higher mobile termination rate; but then the idea was well we  
27 would not want to give them incentives to stay small so we'll reduce the asymmetry over  
28 time. There may be a period say five years, for example, where this asymmetry will be  
29 reduced so the entrant cannot rely on this high termination rate, the lower termination rate  
30 that the incumbent had. So the philosophy was slightly different from what we look at  
31 today I think where the question is whether how fast the two incumbents should adjust  
32 their rate.

33 No, there's another sort of first principle point of view. James I think very directly

1 pointed out yesterday that what we're trying to do in these network industries is to set  
2 prices in bottleneck parts of the industry as if there were competition in the market. So  
3 because we know there are parts where there isn't competition we try to think about what  
4 would be the price, the hypothetical price if there were competition in this part of the  
5 market. And if we think about, well, if regulation is aiming at stimulating competition  
6 then one could also ask the question well, what would happen if there were competition,  
7 would an incumbent have a glide path of five years to reach the price that somebody else  
8 would be able to offer?

9 There may be markets where for various circumstances switching across and  
10 whatever, incumbents may have a long time to adjust their prices. But if we look at the  
11 philosophy of contestability that often lies behind these ideas then in most markets it  
12 would be quite unlikely you would have five years to adopt to a competitive price in  
13 many markets. So if one wants to be consistent in the philosophy behind it a glide path  
14 doesn't quite fit to that philosophy.

15 **MS MAZZOLENI:** So picking that up in the telecommunications market, what sort of period of  
16 adjustment time would be relevant?

17 **DR HAUCAP:** It depends on what you compare to, but usually you would say you have to react  
18 very fastly to - if you really think that it's based on the idea of contestability then you  
19 would almost have to reduce prices immediately. I mean much of the liberalisation and  
20 deregulation and then re-regulation was based on the idea of some sort of contestability,  
21 that's why I think - that's my understanding of the philosophy behind the TSLRIC or  
22 LRIC standard that firms in a contestable market couldn't charge different prices than  
23 TSLRIC prices let's say, and there the idea is they won't have to adjust to the prices  
24 immediately.

25 **MS MAZZOLENI:** Thank you. Vodafone.

26 **DR SMALL:** Thank you, so a few points. I think the reason for glide paths is reasonably clear,  
27 it's to handle adjustment costs. And as we discussed yesterday adjustment costs are  
28 going, in this proceeding, if you go the way that you've indicated those adjustment costs  
29 will - the incidents of those will fall on certain customer groups as well as on operators.  
30 So if there's a glide path those adjustment costs are easier for everyone to manage. The  
31 length of the glide path should be I think, therefore it follows, a function of the size of the  
32 drop, so if that's the function is to manage adjustment costs, then it follows that the bigger  
33 are the adjustment costs the bigger is the management problem.

1           Then you go well is there a counter example where Regulators have slashed prices  
2 quite dramatically from the very start, and that does happen, it happens in more traditional  
3 utility industries where it's referred to as a PO adjustment. I think the distinguishing - and  
4 this may be where Justus was going when he was suggesting, you know, that you should  
5 behave as if there is competition and move directly to the rate that would be there if there  
6 was competition.

7           I think the thing to remember about that is that those PO adjustments are usually  
8 only made after a really quite intensive and rigorous process of estimating costs. And the  
9 reason for that is that Regulators are concerned not to cut prices below cost, and this then  
10 comes back to a point that was made yesterday, I think, from one of the Commission staff  
11 about an example of where Regulators might have gone too far.

12           And to that I would say, because I think it's on point here, that it's - I mean  
13 Regulators are naturally averse to doing that so they try hard not to, but additionally if  
14 they do it doesn't usually show up very quickly because these are very capital intensive  
15 businesses and so, you know, you can kick them around for quite a long time potentially  
16 before lack of maintenance or whatever shows up in poor service. So just because  
17 somebody might remain in business doesn't mean that you've priced them below cost.  
18 That you haven't priced them below cost.

19           In terms of the period finally I'd suggest that you should follow international  
20 practise unless you've got a strong reason to depart from it, something urgent that causes  
21 you to think that you should do something different to the way other Regulators have  
22 behaved.

23 **MS MAZZOLENI:** Thank you. If we could just get the same comment from the operators,  
24 maybe just go back around the table; Vodafone.

25 **MR FEASEY:** I'd like to make two points about at least European practise on this. The first is  
26 in response to Justus' comment. Where I think he said the main rationale for glide paths  
27 in Europe is because you have this difference between the operators and you're trying to  
28 get to a single sort of symmetric rate. I don't think that's quite right, so actually in the  
29 current European Commission's recommendation the Commission adopts a view that  
30 these differences between operators, these asymmetries should narrow more quickly than  
31 their view about how quickly we should get to a, in the Commission's case, a LRIC  
32 number for the whole industry. So they see a distinction between a period of time that  
33 you might allow for the smaller operators to get to scale where they can support the same

1 MTR as the big operators, and the length of time that's required for the whole industry to  
2 adjust to a new situation.

3 And the Commission's view on this in the end was that for the whole industry,  
4 which is I think what we're talking about here, they took a view that that was about four  
5 years. So the LRIC proposals in Europe at least anticipate that essentially January 2013 is  
6 when we get to LRIC, we'll see whether we do that. So it's not just about narrowing the  
7 differentials between small operators and large operators, it's about adjustment for the  
8 whole industry.

9 And the second point is the reason for that I think amongst European Regulators is  
10 much of what was discussed yesterday, which is everybody accepts, I think, that there is  
11 an interdependency between prices in this market but that that works in an uncertain way,  
12 and that therefore if you make big and radical and dramatic movements in one set of  
13 prices in this market those will have effects and consequences that are quite uncertain for  
14 other prices in the market, and those will have consequences for customers and  
15 potentially for shareholders as well, and that it is unreasonable and undesirable that you  
16 do not allow people some time to adjust, particularly if that intervention is essentially  
17 changing the rules of the game against which people have invested in in the past. So  
18 there's a big concern, I think, on glide paths that investors and shareholders should be  
19 given an opportunity to adjust to a change in the rules in the game, and that is important  
20 for ensuring that investment confidence continues.

21 **MS MAZZOLENI:** Thank you. Ernie did you want to make a comment?

22 **MR NEWMAN:** Yes, thanks Anita. The point I haven't heard mentioned around the table yet is  
23 the question of when the glide path actually starts, because in the view of our members  
24 we've been on this glide path for some little time now. I guess you could argue, as I think  
25 we would, that the operators have had their glide path already, you could also perhaps  
26 argue that the glide path started at the time that undertakings kicked in, or at the time that  
27 the Commission formally put this matter on its agenda, or when the issue was first raised  
28 in 2003, or when it became obvious internationally that regulation of termination rates  
29 was becoming orthodox regulatory practise; because it seems to us that that is the time at  
30 which the industry started to adjust in anticipation of inevitable regulation.

31 So I think the point at which the glide path starts has got to be considered in  
32 relation to the length of the glide path, and our position quite clearly is that we've been on  
33 a glide path, albeit a shallow one, and that during the period of that glide path the users

1 have demonstrably been paying more and the carriers have demonstrably been earning  
2 more and therefore the balance of doubt in this should go towards the payer side. So we  
3 would firmly favour, in the light of all that, a one-off move to a cost orientated price.

4 **MS MAZZOLENI:** Ernie I can understand that and it has been raised in the public forum quite  
5 a bit, but how do you deal with the issues that Richard's just raised, you know, these big  
6 shocks? If you look at the difference between, say, our preliminary benchmarks and  
7 where the rates are today, that does imply some fairly significant shocks to, as Richard's  
8 just pointed out, customers as well as the investors behind the various mobile networks.

9 **MR NEWMAN:** Well, the issues to the shock -

10 **MS MAZZOLENI:** And the waterbed effect obviously, you know, the bigger the splash here  
11 could have quite a significant effect elsewhere to consumers.

12 **MR NEWMAN:** I guess the issue of the shock to customers depends again, it comes back to  
13 how much store you put on the waterbed effect, and our position is that we don't place a  
14 great deal of weight on that and that we're prepared to live with whatever consequences  
15 the waterbed effect may deliver. The shock to investors, I think any investor who doesn't  
16 realise that regulation in this area is an inevitability would probably be very much the  
17 exception rather than the rule.

18 Having said all that, you know, we rely on the judgment call of the Commission  
19 on this and if there is to be some kind of glide path then that is the Commission's call to  
20 make. But our key point here is that there has already been a glide path. We're not  
21 starting from a zero base here, and our side of the table or our side of the market demand  
22 side has been the one that has been demonstrably over paying for a period of time; so that  
23 needs to be factored into the Commission's judgment.

24 **MS MAZZOLENI:** Thank you. Bill.

25 **MR McCABE:** Yeah, I've got a number of points actually thank you. I've just had a look at  
26 what the EU actually said and they talk about glide paths and they talk about "termination  
27 rates that are set above efficient cost can create substantial transfers of wholesale  
28 termination revenues from fixed operators to mobile operators". And when referencing  
29 glide paths that are above cost they say, "this results in substantial transfers in an indirect  
30 subsidy from fixed operators and their customers to mobile networks and services and this  
31 may in turn be contributed to inefficiently low usage of fixed networks in some member  
32 states and could prove to be a barrier to important innovations and investments in the  
33 fixed sector such as fibre roll-out and delivery of next generation networks and bundled

1 convergent services".

2 So that's what the EU has said about glide paths, but I've got a number of  
3 additional points on this. The EU has been regulated in general for the last sort of  
4 decadeish in many places. Here it hasn't been and we've been charged above cost for a  
5 decade paying monopoly rents and subsidising the big mobile networks. This distorts  
6 competition. To suggest that that has to stay in place for another while while everyone  
7 adjusts to efficient competition delays the benefit of competition and embeds the subsidy  
8 further. Why do we have to subsidise the incumbents for a greater period of time? We're  
9 not seeking above cost termination rates by the way.

10 There's a precedent of course with fixed termination rates where they came down  
11 nearly 60% overnight so there's already precedent here in New Zealand. We haven't seen  
12 any harm either, I don't think that's been demonstrated and in some European countries  
13 there was a 50% drop in mobile termination rates overnight with no demonstrable harm.  
14 What it does is it allows incumbents to have a lock in period, so if they know that they  
15 have above cost termination rates for another period of time then there are strong  
16 incentives for them to put people on to contract, and here contracts are up to 36 months  
17 which are exceptional.

18 So if you do a glide path you may say well, the lock in period that operators have  
19 should be shortened say to 12 months. It's not a surprise to operators, we've heard that  
20 we've been talking about this for the last seven years and it's in their FCC filings, there's  
21 warnings to shareholders that this is a possibility. So there's no surprise to the  
22 shareholders of incumbents. And don't forget that we've got shareholders too, so it works  
23 both ways where we're talking about if it's unreasonable for one lot of shareholders to  
24 have a reduction in their monopoly profits, why is it fair on our shareholders to prop them  
25 up?

26 And the final point is the shock to customers that we talked about. I don't think  
27 that lower prices is gonna be a shock that customers are going to dislike, so I don't think  
28 there's a problem there.

29 **MS MAZZOLENI:** Thank you. Susie.

30 **MS STONE:** Yeah, I'd agree with many of the points that Ernie and Bill have made, in  
31 particular the observation that I think Bill was reading from an EU report. Our concern  
32 with fixed to mobile termination rates is exactly that, when they're above efficient cost it  
33 is a transfer of wealth from the fixed line operators to the mobile operators, and we'd like

1 to see that cease as soon as possible and don't understand why there's a particular need for  
2 glide paths in the mobile industry compared to say the fixed industry.

3 **MS MAZZOLENI:** Graham, did you want to add anything?

4 **MR WALMSLEY:** Nothing to add.

5 **MS MAZZOLENI:** Chris?

6 **MR ABBOTT:** Just from TelstraClear's perspective, I mean I think as Susie and Ernie have  
7 picked up around, while mobile termination rates remain significantly above cost, there is  
8 obviously detrimental effects to the down-stream market, and so that in some sense  
9 maintaining that while you have a glide path impedes free flowing competition in  
10 down-stream markets.

11 Having said that that I do have some sympathy for the need for a glide path but I  
12 think you do need to take into account the context in which this is considered, such as this  
13 has been an ongoing festering sore, mobile termination, since about 2004 and there is  
14 some certainty and inevitability about it. So I think that should guide your decision about  
15 what length you would potentially set for a glide path to get you down to the actual  
16 cost-based mobile termination rate.

17 **MS MAZZOLENI:** Thank you. Telecom?

18 **MR WESLEY-SMITH:** Look I spoke about glide paths quite a bit yesterday so I'll keep it brief  
19 today. I don't have much to add to what Vodafone and James have said already, but this  
20 is a two sided market, I think it's standard international practise is the way to manage the  
21 potential for shocks and disruptions to the market as a result of a significant drop to cost  
22 is via a glide path, and I don't see any contextual reasons why we'd do anything different  
23 here.

24 **MS MAZZOLENI:** Thank you.

25 **CHAIR:** The second question related to spam I think.

26 **MR PICKERING:** Could I just focus a little bit on this SMS spam. I direct this at Vodafone  
27 because something was raised yesterday. You submitted about the concern that reduced  
28 SMS termination rates could increase the risk of spam SMS. This concern was reiterated  
29 by Russell Stanners in his opening statement yesterday, Paul Partridge I believe also  
30 commented on the issue of spam SMS in relation to the international interconnection.

31 Do you have evidence of situations where spam SMS has become an issue  
32 internationally, or that is a current issue in New Zealand? And if it is in this domestic  
33 market wouldn't it be prevented by the Unsolicited Electronic Messages Act? And if not

1 are there other methods you could use to mitigate the risk of spam SMS? So I just  
2 wonder if you could address that, Richard, or whoever in Vodafone.

3 **MR PARTRIDGE:** Okay, so I think the important thing to consider is that today Vodafone  
4 blocks 97 to 98% of the e-mails which our customers receive and they are spam. So with  
5 e-mail you effectively have a bill and keep system, and there is a huge amount of spam  
6 for e-mail. There is absolutely no reason why that won't happen for SMS. It will happen  
7 for SMS and spam is the fixed to mobile equivalent for SMS, it's generated from a  
8 machine, whereas person to person text tends to generate a response, machine to person  
9 text does not generate a response a lot of the time and results in huge imbalances. There  
10 would be a huge cost in putting in place spam filtering and blocking systems and it would  
11 fundamentally change the nature of SMS so that it essentially becomes the same as  
12 e-mail.

13 **MR PICKERING:** Do others want to make a comment either from Vodafone or other -

14 **MR YORK:** Just in terms of the UEMA Act, that applies to e-mail at the moment as well, as I  
15 understand it, and as Paul says we're still having to block 97 to 99%.

16 **CHAIR:** We can't hear you. Speak into the microphone.

17 **MR YORK:** I was gonna say with the UEMA my understanding is that that applies to e-mails as  
18 well and it's meant to be a protection against that. But as Paul says we are still blocking  
19 97 to 99% of our e-mail traffic because it is spam. So the basic contention is if you do  
20 drop price to zero there is no disincentive for you to send vast bulks of SMS to our  
21 customers. Having a price there does have that benefit.

22 **MR PICKERING:** Could I ask other operators to comment?

23 **DR HAUCAP:** Just a question that's occurred to me in this context, is that I don't know whether  
24 I fully understood correctly that on an international basis there is already bill and keep for  
25 SMS. I'm wondering only why spam isn't already occurring to a large degree just not sent  
26 from outside New Zealand but from one of the 198 other operators. Maybe it is but  
27 apparently a small operator can deal with this. I don't know what the exactly reason may  
28 be.

29 **MR CHIGNELL:** I think I answered that yesterday, we start off with bill and keep  
30 arrangements in the international context but as soon as we see patterns of imbalance then  
31 we set up - we've got the rights within the contracts, I believe, to set up charging, so when  
32 we get that sort of spamming situation we set up charging and it usually stops.

33 **CHAIR:** I thought you said your current international SMS is on a bill and keep basis.

1 **MR CHIGNELL:** No, I said that would be the default to start with.

2 **CHAIR:** Isn't your current international arrangements basically bill and keep? I thought that  
3 was what came out in evidence yesterday.

4 **MR CHIGNELL:** Yes, what I said was that was the default that we started with but when we  
5 monitor the situation -

6 **CHAIR:** Sorry, my question, is it the case currently today that still the majority of your  
7 international arrangements are bill and keep? I thought that was what you said.

8 **MR PARTRIDGE:** So what we have today is that international SMS arrangements are part of  
9 an international roaming relationship and arrangement and contractual arrangement.  
10 Those international roaming partners are interested in having an ongoing international  
11 roaming relationship. The premise for international bill and keep arrangements for SMS  
12 is that they're part of those international roaming arrangements, and as a by-product of  
13 having the signalling link in place for international roaming set up, carriers can also send  
14 each other SMS. And the basis for that is that it is for P to P, person to person traffic,  
15 between our subscribers and the other international roaming partner subscribers.

16 Some carriers do cheat and we do see significant quantities, significant quantities  
17 of international SMS spam today. So of our partners we do find people that cheat and  
18 don't use it just for person to person SMS and we move those partners to paid  
19 arrangements.

20 **CHAIR:** So one of the proposals which has a bill and keep with a 10% adjustment, or something  
21 like that, would actually address the spam concern?

22 **MR PARTRIDGE:** There is a huge difference between a mandated bill and keep with  
23 absolutely no limitations versus a commercial arrangement where the parties have the  
24 protection of being able to move to a paid arrangement, and all of those international  
25 roaming partners understand that if they send spam they will be moved to a paid  
26 arrangement; that's one of the reasons for moving to a paid arrangement, there are other  
27 reasons as well.

28 **CHAIR:** Understand, I'll ask the question again; but the ability to move off bill and keep if  
29 there's a 10% imbalance in a mandatory arrangement would address the spam issue that's  
30 been raised, yes or no?

31 **MR PARTRIDGE:** Yes.

32 **CHAIR:** Thank you.

33 **MR WALMSLEY:** Can I just make a comment. I mean I just get worried by this kind of logic,

1 because I mean we have like free local calls, is that encouraging spam? We have free  
2 dial-up internet, is it encouraging spam? I just don't know where you go with this line of  
3 logic. It just seems to me the wrong solution to a different problem.

4 **MR McCABE:** Just a quick comment on international; yeah, I think there's a difference between  
5 bulk e-mail which is generally generated off-shore and it's difficult to find the source, and  
6 SMS where you need, as Vodafone have said, you need a direct signalling link between  
7 networks to be able to send SMS between networks. And if one of those is used for  
8 unsolicited spam then that can be dealt with separately within an STD process, and under  
9 New Zealand law I think it's - I understand it's illegal, I could take advice from the  
10 lawyers, but to say that there's a - so it can be dealt with elsewhere.

11 And if I really wanted to spam Vodafone customers I'd get SIM bolts and set up a  
12 lot of - get a lot of prepaid and 2000 texts and I could spam them for half a cent at the  
13 moment. And I don't think that's been shown to be the case. And so I think there are a  
14 number of differences here and those can all be dealt with in the STD and current  
15 New Zealand law.

16 **MR PICKERING:** Thanks Bill. Telecom?

17 **MR WESLEY-SMITH:** I don't have a lot to add. In principle our guys agree that it is a risk,  
18 it's been a risk that the industry has known about for some time now, but to date we  
19 haven't seen the same level of spam as you see in e-mail. I don't think we honestly know  
20 whether there is something structural that explains that, whether we've just got better  
21 controls over SMS than e-mail and how that transits our network. So in principle, yeah, it  
22 is a potential issue, we haven't seen much of it to date.

23 **MR PICKERING:** Why would it be that you haven't seen much, and apparently Vodafone have  
24 this enormous spam, or is that confidential?

25 **MR PARTRIDGE:** I guess one possible reason is that currently there are now more than one  
26 party providing an international roaming service in New Zealand, but historically the  
27 majority of the international roaming arrangements were for GSM, in fact all of the GSM  
28 international roaming arrangements were with Vodafone.

29 **MR PICKERING:** Okay. Experts, do you want to say anything? Nothing John? Anything  
30 from 2degrees?

31 **MR MELLISOP:** Only that I wasn't actually sure these guys we were talking about the same  
32 product. I think they were talking about e-mails was the 98%. It's nothing important, it  
33 just wasn't clear to me that we were talking about the same thing, that was important to

1 get that straight I guess.

2 **MR PICKERING:** All right, that's all from my point of view thank you.

3 **CHAIR:** So they were the issues that were left outstanding from yesterday. So we can move on  
4 to our next agenda item which is initial pricing principle. We put that on the agenda  
5 because there were a couple of issues we wanted to explore, but those issues were  
6 covered in our discussion yesterday. So from the Commission's perspective there is  
7 nothing further that we need to deal with on IPP. But are there any issues, seeing it is an  
8 agenda item, that parties wanted to raise in relation to that, otherwise we can move on to  
9 counterfactual issues. **[No comments]** What we might do is move on to counterfactual,  
10 and if it occurs to you there was some very important IPP issue you can raise it after the  
11 break.

12

13

### COUNTERFACTUAL ISSUES

14

15 **CHAIR:** So moving then to counterfactual issues. We discussed yesterday the process and  
16 everyone's very familiar with it, of the factual and the counterfactual and the assessment  
17 that's required. And so the issue is what is the appropriate counterfactual, or  
18 counterfactuals, for the Commission to use in its assessment.

19 In the Draft Report the Commission considered a range of possible combinations  
20 of accepting undertakings for the purposes of identifying the clarification, and looking at  
21 commercial offers, there were a range of possibilities that were considered. Sorry I'll read  
22 that again. In the Draft Report the Commission considered a range of possible  
23 combinations of accepting undertakings for the purpose of identifying the counterfactual  
24 before determining that the counterfactual should be acceptance of Telecom's and  
25 Vodafone's undertakings together in conjunction with the commercial agreement between  
26 Vodafone and 2degrees, that's a quote out of the report. This reflected the similarity in  
27 price terms between Telecom and Vodafone's undertakings.

28 The 2degrees undertaking wasn't included in the counterfactual for reasons that we  
29 discussed briefly yesterday, but particularly the requirement that the undertaking was  
30 contingent on it being accepted by specific parties. Then yesterday that same issue arose  
31 with Telecom's undertaking and we asked whether that undertaking could be revised; and  
32 if you can advise the decision made in relation to that.

33 **MR WESLEY-SMITH:** We have revised the undertaking.

1 **CHAIR:** So the undertaking no longer is conditional on -

2 **MR WESLEY-SMITH:** That's correct.

3 **CHAIR:** So it's open to all access seekers now, thank you. Right, on that basis I'll move on.

4 What we did in the Draft Report is that we used a counterfactual which was an average  
5 rate for Vodafone and Telecom's undertakings. We also made a qualitative assessment of  
6 the Vodafone/2degrees ICA. Now that we have before us an undertaking from Telecom  
7 that is capable of acceptance and therefore capable of being used as a counterfactual, the  
8 question remains given the differences between the mobile termination rates that apply on  
9 the two undertakings that we now have, there's one from Vodafone obviously one from  
10 Telecom, and a commercial agreement, the terms of which are confidential but which you  
11 can assume are in some way different from those two undertakings.

12 The question really arises as to how the Commission should deal with the  
13 counterfactual. Should the Commission attempt to separately assess each of the  
14 undertakings, noting the different prices in them and separately assess the ICA? In other  
15 words should there effectively be three separate counterfactuals or should the  
16 Commission seek to somehow blend them together?

17 So the issue, and we'll ask parties to comment really on the appropriate approach,  
18 which there's a number of counterfactuals or one, and then how that can be done  
19 effectively. So John, do you want to - being closest has its disadvantages.

20 **MR WESLEY-SMITH:** It's one of those impossible questions whether an undertaking is a  
21 factual or a counterfactual. I think we think it's a factual but that's beside the point. We  
22 don't think that you can -

23 **CHAIR:** You might help me out on that.

24 **MR WESLEY-SMITH:** To our mind the undertakings are a form of regulation, just an  
25 alternative to traditional regulation. The counterfactual today is the rates that apply in the  
26 market today. If the Commission decides not to accept undertakings and not to Regulate  
27 we're left with the counterfactual.

28 **CHAIR:** Does that make any difference to the process?

29 **MR WESLEY-SMITH:** No, I don't think it makes any difference. It's just at least how we  
30 think about the framework.

31 **CHAIR:** Yeah, understand.

32 **MR WESLEY-SMITH:** In dealing with undertakings to start with the easy question, I don't  
33 think you can assume that you accept multiple undertakings with differing rates, so both

1 the Vodafone and Telecom undertakings in their current form. We've been pretty open, I  
2 think just about everyone has agreed we don't want asymmetric rates in New Zealand. I  
3 suspect Vodafone might have a different view. In our view you've got one undertaking  
4 that is put forward on a commercial basis by an operator that's lower than the other.  
5 We're all sitting around here talking about how as a Regulator you can make sure that you  
6 get rates that are close to but not below TSLRIC. I think you can rely on the fact that an  
7 undertaking that Telecom's put up won't be below the TSLRIC cost or is unlikely to be.  
8 So to that extent our view is you should assume the undertaking that gets accepted is the  
9 lower, Telecom's.

10 **MS MAZZOLENI:** So in a market where there's no regulation and say, for example, two  
11 undertakings capable of acceptance and one commercial agreement, you could not have  
12 those multiple situations? Because presumably anyone that transacts with you would be  
13 on the basis of your open offer.

14 **MR WESLEY-SMITH:** Yeah, I guess this is where you start getting into impossibilities. Our  
15 undertaking will require reciprocal rates from Vodafone, they'll require the same. One of  
16 them's gonna have to win. I don't think either of us would be particularly keen to have  
17 asymmetric rates, so -

18 **CHAIR:** I think you've highlighted our difficulty.

19 **MR WESLEY-SMITH:** Look I completely understand the difficulty, yeah. You're gonna have  
20 to make a call as to which is the undertaking more likely to be accepted by the  
21 Commission, and then make a call on what you think the flow on consequences of that  
22 would be.

23 **CHAIR:** But if we were of the view that there are these different undertakings and we have no  
24 idea whether any of them are gonna be accepted by anybody else because they're so far  
25 apart, how can we make a judgment that, well, let's say Telecom has the lowest rate so  
26 that's what we would use when the reality is that Vodafone may never agree to it and they  
27 will never be the rates and they may be to a third party interconnecting with you, but  
28 that's currently a very small part of the traffic.

29 **MR WESLEY-SMITH:** Yeah, I agree, this is what modelling's about isn't it?

30 **CHAIR:** That's what the discussion's about isn't it.

31 **MR WESLEY-SMITH:** Yeah, we just have to make a call on what the most likely outcome is.

32 **CHAIR:** Exactly.

33 **MR WESLEY-SMITH:** So I take it that take our undertaking, the Commission puts a decision

1 out because we accept Telecom's undertaking, you're implicitly accepting the rates that  
2 we put forward as optimal for New Zealand. In those instances, I guess it's up to  
3 Vodafone and 2degrees to explain what they would do, I think it's most likely that they  
4 would sign up to them.

5 **CHAIR:** On the basis that the risk is regulation?

6 **MR WESLEY-SMITH:** On the basis, yeah, I guess everyone's got different incentives in the  
7 market, they'll have their own view, that's my personal view is rates with the  
8 Commission's stamp of approval, that's a pretty strong signal you're sending to the  
9 market.

10 **MR ABBOTT:** I think it's interesting just looking at, for example, under the current Vodafone  
11 undertaking in April 2010 the rate would be 14.4 cents, so I think Vodafone's offer it  
12 would be 10.95 cents. You know, there is a lot of difference between what the  
13 opportunities that you have.

14 I think there is a strong need for, as John says, symmetry. I think you see that in  
15 PSTN interconnection where the rate is symmetrical between interconnection with  
16 Telecom's PSTN and interconnection with any of the others. So there is that symmetry. I  
17 think if you were to accept one undertaking and not the other I think you condemn the  
18 industry to having asymmetric pricing. I think from asymmetric pricing you get a lot of  
19 down-stream distortionary effects so that is problematic.

20 There's two options; one is the undertakings themselves become more closely  
21 aligned in pricing which I think would alleviate the problem, or alternatively I see it as  
22 there being such fundamental difference that actually you're left with no other option but  
23 to practically recommend regulation and reject the undertakings simply on the basis of the  
24 asymmetry.

25 **CHAIR:** Thank you. CallPlus?

26 **MR WIGLEY:** It seems a very unsatisfactory situation that a conclusion could be drawn that  
27 the most favourable publicly available undertaking which is Telecom's would be  
28 notionally deemed to be the one to be used and applicable to all of the parties, 2degrees  
29 and Vodafone, that they would notionally sign up to the same thing. And if the effect of  
30 that - and we know that that may well in fact not happen, all the signs are at the moment  
31 that that won't happen - the effect of that is that we have no regulation, if that's the  
32 outcome, based on an undertaking put forward just by one party. So it seems to me that  
33 that would be too dangerous a thing to do.

1           It does show the difficulty of the situation and maybe the only solution is to take  
2 each of the parties undertakings and apply that to termination on each of their networks.  
3 So Vodafone has an offering, you use the undertaking they've provided to terminate on  
4 their network, the percentage of traffic there, Telecom and 2degrees respectively, but  
5 even that sounds problematic.

6           But certainly taking the most favourable of the options and assuming that's going  
7 to be applied could lead to the disastrous result of no regulation where it's not appropriate.

8 **CHAIR:** So your point is it could lead to no regulation and nobody accepting the undertaking so  
9 we're back where we currently are, is that what you're saying?

10 **MR WIGLEY:** The question of accepting the undertakings is really a separate piece. This is  
11 about establishing a counterfactual. And to have a notional counterfactual based on  
12 Telecom's undertakings applying to everybody seems to be a long stretch.

13 **CHAIR:** Understand, yes.

14 **MR WIGLEY:** Completely different question about whether or not undertakings are going to  
15 be accepted, that seems a different issue. Are we dealing now with the Vodafone and  
16 2degrees ICA or is that a separate issue?

17 **CHAIR:** No, well only to the extent that that also be, or not be, a counterfactual. So the issue  
18 was do we look at each of them and combine them or what. So the issue of whether or  
19 not the commercial agreement be a counterfactual is on discussion now as well.

20 **MR WIGLEY:** Well rather than going on at length about it because I've done that in  
21 submissions, and unfortunately you're hearing from me rather than Susie and Graham, the  
22 unfortunate situations that I've seen, a lot of the confidential information.

23 **CHAIR:** Understand.

24 **MR WIGLEY:** So you're hearing from the monkey rather than the organ grinder, so but, you  
25 know, in a number of pages I've gone on about, having seen the material, about the most  
26 unsatisfactory situation of an informal offering being given, or being used by the  
27 Commission and a number of reasons given. And at the end of the day there's quite a  
28 simple answer to that, and that is that there is a clear procedure for setting up a  
29 counterfactual which is the formal process. And it's really highlighted by the fact that  
30 Vodafone can turn around and say - they can talk about secret deals and that the secret  
31 deal is far more favourable than the one that's publicly available; why on earth did they  
32 not just make it the undertaking rather than seemingly gaming the situation?

33 **CHAIR:** So can I take your point, you are really saying there's an undertaking process in the Act

1 and that's available, and if that isn't used, secret or whatever, confidential commercial  
2 agreements should be ignored by the Commission in its assessment?

3 **MR WIGLEY:** Exactly, that's the simple point, there's a number of variations on the theme  
4 but -

5 **CHAIR:** Exactly, I've read your submission, that was the -

6 **MR WIGLEY:** Okay, thank you.

7 **CHAIR:** The view that I took. 2degrees position?

8 **MR MATTHEWS:** This is jumping slightly to agenda item 10 which is where we had some  
9 stuff about undertakings but I think it's important to deal with now.

10 **CHAIR:** Be careful because we are dealing with them, but go on.

11 **MR MATTHEWS:** We've submitted on that separately on behalf of 2degrees, but I think it's  
12 important because it does go to which counterfactual you adopt. The key point is that we  
13 know the history of what happened on the F to M process, and the Cabinet papers when  
14 they introduced the undertakings regime explicitly acknowledged the risk of an ongoing  
15 undertakings regime. And we've submitted on that and said in the written paper so I  
16 won't go into the detail on it. And for the same reason the Fletcher report rejected an  
17 undertakings regime as part of the initial Act.

18 2degrees position is that this has gone on for too long and really we can't keep  
19 negotiating undertakings, and it is part of a general process of regulatory delay, and so  
20 that the undertakings should be rejected, in which case the counterfactual is the status  
21 quo.

22 Just to pick up a point on what Michael was saying about agreements, Vodafone  
23 has said, and TelstraClear agreed with them, that the arrangements in place between  
24 Vodafone and 2degrees at the moment were only as a result of arm twisting by the  
25 Minister, which would mean that at the end of the term without regulation one would  
26 expect them to revert to what they would otherwise have done without that arm twisting,  
27 which would mean that under a counterfactual of no regulation or with a commercial  
28 agreement in place, without an undertaking in place then one would expect them to  
29 exercise their market power when setting prices for access to the bottleneck facility. I  
30 think those were our only comments.

31 **CHAIR:** Thank you. TUANZ, Ernie?

32 **MR CHIGNELL:** I'll start and maybe Richard's gonna have some comments.

33 **CHAIR:** Okay, Vodafone first and then if TUANZ has a comment.

1 **MR CHIGNELL:** I'm sorry.

2 **CHAIR:** Probably best for Ernie to come in at the end I think after he's heard what all the parties  
3 have to say.

4 **MR CHIGNELL:** There's quite a few points around this, I just wanted to clarify we're not doing  
5 the process topic right now.

6 **CHAIR:** No, we're not doing the process.

7 **MR CHIGNELL:** Because a lot of this actually goes to the process around undertakings  
8 which -

9 **CHAIR:** We will discuss the process and we might do it in this session or under undertakings,  
10 but currently we're just focused on the role that we have to take in identifying the  
11 counterfactual.

12 **MR CHIGNELL:** Yeah. Well, I guess -

13 **CHAIR:** So assume you have an undertaking, it may be the one you have currently, it may be  
14 another one, but there is an undertaking and assume it will be different from - it may be  
15 identical to Telecom's.

16 **MR CHIGNELL:** So undertakings are in the Act and I guess we can complain about that, but I  
17 think that's just fact and we've got to work with it. We've only had two processes that  
18 have used undertakings so far, one was the national roaming one in, was it 2007 Ross? I  
19 think it was.

20 **CHAIR:** Mmm.

21 **MR CHIGNELL:** Which didn't come to fruition, it was close but I think it had three stages in it.  
22 And it was certainly a learning process for both Vodafone and I think the Commission it  
23 would be fair to say as well. But this one that we've got this time around is far more  
24 complex in the sense that it's a multi-access provider undertaking this process, so I'm sure  
25 we're going to have some discussion later on about how we can get to an end point  
26 because we do want to get to an end point on that.

27 **CHAIR:** Yes, yeah.

28 **MR CHIGNELL:** In terms of asymmetry around undertakings that wouldn't be our preference  
29 either, so we're not suggesting that what's on the table now would be easy for the  
30 Commission to accept. We do have that slight asymmetry in the deeds that was referred  
31 to, and that wasn't ideal either, but it just shows you the deeds were the deeds and they  
32 were done on a bilateral basis with the Crown, not between Telecom and Vodafone, we  
33 ended up with different prices for the last two years.

1           We haven't really had to confront the issue yet between Vodafone and Telecom  
2 because it's not yet the 1st of April 2010 when the first bit of asymmetry would come into  
3 effect. We do think that the arrangements between Vodafone and 2degrees should be part  
4 of the counterfactual. You can't be sure unless you've done the analysis, and I don't think  
5 you have, that an undertaking would be accepted by 2degrees over the current  
6 arrangements they've got with Vodafone. Maybe that piece of analysis needs to be done  
7 so you can make that judgment call because one has to assume there'd be logical around  
8 that.

9           And the last point I guess was to the worry that at the end of that arrangement that  
10 somehow Vodafone will exercise some sort of market power in mobile termination which  
11 was I think referred to by the 2degrees lawyer. Golly are we trying to solve a problem  
12 three or four years down the track, or whatever it is, today? I don't think we need to  
13 worry about that right now.

14 **CHAIR:** Yeah, undertakings run for five years so I think if there was going to be a problem in  
15 three years that's a relevant consideration because it would be within the undertaking  
16 period, so it probably is - it may well be a relevant consideration, I'm not saying whether  
17 it is or not, but it may well be.

18 **MR CHIGNELL:** No, but I think the way we take the commercial arrangement into  
19 consideration, you'd assume that at the end of that commercial arrangement if there was  
20 an undertaking that was available from Vodafone that 2degrees would avail themselves of  
21 the undertaking.

22 **CHAIR:** So you're now in a position of the commercial agreement plus an undertaking, okay.

23 **MS MAZZOLENI:** So one counterfactual is the current deeds, both of them, plus the -

24 **CHAIR:** Sorry, we're talking about the ICA on mobile to mobile aren't we? You said deeds.

25 **MS MAZZOLENI:** Well in terms of the prices for mobile.

26 **CHAIR:** Understand, yes, sorry.

27 **MS MAZZOLENI:** Plus the commercial agreement? That's one counterfactual.

28 **MR CHIGNELL:** Well you could have a whole range of counterfactuals, I don't think you've  
29 actually modelled that one, I think you've modelled the undertakings.

30 **CHAIR:** Sorry, just so I understand in terms of the commercial agreement, you're saying the  
31 counterfactual would be the commercial agreement for, say, three years, whatever the  
32 period is, and then the undertaking for the last two years?

33 **MR CHIGNELL:** Well I think you'd have to work out flows and all that sort of thing and work

- 1 out whether 2degrees would accept it or not.
- 2 **MS MAZZOLENI:** But the substitution for the current deeds can be two separate offers from  
3 either Telecom or Vodafone, it's just that I think we've heard parties say where that gap is  
4 considerably wide you can't see that working in the marketplace.
- 5 **MR CHIGNELL:** I think both deeds fall away if there's acceptance of the undertaking.
- 6 **MS MAZZOLENI:** Yeah, I understand that, it's the second counterfactual, if there are new  
7 undertakings that would replace those.
- 8 **MR CHIGNELL:** Yeah, I don't know whether Richard's got anything to add.
- 9 **MR YORK:** I guess what I'd add to it, the whole objective of a factual/counterfactual exercise is  
10 it's a with or without test kind of scenario. And the questions, I guess, that are before us  
11 are A do you designate, and B do you accept an undertaking, or C do you allow things to  
12 go on as they would. So they're the three situations that are potentially on the table.
- 13 If you go down the path of leaving things as they are there are the deeds in place  
14 and there's also an interconnection agreement in place between ourselves and 2degrees.  
15 So I think for that particular consideration the interconnection agreement is relevant.
- 16 If you go down the path of regulation that's the factual one, we don't need to talk  
17 about it. The third scenario is that undertakings are put forward and there's a potential  
18 range of options there which is quite difficult for you. But if you assume - one thing that  
19 is very important to remember in any of that analysis is, and I think I'm right in saying  
20 this, and I think this is on the public record, that - actually maybe there's something in the  
21 ICA as a term in terms of the interplay of the ICA and a situation of undertakings being in  
22 place.
- 23 **MS MAZZOLENI:** That doesn't matter because we can analyse it.
- 24 **CHAIR:** Just one thing I'm trying to understand what you said, you're saying there's two issues,  
25 one is the decision of whether or not to regulate you look at the deeds and the ICA  
26 because that's the real world?
- 27 **MR YORK:** Yes, that's right.
- 28 **CHAIR:** And then it's a second exercise to look at the undertakings, but the undertakings you  
29 would say would not be part of the first process?
- 30 **MR YORK:** That's right. Okay, three situations, let me summarise again.
- 31 **MS MAZZOLENI:** No, you've either got the deeds and the commercial agreement.
- 32 **MR YORK:** That's right.
- 33 **MS MAZZOLENI:** As one situation. It seems to me that one of those deeds is being replaced

1 under the scenario we're looking at to compare with the factual of regulation by the  
2 change that Telecom has now made to its undertaking.

3 **MR YORK:** Okay, so what you have -

4 **MS MAZZOLENI:** So that's the situation that you move forward with because you've got an  
5 open under -

6 **MR CHIGNELL:** No, it's not been replaced, with respect, it's been offered, it's not replaced  
7 until you accept it. You have to make the decision whether it's better than the deed.

8 **MS MAZZOLENI:** Thank you, in terms of the counterfactual assessment.

9 **MR YORK:** Okay, so I think I can summarise this, try one more time. Factual, what you do  
10 under regulation; first counterfactual you just allow the world to go on as it is, okay, so  
11 the MTR deeds and the ICA. Second counterfactual undertakings that are there before  
12 you, but when you consider that look at the implications acceptance of undertakings has  
13 for the terms and conditions in the interconnection agreement, okay, because it may be  
14 the interconnection agreement may still sit if undertakings are accepted.

15 **CHAIR:** I mean what you're saying is the factual compared with regulation is one exercise, is  
16 what you're saying, and then the factual compared with the undertakings is a second  
17 exercise separately, but what you're comparing the undertakings to is the commercial  
18 agreement.

19 **MR YORK:** No, I'm saying there are three states in the world.

20 **CHAIR:** Understand that.

21 **MR YORK:** Okay, and you compare factual to the current commercial existing arrangements  
22 and factual compared to what you would get if undertakings are accepted.

23 **CHAIR:** Yeah.

24 **MR YORK:** What we're saying is that parties have the option under the interconnection  
25 agreement to stay on that rather than go to the undertakings. So the ICA is an important  
26 part of your consideration of the counterfactual with undertakings still.

27 **MR CHIGNELL:** Both counterfactuals, yeah.

28 **MR YORK:** Both counterfactuals.

29 **CHAIR:** Bill, did you have a comment?

30 **MR McCABE:** Yeah, sorry, just a couple of points on the 2degrees contract, which actually  
31 terminated just over a year into the welfare analysis, so the welfare analysis has been  
32 done over a period of 2011 to 2015 and the interconnect agreements are terminated long  
33 before the end of that, so how relevant they are is another matter.

1           The other point that I wanted to make is that Telecom have put forward a - now  
2 that it's taken into account an undertaking which takes us on a glide path towards the cost  
3 of in Australia, and I think they use that as a benchmark, but actually where Wik said it  
4 was about 6 cents in Australia, 7 cents New Zealand, we only get that in the year ending  
5 31st of December 2015, and we've got this minute second rounding.

6           So by 2015 Telecom is suggesting that we have something that's aligned with cost  
7 but it's actually 40% above and we've got to wait for another five years to get there. So  
8 the headline rates sound great but we've got this minute second rounding and comparing it  
9 to Australia of a couple of years ago to 2015 is completely out of whack with how rates  
10 are going elsewhere.

11 **CHAIR:** Any other - yeah.

12 **MR WIGLEY:** Bill's just indicated that the agreement ends in, when was it? 2012, the period at  
13 the moment is that regulation starts in 2011, that's another five years so that's 2016, and  
14 those of us - now that that information is public we can talk very openly about this  
15 because the approach by Vodafone in its submissions has been stridently supportive of  
16 this secret deal which it keeps on talking about as being a great thing, but when you  
17 finally look under the covers you find that the situation is very different, that they're  
18 putting forward a counterfactual which actually only runs for about a year until the  
19 relevant time as opposed to five years.

20           I guess this really highlights just how unsatisfactory the situation is. You then get  
21 problems arising such as this press leak, however that happened; we just don't need this.  
22 And this is an opportunity for the Commission to say once and for all let's not go through  
23 this messy business of counterfactuals, of using commercial agreements, let's try and  
24 avoid this in the future and let's use the formal process. It is such a good practical  
25 example of why this is wrong.

26           Just while I'm talking can I just clarify now that John has confirmed the ICA, or at  
27 least the undertakings have changed so that it's not conditional so it now is in play; just to  
28 clarify of course the Commission's point in its Draft Report that there needs to be an  
29 upwards adjustment, if the Commission's minded to take the same approach as it was  
30 before, an upwards adjustment to reflect the minute plus second issue. Because the  
31 undertaking is a minute plus second offering, and just to give you some indication of  
32 that -

33 **MR WALMSLEY:** Based on our experience looking at our calls to mobile the impact of minute

1 second is around 23%.

2 **MR WIGLEY:** I should say that those of us that have seen restrictive information have actually  
3 seen that information, so Graham is just making that public.

4 **MR WESLEY-SMITH:** I can confirm from Telecom's perspective that sounds about right.

5 **MR WATT:** As you know Vodafone's been very keen to have that agreement made public. We  
6 think it's important to have it revealed and expose it to everyone because it really is -  
7 certainly some of the public statements give you a completely different impression as to  
8 what that agreement really is. We note that it's already now been revealed one aspect of  
9 that agreement just now by Bill, the term, which is a part of the agreement, we'd welcome  
10 any other revelations from 2degrees as to the terms of that contract.

11 But we would also note that - I must admit I can't quite remember what the  
12 extension provisions were in the 2degrees agreement. In the end that will be a matter for  
13 commercial negotiation between the parties.

14 **CHAIR:** Yeah, I don't think at this stage we need to get in - I mean I'm happy if 2degrees say  
15 let's have those arrangements public now, I don't know what your position is.

16 **MS MAZZOLENI:** Or we could have a closed session.

17 **CHAIR:** Or we could have a closed session specifically to discuss it. So we've got two choices  
18 there.

19 **MS MAZZOLENI:** I think it would be our strong preference if you did want to lift  
20 confidentiality to go through the process as opposed to what's been done today.

21 **MR McCABE:** I think if this particular one becomes public, I know actually that Vodafone put  
22 it on their blog yesterday and was asked to remove it again, so it keeps on popping up.  
23 But I think it's - in isolation this agreement - it's inappropriate to have this agreement just  
24 in isolation, there are plenty of non-price terms. I think if we had this then we would  
25 want to see all interconnect agreements made public and roaming agreements and all  
26 other access agreements, I don't think that it's appropriate to have a single agreement  
27 made public. If it's important to have one, then it's important to have all of them. I'm not  
28 saying I agree to that, but it's the principle which we would consider, but not in isolation.

29 **CHAIR:** I think we've got a choice of either now going into confidential session and asking  
30 everyone - I'll let Ernie make a comment before we do that - but I'm just saying the choice  
31 we have, seeing it is a matter that's now quite central is - and just consider this - is that we  
32 will have to ask those who don't have availability to that information to leave the room  
33 and then discuss the issue. So consider that, I'll just ask Ernie, who's been wanting to

1 make a comment on behalf of TUANZ, to just come in now.

2 **MR NEWMAN:** Yeah, I think that we're probably the only party around the table that doesn't  
3 have someone on their team who's seen the confidential information, so we have more  
4 difficulty in commenting on some of these situations perhaps than others. But it does  
5 seem to me there are three potential outcomes of this process. One is do nothing, the  
6 second is stitch together some undertakings and the third is regulation. And from what  
7 I'm hearing and reading and some of the speculation, it does appear that the undertakings  
8 are presenting the Commission with a very difficult implementational task.

9 I think it's implicit that to go down the undertakings route you actually need to  
10 have a set of undertakings that is coherent and that fits the total picture, and my sense is  
11 that that's not where we're at at the moment. And the Commission in fact has several  
12 pieces from different jigsaws, and if that's the case it seems to me that the only way  
13 forward is to virtually take undertakings off the table and say that the factual is regulation  
14 and the counterfactual is status quo, or vice versa. Unless the undertakings make sense in  
15 their totality as a way forward I can't see how they can possibly be considered as a next  
16 step.

17 **MR McCABE:** Vodafone are saying that I've spilled the beans on a part of the contract, I was  
18 actually just correcting them where they were saying it's 3 or 4 years, it was them who  
19 tried to spill them first.

20 **CHAIR:** So they spilt the wrong beans.

21 **MR YORK:** Pretty well since, well for some time. And actually the agreement isn't just a  
22 one year agreement from 2010 to 2011; and when you go and say you're doing your  
23 factual/counterfactual analysis, a key consideration in that is that you can do things with  
24 an undertaking in advance of what you can do under regulation, and so your period of  
25 considering the benefits and costs would go from the time of acceptance of the  
26 undertaking, and that would be early 2010 most likely or late this year.

27 **MS MAZZOLENI:** So does Vodafone need a closed session now?

28 **MR YORK:** I think what's certainly very important to us is at some stage today that we're able  
29 to have a decent discussion around what's in the interconnection agreement, because we  
30 think it does bear quite materially on whether or not you should be thinking there's an  
31 urgent need to jump in and regulate mobile to mobile termination. Now maybe we can  
32 wrap that issue and all issues into one session or we can keep trying to soldier on sort of  
33 talking about it in trounce.

1 **CHAIR:** Okay, we will deal with it in confidential session now. I believe this is the only  
2 confidential issue that needs some discussion, but if there is any others I think they should  
3 be dealt with at the same time. So if I can ask everyone to leave who doesn't have access  
4 to confidential information. We'll restart at half past 10 for public session so you can  
5 have the morning break as well and back at half past 10, we'll deal with the confidential  
6 session for as long as it takes. 2degrees and Vodafone people can stay because it's their  
7 information that we're dealing with. Can everybody else leave the room immediately  
8 please so we can start the session. That includes everybody in the public area. The only  
9 people who should be left are those who have seen the confidential information. So can  
10 we ask all the public to leave.

11  
12 **Conference closed for confidential session**

13  
14 **Adjournment from 9.24 am to 10.33 am**

15  
16 **ASSESSMENT OF BENEFITS AND DETRIMENTS OF**  
17 **FTM TERMINATION REGULATION**  
18

19 **CHAIR:** We're now heading into the second session, and we are dealing now with the  
20 assessment of benefits and detriments generally across the three markets, or sectors that  
21 we are discussing. I've left all my papers upstairs so I'm relying on my memory at the  
22 moment.

23 And the first issue before we get into the specific issues that may arise in fixed to  
24 mobile and mobile to mobile to SMS, there's sort of a - I'd like to have a preliminary  
25 discussion on the approach generally to assessing benefit and detriments which really  
26 applies to all three markets. And I was going to start, just excuse me while I now try and  
27 find the document that I was going to start with Professor Haucap, and I'll remember the  
28 question, which was in your submission you discuss the difference between first order  
29 and second order competitive effects, and I'd like you just to explain how you categorise  
30 effects into first order and second order and the relative importance in your eyes of first  
31 order effects as against second order effects.

32 **DR HAUCAP:** Often the - I think as I also pointed out in the report there's some inherent  
33 difficulty in assessing the benefits of increased competition in many markets on a

1 quantitatively exact view because you have to make some assumptions obviously about  
2 how prices will develop and decrease and what other benefits may be associated to  
3 competition that we usually not only assume, but also have some empirical evidence of  
4 the past that are usually associated with competition.

5 Many competition laws, at least in Europe but my understanding also in  
6 New Zealand, there is a general presumption that there are benefits brought along with  
7 increasing competition in markets and removing artificial barriers to entry in markets, or  
8 trying to prevent artificial barriers to entry to be erected in a market. So that seems to be  
9 a general presumption made in virtually all competition laws that I am aware of.

10 Then I think what is also true in almost all markets, if competition is increasing  
11 there will be some reshuffling of tariffs due to increased or changed competitive nature in  
12 the market. There are probably very rare instances where you have only a single product  
13 firm operating with a single price for all consumers. There may be these kinds of  
14 markets, but what we see in many markets there are different pricing structures and many  
15 firms are multi-product firms, so you must expect that when competition in one market is  
16 increasing that there will be some tariff rebalancing over the market that you see.

17 The general presumption that I think is correct is that these tariff rebalancings that  
18 happens I think in virtually all markets that we see of competition is introduced or  
19 increased in these markets, is taken to be second order effect that comes along that means  
20 that some rents are shifted around between consumer groups but also between producers  
21 and consumers and they are also inherently difficult to exactly quantify.

22 It's difficult to point to one that's a precise piece of evidence that has sort of said  
23 well in the majority of cases increased competition has really sort of - we can  
24 quantitatively demonstrate that this is benefiting us more than trying to have a limited  
25 number of competitors and try to reshuffle, or to rebalance the terrace in an optimal way.

26 But I think the overall experience from most countries that competition is  
27 beneficial, I would sort of classify these effects as being increased competition effect. So  
28 the removal of barriers to entry effect as a first order effect is what competition law is  
29 trying to achieve, and the other effects, the side effects that come along from increased  
30 competition as being the effects that are taking as, well, as side effects that come along  
31 that are usually assumed to have a lower impact on consumer welfare.

32 **CHAIR:** And in terms of weighting first order effect and second order effect, is there any sort of  
33 weighting that you would put on a -

1 **DR HAUCAP:** My general sort of presumption is that increased competition brings more  
2 benefits to consumers, than the rebalancing of terrace may do harm to them.

3 **CHAIR:** Can I ask the other economists to just comment on that general proposition, perhaps  
4 James.

5 **MR MELLISOP:** Okay, I suppose a couple of comments. One thing I think that's important in  
6 this process is not to conflate, or if we do conflate them to do it on purpose, two issues;  
7 one is MTR regulation and the other is entry. And I've made that comment in one of my  
8 reports in respect of the report by Eric and Emma. And that's not an easy thing to do,  
9 because the argument here is that lowering the MTR will help entry. So I acknowledge  
10 that that's a difficult thing, but I think it's important to keep those two issues separate.

11 In terms of the size of these two impacts, or effects we're looking at, I mean I  
12 agree with Justus that more competition is a good thing. My suggestion as to quantifying  
13 the impact of the entry of 2degrees versus the waterbed effect, which I think is the two  
14 things we're weighing up, is to try and look at what we can from the empirical literature  
15 and what can we get from that, and in our latest report we had some discussion about sort  
16 of the view that Eric and Emma have put in their report versus what I think is the view, so  
17 I won't necessarily repeat that now. So let's look at the empirical literature is my main  
18 answer.

19 **CHAIR:** Thank you. And John, do you have a -

20 **DR SMALL:** Yeah, I think certainly agree with what we heard from Justus and also, I think,  
21 from James. I'd say I do wonder where we're going with this, though, because we have - I  
22 mean the first order effect is entry, we have entry, we may be talking about, you know,  
23 efficient expansion or -

24 **CHAIR:** I think we are.

25 **DR SMALL:** Are we? Okay.

26 **CHAIR:** I don't think entry stops on day one.

27 **DR SMALL:** Okay.

28 **CHAIR:** Entry and efficient expansion in the market.

29 **DR SMALL:** Yeah, all right. I mean I assume that the entry that we've seen to date is efficient,  
30 and I expect it will give, you know, very durable consumer benefits, and simply because  
31 the asset's there, not necessarily because Bill's running it, whoever's running it I think it  
32 will give good durable benefits to consumers.

33 **CHAIR:** So is that sort of an inference that if 2degrees go out of business because they can't

1 make it someone can pick up the assets cheaply so the assets will be there so we don't  
2 need to worry?

3 **DR SMALL:** I'm not saying you don't need to worry but that is a fact I think, that the assets will  
4 remain.

5 **CHAIR:** It's certainly in a footnote, I think, in one of the submissions that the assets are here so  
6 someone will run them. Is it a matter for concern to this Commission? Or are you saying  
7 well, the assets are there now so you really don't need to be too concerned, someone  
8 might pick them up cheaply and competition will continue.

9 **DR SMALL:** Well, I mean I think there's a valid point to be made that what we're trying to do  
10 here is to protect the process of competition rather than any particular competitor and that  
11 this is a durable asset. I'm not suggesting that you should take from that that you should  
12 be in no way concerned whatsoever.

13 **CHAIR:** Thank you. Then a second question then for Dr Haucap then I'll get the economists to  
14 comment again. Paragraph 11 of your report you make a note again about welfare  
15 benefits of competition and you say; "Welfare effects of enhanced competition are  
16 notoriously difficult to estimate due to the dynamic nature of competition. Since it's often  
17 almost impossible to predict firms' business strategies and the innovations they may come  
18 up with, it is often considered a good approach to focus on market liberalisation and  
19 safeguarding of competitive processes".

20 Now an issue that we have before us is the extent to which cost benefit modelling  
21 should have been done or done to a greater degree in relation to the mobile to mobile and  
22 SMS markets compared with the approach that was taken in the fixed to mobile market.  
23 So my question for you is firstly is the modelling process that would be needed to model  
24 the dynamic effects of competition more difficult than the TSLRIC cost modelling  
25 exercises that we were discussing yesterday in terms of the assumptions you need to  
26 make, how would those two modelling processes compare?

27 **DR HAUCAP:** My initial reaction would be that from - I'm not a cost modeller, but what I  
28 know about cost modelling it is a difficult exercise, but I would still regard it as being  
29 easier in the way that you don't - well there is a set of assumptions that you have to rely  
30 on somewhat clearer. You of course have to make - in the end these are engineering type  
31 models where you have a rather clear picture of how a network will be structured, then of  
32 course you have to make a lot of assumptions about the cost of capital and also to some  
33 degree about future, well, usage and optimal investment paths that may be followed.

1 But, well, if you take different assumptions into account, as was mentioned  
2 yesterday, you can probably have some range of estimates that you can come up with and  
3 have some sensitivity analysis whether you think well you can see how the estimates  
4 vary. But you have a pretty clear picture of what you actually model because this is a  
5 given network in a given country, competitive process. I mean that's the nature of  
6 competition, that we don't really know what firms come up with in five years time, what  
7 kind of pricing packages they will introduce; we may still have some sort of idea about  
8 that.

9 What kind of services will be introduced to the market may be much more  
10 difficult to estimate. I mean who would have known what kind of service - I mean if we  
11 look five years back may have some sort of idea what service may be introduced, but  
12 there has been a lot of uncertainty also among the firms. I mean if we look at what they  
13 bid for UMTS licenses in Europe there are certainly some, well there's some opinion that  
14 they overestimated what they can offer over these networks. So there seems to be great  
15 uncertainty about what services may be introduced to the market.

16 I find it very difficult to predict what will be offered, and how consumers will  
17 react, because we also have to take into account what may consumers actually like in  
18 markets and what they don't like. And this is also why it's so difficult, I think in - well, if  
19 we look at sort of traditional competition law there's hardly any cost modelling that I'm  
20 aware of that is needed to keep markets open and to prevent anti-competitive strategies.  
21 At least in Europe I'm not aware that you need cost benefit modelling in order to prevent  
22 let's say predatory pricing or price fixing or any other anti-competitive strategy, because  
23 the general experience and presumption is that open markets that are open to competition  
24 will bring the benefits which are difficult to quantify.

25 **CHAIR:** But in short you're saying that it is far more difficult to model, if it's possible at all, and  
26 in fact I think your report said it was impossible to predict what future competitive  
27 behaviour would be, and I assume you say, therefore, whatever assumptions you make  
28 would be just a guess?

29 **DR HAUCAP:** Yeah, I would say it may be an informed guess, but then how well we are  
30 informed about the - I mean this is close to, well, it's very very difficult, let's put it that  
31 way.

32 **CHAIR:** Perhaps, James, you want to comment on that general proposition?

33 **MR MELLISOP:** Yeah, thank you. I think the issues - modelling TSLRIC is quite different to

1 modelling competition, I agree with what Justus is saying. I think the key difference may  
2 be for TSLRIC, the issue is that we know what the parameters are, that there's uncertainty  
3 around those parameters. Whereas when it comes to modelling competition issues it's a  
4 much more dynamic problem. So I think it is harder. It's not intractable, I don't think,  
5 and I note that the Commission, for example, in the merger area undertakes merger  
6 simulation. Now that's got to be regarded as just a tool as part of a broader analysis. But  
7 nevertheless it's regarded as one useful input.

8 **CHAIR:** Presumably based on experience from other mergers in terms of predicting.

9 **MR MELLISOP:** Well these models tend to be, you know, you take a Cournot assumption about  
10 how competition works with Bertrand. Now I'm not sure they're applicable for what  
11 we're talking about.

12 **CHAIR:** Yes.

13 **MR MELLISOP:** So I guess it seems to me coming back to the same point really that for - a cost  
14 benefit analysis is useful, but the best way to populate it here, I think, is to look at  
15 empirical evidence of the impact of entry, for example overseas. So that would be how I  
16 would approach it.

17 **CHAIR:** And John?

18 **DR SMALL:** Yeah, I think your question was is it more difficult and I would probably agree  
19 that it is more difficult than a TSLRIC model. What we're talking about is the welfare  
20 impacts of competition, but in order to predict that or form a view on that you need to  
21 understand how the competition itself is working.

22 But I think it's probably - I mean we should think of a model in this context as  
23 being a framework for analysis and there are many choices that you could make in terms  
24 of how you design that kind of framework. In fact, you know, to a degree Concept have  
25 done something like - they've gone some way down this path, they've done kind of a  
26 scenarios type analysis. And obviously in that kind of a - underneath that is some view  
27 about how competition's working, so they have not posited a formal model of that  
28 competition which would be going a step further.

29 So but I think there are various ways you can go about this. I don't think that  
30 uncertainty is really a reason not to - Justus referred to uncertainty and I acknowledge that  
31 there is uncertainty as there is in a TSLRIC context. But I don't think that's necessarily a  
32 reason not to do it. That's a reason to be cautious about how you do it and to use ranges  
33 and so on. I'd also say that it's in this context - it's quite different to predation and price

1 fixing and those sorts of issues which tend to be relatively easy to determine on the facts.  
2 It either is or it isn't, you know predation is a threshold with price fixing, there's usually a  
3 smoking gun somewhere in documents, that kind of thing.

4 So I don't think it's similar to that, I think it's different. So I guess in summary I  
5 acknowledge it's probably more difficult, or some ways of modelling competition would  
6 be more difficult than building a TSLRIC model, but there are many ways of going about  
7 it. And I think it probably is important to have at least a plausible story that you can point  
8 to and say well this is why competition increases and this is how that benefits consumers.  
9 I'd perhaps even - yeah, so -

10 **CHAIR:** I mean given the factual situation that we have in New Zealand with a new entrant and  
11 the statements that I referred to yesterday by competitors about how competition was  
12 going to be so beneficial, isn't that your plausible story, what more would you want? And  
13 while you're thinking about that I'll just move on to the next thing.

14 Having accepted that, and everybody agrees I can that modelling the dynamic  
15 effects of competition are more difficult than the TSLRIC cost modelling exercise, I'd just  
16 like to remind parties of our discussion about TSLRIC cost modelling yesterday when  
17 there was a high degree of criticism of how accurate this modelling was. There were  
18 words - I haven't got the transcript before me, but parties around the table said the  
19 modelling was very fragile, a change in assumption and you get a totally different answer  
20 and various comments of that sort. There was a general feeling that for the Commission  
21 to rely on TSLRIC cost models was highly dangerous because they really were not  
22 reliable.

23 And yet Vodafone, and I'll come to you now, have made submissions saying that  
24 the Commission must cost model MTM and SMS markets where we are faced with new  
25 entry. We've done some work on it but we said we're relying more on really the first  
26 order effects and the effects of competition and we think it's quite clear, and that  
27 modelling is really to assist in coming to, as we've said, a tool of analysis and the  
28 Commission came to a judgment that it was too unpredictable to go any further with  
29 modelling and that it would not be helpful.

30 And given the attacks on TSLRIC modelling yesterday and their reliability I just  
31 want Vodafone now to say, do you still say that the Commission must enter into cost  
32 modelling, and the word was 'must', it was not it might be helpful or it has a discretion.  
33 There were submissions from 2degrees on the legal aspects of that and that in fact there is

1 no legal obligation; but given that discussion do you have a different view to the one that  
2 you expressed in fairly forthright language in the submissions?

3 **MR YORK:** I think I'll start and perhaps Tom will add something to it after. I think what we  
4 think is vitally important is to do some form of quantitative analysis of the impacts, and  
5 we've had discussion in the closed session today which I won't talk about any more, but I  
6 think that's the kind of quantitative analysis that we think is vitally important for the  
7 mobile to mobile and SMS story. What we want to see is some analysis that will show  
8 that the kinds of regulatory activities that you might be contemplating doing will actually  
9 make a material impact, and we tend to think the two-way nature of both mobile to  
10 mobile and SMS bring into question how significant an impact it will have.

11 So I think it's that kind of analysis that we really think has to be done in quite a bit  
12 of detail and more than we've seen so far in the Draft Report. Is there anything you  
13 wanted to add to that Tom?

14 **MR CHIGNELL:** I guess just that it is a very material part of our business the mobile to mobile  
15 part of our business and probably a growing part of our business as well, so I'm not sure  
16 why the Commission would choose to give that less emphasis than fixed to mobile -

17 **CHAIR:** No, the point was just to clarify, it wasn't that it was given less emphasis, it is that - I  
18 mean fixed to mobile is an established market with historical situation that is capable of  
19 assumptions being made. This market where we've had two parties for many years and  
20 now a third party entering and the unpredictability, as all the parties have said, of the  
21 effects of competition has meant that we've taken a different approach, not because it's  
22 less important, but because the benefit of that sort of analysis is less apparent because of  
23 the - to use a Vodafone term - the heroic assumptions you would be making to try to  
24 predict what's gonna happen in 12 months. I mean 2degrees probably don't know what  
25 their strategy is going to be six months from now, so how the Commission is supposed to  
26 model it is - and that is the reason for a different approach, nothing to do with not treating  
27 it as seriously.

28 **MR FEASEY:** Maybe I could just add one comment, which is I think there are two aspects of  
29 the modelling you may be referring to. One is clearly how the competitive dynamics  
30 work out and what I think Justus was calling first order effects. But the second is what he  
31 was referring to second order effects, which is, if you like, the consequential implications  
32 for prices to existing customers, and in particular a point that we've made to the  
33 Commission here but we've made also as Vodafone in more detail, I think, to other

1 Regulators, to the different implications that that has for different segments of Telecom's  
2 users.

3 There is quite a lot of data that is available and has been modelled by Vodafone in  
4 submissions to Regulators around the world, that allows Regulators to - and we think it is  
5 important that they do, understand the second order consequences and what those might  
6 be for different categories of customers, depending on their usage characteristics and the  
7 relationship between mobile termination and the revenues that those customers generate.  
8 We think that is a relevant and important consideration not least for those customers, in  
9 making assessment and a judgment about the consequences of any proposed action on the  
10 market.

11 **CHAIR:** Thank you. Now do other parties want to make a comment on this? The general  
12 approach to measuring the benefits and detriments in specifically the mobile to mobile  
13 and SMS markets? I'll get you to - do 2degrees have any contribution? Nothing to add,  
14 you don't have to if there's -

15 **DR HAUCAP:** No, I think - no, nothing to add.

16 **CHAIR:** Okay, any comment around? Okay, James, I think you were -

17 **MR MELLISOP:** I partly just want to clarify, because I think the word 'fragile' I think came  
18 from me yesterday. I wasn't referring to -

19 **CHAIR:** I didn't think it was you, but okay. **[Laughter]**

20 **MR MELLISOP:** Okay, it's a word that I've used to describe -

21 **CHAIR:** It was someone from the Telecom team but I don't think it was you. He's not here  
22 today so we can't ask you.

23 **MR MELLISOP:** Certainly it is a word I have used, maybe yesterday but I've certainly used it in  
24 the past couple of weeks, not to describe TSLRIC modelling but to describe the  
25 theoretical literature on two-way interconnection. And that's when you change one  
26 assumption you suddenly get a socially or privately optimal price going from above to  
27 below cost. So that's where I see the word 'fragile', so that's just a point of clarification.

28 But the second point I really just wanted to make on the MTM and SMS, I  
29 suppose when I first read the Commission's Draft Report I was surprised that there wasn't  
30 a CVA of MTM because I don't see it as being any harder than FTM. I take your point  
31 there's more history with FTM, but I'm not sure it's actually any more heroic assumptions  
32 involved in MTM than there are FTM. And it just seems to me that the benefit of  
33 quantification, as long as we keep in mind how strong the assumptions are it adds a bit of

1 discipline to the way we think about the issue, and it will hopefully give some sort of feel  
2 for the magnitude of costs and benefits.

3 So I see it as a great discipline and one that - it's hard but I think should be  
4 undertaken - I don't know about the legal issue but from a public policy sort of  
5 framework.

6 **CHAIR:** Understand. Okay, I think - have you got one?

7 **MR FEASEY:** I just wanted to make one very quick point which is Justus' distinction between -  
8 a key part of the argument, as I understand it, from 2degrees and possibly for the  
9 Commission is that the so-called first order effects are bigger than the second order  
10 effects. In other words any detriments that may arise on mobile to mobile from a  
11 reduction in termination rates are overwhelmed by the dynamic benefits from  
12 competition.

13 Now it seems to me if - first of all I don't accept that there is any difference in the  
14 significance in terms of the weight that the Commission should attach to first order and  
15 second order effects, so if the implication is in some sense first order effects are more  
16 valuable to consumers I simply don't accept that, I think that those effects have equal  
17 weight, so they all have the same value.

18 The question then is which is bigger than the other. If that is the key contention  
19 and a key part of this proceeding I think it's quite tricky for the Commission to say well  
20 we don't need to attempt any very rigorous determination of the answers to that question,  
21 we don't need to model that question at all. And since a big part of the case for reducing  
22 termination rates from their current levels relies on that claim, it seems to me that's  
23 something the Commission would want to ensure it's done all it reasonably can on.

24 **MR YORK:** Can I raise one other point, I think Vodafone's view is that at least the attempt to  
25 do the fixed to mobile cost benefit model has been a good thing and it's been part of what  
26 the Commission's done for a number of years. What it nicely does is it recognises that  
27 there are benefits and detriments that come from this activity, and you try to quantify  
28 those. And then within that context you can compare the impacts with different rates,  
29 say, with an undertaking or with potential regulation. And you've done that with national  
30 roaming as well to some extent.

31 And I think the key point that we think comes out here is that there is the potential  
32 for detriments for mobile to mobile, you know, the impact on particular customer  
33 segments as Richard says, so the prepay and particularly the low stem(?) prepay. And I

1 think a model that tries to capture those impacts can help almost in a sense guide you in  
2 terms of seeing how significant those detriments can be for particular customer groups,  
3 and therefore the need really to have some kind of managed process around reductions in  
4 you're going to do it.

5 And so I think just as it's been very useful to have a fixed to mobile model, and we  
6 might have differences of opinion about the assumptions, but I think doing a cost benefit  
7 model along similar lines for mobile to mobile and SMS would be immensely valuable.

8 **CHAIR:** Final comment?

9 **DR HAUCAP:** Yeah, that's more a general comment because we talked about this is a two sided  
10 market which may make the modelling more complicated because there are these cross  
11 price effects that we also see sometimes in other markets when we have complementary  
12 products in multi-product firms or something. I am aware of some literature that suggests  
13 that market entry into platform markets, two sided market is more difficult. I'm not aware  
14 of literature that suggests that market entry in platform markets is some systematic way  
15 more harmful than entry in other markets.

16 We also know from the literature that entry into normal markets may be harmful  
17 because there may be too much product differentiation or inefficient duplication of fixed  
18 costs. I'm not aware of competition authorities who have taken the argument seriously  
19 and tried to prevent market entry in order to prevent inefficient product differentiation or  
20 something, because I don't think it's taking us a too relevant argument, and I'm not aware  
21 that in two sided markets it has been shown that there's a systematic difference that here  
22 market entry is more harmful than in other markets.

23 **MR YORK:** Could I just add one point then maybe Richard might add another. I don't think  
24 we're trying to suggest that market entry per se is harmful, it's what you do around mobile  
25 termination rates that has the potential to be harmful. And we also just don't think you  
26 need to do anything much more around mobile termination rates in order to make that  
27 market entry occur or be sustainable.

28 **CHAIR:** Yeah, thank you. That really dealt with a higher level issue that covers the three  
29 market sectors that we're going to deal with. So now looking specifically at fixed to  
30 mobile and the issue of pass-through. I thought that the way we might start this  
31 discussion is refer you to - and the question I'll put first to the fixed operators who are  
32 represented here, to start off by referring to Vodafone's cross-submission and I'll read it  
33 on paragraph 254 they say; "TUANZ often talks about the tort that is mobile termination

1 rates. We think the rort is actually with the fixed line operators rather than the mobile  
2 operators. Fixed line operators are happy to take massive reductions in mobile  
3 termination rates and keep the vast majority of it for themselves".

4 And at 245 they say; "No wonder smaller operators have pushed hard over the  
5 years for greater and greater decreases in fixed to mobile termination rates. It is a  
6 lobbying game that greatly flattens their margins. Of even more concern the Commission  
7 itself seems happy to sit back and watch these margins grow".

8 So that was a fairly provocative statement and I thought that there was a  
9 possibility that those who were engaged in the rort might like to respond. So I don't  
10 know, Chris, you're the closest, have you got a view on that?

11 **MR ABBOTT:** Yeah, I think it's certainly an interesting issue. I think fundamentally where we  
12 start the starting proposition is around above cost termination, it has a distortionary effect  
13 in the down-stream market. Now what is the down-stream market, what is the  
14 competition we see occurring in the fixed line market? It's around bundles, it's not around  
15 stand-alone services. If we look at the genesis of competition it started around tolls fixed  
16 to mobile and the genesis of that was largely Clear Communications, the predecessor  
17 company to TelstraClear.

18 What we now see in the market is a movement towards bundles, so that is access  
19 calling, broadband and television. And we all fairly ferociously compete around that  
20 whole parameter. What we sell to our customers is a value proposition and a bundle, and  
21 I think everyone, and I see it in the propositions Vodafone make as well, it's around  
22 bundling, it's not around single services.

23 I think the other thing to note is that we do, and we've provided the Commission  
24 with confidential information around pass-through, we do see pass-through and it occurs  
25 in multiple ways. In the business market we aggressively compete against everyone  
26 around the table to compete for customers, and we're require to compete against retail  
27 rates for fixed to mobile that are below the wholesale price that we currently pay.

28 So to the extent that there's distortion from above cost, that makes it more difficult  
29 for us to compete than for integrated players in the market. These are always bundles,  
30 we're very happy to compete. The notion that TelstraClear with I think in the fixed  
31 market around about 15% market share can over the longer term in a competitive market  
32 sustain ridiculously high rates, or rort, rort the system seems to me to be somewhat  
33 unrealistic in the face of bundles.

1           In the residential market too I think simplistic analysis of what might be headline  
2 rates on the internet sites are unrealistic. I think Telecom, for example, has a 45 cent  
3 headline rate. The reality is people buy bundles of services, buckets of minutes. People  
4 buy from us toll buckets, something called Yak Paks, and that is a bundle of national,  
5 international and fixed to mobile minutes. It's a proposition which our customers like and  
6 prices have come down. I go back to the genesis of the Clear Communications' entry into  
7 the fixed mobile. What did we see happen in that market? High prices from an original  
8 monopolist couldn't be sustained and those prices came down. I have no reason to think  
9 any other outcome is likely in a bundled market.

10           The other issue I think Vodafone has picked up on around mobile termination rate  
11 and alleged pass-through from Telstra in Australia. I think Telstra's view is very clear  
12 and it's the same, it's around pass-through in bundles. The other thing the ACCC has  
13 identified is the innovation that comes from improving competition in up-stream  
14 bottleneck markets that flows through.

15           So in our view, not only does over the longer term in a dynamic market, the  
16 benefits do get passed through, I think it's an unrealistic assumption and I think most  
17 markets where you improve competition you don't sustain these alleged rorts.  
18 Furthermore we believe, and the information we've provided to the Commission strongly  
19 suggests, that there is significant pass-through occurring.

20 **CHAIR:** Graham have you got a contribution to this?

21 **MR WALMSLEY:** Yeah, thanks. I guess the issue we're dealing with is we're seeing  
22 increasing bundling being driven by the mobile operators that are also fixed operators. So  
23 we've kind of got that horizontal bundling being driven by the mobile operators and we've  
24 got the on-net/off-net pricing that's dropping through into the fixed to mobile space. It's a  
25 sort of, to coin a phrase, a toxic cocktail for acquiring and retaining customers for us.  
26 We've got mobile to mobile rates that are below our fixed to mobile termination rate, and  
27 that's driving people to pick up mobile devices and landline devices. And then we've got  
28 the issue that that also moves into offers in the fixed to mobile space that are below our  
29 cost. So it's a difficult issue to deal to.

30           In terms of the issue of pass-through, I mean we're a small business, we're a very  
31 small business, growth is an imperative to us, we have to achieve growth to survive  
32 really. So we're very focused on growth and one of the few cards we've got to play is  
33 offering consumers a better deal.

1           The suggestion that we react - but, yeah, as a reduction in mobile termination rates  
2 the suggestion that we react by lowering our LTC prices in that sort of mono-dimensional  
3 view just isn't a reflection of the market we operate in. We're up against bundles that are  
4 being driven by the other guys. Going into a head on battle on one single product actually  
5 is a battle that we shouldn't be fighting because we're not well able, in a marketing sense,  
6 to win that battle, so we pick our battles more carefully as the small guy.

7           We're actually more likely to focus our propositions around broadband,  
8 international rates, which are battle grounds we're more able to fight on because of our  
9 extensive POT networks and so on and so forth. So the notion that by dropping a  
10 wholesale price over here should directly flow through in the same product line in an  
11 integrated telecommunications market is a nonsense, in fact actually it would be the  
12 dumbest thing we could do in a marketing sense.

13           So we do pass-through, it's an imperative we pass through, because we will only  
14 survive by offering a better deal, and that's the bottom line for our business. So we  
15 believe pass-through occurs, it just doesn't occur in that sort of myopic way.

16 **CHAIR:** Thank you. Susie have you got a comment?

17 **MS STONE:** I just agree with the point that Chris and Graham have made. I reject the assertion  
18 that Vodafone's made that this is some kind of lobbying game, I think that belittles the  
19 actual impact that it does have on our business which is real. We're also a small operator  
20 in the marketplace and like CallPlus and TelstraClear we compete absolutely on bundles  
21 and we play to our particular strengths. So I absolutely reject the assertion that there's no  
22 pass-through occurring here.

23 **CHAIR:** Before I come to Vodafone who made the assertion, I might ask whether Telecom  
24 shares the view that was expressed by Vodafone in its submissions.

25 **MR WESLEY-SMITH:** Yeah, it sounds like a pretty good market that Vodafone describes to  
26 me. In practise, look I think Chris, Graham and Susie have given a pretty good  
27 break-down of what the fixed side of our market looks like. Fixed margins are only going  
28 one way on calling and the specific market that we've identified for CBA purposes, that's  
29 the market that Google and Skype are operating in today and that's what's driving  
30 consumer behaviour and pricing in that market. So to claim that there's some rort going  
31 on we just don't see it in practise and it doesn't show up on our bottom line.

32 **CHAIR:** Going to Vodafone I wonder whether you, reflecting on that submission that was  
33 made, do you still maintain that these operators are rorting the system, or do you think

1 perhaps that is overstating the position?

2 **MR YORK:** I guess our question would be to say is the market perfectly competitive already in  
3 the fixed line side of things, are all the conditions in place so that it is effectively  
4 competitive and you can be confident and sure that 100% pass-through would occur, and I  
5 don't think you can be of that view.

6 The second point -

7 **CHAIR:** Sorry, can I just test that out. We've got the fixed line operators telling us this is a  
8 market of bundles as everybody knows.

9 **MR YORK:** Yeah.

10 **CHAIR:** And that pass-through occurs in a multitude of ways that can't be measured, you've  
11 suggested you can only measure it in one way, which they say just is unrealistic and  
12 would be the silliest thing that any of them could do. So just focusing on that proposition,  
13 do you agree there's some merit in what they've said and if there is doesn't that really  
14 impact on everything you've said about pass-through in this market?

15 **MR YORK:** I think what you've got here is a situation where we're meant to accept there's an  
16 article of faith that -

17 **CHAIR:** No, no, not article of faith, your understanding of market conditions, would you think  
18 it is more likely that their explanation fits with what you see in the market, or do you  
19 think it's more likely that they don't compete and they increase their margins in the market  
20 that everybody else told us is competitive.

21 **MR YORK:** The evidence on fixed to mobile as a service is that the margins are increasing,  
22 that's clear, because the evidence that we're seeing, even from your own tables, is that  
23 while mobile termination rates have been coming down rapidly over the years fixed to  
24 mobile prices aren't coming down nearly as much. And the RI information -

25 **CHAIR:** Have you taken account of bundles in your analysis or only headline prices?

26 **MR YORK:** Well the data that goes into the work that you've looked at is minutes that have  
27 come out of bundles. Now whether there is additional mobile termination rate reductions  
28 that might be being passed through in other parts of the bundle, you know, that's possible,  
29 but we're being asked to take that as an article of faith that that is going on. What you  
30 have in the alternative is a deed where you can have assurance that reductions in  
31 termination rates are passed through in full.

32 **CHAIR:** I'm more interested in your assertion that there's a rort going on, I just wonder whether  
33 you still assert that is the case.

1 **MR YORK:** I have a look at the numbers and I see the margin on the fixed to mobile service is  
2 growing, I have nothing before me to show that the mobile termination rates are being  
3 passed through in other services.

4 **CHAIR:** But that is a sort of a step further to say therefore there must be a tort.

5 **MR YORK:** Well I have a look at the service and I see the margins increasing.

6 **CHAIR:** Okay, that's fine, you hold your position, you're perfectly entitled to do that. Can I ask  
7 Mr Newman to contribute.

8 **MR NEWMAN:** Yeah, we would generally be supportive of the view that Chris Abbott  
9 expressed and that's been expressed across the table. In a sense users are never satisfied  
10 with the level of pricing and competition, but I'd have to say the fixed line market for  
11 voice generally is regarded as having a healthy level of competition. We have no  
12 problem in that context with the notion that the pass-through comes in the form of  
13 bundles which means that it's not necessarily as transparent as one might want in a pure  
14 economic sense, but we regard that as being one part of the market that is working  
15 reasonably well.

16 And we certainly don't accept the argument that mobile termination rates should  
17 be allowed to stay excessively high because if that excess pricing is not allowed to  
18 continue it will result in excess pricing somewhere else in the market; that's not valid to  
19 us. So we're supporting Telstra and CallPlus and Kordia in that view.

20 **MR YORK:** Can I ask a question of Ernie through the Chair?

21 **CHAIR:** Yes please.

22 **MR YORK:** As you know the MTR deeds have that 100% pass-through commitment in them  
23 that ensures that any reductions are passed through in full. Do you see that as a valuable  
24 element in itself? And so that whatever does happen, say through undertakings where  
25 parties might agree to reductions, they might even be greater reductions than are in place  
26 right now, that having that pass-through commitment in there provides benefit for  
27 consumers and guaranteed benefit for consumers for whatever level of reductions occurs?

28 **MR NEWMAN:** You can make that argument in sort of a short-term sense, but if you actually  
29 get to the point that you are incorporating pass-through into the regulatory process in that  
30 way you're almost starting to verge on price control in the retail market, and we're not  
31 sure that that's philosophically a desirable way to go. We have confidence in the process  
32 of the market which is on the face of it reasonably competitive to pass that through  
33 through the normal commercial process. We would prefer to see that happen, even if it

1 takes a little longer, which we accept that it might, we'd rather see the market passing  
2 through over time and in its own way bundles or otherwise than have in effect a tiny  
3 portion of the fixed to mobile market sort of secondarily regulated.

4 **MR YORK:** So just to clarify for any given level of rate reduction you would rather just leave it  
5 to the market to sort it out rather than a pass-through guarantee?

6 **MR NEWMAN:** When you say any given level of rate reduction, I mean if you take the  
7 extreme, if you said to us, you know, we'll go straight to bill and keep you possibly get a  
8 different answer on that. But that's hypothetical. But what I'm saying is that we would  
9 prefer market forces to prevail where there is demonstrable working competition rather  
10 than have regulation start to stray into areas where it really doesn't need to be.

11 **CHAIR:** Thank you for that, I think really that deals with the pass-through issue, and we can  
12 move to discuss the waterbed effect in relation to the fixed to mobile markets. I'll start  
13 with a question to the economists to help me understand the theory of the waterbed effect.  
14 As I understand the theory the greater the level of competition in a market the greater the  
15 waterbed effect in what I read, and that sort of struck me as very odd until I did some  
16 more reading.

17 So my understanding is, and the economists can put me right on this, is that the  
18 theory is the greater degree of competition in the market the closer prices will be driven  
19 towards some level of cost so that in perfect competition there are no rents at all being  
20 earned, so that in the event that costs increase somewhere on one side of the market they  
21 would need to be recovered on the other side simply because there were no rents to be  
22 competed away, if you like, but the less degree of competition the less likely, or the less  
23 the waterbed effect would be because there are some rents in there that presumably could  
24 disappear.

25 Is that the explanation - I'll start with James, you're closest, is that the basic  
26 premise behind the proposition that the waterbed effect is greater the greater the level of  
27 competition, or have I got it completely wrong?

28 **MR MELLISOP:** I wouldn't say completely wrong, I guess I would just emphasise a couple of  
29 points, though, just to make it very clear.

30 **CHAIR:** You're very kind.

31 **MR MELLISOP:** The first thing is that even if there's a monopoly mobile network operator  
32 there is still a theoretical waterbed effect. And I mentioned yesterday that it's actually  
33 about changed incentives, that's what drives the waterbed effect. And in respect of a

1 monopolist, in effect maybe the easiest way to think about it is that if you push down  
2 MTRs the marginal revenue per customer for the monopolist has dropped, and one might  
3 think about that as a change in marginal cost. Either way if you think about your basic  
4 monopoly diagram demand and supply curves you get a change in price and output just as  
5 a rationale response. So that's the first point, does that make sense?

6 **CHAIR:** Mmm.

7 **MR MELLISOP:** Then the other extreme is perfect competition where any rents from mobile  
8 termination are just competed away by trying to get subscribers. So at the extreme they're  
9 all competed away, so there are zero profits. And then there's this kind of in between  
10 world which is of course the most realistic. But I think fundamentally, just to made the  
11 same point again, it's not just a matter of I've lost money here I'll pick it up there, it's  
12 actually customers are made less attractive by MTR drops, therefore my rational  
13 response, whether I'm a monopolist, whether there's two or three players or not, my  
14 rational response is to change my pricing on the other side just because my marginal  
15 revenue or marginal cost curves are altering. So it's driven by the incentive, I really  
16 wanted to clarify that.

17 **CHAIR:** Okay, I might come back to that later. Professor.

18 **DR HAUCAP:** I think this is a very valid point that James already made yesterday as well that it  
19 is about the incentives. If I have a monopoly on termination then it's of course very - I  
20 have very high incentive to compete for that customer in order to obtain these monopoly  
21 termination rights. If competition is really really intense then it would be so intense that it  
22 would hand back all the money that I earn on that customer to that customer through  
23 whatever retail price reductions there may be, handset subsidies or some other retail  
24 reduction. If, of course, competition is not so intense I don't have to hand back all the  
25 money but only part of the money to the customer.

26 What is, I think, especially relevant to our analysis here is the question, and I think  
27 Vodafone and we disagree here, whether the waterbed effect or the reduction in mobile  
28 termination rate is inseparably connected with market entry or not. If you assume it is not  
29 connected to market entry then you may think well then the higher intensity of market  
30 competition that we have in any case here would make the waterbed effect stronger.

31 **CHAIR:** We're really talking about fixed to mobile waterbed effect at the moment.

32 **DR HAUCAP:** That's right.

33 **CHAIR:** Rather than mobile to mobile, so that does still impact?

1 **DR HAUCAP:** Yeah, so if you assume we have fewer customers - fewer operators who  
2 compete you may think okay the pass-through is not as high as with three operators from  
3 this fixed to mobile money that they get. If you think, however, that it's sort of conducive  
4 to entry then the degree of competition may be changed as well with the reduction in  
5 mobile termination rate, so you cannot analyse the waterbed effect for a given degree of  
6 competition but it may change in the market.

7 So and then the question is not so easy to answer, that means the waterbed effect  
8 becomes stronger now suddenly because we have three operators, but it may also become  
9 weaker because suddenly it's not so easy if we have a reduction in mobile termination to  
10 just recover it from your customers. But the pass-through may be weaker because, well,  
11 there is a competitive restraint, there is suddenly an additional competitive restraint in the  
12 retail market, so you may not be able to get the money back even if you would like to  
13 have it back.

14 So this is a very delicate analysis and that's also why I think some of the literature,  
15 well, the New Zealand circumstances are really somewhat special, in my view, because  
16 market entry is a crucial issue here and much more crucial than it may have been in some  
17 European countries where entrants have been established for 15 years or longer.

18 **CHAIR:** Thank you, John.

19 **DR SMALL:** I don't really have a lot to add. My answer to your question is broadly yes, that's  
20 my understanding of how it works. I would, I guess, agree with Justus that the intensity  
21 of mobile competition is changing in New Zealand and that's going to complicate things,  
22 but in terms of your basic proposition yes, I agree.

23 **CHAIR:** Okay, then just moving on from there, we've sort of heard about first order/second  
24 order effects and it seems to be that the way the waterbed effect will work if termination  
25 rates are lower it is suggested that prices are likely to increase on the other side of the  
26 market, which is in subscriber costs or something like that, that that's where the balancing  
27 act and - which raises another issue I think for competition Regulators to consider.

28 Just drawing on my experience with the EFTPOS interchange cases in Australia  
29 where the primary driver the Reserve Bank of Australia was concerned about in  
30 regulating those interchange fees was to move the cost from a hidden wholesale charge to  
31 a transparent retail charge, so they accepted the waterbed effect and what they were really  
32 saying was "we'll regulate the interchange fee, you the banks can recover whatever  
33 amount of it, and let's say 100%, in the retail side by charging your customers, and

1 competition will very quickly whittle away those charges".

2 So you're moving the cost into an arena where it's transparent, where it's sending  
3 price signals to consumers and competition can work to reduce it. Because the same way  
4 as these termination fees in New Zealand are not subject to any sort of competition, they  
5 have been subject to some political pressure with the deeds and they're being subject to  
6 some regulatory pressure, but these bilateral arrangements that are the same on either side  
7 so they're not subject to competition pressure at all.

8 So one of the benefits to the competitive process was that the waterbed effect  
9 would move those costs to where price signals and competition could compete them  
10 away. So my question really is that even if there were 100% pass-through into retail  
11 pricing somewhere, the anticipation would be that that would be, in a competitive market,  
12 competed away very quickly and that in itself, the fact that that is possible is another  
13 reason for doing it. Just from an economic perspective first then we can get the parties.  
14 Perhaps, James, we'll start with you again.

15 **MR MELLOP:** I hadn't quite thought of it in that way before so I'm just trying to collect my  
16 thoughts. One reaction I had while you were describing the question, Ross, is it's kind  
17 of - there's been a lot of discussion about subsidies and rorts and operators, and I guess it  
18 relates to the last discussion about pass-through as well. But there is a price signal at the  
19 retail level from high MTRs and that's it for fixed calls.

20 So there is some degree - I'm not sure if this is your ultimate question, but early on  
21 I thought that - and I'm not familiar with the Australian EFTPOS situation, I'm familiar  
22 with the credit card situation but not the EFTPOS. I took your question to be about  
23 getting the price signals where they were more transparent.

24 **CHAIR:** Yes.

25 **MR MELLOP:** So one response is that it's ultimately not the fixed operators who pay this it's  
26 their customers, so we're seeing the transparency at the fixed customer retail level, subject  
27 to the discussion about pass-through.

28 The other thing to put in the mix, look I don't have a particular view as yet  
29 because I haven't thought about it carefully enough, but it comes back a bit to this  
30 discussion about where you're best to recover common costs. And it reminds me a little  
31 bit of the Commission's theory in the credit card case here about inefficiencies in certain  
32 areas and how potentially shifting around the fees could get a more allocatively efficient  
33 fee structure. I guess I'm always wary about Regulators doing that because it's like trying

1 to set Ramsey pricing, it's very difficult informationally.

2 One thing the literature does say is that the demand elasticity is lowest for  
3 termination calls, for termination services. So that would be an argument to recover a  
4 greater proportion of common costs from termination services. I'm aware you do run into  
5 this issue about is that what we're seeing currently or are we seeing actually higher  
6 recovery than that due to the bottleneck? So there's a conflation of issues there. Overall  
7 I'm not sure I have a particularly good answer but think those are issues which are useful  
8 to think about.

9 **CHAIR:** No, it's helpful comment. It's not something you were expecting. Professor Haucap.

10 **DR HAUCAP:** I'm not so much an expert in credit card markets, I don't know as much about  
11 credit card markets as telecommunications markets. It sounds plausible on first sight to  
12 me what you suggest. But I think there's one important difference between two sided  
13 markets in telecommunications and other two sided markets as one always has to take  
14 into account. That is in telecommunications all these competing platforms that we  
15 have need to be interconnected. There is a bottleneck problem because I want to have  
16 interconnectivity and to make mobile calls from all networks to all other networks. That's  
17 different certainly from newspapers or nightclubs or also credit card, I think from credit  
18 cards where I'm not aware Visa needs access to Mastercard's network necessarily,  
19 whereas mobile telecommunications is essential.

20 So I would think that here if we still have this termination monopoly, which I  
21 wouldn't exactly see the analogy to what the termination monopoly may be in credit card  
22 markets, so here still the analogy would probably - so the effect may be even larger  
23 because here we have monopoly price and if reduce them this induces entry, then the  
24 mark-up may be reduced on the competitive retail side of the market; so it may be similar  
25 to what you suggested I think.

26 **DR SMALL:** I've got a rough idea what you're talking about in regards to the EFTPOS in  
27 Australia. And I think one of the manifestations of that was this idea of very transparent  
28 charges at ATMs so that people could see.

29 **CHAIR:** That was part of it.

30 **DR SMALL:** That kind of thing. I could see a lot of merit in that. But your general proposition  
31 was is there a benefit from shifting charges from a wholesale environment to a retail  
32 environment where they're transparent to customers and therefore more likely to be  
33 competed away. I think, it seems to me that in this context that's not actually a reason to

- 1 do it. If that was a reason to do it then you'd wonder about -
- 2 **CHAIR:** I wasn't suggesting it was a reason to do it, but is it a factor to take into account more  
3 than -
- 4 **DR SMALL:** Is it a benefit for example?
- 5 **CHAIR:** Yeah.
- 6 **DR SMALL:** Yeah well, I think - yeah, it could be some form of benefit, I'd caution that  
7 obviously there's a constraint to how far you can go with that.
- 8 **CHAIR:** Of course.
- 9 **DR SMALL:** And obviously it does alter the structure of prices and will have welfare effects.
- 10 **MR YORK:** Just wondering if I might make a comment. On the assumption, and it's an  
11 assumption we don't accept, but on the assumption that prices were above cost, reducing  
12 the rates, as long as you don't move to bill and keep, isn't gonna take away the fact that  
13 there still will be a termination charge and there will, to that extent, still be something that  
14 isn't transparent to the consumer. So the question is where are prices now in relation to  
15 costs.
- 16 **CHAIR:** Correct, yeah.
- 17 **MR YORK:** Where our view is that, you know, actually the prices we're at now aren't really too  
18 far away from what you thought costs were during the last investigation where we were  
19 thinking around about 15 and declining a little bit.
- 20 So I guess our point is we're not saying they're above cost now, but if you're of a  
21 different view and think prices should come down then really it should occur over a  
22 managed glide path, because there can be detrimental consequences that occur in the  
23 mobile space. But even reducing it to cost won't take away the fact that termination's a  
24 hidden, in a sense, wholesale charge.
- 25 **CHAIR:** Of course.
- 26 **MS MAZZOLENI:** But even if it's hidden to consumers the true costs should fall in the  
27 appropriate place.
- 28 **MR YORK:** I don't think we're saying any different, we still think the appropriate pricing  
29 principle is TSLRIC. We don't think our prices are departing from that. But if you're of a  
30 different view and think that the prices should come down we would argue that will have  
31 consequences in the retail space, and that they need to be managed and they should be  
32 managed over a glide path.
- 33 **CHAIR:** Stephen, have you got some questions?

1 **MR HUDSON:** I had a question around the potential magnitude of the waterbed effect. We  
2 heard earlier on this morning about a couple of, I guess, extreme sort of scenarios in terms  
3 of perfect competition at one end and a monopoly mobile network at the other end. These  
4 examples, as I understand, are based on competition between mobile networks that are  
5 sort of homogenous. They're pure mobile only operators and you can look at the impact  
6 of reductions in termination rates on those networks.

7 But if one of the mobile operators also has a large fixed network then the analysis  
8 or the results of that analysis could potentially change. And I note that in 2004 Covec on  
9 behalf of Vodafone did some analysis of the relative impact of reductions in termination  
10 rates on a fixed and mobile integrated operator versus the impact on a pure mobile  
11 operator and found that, you know, there are potentially quite different impacts. Indeed in  
12 2003 Vodafone Australia appeared to refer to this issue pointing to Telstra and submitted  
13 that as a result of that there would likely be no waterbed effect as a result of reductions in  
14 termination rates.

15 So I'd just be interested in the views of parties on the significance of Telecom in  
16 the market as a mobile competitor in New Zealand also have in a fixed network, what  
17 impact that might have on the incentives for the mobile operators to rebalance their  
18 tariffs; and also I guess maybe from Vodafone's perspective given the argument that they  
19 made back in 2003, what's different between that fact scenario and the scenario that we've  
20 got in New Zealand now where obviously Telecom has a fixed and a mobile network?

21 **MR FEASEY:** Maybe I'll start. I mean there's lots of beliefs about the waterbed, but I very  
22 much agree with James, which is that at the end of the day all we can do, I think, is look  
23 at the evidence and look at the data and the empirical data, which is why Vodafone  
24 worked with Valletti and Genakos on looking at that. So we have the empirical data and  
25 the data set that they looked at, which was a wide range of Vodafone companies  
26 competing across a large number of markets. In many cases those involved markets  
27 where there were integrated fixed mobile incumbent operators principally, and Vodafone  
28 clearly was pricing to remain competitive with those players. So we have some  
29 measurements and some results but I think ultimately this is a question of the data.

30 The second point I'd make is Justus' point. He says, I think, that's all very  
31 interesting but we've got something else going on in New Zealand which is in addition  
32 we've got this factor of entry. I agree with that, but I think he also went on to say, which I  
33 also agree with, that the consequence of entry for whether the waterbed goes up or down

1 in magnitude is very subtle, and very uncertain, and you can't therefore say, or put to one  
2 side, the empirical data that we've got. We'd obviously like there to be more empirical  
3 data out there but that is what it is.

4 You can't, I think, discount that and say we're entitled to assume that there isn't a  
5 waterbed of similar sorts of effect that we observe in other markets in the New Zealand  
6 market simply because of the fact of entry; could be greater, could be less. I haven't  
7 actually seen any evidence submitted by 2degrees or any of the other parties, including  
8 us, that would allow you at this stage to answer that question.

9 **MR HUDSON:** I guess just in response to that, I guess you do have some empirical work that's  
10 been done, as you say, looking across a broad section of countries. I guess in the  
11 New Zealand situation let's say that Telecom as a whole, there was a neutral impact on  
12 Telecom as a whole from a reduction in termination rates because of the fact that it's got a  
13 large fixed network. If Telecom has little incentive or little need to rebalance its tariffs as  
14 a result, then how, if the mobile market is as competitive as you have said it is, how could  
15 Vodafone get away with -

16 **MR FEASEY:** I agree with that, which is why I made the point that the empirical evidence that  
17 we have from other markets precisely looks as that issue because in those other markets it  
18 is precisely Vodafone competing with those integrated operators.

19 **MR HUDSON:** So you'd accept, looking at some of those other markets, I mean for example in  
20 the UK, Ofcom has come to the view that there may be, you know, there's likely to be a  
21 waterbed effect although it's likely to be less than complete. That's a market where there  
22 are five, I think there are still five pure mobile operators. In New Zealand where we've  
23 got two large and one small mobile operator, one of the large mobile operators has a fixed  
24 network, you would expect the waterbed effect in New Zealand relative to what's been  
25 found in the UK to be significantly less.

26 **MR FEASEY:** No, I don't think I'm saying that. I don't think you can make any clear deduction  
27 about what the waterbed effect would be simply as a result of there being an integrated  
28 firm or not being an integrated firm. All we have, I think, before us is the evidence of  
29 looking across a large number of markets, and to my knowledge in all of those markets,  
30 with the one exception of the UK, we are looking at a market structure not in terms of the  
31 number of firms but otherwise similar to New Zealand; in other words some mobile only  
32 players in the market, including Vodafone, and typically an integrated fixed mobile and  
33 incumbent operator.

1           And therefore I don't see any reason why the results from that paper would a priori  
2           be inappropriate to thinking about New Zealand, with the exception of the point that  
3           Justus made, which is the difference in New Zealand is you have new entry perhaps in a  
4           way that you don't in those other markets.

5           **CHAIR:** Do other parties have a comment on that exchange or view?

6           **MR MELLISOP:** It's a comment I've made several times. I can't remember, I've probably read  
7           that particularly Covec report but it's a long time ago. But I'd just like to come back again  
8           to the difference between incentives and revenue impacts, and if it's the case that Telecom  
9           gets revenue from one area and puts it in another that's different than what happens to  
10          prices in each area because they're driven by incentives.

11          So I think that's an important distinction, and I say that without knowing - these  
12          guys can obviously speak to the paper. I worry about conflating those two things again,  
13          that's why I keep coming back to the waterbed effect is about incentives not just finding  
14          profits.

15          **MR HUDSON:** Just on that you did open your initial sort of comment around the line that what  
16          we're probably talking about here is a change in marginal revenue which is roughly  
17          equivalent to a change in marginal cost. If from Telecom's perspective as a whole there's  
18          no change in marginal cost then doesn't that suggest that they won't actually move on  
19          price?

20          **MR MELLISOP:** But the fixed business has different customers, we're talking about the  
21          marginal revenue for a mobile customer versus the marginal revenue. So it depends on  
22          the increment you take. I can't speak for how Telecom does its marketing, but I would  
23          expect there are different parts of the business who think about mobile revenue from a  
24          customer and how they should behave versus a fixed customer. So I'd be surprised if  
25          Telecom just says "the pie is the same, we won't change"; I think it's likely to be more  
26          complicated than that.

27          **MR WESLEY-SMITH:** I can confirm that, that's importing a fair amount of sophistication into  
28          how we run our marketing and business. And going back to James' incentives, I just  
29          don't see in the mobile market what the incentive for Telecom to act that way would be.

30          **CHAIR:** John it's your report, I think, so if you go first.

31          **DR SMALL:** I was just gonna make a suggestion, I think there's an easy way to answer this  
32          question, which is probably to ask Telecom how they incentivise the people who run their  
33          mobile network. I mean if they treat that as a separate division essentially, and someone's

1 rewarded for, you know, optimising in there, then I think it would be reasonable to  
2 conclude that this integration, while it will have revenue effects and I think that was  
3 where our report was focused, it probably won't have the effect that Stephen's referring to.  
4 So I think it's a relatively easy test, I don't know what the answer is.

5 **CHAIR:** I think we know what the answer is. John, do you want to answer the question,  
6 nobody else knows the answer.

7 **MR WESLEY-SMITH:** Look I can't tell you what Paul Hamburger's incentive structure looks  
8 like but he's fairly focused on mobile. **[Laughter]**

9 **CHAIR:** Thank you. Any other comment on this issue?

10 **DR RALPH:** Yeah, can I just make a couple of comments. The first one, I guess, is just to say  
11 that it does seem pretty clear to me that if you were to think about duopolists who are just  
12 pure mobile duopolists competing and you were to think about duopolists, one of whom is  
13 both a supplier of fixed services and a supplier of mobile suppliers, then presumably the  
14 degree to which that fixed plus mobile operator is going to compete in the mobile market,  
15 they're going to take account of the obvious fact that mobile service competes with their  
16 fixed service. So it would seem to me just as a pure question of market structure  
17 comparisons, it's not - you know, I think your a priori assumption would have to be that  
18 the New Zealand situation you might want to characterise as one and a half competitors  
19 rather than a duopoly; and so that's just one point.

20 A second point to make is just to come back to the idea of the waterbed effect, and  
21 Justus may want to correct me if I'm mis-characterising him, but certainly my view is that  
22 the waterbed effect, whatever it is, is very likely to be swamped, in terms of the harm that  
23 may be incurred by some customers due to higher prices, is very likely to be swamped by  
24 overall decline in prices brought about by entry. So if what you're doing is you're - again  
25 just to make two simple comparisons.

26 If you're asking the question what would happen in a market with a fixed and  
27 mobile competitor and a mobile competitor where you lowered the mobile termination  
28 rates you would get one effect and there would be some amount of waterbed effect that  
29 occurred there. I wouldn't personally want to describe a lower MTR rate as lowering  
30 competition in the mobile market, I would just simply imagine that the amount of  
31 pass-through would roughly be comparable from one to the other.

32 And so if there were fat profits being made in that one and a half-opoly then there  
33 would still be fat profits being made in that one and a half-opoly. After the MTR rate

1 went down they just - but it is indeed true you might see retail prices rise a little bit, okay.  
2 And it might rise so much to leave everybody more or less indifferent, it probably  
3 wouldn't, probably could lower the absolute level of profits being earned there or raise  
4 them, but the difference is probably gonna be neither here nor there.

5 If you were to compare that little thought experiment with a thought experiment  
6 where you start with a one and a half-opoly and you add a second player with lower  
7 mobile termination rates, then I think that's an entirely different kettle of fish, and in my  
8 view you'd see very substantial benefits in that world.

9 And if you wanted to stick a third little picture in there with the new entrant but  
10 with high MTR rates, again I think you would see a very substantial difference because of  
11 the discussions that we've had earlier that the high MTR rates make it very difficult for  
12 that little guy to be a competitor, an effective competitor; lower MTR rates will make  
13 them better at being an effective competitor. And so the kinds of competitive effects you  
14 would expect to see with a new entrant will emerge in the market with lower MTR rates.  
15 And in my view that will completely swamp any fussing around with minor adjustments  
16 at the margins by the one and a half-opolists.

17 **CHAIR:** Richard.

18 **MR FEASEY:** I was just gonna say I think Eric's just very clearly and helpfully explained their  
19 view, I understand that. I think my comment would be there is simply no evidence before  
20 the Commission to support any of those assertions. So it may be the case that the  
21 competitive effects or the consequence of entry is to swamp waterbed effects, it may be  
22 the case that entry increases the waterbed effects or reduces the waterbed effects, all of  
23 these things may be the case, I don't think Vodafone would dispute that. There's simply  
24 no evidence presented in support of those assertions.

25 **DR RALPH:** Can I just make a one sentence response.

26 **CHAIR:** Yes, thank you.

27 **DR RALPH:** I believe that we have evidence to that effect in our submissions, and I also  
28 believe it's very much a matter of commonsense.

29 **MR WESLEY-SMITH:** And as the half-opolist can I make a brief comment as well?

30 **[Laughter]** Because we've heard this quite a bit over the last two days the benefits of  
31 entry. And I don't think anyone has disputed that entry is a benefit and can drive  
32 significant benefits. The issue that we've got here and what we've got to try and get some  
33 quantitative or qualitative assessment of is what is the relative benefit of a reduction in

1 termination rates to the expansion or entry, however you want to describe it, of 2degrees.  
2 So take the point but I think we're talking about something slightly different.

3  
4 **ASSESSMENT OF BENEFITS AND DETRIMENTS OF**  
5 **MTM TERMINATION REGULATION**  
6

7 **CHAIR:** I think that deals with fixed to mobile, very clear on those issues. So we move on  
8 looking at the mobile to mobile market. We've actually discussed the waterbed effect  
9 yesterday, and I think we got to the position where there was an acknowledgment that in  
10 terms of dollar impact there was a netting out, and that all that we were talking about in  
11 mobile to mobile was an impact on incentives.

12 So I'd just like to explore this issue of the incentives and how that is going to have  
13 an impact on the market that we should be concerned about, obviously for good or for  
14 bad. So, James, can you sort of talk us through the incentives and then we'll go to the  
15 other two economists for comment and then to the parties.

16 **MR MELLSOP:** I think I'm the incentives man. Apologise for that. The Genakos and Valletti  
17 paper that Richard referred to, and you probably don't have it in front of you now.

18 **CHAIR:** No, we don't.

19 **MR MELLSOP:** No doubt the Commission does have it. Although I think the Draft Report of  
20 the Commission referred to an older version, there's actually a 2009 version.

21 **CHAIR:** I think we've got that.

22 **MR MELLSOP:** Okay, I just think on page 10 it sets out - it summarises the two-way  
23 interconnection literature and a bit of this fragility that I've referred to. But it sets out in  
24 the language of calculus but in a nice summarily way what the impacts on the various  
25 prices will be as you change the termination rate.

26 And so I guess I just commend the Commission to have a look at that because  
27 what it says, for example, is that if you lower the termination rate then fixed prices will go  
28 up, this is mobile to mobile fixed prices subscription prices, for example, will go up,  
29 whereas your off-net calling prices will drop. So it just sets out - I guess it's a nice  
30 summary, it seems to me, of what the literature is saying about the direction of price  
31 impacts.

32 It's not saying how big they are, that comes in the empirical part of the paper, but I  
33 guess that's just - I do keep worrying, I sound like a broken record I suspect, but I don't

1 think we should be thinking about this as simply revenue here and revenue there, I think  
2 we should be getting down to the nitty gritty of the different prices and how they will be  
3 impacted. I think that paper does the best job I've seen of actually saying what is the  
4 literature telling us. Then it goes on to do the empirical work that Richard's just  
5 described. So is that helpful, Ross, in terms of your question or have I not -

6 **CHAIR:** I'm sure the economists on the staff will have understood what you said.

7 **MR MELLOP:** Okay, sorry.

8 **CHAIR:** No, no it's fine, at a high level. Professor do you want to comment?

9 **DR HAUCAP:** It all sounds a bit repetitive in the end, as James already mentioned, so I think  
10 this paper provides some evidence. The problem, not with the paper because - rather with  
11 the data I would say, because there are - well, it's very difficult to disentangle the effects  
12 of entry and reduction in mobile termination rates. The paper is absolutely silent on this,  
13 it must be silent on this because I think you cannot - I don't know how to disentangle the  
14 fact with the small sample size that there is necessarily where we see the sort of entry and  
15 mobile termination reduction occurring. So I agree with Richard here that this is of  
16 some - well we have to be - we don't know how much this paper can tell us sort of when  
17 we add other circumstances here, but I think this has been made clear previously.

18 **CHAIR:** Yeah, we did cover part of the ground yesterday, but this was a session we probably  
19 should have talked about it. John.

20 **DR SMALL:** I think from a practical point of view that the impact that we should be thinking  
21 about here from a welfare angle is on different consumer groups basically, and we have  
22 traversed this at some length yesterday. But briefly, you know, different consumers  
23 have - networks get revenue incoming and outgoing revenue in different proportions from  
24 different sets of consumers, or individual consumers in fact. And so it's those kinds - it's  
25 what happens when you reduce the mobile termination rate is that some consumers  
26 become less attractive, other consumers become more attractive. So to me the welfare  
27 effects that you should be concerned about here are those ones that are below the level of  
28 the aggregate set of consumers.

29 **CHAIR:** In terms of waterbed effect, any other comment from the parties now on that issue?

30 **MR FEASEY:** I wonder if I could just make one comment. There's a temptation, I think, to say  
31 well at the aggregate level it all washes through and there are puts and takes between  
32 different consumers. But, you know, unless we ascribe a greater value to some types of  
33 consumers than others then sort of it all washes through, so why are we concerned about

1 this?

2 The reason I think we should be careful about this is because different groups of  
3 consumers will then react in different ways to changes in price. And in particular the big  
4 effects that we see on the modelling of this arise if you think that there are some groups of  
5 consumers who might actually leave the mobile market because that not only has effects  
6 for the welfare of those people but it also has effects for the welfare of other mobile  
7 consumers who remain in the mobile market but are no longer able to call them.

8 And given the concerns about interconnection and the need for people - any to any  
9 and people to be able to call other people, which we've heard about from 2degrees, I think  
10 that is an area - that is why this issue is important. I just wanted to address any  
11 suggestion that if it all washes out we can be largely indifferent to the effects. That is  
12 only true if you believe that consumers will not react to those changes in prices in  
13 particular ways, which is why frankly data about that and understanding what consumers  
14 would do, I think, is an important area of data for the Commission.

15 **CHAIR:** Okay, I've got a question on this subject to put to Wik, I'm not sure which of you will  
16 wish to answer it. It's that the Commission understands that the work on the empirical  
17 evidence of the waterbed effect such as in the paper that James referred to is still  
18 developing, I think as was indicated in that you've got a version of the paper that was  
19 different to the one that we reported to. Do Wik have any comment on development of  
20 this evidence and how robust the empirical evidence is and how well established the  
21 results are?

22 **DR NEUMANN:** Yeah, we are talking on some important potential impact of regulation and we  
23 really have to recognise that there is not too much strong analytical empirical work to be  
24 done. I guess we should be aware of this piece of Valletti and Genakos that has changed  
25 in its results over, I guess, two or three years time in which this paper evolved quite a bit.  
26 And that was due to a lot of critique which came out of various approaches which were in  
27 that.

28 And therefore I don't see that the Commission and other Regulators can really rely  
29 in a robust sense on such type of work. We have to see more before we just can really  
30 have robust impact analysis on this. Let me give you perhaps some example where I also  
31 see potential effects which I do not see reflected in such analysis.

32 One reaction of mobile operators could also be when they face more competition  
33 due to lower termination rates, they might reduce customer acquisition costs, or they

1 might reduce handset subsidies. Given the level of penetration we have in the market I  
2 would say that there are good indications that such type of pricing reactions would not be  
3 welfare decreasing but welfare enhancing. And we also have to take these reactions into  
4 consideration which show that current pricing behaviour sometimes also demonstrates  
5 rent seeking behaviour in a highly concentrated market, in particular the bundle you have  
6 here in New Zealand.

7 **CHAIR:** Probably just as a follow-up question and then I'll come back, are Wik aware of any  
8 other evidence on the waterbed effect? We've had one paper referred to, but are you  
9 aware of any other evidence of that effect and the impact on overall welfare?

10 **DR NEUMANN:** Not on the empirical side.

11 **CHAIR:** Thank you. I don't know if the economists have any response or comment on those  
12 observations.

13 **MR MELLISOP:** Yeah, mainly there are a couple of other papers I'm aware of which I suspect  
14 Commission staff are already but just to be sure about that I guess. One is the paper  
15 this year by Anderson and Hanson who found 100% waterbed effect. I'm not saying that's  
16 absolutely robust, I don't have a particular view on that, but just suggest that the  
17 Commission have a look at that.

18 And secondly the work CEG did for Ofcom which probably wasn't so much  
19 focused on a waterbed effect, I think it was largely focused on bill and keep and caller  
20 pays versus receiver pays etc. But one of their findings I think is relevant, and that's that  
21 they couldn't find any robust statistical evidence of a link between the level of MTRs and  
22 mobile price levels.

23 So I think that's also relevant evidence, they're the empirical papers that I'm aware  
24 of. So as long as the Commission is aware of those then I think that's the key.

25 **CHAIR:** Are there any other issues about -

26 **DR RALPH:** Let me just make the -

27 **CHAIR:** Please do.

28 **DR RALPH:** Sorry, did I jump in front of someone? Let me just make the comment, and it ties  
29 a little bit back into what was said earlier, but while there are to my knowledge very few  
30 papers that look at empirically happens with an M to M type waterbed effect, there's lots  
31 of papers that look at just the theoretical idea of competing networks and thinking about  
32 how firms would respond in their retail price setting and some of these models have  
33 multiple prices in the retail market, sometimes they have single price in the retail market;

1 some of the models even have a fixed player as well etc.

2 One of the basic results that comes through from these papers is that in a range of  
3 cases the mobile carriers are incented to set mobile termination rates at quite high rates, in  
4 a kind of perverse way rates that are so high that they actually - in some cases they can be  
5 set so high that they actually make lower industry profits, but it's individually rational for  
6 each player to set quite high rates but unhappy for the industry as a whole.

7 In other cases you get something more of a balance and indeed there are cases  
8 where I think, as was mentioned yesterday, particularly if they're allowed to set the  
9 termination rates in concert with each other, so everybody sets exactly the same rate; and  
10 again most of these models don't take account of the impact of entry, they can even set it  
11 very low as a way of maximising industry and firm profit.

12 But the point I want to make here is that there generally are identifiable optimal  
13 termination rates in those models. And those termination rates generally are what you'd  
14 expect, there is something like the marginal cost, and I mean marginal cost because that's  
15 what it is in those models, they have a simple per minute cost in there that's incurred, and  
16 it's set to that level with an adjustment made for whatever externalities might be assumed  
17 in the model so if there are externalities they adjust them.

18 If the rate is set above that level in the equilibrium where the firms are not  
19 regulated, then what you can actually have when you get a reduction in profits is a  
20 waterbed effect that's very beneficial to all consumers, depending on the extent to which  
21 the firms have market power, which may well also be beneficial to the firms.

22 So putting aside entirely entry, if current mobile termination rates are set too high,  
23 it's quite possible, just thinking about mobile to mobile termination, that getting them  
24 down to reflect something closer to what the efficient mobile termination rate would be;  
25 not quite possible, given the if that they're too high and they're above that, getting them  
26 closer to the optimal rate in all likelihood is gonna benefit consumers broadly and not  
27 harm them.

28 That's without even talking about the benefits of getting a third party into this  
29 market to start getting the players to give some of the fat that they're currently collecting  
30 back to the consumer.

31 **CHAIR:** Okay, thank you. Do any other issues relate -

32 **DR SMALL:** Can I make a comment on that please?

33 **CHAIR:** Yeah, respond.

1 **DR SMALL:** So just on these general issues, commenting on the gentleman from Wik who  
2 suggested, if I heard him right, Genakos and Valletti should be discounted because it's  
3 been revised several times in response to criticism; I think that's what he said. If that is  
4 what he said then I'd disagree, I'd say that that would make you more confident in the  
5 paper.

6 **CHAIR:** Just on that, John, isn't the danger that there's another revision coming?

7 **DR SMALL:** I guess that's true, that's a possibility, sure.

8 **CHAIR:** Rather than - I think it was the point that was being made.

9 **DR SMALL:** Okay, fine. James' identified the other two empirical papers we're aware of. But I  
10 would say, and this is really addressing Eric's points, that, you know, I agree that the  
11 empirical literature is relatively thin; there's really strong theoretical support and not in a  
12 sort of model specific fragile type of way, in a very fundamental way; we know what this  
13 does and it can be explained in really quite simple terms. So it does exist and the question  
14 is just how big is it.

15 Can I just also -

16 **CHAIR:** And John, can I just ask you because of the comment made by Eric, not only how big  
17 it is but which direction it goes in? Because there was a suggestion that -

18 **DR SMALL:** I was interested in Eric's comment on that, I'd be very keen to see the paper that  
19 shows that - and the model in which a waterbed effect is beneficial to all consumers was  
20 what I thought he said. I'm not aware of that paper.

21 **DR RALPH:** I said broadly, of course, some individual consumers may be - I mean we're in a  
22 complicated world, I don't think that - I mean a lot of these models they do show all  
23 consumers benefit, but because their consumers are all essentially identical, so that's  
24 virtually true for at least two-thirds of the model.

25 **DR SMALL:** Okay, I think that's a very important point, because the key thing about a waterbed  
26 effect is that some people gain and some people lose.

27

## 28 **ASSESSMENT OF BENEFITS AND DETRIMENTS OF**

## 29 **SMS TERMINATION REGULATION**

30

31 **CHAIR:** If there's no other issues on mobile to mobile, staff no issues that we left unexplored?  
32 We've got then benefits and detriments of SMS termination regulation. Now the  
33 Commission, I think, has no questions that we want to explore on that subject, but do the

1 parties wish to raise any issues about either the benefits or the detriments of SMS  
2 termination?

3 **MR YORK:** Just I suppose an overall perspective, which is one that normally you would only  
4 want to intervene and regulate in a market where you thought there was a problem. We  
5 look at the market and we look at SMS and we see that our rates here are some of the  
6 lowest in the world, and we've provided you data on that that compares to how we looked  
7 at particular countries. Our usage levels are some of the highest in the world. And so  
8 when we look at it on that basis it doesn't look like there's a big problem that needs fixing.

9 We look at our SMS termination rates here, they look broadly comparable with  
10 any other country. We look at the interconnection agreement and see the implications of  
11 that that we have with the new entrant. We just don't think there is going to be a massive  
12 problem here in SMS that needs fixing.

13 What we have instead appears to be a system that works. Prices are low, usage is  
14 high, it doesn't seem to prevent all sorts of on-net and off-net packages being created at  
15 the retail level, and we've got termination rates that broadly probably washout, and  
16 actually have, by being non-zero and positive, a deterrent effect on spam. So we just  
17 don't see it as something that warrants jumping in and intervening on. That's our general  
18 comment.

19 **CHAIR:** If I can ask one question, you've indicated, certainly in discussing voice termination,  
20 that you're comfortable that your pricing is at roughly around TSLRIC; you've said a  
21 number of times, so you're comfortable there's no need to intervene. What's your  
22 comment on your SMS termination rate, and this is an area where there is a vast  
23 difference between two undertakings and we've heard from Telecom that they're  
24 comfortable that their offer is above TSLRIC. Can you explain that?

25 **MR YORK:** The obvious and easy answer is I've never constructed an SMS termination rate  
26 model so I don't know. But I think the point we've tried to make in our submissions is  
27 that what's important here is the effective termination rate. So the nature of SMS is that  
28 when someone sends a text one comes back, so the net cost of engaging in sending an  
29 SMS is quite trivial.

30 **CHAIR:** Isn't that an argument for bill and keep rather than -

31 **MR YORK:** And as we've come I guess - yeah, that's right, as we've come to at various times  
32 throughout the discussion, whilst with person to person SMS traffic tends to balance out.  
33 There are risks around spam if you go to bill and keep, especially with issues around

1 application -

2 **CHAIR:** Understand that, but I think my question was, I go back to it, you've said publicly that  
3 you regard your voice rate as being TSLRIC or near as.

4 **MR YORK:** Yeah.

5 **CHAIR:** Is that also your position in relation to your SMS termination rate?

6 **MR YORK:** I think in fairness I don't know what SMS TSLRIC is, I'm not gonna go and tell  
7 you here today that I think our SMS termination rate is TSLRIC.

8 **CHAIR:** Okay, that's fine. Any other comment? Mr McCabe.

9 **MR McCABE:** Thank you Commissioner. SMS termination; SMS is, I think I described it  
10 yesterday, it's an essential part of the bundle that we provide to customers. The ability to  
11 be able to send text, receive text, send voice and receive voice is all part of the basic  
12 mobile bundle. And if we can't send text, or if our customers don't receive texts from  
13 others, then we can't attack for voice, they're intrinsically linked.

14 And we're hearing that traffic is broadly in balance from people who have been  
15 around the market for a lot longer than we have. But it sounds like it's very close to zero,  
16 that balance of traffic is - may be linked but it's a tiny amount of the traffic, the total SMS  
17 traffic, there's no cross-network traffic. This whole any to any connectivity principle is  
18 completely lost on text.

19 And just a further thought, if 90 to 95% of text is already effectively bill and keep,  
20 there's no termination fees received because they're all on-net, yeah, those low end  
21 customers are only profitable because of text received or termination fees received from  
22 other people's customers, then it strikes me that for 5 or 10% of the market that bill and  
23 keep is obvious. And as Vodafone have said, they've got no idea what the costs are but  
24 presumably it's a lot lower than what it is right now. So we think it's very important to be  
25 able to enter the market for other services.

26 **DR RALPH:** Can I just make two quick economic points.

27 **CHAIR:** Please, yeah.

28 **DR RALPH:** The first one is on the effective termination rate. I think, as has been made clear  
29 by a number of people around the table, that's just not relevant, the marginal rate is what's  
30 relevant, what you pay every time you have to terminate a call is what's relevant, that's  
31 widely recognised, otherwise we wouldn't be fighting about any of this stuff, bill and keep  
32 would be identical to any rate where traffic was balanced.

33 But that's not at all the case. If we have a waterbed effect that's exactly because

1 the marginal rate matters. So either we don't have a waterbed effect, or we do, and if we  
2 do then the effective rate is irrelevant, it's the marginal rate, what rate you pay, not what  
3 rate you pay after you net off the traffic, so that's the first point.

4 The second point is that traffic imbalance is driven by prices. You know, it's one  
5 of the very first things you learn in economics is that as you tend to raise price you tend to  
6 see less demand. And it seems to me a reasonable proposition that if it's costly for a  
7 Vodafone customer to terminate a text message on, say, 2degrees' network, and because  
8 2degrees is trying to compete with Vodafone's on-net packages, it's very cheap, very very  
9 cheap relative to the price coming in the reverse direction for a 2degrees customer to  
10 terminate on Vodafone's network. We will see material traffic imbalance.

11 And I understand that there is some evidence in the record as to whether or not  
12 there's presently traffic imbalance, and that is of course at prices that don't in any way  
13 compete with Vodafone's - off-net prices on 2degrees network that don't in any way  
14 compete with Vodafone's on-net discount. So, you know, I think that that needs to be  
15 taken into account.

16 **MR YORK:** John might have a point as well, but we've had the discussion I guess this morning  
17 and we'll provide the evidence that we think -

18 **CHAIR:** Yes, that's - yeah.

19 **DR SMALL:** Just on the effective termination rate, a long time ago I used to do some consulting  
20 work for the IRD and they were always worried about the difference between tax rates  
21 and effective tax rates, and we used to calculate what we called an effective marginal tax  
22 rate which is the - what in practise was actually paid. I think it's a very relevant concept  
23 and I think it's the same concept that I talked about yesterday. It's the effective marginal  
24 termination rate for text messages. So Eric said -

25 **CHAIR:** What is the effective marginal termination rate?

26 **DR SMALL:** The effective marginal termination rate is one minus the probability of getting a  
27 text back multiplied by the termination rate where the termination rate is symmetric.

28 **DR RALPH:** Can I respond to that by asking John a question? Is that probability of calling  
29 affected by the prices?

30 **DR SMALL:** Of course it is.

31 **DR RALPH:** Thank you.

32 **MR YORK:** Sorry, just a final comment.

33 **CHAIR:** Yeah, we've got 5 minutes until lunch, so we want to get right around the table, there's

1 more comments to come.

2 **MR YORK:** That's fine, mine will just be, again we have evidence of five years of behaviour in  
3 the market here in New Zealand where different types of offerings get launched.

4 **CHAIR:** Yeah, I know, you don't have to repeat it, we know that, thank you. John or James?

5 **MR WESLEY-SMITH:** Look I've just got a very brief comment. I have a lot of sympathy for  
6 what Vodafone have said. I don't think by any measure you can say there's a competition  
7 problem in our texting market. We get cited around the world as having some other, you  
8 know, some world leading texting offers out there in the market, and domestically that  
9 gets used against us to prove that there's some other problem somewhere else structurally  
10 in the voice side of our market. So to now have it claimed that we're not doing well  
11 enough on texting and we're short changing consumers, look it just doesn't show up in  
12 practise.

13 I also wanted to make a comment, and this is the real substantive comment; after  
14 yesterday's discussion and the discussion that's been had today about traffic imbalances  
15 that are starting to appear. We just wanted to make a request for a week for us to go away  
16 and have a think about this idea of a bill and keep or hybrid bill and keep structure for  
17 SMS as opposed to with a TSLRIC structure maybe for voice. It's just something we  
18 haven't given a lot of thought to and no-one's spent a lot of time on in their submissions,  
19 so if -

20 **CHAIR:** We'll take that into account in terms of process from here on, which at the end of the  
21 conference there are a few things that are going to happen after the conference and we  
22 will give you an outline of what that will be and then have a detailed document to follow.

23 **MR WESLEY-SMITH:** That would be great, thank you.

24 **MR MATTHEWS:** Just a process point, it was in the Draft Determination, I'm not sure why it  
25 needs further consideration.

26 **CHAIR:** What was?

27 **MR MATTHEWS:** The options for the initial pricing and final pricing principle.

28 **CHAIR:** No it's - okay.

29 **MS MAZZOLENI:** Sorry, I understood John to say that he specifically wanted to think about  
30 some of the practical consequences of bill and keep for voice, or hybrid bill and keep.

31 **MR WESLEY-SMITH:** For SMS.

32 **CHAIR:** For SMS, for SMS. Yeah, so it's in the Draft and this is a suggestion to consider the  
33 practical implications of that and I think that's -

1 **MR WESLEY-SMITH:** Yeah, and in particular this concept of having a bill and keep structure  
2 for one service and another structure for voice.

3 **CHAIR:** Yeah, because one of the things we've raised afresh here is the possibility of having  
4 different pricing principles for different services and that's that issue.

5 **MR MATTHEWS:** That's explicitly contemplated in the Act, though, as well.

6 **CHAIR:** Yes, but this is a practical application of that, so that would be very useful for our  
7 decision-making I'm sure. So if we close for lunch. That's actually - we're ahead of time  
8 now so we come back to undertakings.

9

10 **Lunch adjournment from 12.31 pm to 1.35 pm**

11

12 **UNDERTAKINGS**

13

14 **CHAIR:** Good afternoon and welcome to the afternoon session, and the way we're going the last  
15 session for this mobile termination conference. We're at agenda item 10 which is  
16 undertakings. As you'll all know Vodafone's requested an additional opportunity for  
17 revised undertakings to be submitted. The Commission has considered this request and  
18 our preliminary view, which we would like to have discussions on in this session, is that  
19 an additional opportunity should be granted for parties to submit revised undertakings  
20 provided that this does not compromise the Commission's timetable, which is to make a  
21 recommendation to the Minister in December of 2009.

22 We want to say that the Commission does not agree with Vodafone's assertions  
23 that the Commission must provide additional CBA modelling prior to revised  
24 undertakings being submitted. The Commission has set out its preliminary view in the  
25 Draft Report on the assessment of the undertakings. We have discussed at this conference  
26 many issues that would be relevant, including the limitations of modelling, the  
27 Commission is confident that parties now have some sufficient information to submit an  
28 informed revised undertaking.

29 The process that the Commission has in mind is that parties will have until Friday  
30 the 2nd of October to lodge revised undertakings. Submissions on those revised  
31 undertakings will be provided to the Commission by 16 October. The submissions will  
32 be limited only to matters directly relevant to the revised undertakings and submissions  
33 on other matters will not be considered.

1           The Commission does not intend to allow for cross-submissions. If there are  
2 residual issues of incompatibility, for example, in relation to reciprocity and some of the  
3 other issues we've discussed this morning, the Commission will convene a workshop to  
4 address those issues if it considers that otherwise the undertakings are capable of a  
5 recommendation to the Minister that they be accepted.

6           Now we want parties' views on this process and we intend if possible to make a  
7 final decision today so that when parties leave this conference they will be aware of the  
8 process and we would deliver a written detailed document following. So I just open the  
9 floor, perhaps to Vodafone first as the party who have requested an opportunity to  
10 comment on the Commission's view on this process.

11 **MR YORK:** Perhaps I'll start. In the first instance thank you for indicating you're willing to  
12 discuss the issue, and also for the indication around a preliminary view on a revised  
13 undertaking, we're grateful for that. And I think we also are cognizant of your concerns  
14 about not delaying the process any longer and we're happy to work within that objective.

15           Also I think the idea in terms of submissions in response to a revised undertaking  
16 being fairly limited I think is a good thing too, we've probably talked to death about the  
17 issues on all the key parameters and assumptions.

18           The only issue I guess I'd raise is one thing we had been hoping to get was, I  
19 guess, the Commission's final views on those parameters before we put in a revised  
20 undertaking. I think the overall objective and the thing that would be best for the industry  
21 and consumers here is if we can find a set of undertakings that could be accepted now that  
22 would do better than what your final views will be around what form regulation would  
23 take. So that we could, I guess, resolve of the issues, not have another year or two of  
24 disputation to follow and consumers can start getting the benefits that you think -

25 **CHAIR:** I might say Anita is going to make some comments on substantial issues following this  
26 discussion but we certainly - other than that discussion it's simply unwieldy and probably  
27 inappropriate to wait to almost a final report and then have another -

28 **MR YORK:** Can I suggest the option, I guess, we were thinking and perhaps that can inform the  
29 views you may be about to put on that, I suppose what we thought might have been  
30 possible was some short time before your final report gets submitted, perhaps a month  
31 out, mid-November perhaps, you provide this very same opportunity.

32 **CHAIR:** The problem simply is timing that you would then need time to consider that to put in  
33 an undertaking, which would then require a round of submissions. But certainly we hear

1           what you say and we'll see the view of other parties, other parties may be happy for time  
2           to -

3 **MR YORK:** The only thing I would add just in that is that we are supportive of the idea that  
4           short window for Commerce - and not an opportunity to keep agitating on all the  
5           assumptions, that's not the thing we're searching for here.

6 **CHAIR:** Exactly, thank you. 2degrees?

7 **MR MATTHEWS:** Just a question really, is that sort of meant to be the drop dead date for the  
8           undertakings?

9 **CHAIR:** Our preliminary view is that is the drop dead date because that is the date that drives  
10          through to delivering our report on time. The feedback that we did have from parties  
11          generally is they don't want to see any further delay, so this process has been built around  
12          those concerns.

13 **MR MATTHEWS:** That's fine thanks, I mean we've submitted our other comments in writing.

14 **CHAIR:** Yeah. Around the table, Susie?

15 **MS STONE:** We'll support the process.

16 **MR ABBOTT:** We support.

17 **MR WESLEY-SMITH:** Look I'd just echo Richard's comments, I think that's an excellent  
18          addition to the process. We appreciate the flexibility that you've provided, and  
19          understand completely that we've got pretty tight timeframes here. It sounds like a good  
20          process.

21 **CHAIR:** So other than this one question for more information, which I don't think we can  
22          concede to, but we will consider, we should be in a position to just consider that at some  
23          stage before we finish and come back with a Final Determination.

24 **MR CHIGNELL:** I wonder if we could ask whether it would be okay to just revisit this briefly  
25          after we've heard from Commissioner Mazzoleni.

26 **CHAIR:** Yeah.

27 **MR CHIGNELL:** Because we're not quite sure what you mean by telling us what your views  
28          are on some substantive issues, we've got a different set in our mind.

29 **CHAIR:** Some general observations of the form of the undertakings and based on our  
30          discussion, so certainly we'll -

31 **MR CHIGNELL:** And the other thing I'd say, I suppose, would be that obviously the  
32          Commission staff are going to be working hard between now and the 2nd of October.  
33          And if the Commission does come to different views about issues which are material then

1 it would be very helpful, I think, for the access providers to be aware of those before the  
2 2nd October date, if they're material.

3 **MR YORK:** To be frank we just want to know the target we're shooting at.

4 **CHAIR:** Ernie would you like to contribute?

5 **MR NEWMAN:** I'd just like to say our instincts had been that we didn't want to see the process  
6 extended but we do have confidence in the Commission to make a judgment call on this.  
7 At the end of the day the undertakings regime, as we see it, is there to shorten and  
8 simplify the regulatory process. There's a bit of a risk here that it's actually having the  
9 opposite effect. But we accept that provisional ruling of the Commission.

10 But we would just ask that Vodafone does come forward with something that  
11 materially advances its position and that takes genuine cognisance of many of the genuine  
12 views here that have been expressed by new entrants and users. I think the test of  
13 whether the intent of what Vodafone is asking has been met will be how this is received  
14 by the other parties to this investigation.

15 **MS MAZZOLENI:** The first point I'd like to make is we note the sizable movement by  
16 Telecom in its revised undertakings which is consistent with their actions to achieve  
17 commercial solutions and we thank them for that. We have also noted all of parties'  
18 submissions on the Telecom undertaking and we do not require further comment on that  
19 today.

20 Second point I'd like to make is given the discussion around the possibility of  
21 different pricing principles for different services there may be some benefit for parties to  
22 consider in submitting separate undertakings for different services as I think Vodafone  
23 did in the very first round.

24 And there may also be some benefit in using second per second pricing in the  
25 undertakings, I guess not least for our own ease of comparison.

26 And the last point we would make to make is that parties must make their own  
27 decisions in relation to pricing in the undertakings. However, given the mobile  
28 termination costs that operators currently charge themselves for 80 to 90% of the traffic,  
29 the Commission considers at this stage that it would find it difficult to recommend  
30 grounds for acceptance of undertakings that are materially different to those initial prices.

31 **MR YORK:** Can I just understand exactly what that last point meant. Is that something along  
32 the lines of basically saying half your on-net rate?

33 **MS MAZZOLENI:** [Nods]. I guess we assume some retail costs can come out of that.

1 **MR WESLEY-SMITH:** And if I just unpick that a little bit further, I've taken that the  
2 conversations to date, there to be a general acceptance that consultative glide path is  
3 something the Commission thinks it could apply under a TSLRIC pricing principle, if it is  
4 minded to. Do I take you to be saying you would need to see undertakings that reflect the  
5 on-net price today immediately?

6 **MS MAZZOLENI:** I think we made it quite clear that those prices are being charged for 80 to  
7 90% of the traffic and so it would be a fair proxy. That's for current prices. We're still  
8 expecting to see a forward price path from that initial point.

9 **CHAIR:** Any other questions or comments? If there aren't we are in a position to come to a  
10 final decision on the process, which is basically that our preliminary view is now our final  
11 view and the decision which will be set out is for revised undertakings to be lodged, as I  
12 said, by Friday the 2nd of October. Submissions on that solely on issues arising from the  
13 undertakings and on no other issue by the 16th of October, and there is a possibility for a  
14 workshop if the Commission felt that otherwise those submissions would be acceptable  
15 and there were just issues of reciprocity and other things. That will be communicated in a  
16 written decision which will probably come out in a week or so, but the decision's effective  
17 today.

18 **MR McCABE:** I had a question that may or may not be appropriate so you can just not answer  
19 if you need to, but on reciprocity I think most of the undertakings have assumed bilateral  
20 prices, but that's not offering access, that's offering access on a condition. Are you  
21 expecting people to just offer this is what it costs to terminate on to my network without  
22 any bilateral - so "you get that as long as I get it with you", is that the intent? Or are you  
23 saying, as happens in other places, this is what it costs to terminate on to my network and  
24 anyone can sign up to that, but it's not conditional on me getting access to your network at  
25 the same price. Does that make sense? Not really.

26 **CHAIR:** I think the reciprocity issue was that it be a bilateral arrangement on the same terms, if  
27 that becomes an issue in the undertakings. Parties have to make their own undertakings,  
28 maybe their own judgment, but we discussed earlier the complications of getting a  
29 workable regime with different undertakings and different arrangements, so we'll just  
30 leave it to the parties to read the tea leaves.

31

32

## NON-CORE IMPLEMENTATION ISSUES

33

1 **CHAIR:** There was some non-core implementation issues, if we can move very quickly on to  
2 that. Ernie will be smiling because we're moving ahead very quickly now. We had some  
3 non-core implementation issues that we wish to raise, most of them I think have actually  
4 been dealt with in the course of other discussion, but I just want to make sure that they are  
5 not still outstanding issues.

6 The first was about internationally originated calls that actually came up yesterday  
7 and I think satisfactorily dealt with, so there were no other outstanding issues on that.  
8 Hand-over arrangements, I think staff have a question about hand-over arrangements.

9 **MR KINLEY:** Shane Kinley from Commission staff. On the hand-over arrangements the first  
10 question I've got is to CallPlus. Graham, you've submitted that you believe 16 hand-over  
11 points would be appropriate for this service. The question we have for you is on what  
12 basis do you believe that 16 hand-over points is appropriate and how would you propose  
13 determining the calling regions for those hand-over points, and how do you consider that  
14 this could be reconciled with the current POI arrangements, for example, under the  
15 backhaul STDs where there are 29 POIs or the 24 hand-over locations proposed by  
16 Telecom?

17 **MR WALMSLEY:** I suppose with difficulty is probably the most obvious response. I think the  
18 16 really, just a reflection picking up on a point Telecom made in the submissions, that in  
19 actual fact fixed line operators who currently build out and have built out to 24, it's a sunk  
20 cost we have. We do that so that we don't have to backhaul traffic. 24 seems a lot, 16  
21 seems to give a better spread on broadly, but I mean that's without working out the detail.

22 To be honest it was more in response to the whole issue around transporting things  
23 up and down the country, which to be honest the other thing we did say we did say in our  
24 submission is, the cost is next to zero to be honest. So it's actually not a major issue I  
25 don't think if there were three MSCs to be honest. But there's a quid pro quo in that  
26 because I know that Vodafone have also made some points about a handful of traffic that  
27 they have to, with international origination, terminate nationally.

28 So from our point of view, you know, from the fixed line operator perspective,  
29 obviously the more MSCs there are the more efficient it is for us, but I wouldn't want to  
30 overstate the point because in actual fact the cost of national transit is pretty minimal.

31 **MR KINLEY:** A follow-up question, and this is to Telecom, John; your submission indicated  
32 that you were exploring the costs of allowing MSC hand-over and then commercially  
33 negotiating transport charges. Can you provide any update on the costs involved, I guess

1 in light of Graham's suggestion then, which is contained in CallPlus' submissions as well,  
2 that the transit or hand-over transport costs were minimal from their perspective. So any  
3 update from Telecom's perspective on the costs involved or the likely magnitude of  
4 commercial transport charges?

5 **MR WESLEY-SMITH:** Look I'll just introduce a couple of new faces at table, we've got  
6 Michael Goldfinch to my left who's our Product Manager for interconnect and Carl  
7 Allwood who's a senior counsel from our wholesale unit who's helped prepare the  
8 undertake. Do you guys have an answer? They may not even have an answer after all  
9 that.

10 **MR GOLDFINCH:** I don't think we do have a firm - we haven't modelled the transport costs.  
11 At the moment our arrangements with fixed networks put that cost at zero for picking up  
12 the traffic at a local point of interconnect and getting it to our MSC for termination. But,  
13 you know, that remains to be seen whether that is the best model going forward if we  
14 move to the Commission's advocated position of MSC hand-over for all traffic.

15 **CHAIR:** The next issue, which was going to be an implementation issue, dealt really with the  
16 minute second issue and I think that has really been subsumed as well in the discussion.  
17 And certainly if undertaking pricing is calculated on that basis then we will be - the next  
18 item which I think was also dealt with was asymmetric pricing. I think that was taken off  
19 the table and there was no outstanding issues on that. We have dealt with that.

20

## 21 **OTHER ISSUES PARTIES WISH TO RAISE**

22

23 **CHAIR:** So we then move now to item 12 which is other issues parties wish to raise. So there  
24 was a CallPlus/Kordia issue on 0800 and price squeeze imputation test that you wish to  
25 raise, so now is your moment.

26 **MR WALMSLEY:** Just to talk to the toll free issue, I note the Commission's comment that they  
27 don't want to ask questions about toll free. Nevertheless there is a problem which  
28 occurred when the first lot of undertakings came in. I'd acknowledge that Vodafone  
29 haven't actually been charging a differential rate for toll free traffic compared with fixed  
30 to mobile, however Telecom have.

31 We're in the ludicrous situation where it's 24 cents coming one way and 15 cents  
32 undertakings rate going the other way. It has a real impact on our ability to compete in  
33 the fixed line market, particularly in the bundled scenario where toll free's one of the

1 components. I'm sure Ernie would have a few comments that clearly impacts on  
2 consumers.

3 So the issue's real, it needs addressing, if it's out of scope in terms of the  
4 regulatory process possibly it could be included in the undertakings, but I really just  
5 wanted to note it is a real issue in the market.

6 **MR NEWMAN:** TUANZ would like to back up that point. We've found increasing concern  
7 from our larger members over the last few months about the magnitude of this problem,  
8 and essentially what's happening I think is that more and more people are using mobiles  
9 for 0800 calling and those volumes are not being offset by any reduction in the pricing.  
10 That has led to a situation where there are some very very large users who are just  
11 declining now to receive 0800 calls from mobiles and I believe that trend is about to  
12 increase.

13 So we had rather hoped forlornly that might be in scope for this conference, we  
14 accept the Commission's decision that it's not, but we would certainly welcome any signal  
15 from the Commission as to how we might get that on to the regulatory agenda.

16 **CHAIR:** Well it's certainly a matter that parties can take account of in undertakings because we  
17 have said that undertakings can extend beyond regulated services if they wish to consider  
18 that and think it appropriate to include in an undertaking.

19 **MR NEWMAN:** Thank you.

20 **CHAIR:** There was a Vodafone process for undertaking which I think we've dealt with.

21 **MR YORK:** That's fine, only just to note that we would have liked that final set of assumptions,  
22 but grateful for what we've had so far.

23 **CHAIR:** So now there's an opportunity really for any other, before we get into closing  
24 statements for any other issues that anybody may wish to raise. We've pretty well  
25 covered them all but -

26 **MS STONE:** Ross if we could just deal with the other issue that we wanted to raise.

27 **CHAIR:** The price squeeze?

28 **MS STONE:** Yes.

29 **CHAIR:** I'm very sorry.

30 **MR WIGLEY:** Margin squeeze, and we've asked for the opportunity to raise this. CallPlus and  
31 Kordia have sought in submissions a margin squeeze imputation test to be added, and put  
32 simply it would be ideally a sentence or so in the services description which says that  
33 there should be a margin squeeze imputation test to determine the detail of which is sorted

1 out during the Determination phase. Second choice if that's not acceptable is a margin  
2 squeeze imputation test to be considered and then implemented if appropriate, and then  
3 third is some indication at least in the Draft Report that it would be seriously considered  
4 at Determination stage.

5 So example given of why this is a problem, we've already heard a lot about the  
6 off-net and on-net pricing and the issues that that has raised, and we would say that that's  
7 classic margin squeeze in terms of the relativity of wholesale input, the mobile  
8 termination rate service, and the retail prices. And then we've got the bundles. So we  
9 know, we've heard a bit about bundles and we know from the report there is a single  
10 example of a bundle supplied by Vodafone which includes fixed to mobile retail service  
11 at 13 cents a minute, which lies as against a fixed to mobile wholesale inputs rate of 15  
12 cents a minute.

13 So if you're a competitor trying to attract the same customers you're playing  
14 against an up-stream provider of an essential wholesale input over which it has a  
15 monopoly - it could be Telecom, it could be Vodafone, it could be 2degrees - over which  
16 it has a monopoly where it can't compete at efficient prices.

17 James, in his report, notes that the cost of terminating a fixed to mobile call, if you  
18 take out the termination charge - that's, let's say, the 15 cents - is about 4 cents a minute,  
19 that's your origination costs, your SAC, your other bits and pieces that go in. So the cost  
20 of terminating a call if you're another provider is your 15 cents plus your 4 cents on top of  
21 which is 19, so that's playing against a price in the market of 13.

22 Now that's today, of course it's anticipated and hoped that the Determination rate  
23 will drop considerably, but the strong submission from Kordia and CallPlus is that it  
24 won't drop far enough to eliminate and take out the price squeeze problems, whether they  
25 be on-net and off-net pricing, or whether they be bundling issues. The problems are still  
26 going to be there. We're going to go away, maybe fix some magical rate and we're still  
27 gonna have those price squeeze issues sitting there. So it's submitted that the imputation  
28 test is an important solution.

29 Now we all know that imputation tests are margin squeeze, particularly when we  
30 start talking about bundles, is pretty complicated.

31 **CHAIR:** Sounds like an economic model to me Michael.

32 **MR WIGLEY:** It is, it is complicated, but we do have a tough problem. We have a real  
33 problem in that dropping the termination rates, let us say, to 7 cent a minute, as in the

1 counterfactual, or, let us say, 4 cents a minute or even 3 cents a minute, or whatever it  
2 might be, there are still going to be problems, it's still gonna happen. And the only way to  
3 solve it, we can't have retail regulation, the Commission's made it clear; the only way to  
4 solve it is to have some sort of wholesale remedy and here we have it in the form of  
5 margin squeeze.

6 It's a system that is used overseas, Telstra of course face it; it's applied in Ireland,  
7 and there are various papers and various approaches which have been accepted;  
8 complicated but worth it for a tough situation. Now I've actually done some speaking  
9 notes and I've just spoken to those, they're about a page and a half, but I wonder if I may  
10 the sensible thing may be to hand these around. I appreciate my colleagues haven't really  
11 had a chance to think about this, but it does seem an issue that's worth thinking about, and  
12 perhaps the approach for me is to hand this up and the Commission can either decide now  
13 or consider whether perhaps parties can have seven days to respond.

14 **CHAIR:** I think hand it around by all means, but I think in terms of this conference and what  
15 we're dealing with that it's not an issue that really can be addressed in the regulatory  
16 process that we are engaged in.

17 **MR WIGLEY:** If I might respectfully disagree with that conclusion, because -

18 **CHAIR:** Sorry, just so I'm clear, is this a matter that you filed submissions on early on and  
19 there's been cross-submissions and has been dealt with in this process as a central issue?

20 **MR WIGLEY:** It's been raised predominantly two times, it was raised right at the outset in  
21 response to the issues paper, but most recently it's been raised in the submission we did  
22 on the restricted information -

23 **CHAIR:** About a week or so ago.

24 **MR WIGLEY:** No, no, about a month or so ago. But critically, and strangely nobody seemed  
25 to respond to it. And it seems unfair to the other parties they don't have a chance to  
26 respond to this because it has been there and it was there at the time that submissions  
27 were to be filed. So I just want to add to your point that you consider this as out of scope.

28 **CHAIR:** I think for the reason that it - I can't recall now, it may have been an issue raised in the  
29 original Discussion Paper, but since the investigation we have had a process of  
30 submissions, cross-submissions; the issue was only raised, as I understand it, way back in  
31 the - a month ago and no-one else has seen or turned their mind to it. So I'm not sure that  
32 it's - I'm not saying it's not a live issue but I'm not sure it's appropriate at the closing of a  
33 two day conference to ask parties to give their views on something that they haven't even

1           seen in detail.

2   **MR WIGLEY:** Well -

3   **CHAIR:** I mean perhaps as a matter of process do other parties have a comment maybe?

4   **MR WIGLEY:** May I finish the -

5   **CHAIR:** Yes.

6   **MR WIGLEY:** If I can respond to your submissions. I want to reiterate first of all that we do  
7           have a serious problem here.

8   **CHAIR:** Yes, understand.

9   **MR WIGLEY:** And to be bogged down with a process issue in answer to what is a serious  
10           problem would be unfortunate. If there was a way to solve it; it's our submission that,  
11           you know, we're gonna come next year and we're gonna have the same old problems and  
12           we've done some nice things by fixing a rate, but still the on-net/off-net pricing is sitting  
13           there, still the bundling problem, which we all know is a major issue for us, is still sitting  
14           there; so that's the background.

15           Secondly, in terms of scope clearly it is within the Commission's power to make a  
16           decision to include this in the description.

17   **CHAIR:** I think what we can say is we will consider that, consider what you've said and you can  
18           put up the papers. Do parties generally have a comment on the appropriateness of dealing  
19           with this issue at this stage in the process?

20   **MS JONES:** Yeah, we do. The Telecommunications Act is all about regulation between service  
21           providers so we don't see if there is a problem at the retail level, which we don't agree that  
22           there is, this is essentially a Commerce Act issue; so we think it's using the wrong tool to  
23           deal with it through the proposed regulated service.

24   **CHAIR:** I mean certainly I was going to say the Commerce Act provides certain remedies and it  
25           under the current regime is more appropriately dealt with there. Telecom response?

26   **MR WESLEY-SMITH:** Look we'd have a similar view. I'm sorry that no-one's talking back to  
27           you, Mike. Areti's just come and whispered in my ear, though, and said that may be  
28           because you raised this issue in a letter on RI and there was just so many of those I gave  
29           up reading them. **[Laughter]**

30   **MR MATTHEWS:** Just very briefly, 2degrees has obviously fairly consistently advocated for  
31           some level of retail control. We appreciate where the Commission has gotten to on that,  
32           2degrees has expressed concerns as an ongoing issue. So I've got some sympathy for the  
33           submission put forward, we think it's consistent with the issues raised. I guess appreciate

1 concerns there but we have had prohibition on on-net/off-net price differentials before  
2 and we submitted a lot on that, so I won't repeat those.

3 But it does perhaps, as the Commission's already noted, given the low level of  
4 on-net prices, I think that's something that 2degrees would like to see in some way  
5 recognised; whether it's through the offer prices in undertakings or however, we think it's  
6 something that needs to be taken into account.

7 And finally just it would provide the benefit of some ex-ante certainty and the  
8 Commission is obviously well used to applying an imputation test.

9 **MR NEWMAN:** It does sound like an issue that TUANZ ought to be taking an interest in.  
10 Again having no-one on our bench who sees the confidential information that's probably a  
11 fairly convincing excuse why we haven't picked the issue up. I wonder whether it might  
12 be possible to bring it out from under the covers in some way so that ordinary mortals can  
13 understand it and get a view.

14 **CHAIR:** I think for the purpose of this process I think it hasn't been raised appropriately and  
15 isn't subject for our consideration. My view really is that it's a Commerce Act issue and if  
16 there is an issue that's currently where it should be dealt with.

17 And thirdly I would have thought that it might be more appropriate to wait for the  
18 outcome of this process and if it does result in lowered termination rates by undertaking,  
19 or whatever, see how the market plays out and if there really is a problem still in the  
20 market I've no doubt we will hear from you. But in terms of this process it's not  
21 something that would be incorporated in what we're doing at the moment. Any other  
22 issues parties wish to raise? **[No comments]** Closing statements. First on our list is  
23 Mr Newman.

#### 24 25 **CLOSING STATEMENT BY TUANZ** 26

27 **MR NEWMAN:** I was actually going to write this during the afternoon tea break  
28 Commissioner. **[Laughter]** Look I have been reading back through the opening  
29 comment that we made yesterday morning. We have learned a lot from this conference,  
30 but I don't think there's anything that we said yesterday morning that we would materially  
31 depart from at this stage. I think it has been one of the better conferences that the  
32 Commission has run in that I think we are seeing a degree of meeting of minds around the  
33 table, and I hope I'm right in drawing that inference.



1 issues of judgment.

2 And there are basically I think two views around the table on that issue of  
3 judgment. If, for a moment, you were to accept broad consensus that TSLRIC is, if you  
4 like, your point of departure. One view, I think the 2degrees view by-in-large, is to say  
5 you should have an inclination to move quickly and you should have an inclination of  
6 bias on the low end of any judgment that you're making in terms of the level of numbers.

7 And the basis for that is that you will get more competition, or to put it another  
8 way, less foreclosure in the basis that we've been talking about as a result of erring on that  
9 basis. That's based on a belief that, and that leads you to the conclusion that there would  
10 be a big difference between the factual and the counterfactual cases in terms of the level  
11 of competition, or the level of foreclosure when you're looking at this question. So there's  
12 a big difference between the two cases the Commission will be required to look at.

13 So I'd like to examine very quickly what the evidence is for that view. The first  
14 point is, I don't think there is disagreement that under certain conditions you can have  
15 foreclosure as a result of the on-net/off-net pricing practises, and high termination rates  
16 and big differentials in market shares, market positions between firms. And I note that  
17 most of the views from the advisors and most of the literature on this uses the word very  
18 carefully there can be instances of this.

19 That, though, is not, I think, the relevant test for thinking about regulation. The  
20 test, I think, for the Commission is what is our level of confidence in this particular case,  
21 not Slovenia, but in this particular case that actually there will be a big difference, it will  
22 have a big impact on what we can assume about competition depending on the relative  
23 level of the MTR and how we err in this question of judgment.

24 The evidence from the rest of the world, I think, is not very convincing for the  
25 Commission on this. If you look at entry by small operators elsewhere in the world there  
26 has been plenty of entry, even in conditions under which you'd say termination rates have  
27 been high. There has been plenty of entry into markets where there has been significant  
28 on-net/off-net differential, so just at a very preliminary view, it is not obvious that there  
29 are large numbers of small mobile operators exiting markets around the world in the  
30 presence of high termination rates or extreme on-net/off-net differentials.

31 If you look at New Zealand, which is the more important thing to do it seems to  
32 me, then I think there are a couple of pieces of very important evidence for the  
33 Commission to consider. The first, which we discussed at some length, is the presence of

1 termination rates which are above, I think we'd all agree, TSLRIC in the SMS market a  
2 number of years ago; clearly did not prevent the development of attractive off-net pricing  
3 offers by Telecom.

4 The second is a point that was made, I think, in Vodafone's opening remarks  
5 yesterday. If to the extent that there is an on-net issue and on-net used to lock in  
6 customers, the number of customers in the New Zealand market today who are locked in  
7 in that way is very small. So about 20% of Vodafone's customer base for voice are  
8 currently on, what you might call, on-net tariffs, 80% of our customers are not. I don't  
9 know the numbers for Telecom.

10 Similarly on text, 15, 15%, of Vodafone's customers are on on-net tariffs. So to  
11 the extent that there is a market entry problem in the New Zealand market as a result of  
12 on-net pricing, it applies to a small minority of the contestable customers of the available  
13 customers in the New Zealand market.

14 But even more, or at least as significant as that, those customers who have on-net  
15 tariffs are not getting on-net access to the entire customer base of Vodafone, particularly  
16 in the case of voice pricing. In that case they're getting on-net access to one, two or three  
17 other nominated customers only. And we continue to fail to see why it is not possible for  
18 other operators to move one, two or three customers, from one network to another in  
19 order to replicate the on-net offer. It would be a different argument if there were  
20 widespread use of on-net tariffs where the on-net community extended to the entire  
21 customer base of the large operators, but that is not the position, not the facts that we see  
22 in New Zealand today.

23 Third reason, third consideration which we've discussed today I think helpfully, is  
24 the interconnection arrangements that now exist between 2degrees and other operators  
25 which facilitate entry.

26 And the fourth consideration is that there is, to our mind, not a clear case of major  
27 massive customer detriment in New Zealand today as a result of the alleged market  
28 structure and market prices that exist today. So the volume of off-net traffic relative to  
29 on-net traffic, the 80/20 split that we see referred to is not atypical, is not unusual of what  
30 we see in most of the markets that we operate in the world, many of which people would  
31 regard as highly competitive.

32 There is no evidence to us, either in those terms or in terms of the levels of dual  
33 handset ownership, which we estimate to be in the order of 10%, that suggests there is a

1 major, or different problem of interconnection break-down of people not being able to  
2 communicate between networks in New Zealand.

3 And one of the key reasons for that that I think has been missing in the stylised  
4 examples that we run through that are useful in thinking about this, but it misses an  
5 important point; is that customers in New Zealand and elsewhere are not passive, mute  
6 objects that simply fall on to whichever network in a random fashion in proportion to the  
7 size of a network, customers organise themselves and switch between networks to  
8 maximise the value and the benefits that they get from competition. That is essentially,  
9 we think, what you see in the New Zealand market today where you see low and falling  
10 prices and customers benefiting from that by moving and switching between operators.

11 Finally, as I indicated yesterday, if you did expect on-net prices to lock in  
12 customers you would expect to see big differentials between the churn levels of that 20%  
13 of the customer base that I said are on on-net tariffs and the remaining customers who are  
14 not on such tariffs, and we simply don't see those differentials.

15 So there's no evidence from the New Zealand market to suggest that this is a  
16 significant impediment to competition, and therefore there's no reason to think that  
17 actually the competitive situation in the factual and the competitive situation in the  
18 counterfactual would be particularly different.

19 You can say all of those things, whilst fully conceding and accepted that  
20 competition will produce lower prices and that's a good thing, that's not the question the  
21 Commission, we think, is required to address its mind to. The question the Commission  
22 is required to address is, to what extent does competition change as a consequence of  
23 reducing termination rates.

24 The evidence on that, we think, is not good, and for that reason there's no reason  
25 particularly to depart from what we take to be the general international practise, which is  
26 not to err on the low side, and not to move directly to significant reductions in terms of  
27 movements to TSLRIC, but to exercise more caution.

28 A couple of other points if I may. Today we've really looked at the other side of  
29 that equation, which is if the benefits of competition are uncertain or modest, how much  
30 do we really understand about the likely costs of regulation. And I think there we've  
31 found broad consensus that there are consequences of reducing termination rates for  
32 mobile customers but that there is uncertainty as to the size of the waterbed one way or  
33 the other, and that the fact of entry in New Zealand doesn't allow you to simply dismiss

1 issues around the waterbed as a result.

2 And we again would point you to the comparative data of what we see in the  
3 United States as a market with lower termination rates and other European and the  
4 New Zealand market in terms of trying to understand what it really means for customers  
5 for mobile customers if you err on the downside in terms of termination rates.

6 The other final point I would make very briefly is the other consideration in  
7 thinking about the glide path and waterbed issues is an issue that hasn't really featured  
8 very much in this conference but I think Russell mentioned earlier yesterday, which is  
9 that in addition to the implications for customers in the short-term there is a consideration  
10 around investment and around the incentives for investors that we think needs to be at the  
11 very least in the back of your minds as you think about significant changes in the rules  
12 and the regime.

13 Now given that balance of uncertainty about the significance of how much  
14 competition would change given intervention on the one hand and uncertainty on the  
15 other hand about some of the costs and some of the risks that arise, we think that does  
16 create or should create a sympathy on your part to consider alternative ways of  
17 proceeding in the event that those were possible in lieu of regulation. And therefore I  
18 think your decision to, and willingness to consider undertakings as an alternative way of  
19 proceeding in this matter, is a very welcome and positive one in that regard. Thank you.

20 **CHAIR:** Thank you very much. I'd just like to welcome Roger Kerr from the Business  
21 RoundTable who has just joined us. He was due to speak in the last session on other  
22 issues parties wish to raise but unfortunately our timetable got ahead of the agenda, so  
23 apologise for that. But if we stop closing submissions now and I'd invite Roger to address  
24 us going back to the other issues and then we can proceed with the rest of the closing  
25 addresses. Thank you.

26  
27 **OTHER ISSUES PARTIES WISH TO RAISE (CONTINUED)**

28  
29 **MR KERR:** Thank you Chairman that's fine. I think I've got about five minutes which is fine.  
30 The Business RoundTable, as you know, has had a long-standing interest in  
31 telecommunications issues, it's such an important industry for the country. Our  
32 perspective is the perspective of consumers, the long-term interests of consumers which  
33 we see is synonymous with economic efficiency, particularly the dynamic aspects of that.

1 I just want to make three points, you have our submission. The first one is what's  
2 actually at stake in this inquiry, how significant is it overall, which is what we discuss in  
3 section 6. The Draft Report suggests that the allocative efficiency gains might be of the  
4 order of 50 to \$100 million in net present value terms over five years.

5 Now just taking those figures at face value for the moment, what we're talking  
6 about there is \$30 to \$60 dollars a household; that's half a tank of petrol, the total  
7 estimated net present value gains over five years. Now we suggest in paragraph 6.6 that  
8 even that figure may be overstated by possibly 8 times, and it ignores the efficiency  
9 detriments, it ignores things like rent seeking and property right uncertainty.

10 We also query other aspects of the calculations, and frankly, as we see it, this is  
11 trivial pursuit. It's why we said that the Commission shouldn't be undertaking this inquiry  
12 in our submission last year. Chairman, we just think that New Zealand can't carry on like  
13 this, tying up the time of Commissioners, Commission staff, senior executives in the  
14 private sector, talented people, you only have to look around this room, creating  
15 investment uncertainty, encouraging lobbying for more regulation; can't carry on doing  
16 this and wonder why our productivity performance is lousy.

17 Second point I'd like to make is the rule of law issue which we discuss in section 4  
18 of our submission. The rule of law is hugely important for investment certainty and  
19 productivity. The Draft Report proposal overturns the rules for 2011 and 2012  
20 established in the deeds. We see that as unconscionable. We liken it, for example, to the  
21 Auckland Airport intervention of the Government last year on which we took a complaint  
22 to a Select Committee of Parliament which was substantially upheld.

23 We see it as a totally unsatisfactory situation. These kind of changes of rules,  
24 breaches of what we would see as the rule of law ricochet around the world and affect  
25 investors' perceptions of New Zealand. Just imagine, for example, a New Zealand CEO,  
26 say Vodafone, going to their board for approval of tens or hundreds of millions of dollars  
27 in Telecom investment. The first question they'd get asked is, "how can we have any  
28 confidence that the rules of the game in New Zealand won't change on us? We've got  
29 worldwide investment opportunities, why should we bother about New Zealand?"

30 And it's for these kind of reasons that business organisations are so strongly  
31 behind the current regulatory responsibility exercise to try to give more protection to  
32 investors' property rights and the rule of law.

33 Third point, Chairman, the issue of a regulatory impact statement. As you know

1 the Cabinet manual requires RISs for bills and discussion papers. The Government is  
2 looking to strengthen regulatory disciplines, it made announcements on that recently. We  
3 think the Commerce Commission, whether or not its statutorily required to do so, should  
4 adopt the RIS framework and also have regard to the LAC guidelines on property rights  
5 and compensation in this inquiry.

6 And so our submission at the end is that the final report must contain far more  
7 rigorous analysis and demonstrate far bigger gains in total surplus, that's producer and  
8 consumer surplus combined, than half a tank of petrol or a bottle of wine to support any  
9 proposals to regulate, otherwise we recommend you should abandon the proposals. And  
10 finally on no account should the rules be changed for 2011 and 2012. Thanks.

11 **CHAIR:** Thank you very much. The points you make are important, we have read your  
12 submission and we will certainly be dealing with each of the issues that you raise in our  
13 final report, so I thank you for that.

14 **MR KERR:** Thank you.

15 **CHAIR:** If we move on now in the final addresses to Bill McCabe I think for 2degrees.  
16

### 17 **CLOSING STATEMENT BY 2DEGREES**

18

19 **MR McCABE:** Thank you Commissioners, and thank you for the opportunity to speak at this  
20 conference; and I'll echo the sentiments of the others, it's been very well put together  
21 thank you.

22 The problem here is excessive high termination rates as well as on-net/off-net  
23 retail price differentials. Each in isolation can be deeply damaging but when combined  
24 they can have a crippling effect on a new entrant's ability to compete and expand, and we  
25 didn't talk in great detail about Slovenia, but we have submitted on that and what can  
26 happen in foreclosure.

27 It's resulted in virtually closed networks here in New Zealand where we've heard  
28 arguments that there are small circles of people who call each other, but the reality from  
29 the studies that we've had is that it's entire cities that are foreclosed that are either on one  
30 network or another.

31 And going back to the Fletcher inquiries ten years ago, the idea of any to any  
32 connectivity is very important for competition for productivity and to stop people owning  
33 multiple handsets to be able to call different people on different networks and to receive

1 calls from different people on different networks.

2 But there's - we're taking a look into the future as well, we're trying to average  
3 costs if it's TSLRIC or it's LRIC, average the costs on a per minute basis which is  
4 incredibly difficult to do. I think we've all recognised the difficulty of modelling and  
5 what is cost and what is real cost and what, if any, common costs should be put in there  
6 and how you attribute those over different number of minutes when you look into the  
7 future.

8 But the future's changing. We have had a very clear distinction between what's  
9 been traditionally fixed line networks and fixed line services and mobile services up until  
10 quite recently; but those boundaries are incredibly blurred now, and what you can do with  
11 a mobile phone these days and in accessing the internet, your social networks, your  
12 e-mails, which you pay to receive of course if you have a Blackberry; we heard about  
13 Skype and Google, you can do that on your mobile phone now where you're paying for  
14 data rather than the calls per se, perhaps not in this country but elsewhere you can.

15 And then we look at fixed lines which traditionally have been attached to a wall in  
16 a house but now you can sort of, just through sort of wireless devices, use it around the  
17 house and through home-zone type services you can use it down the street, and the  
18 home-zone services actually - the determinations there allow customers to use them  
19 potentially city-wide if somebody was to come up with that, but it allows that.

20 Then you look at things like femtocells, and again I'm in danger of repeating  
21 myself from earlier, but a femtocell is basically a mini GSM antenna that you can buy and  
22 it backhauls through your own broadband from home and that allows you to use the cell  
23 around the house. So the distinction between the two is becoming blurred and we call  
24 that convergence.

25 The idea that paying termination rates to one set of providers at an unregulated  
26 rate which exceeds fixed line termination rates by an order of magnitude is last century's  
27 solution. I think we need to look to the future. And when we're looking at 3G it's all  
28 data, and 4G, voice becomes just another data service, where you're designing networks  
29 predominantly to supply data, the vast majority of your backhaul and capacity will be  
30 around the data provision and voice will be smaller and smaller parts.

31 So you're gonna see that the allocated costs of voice is going to plummet. And it  
32 strikes me that unless regulation comes in that can deal with the future rather than relying  
33 on undertakings which ultimately do look at the present and try and project into the

1 future, under regulation you have the flexibility to change according to the market and the  
2 demands of that market to ensure that you're not subsidising one technology over another.

3 And subsidy is incredibly important here because we've talked about the balance  
4 of traffic, we've talked about traffic going from fixed to mobile and the incumbent mobile  
5 networks are being subsidised because their termination rates are above cost by fixed line  
6 providers and small mobile networks. And competition cannot take off if you have this  
7 subsidy for the large mobile networks. And competition is all important here, and any to  
8 any connectivity.

9 So I don't actually have much more to say in my closing statement apart from just  
10 picking up on a couple of points that were said earlier. We're talking about investment,  
11 there's been a little bit of a discussion about investment and incentives to invest.  
12 Vodafone's saying well you have to take that into account here.

13 We have invested fresh money into this country. We note that Vodafone has got -  
14 some of its largest investments are in places with very low termination rates. So I think  
15 India is their biggest investment over the last five or six years where they're investing  
16 incredibly heavily where termination rates are very very low, under 1 cent New Zealand,  
17 and we too expect to be able to make a return. And we only want to pay cost, we're not  
18 looking for any favours, we just want to be able to compete on our merits and New  
19 Zealanders will benefit if we are able to do so.

20 **CHAIR:** Finally Telecom, John.

21  
22 **CLOSING STATEMENT BY TELECOM**

23  
24 **MR WESLEY-SMITH:** Once again thank you for letting us speak at the conference, it's been  
25 an interesting couple of days and an interesting new format for these conferences, which  
26 the economists will have found enjoyable and challenging. I really just want to wrap a  
27 couple of threads together that you've picked up over the last two days and make a few  
28 high level conclusions.

29 The first is that there is a fair degree of consensus actually around the table on a  
30 couple of important principles. The most important of those is that I think everyone  
31 agrees with the principle of TSLRIC price termination rates. What's at issue here is how  
32 we get there.

33 There's consensus that it's a two sided market and that means that shooting straight

1 to TSLRIC will have consequences that need to be responsibly managed. These are real  
2 end-users, real operators, and a real retail pricing structure that we're proposing to change.

3 International practise seems to be that the way you do this is to set glide paths of  
4 rates that are informed by TSLRIC modelling and seek to get to some approximation of  
5 TSLRIC. We continue to hold the position that the Commission should adopt a final  
6 pricing principle that does let it, if it thinks it appropriate, follow international practise  
7 and set a glide path. And if that's right, and since we all agree that the benchmarking the  
8 Commission is doing now should approximate what a regulated outcome would be, we  
9 continue to hold the view that that benchmark should also be capable of dealing with  
10 glide paths or decisions by informed Regulators based on TSLRIC modelling.

11 Now we also all agree that no-one definitively knows what the precise TSLRIC  
12 cost for termination is. We can get to a range but at that point you have to make a  
13 judgment call about where within that range you want to sit. And if that's right and we  
14 can get to a set of matching undertakings that gets close to or within that range then that  
15 must be a better outcome for us as an industry and for New Zealand.

16 It might make for a bit of a hit to our colleagues from Wik's pockets, but not  
17 having to spend the next two years fighting about TSLRIC modelling will do a fair bit for  
18 my sanity. And with the process that the Commission has put forward now to allow for  
19 another round of undertakings, then around this table as a collective group we've really  
20 got no excuses not to get it right this time. If not 100% agreement we've got to get damn  
21 close.

22 I said at the start of this process that we had put up our undertaking as a genuine  
23 attempt to engage on a constructive industry-based solution and that still holds. I think  
24 we've had a bit of engagement on it in the last two days which has been good and we will  
25 absolutely come back with a revised undertaking that seeks to reflect it.

26 Now there's also a couple of things that we don't agree on. There's been lot of talk  
27 over the last two days about the anti-competitive strategies and anti-competitive design of  
28 the market. For a start look I've heard stories - I've heard this phrase 'anti-competitive  
29 strategies' in the 2006 roaming conference, in the 2008 co-location conference and again  
30 today. And look I find it as useful as the rest of the room found it when we talked about  
31 the chilling effect of regulation on investment and investment threats. I tell you guys, you  
32 find the market the way it is because that's the way it's evolved as a result of competition  
33 between Vodafone and Telecom, it's got nothing to do with us setting some master plan

1 for potential entry.

2 We've also got some disagreement as to the relative benefits of lower MTRs on  
3 2degrees' entry and expansion, and I am still waiting for someone to produce some  
4 empirical evidence about that. I think our view is pretty clear. I just want to make some  
5 comments from a commercial perspective, a real world perspective about this, because  
6 look 2degrees has talked about how difficult it is as a small start-up coming in to compete  
7 with larger players.

8 And I tell you, the story of the New Zealand mobile market is well-known, and  
9 quite often we sometimes feel like that little entrant competing against Vodafone group  
10 here, but we have never thought that cutting termination rates in half is how we're gonna  
11 succeed in competing with Vodafone.

12 I'll tell you what we think is gonna help us and what is helping us compete with  
13 them, that's getting great handsets that customers want, that's getting great coverage at 2G  
14 and 3G that customers want, that's getting a compelling international roaming proposition,  
15 customers value that; and it's introducing market changing retail pricing constructs. \$10  
16 text is famous. We've gone out with our XT launch with no on-net/off-net differentials.  
17 Those are the types of things that will bear on your success of entry and expansion, those  
18 are the types of things that we're relying on to gain back some of the market share that  
19 we've lost.

20 So at the end of the day, we've got complete uncertainty over what those relative  
21 benefits to 2degrees' entry are from lower termination rates, or whether they are even  
22 material as opposed to those basic competitive fundamentals. And on the other hand we  
23 know that significant sudden drops in termination rates are going to have a negative  
24 impact on segments of our customers. That is why we have to take a responsible  
25 approach to introducing regulation of regulated termination rates. Thank you.

26 **CHAIR:** That completes the agenda for the conference and is left only for me to really sum up.  
27 From the Commission's perspective we have found it excellent. I'd like to thank the  
28 parties. I think also a special thanks to our economists, the economists that the parties  
29 have. We have changed the format, we've focused far more closely on economic issues  
30 and therefore the economists have really played centre stage.

31 I know there were times when some found that rather uncomfortable, but  
32 sometimes in the search for the truth that happens. But in terms of the ability to get  
33 through a large amount of incredibly complicated material very quickly I think it proved

1 its worth. There were parties who submitted that we needed at least twice as much time  
2 as we'd allocated to get through the issues, and here we are two or three hours ahead of  
3 time. So particular thanks to all of the economists for contributing and assisting us in  
4 these issues.

5 Thanks to our stenographer who has done a sterling job over two years including  
6 dealing with interference issues which is something that many around this table know a  
7 lot about, so thank you for that. And certainly thanks to my fellow Commissioners, staff  
8 and the experts from Wik who have assisted the Commission.

9 Just a couple of housekeeping arrangements, I think I am asked to remind parties  
10 to e-mail Shane at the Commission all material provided at the conference so that we can  
11 post that on our website.

12 I remind you that we will be issuing a written confirmation of the revised  
13 undertaking process that we have determined today, and Commission staff will contact  
14 the relevant parties to follow up action where additional information is to be provided to  
15 the Commission on a confidential basis and so staff will follow that up.

16 So it really is left with me only to wish those going on to the TUANZ dinner  
17 tonight to have a very good night, and to declare the conference closed, thank you.

18  
19 **Conference concludes at 2.51 pm**  
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