



TelstraClear Limited

**Schedule 3 investigation into
regulation of mobile termination**

**Submission on undertakings received
from Telecom, Vodafone and
New Zealand Communications**

13 February 2009

Executive Summary

- (i) TelstraClear remains concerned with the state of the mobile termination market in New Zealand, and supports the Commission's Schedule 3 investigation into wholesale mobile termination.
- (ii) TelstraClear does not consider that the undertakings provided by Vodafone, Telecom New Zealand and New Zealand Communications would best give effect to the promotion of competition for the long-term benefit of end-users.
- (iii) Telecom and Vodafone provide undertakings which propose mobile termination rates through to 2013/14 that appear materially higher than benchmarked cost-based mobile termination rates in comparable international jurisdictions.
- (iv) Acceptance of these undertakings risks locking in wholesale mobile termination rates significantly above cost for a further five years, perpetuating the competition issues the Commission has identified in its decision to investigate mobile termination services.
- (v) Telecom and Vodafone argue that the acceptance of undertakings is the only way that wholesale mobile termination rate reductions will be fully passed through to end-users. This ignores the reality that customers purchase bundles of services from providers. Wholesale mobile termination rates above cost reduce the ability of competing carriers to deliver compelling packages in competition with those mobile carriers who are able to cross-subsidize their own bundles with revenue from above cost mobile termination, thereby denying New Zealand end-users with choice.
- (vi) The undertaking provided by New Zealand Communications is limited in scope to mobile-to-mobile termination. It does not cover fixed-to-mobile termination – a central component of mobile termination currently being investigated by the Commission. TelstraClear does not support bill and keep for mobile-to-mobile termination. It is efficient for parties to incur the cost that termination imposes on another network. While symmetric traffic flows between two providers would effectively net out any termination cost between those parties, there is a material risk that asymmetric traffic flows drive costs into one terminating network, without compensation for the costs imposed by the other party.
- (vii) For these reasons, TelstraClear recommends that the Commission does not accept the undertakings, provided in lieu of regulation of mobile termination under Schedule 1 of the Telecommunications Act.

Introduction

1. TelstraClear welcomes the opportunity to comment on the recent undertakings submitted by Telecom New Zealand, Vodafone and New Zealand Communications as part of the Commission's Schedule 3 investigation into the regulation of mobile termination. .
2. TelstraClear remains concerned with the state of the mobile termination market in New Zealand. TelstraClear was supportive of the Commission's recommendation in its mobile termination reconsideration report¹ issued in April 2006, recommending that the Minister regulate fixed-to-mobile termination under the Telecommunications Act. TelstraClear remains of the view that the Commission should regulate all voice calls terminating on mobile services, whether they originate from fixed or mobile networks.

Telecom and Vodafone's undertakings propose MTR significantly above cost

3. As the Commission identified in its issues paper, "a telecommunications provider with significant market power ("SMP") in termination services could charge wholesale prices above costs."² The issues paper then outlines the impact that such market power in the upstream wholesale termination market has, and to the extent that the charge exceeds cost, how this would be likely to affect the downstream retail market.
4. Telecom's undertaking proposes mobile termination rates for both fixed-to-mobile and mobile-to-mobile, which would reduce from 16cpm to 10cpm in 2013/14. Similarly, Vodafone proposes fixed-to-mobile termination rates which would reduce from 13cpm to 11cpm by 2013/14, while mobile-to-mobile termination rates would reduce from 15cpm to 11cpm by 2013/14.
5. On the face of it, the proposed rates provided in the undertaking are materially above the Commission's benchmarked rate. In providing reasons for its decision to investigate mobile termination access services, the Commission noted that:³

...current cost-based benchmark used by the Commission in its Schedule 3 investigation into amending the roaming service is just over 10cpm. The Commission has revised downwards its median benchmarked estimate of cost-based MTRs, as a number of the benchmarks previously used (such as in Australia and the UK) have been reduced...

6. The Commission concluded that:⁴

Current international benchmarks for cost-based MTRs indicate that the prevailing MTRs in New Zealand are likely to be significantly above the cost of providing the service, and that the reduction in MTS that would result from regulation may result in lower retail prices and therefore may increase the long-term benefit to end-users.

¹ Commerce Commission, *Telecommunications Act 2001, Schedule 3 investigation into regulation of Mobile Termination, Reconsideration Final Report*, 21 April 2006.

² Commerce Commission, *Telecommunications Act 2001: Schedule 3 Investigation into Regulation of Mobile Termination – Issues Paper*, 8 August 2008, para 35

³ Commerce Commission, *Reasons for Commerce Commission decision to investigate mobile termination access services*, 6 November 2008, para. 11

⁴ *ibid*, para. 13

7. It is clear that the proposed wholesale mobile termination rates in Telecom and Vodafone's undertakings remain significantly above the Commission's current benchmarked rates from comparable jurisdictions.

Continuing evidence of downward movement in international MT rates

8. Continuing evidence suggests downward movement of mobile termination costs. For example, the ACCC commissioned WIK to develop a mobile network and cost model. In November 2007, the ACCC released its pricing principles for the MTAS, as well as its view of the appropriate price for the service between 1 July 2007 and 31 December 2008. The ACCC's view was that the MTAS service price should be set at 9 cents per minute (Australian), although the WIK model produced a TSLRIC range of 6.1 to 6.6 cents per minute (Australian).⁵ More recently, the outputs produced by the WIK model were even lower, ranging from 5.8cpm to 6.1cpm, depending on the assumed market share of the efficient provider⁶. Importantly, the MTAS regulated by the ACCC includes all voice calls terminating on the mobile network, whether they originate from fixed or mobile services.
9. Telstra has recognised that the outputs generated by the WIK model were in line with other sources, and that the efficient cost of supplying the MTAS was in the order of 5-6 cpm (Australian).⁷
10. One would also have to exercise caution in using current mobile termination rates in Europe, given that the European Commission has urged the national regulatory authorities in Europe to reduce mobile termination rates to the costs of an efficient provider as soon as possible.⁸ This indicates that current termination prices are at a level that is above cost.
11. TelstraClear remains of the view that the Commission's recommendation to the Minister to regulate mobile termination through its inclusion into Schedule 1 of the Telecommunications Act would deliver improved competitive outcomes in the market.

Benchmarking as a proxy for cost modelling

12. As part of MTAS proceedings in Australia, Telstra commissioned Ingenious Consulting Network ("Ingenious") to comment on the use of international benchmarking in setting interconnection rates.⁹ In that report, Ingenious identify adjustments that may be necessary to simple side-by-side benchmarking to truly compare jurisdictions.
13. Ingenious identify generic factors in international cost benchmarking including differences in WACCs, timing considerations, exchange rate movements, negotiation as a element of regulation and the specific costing methodology.

⁵ see "MTAS Pricing Principles Determination 1 July 2007 to 31 December 2008 Report", ACCC, November 2007, p1.

⁶ "Draft MTAS Pricing Principles Determination and Indicative Prices for the Period 1 January 2009 to 31 December 2011", ACCC, November 2008, at p14.

⁷ Telstra, *Submission in response to the ACCC's Discussion Paper on the WIK Mobile Network and Cost Model to inform the MTAS Pricing Principles Determination 1 July 2007 to 30 June 2009*, March 2007

⁸ See for example the comments made by the ACCC in Draft MTAS Pricing Principles Determination and Indicative Prices for the Period 1 January 2009 to 31 December 2011", ACCC, November 2008, at p16.

⁹ Ingenious Consulting Network, *The use of international benchmarking in setting interconnection rates*, December 2008.

14. In respect of mobile termination more specifically, Ingenious identify factors including mobile traffic density, mix of voice and data traffic, costs of telecommunications transmission equipment, spectrum auction processes, and differential costs of masts and leased lines.
15. The inherent limitations of international cost-benchmarking compared with specific cost modelling have been traversed in detail in the mobile termination proceedings since 2004.
16. There will always be a risk that international benchmarks are not an accurate proxy for cost modelling, and in that respect the Commission needs to exercise care in ensuring that any benchmark price it derives accurately reflects a cost-based approach. However, what is clear is that the rates put forward by Vodafone and Telecom are above cost, and that locking in mobile termination charges that are significantly above cost will have a detrimental impact on competition within the industry, for it will perpetuate the requirement for investors in other technologies to subsidise investment in mobiles.
17. The Commission's reconsideration report to the Minister of Communications to designate mobile termination in 2006, the Commission proposed an initial pricing principle of "[b]enchmarking against the price of terminating a voice call on a cellular telephone network in comparable countries where the price calculation is based on a forward-looking cost-based pricing method" and a final pricing principle of TSLRIC.
18. If the Commission were to recommend regulation of mobile termination under Schedule 1 of the Act, and a determination subsequently was made, we note that the risks of error resulting from the Commission's determination could be minimised, as any party can apply for a final pricing determination if it considers that the Commission's initial price, set on the basis of cost-based international benchmarks, is above or below the TSLRIC cost.
19. The final price determined by the Commission is then applied with effect from the date of the Commission's determination of the initial price, with a wash-up of costs between the parties. Further adjustments to simple benchmarking may further refine any benchmark and improve comparability. Such an opportunity is not available, if the undertakings put forward by the three mobile operators are accepted.
20. However, it remains clear that the significant difference between the rates in Telecom and Vodafone's proposed undertakings and the Commission's benchmark rate indicate mobile termination rates would be materially above cost. In effect, acceptance of the undertakings would put in place binding above-cost mobile termination rates until 2013/14 – a situation which may leave New Zealand lagging behind the rest of the world.

Pass through

21. A significant issue during the previous deliberations was the retail pass-through of reductions in the wholesale fixed-to-mobile termination rate. In the Commission's reconsideration report, the cost-benefit analysis estimated that mobile termination pass through of 68% would occur.
22. In providing its offer to the Minister in lieu of designation of the fixed-to-mobile termination service, Vodafone argued that "[t]he reality, based on both historical New Zealand data and international experience, is that pass through rates will not increase voluntarily and the Commission's assumption that pass-through will increase to 100% from the current 68% - simply because of regulation - is lacking in credibility." ¹⁰
23. The Issues paper notes that to assess the potential allocative and productive efficiencies, one of the three isolated effects that would need to be taken into account is the price effect on the retail level, which would reflect the wholesale price effect and the level of pass-through.
24. However, the extent of retail pass-through is only one factor to consider in assessing the benefits of mobile termination regulation, and in any event, the extent of retail pass-through will be difficult, if not impossible, to determine. In particular, given the nature of retail mobile bundles, TelstraClear considers that it is inappropriate to focus solely on the extent of pass-through based on retail termination rates.
25. At a retail level, mobile services are generally sold as a bundle. This will often include a handset, access and calling services. Likewise in the fixed market, mobile termination is not commonly purchased as a standalone service. The total package price to the consumer reflects the total value of the bundle sold. Pricing of individual components with a retail bundle may be designed to attract customers, rather than reflecting the underlying cost of delivering the service component per se. For that reason, differential pricing between termination of calls on or off net may reflect the marketing proposition, rather than simply reflecting the cost of mobile termination as a stand-alone service.
26. This view is consistent with the ACCC's conclusions on the likely extent of retail pass through of wholesale termination savings. In designating MTAS in Australia, the ACCC identified that: ¹¹

... the Commission believes it is difficult to accurately measure the extent of FTM pass-through in any given period, as the price of FTM calls can vary for reasons other than changes in the price of the MTAS. In particular, the Commission notes that changes in the price of other inputs, expansions in demand for the services and contract lags can all influence the price a FTM service provider will set for this service. Accordingly, it is difficult to isolate how much of a given change in the price of FTM services is due to changes in the price of the mobile termination service.

¹⁰ Letter from Vodafone to the Minister of Communications, 20 September (Released under the Official Information Act).

¹¹ P. 129

[http://www.accc.gov.au/content/item.phtml?itemId=551419&nodeId=869923e2dc6450fb03830deb9aca5c19&fn=Final%20report%E2%80%94mobile%20terminating%20access%20service%20\(Jun%2004\).pdf](http://www.accc.gov.au/content/item.phtml?itemId=551419&nodeId=869923e2dc6450fb03830deb9aca5c19&fn=Final%20report%E2%80%94mobile%20terminating%20access%20service%20(Jun%2004).pdf)

27. The ACCC has also recognized the importance of reduced MTAS rates for improving the level of competition more generally for fixed network services, which need not translate directly to reduced retail fixed-to-mobile call rates. For example, in its decision to reject an undertaking by Vodafone which sought to impose an obligation upon fixed-to-mobile operators to reduce their fixed-to-mobile charges for calls terminating on Vodafone's mobile network, the ACCC commented that:

"Further, the Commission does not believe that the extent of FTM pass-through should be seen as the only measure of the extent to which a lower price for the MTAS promotes competition in the market within which FTM services are provided, or the LTIE [long-term-interests of end-users] more generally. A reduction in the MTAS rate alone might put in place necessary preconditions for improved competition and efficient use of and investment in infrastructure. Putting into place those preconditions can itself be in the LTIE, even if there is no certainty that the necessary preconditions will be taken advantage of.

Secondly, to the extent that such preconditions are taken advantage of, improved competition can manifest itself in many forms other than just price reductions. In particular, improved competition may be associated with improvements in the quality of services provided (which may increase the cost of providing FTM call services). Further, lower input costs may be passed-through in the form of reductions in the price of other services provided in the bundle of pre-selected fixed line services. ..."¹²

28. The Australian Competition Tribunal took a similar view in rejecting Vodafone's MTAS undertaking on appeal:

"We are also concerned that the Pass Through Safeguard is inflexible in relation to the opportunity for competition to be promoted as a result of any reduction in the price of the VMTAS [Vodafone MTAS]. It limits the opportunity of access seekers to determine the form in which any reductions they may receive in the supply of the VMTAS may be passed through to the retail fixed services market.

We consider that the pass through provisions in the undertaking deprive access seekers of the flexibility to determine competitively the individual price elements for services within the basket of services that are supplied within the fixed-to-mobile market, and the form in which pass through will take place. This approach retards allocative and dynamic efficiency, inhibits competition, is not in the long-term interests of end-users and, in our view, is not reasonable."¹³

29. The ACCC has also identified that "[t]he extent of pass-through is not the only measure of the extent to which a lower price for the MTAS promotes competition in that market or the LTIE more generally. Improvements in the quality of services provided or reductions in the price of other services provided in the bundle of pre-selected fixed line services can also promote the LTIE".¹⁴
30. TelstraClear recommends that the Commission adopt a similar approach. Attempting to assess that increased level of competition only by focussing on retail stand-alone mobile termination services, which are purchased independently of a retail bundle, rather than considering the full dynamics of the market (including the ability of providers to improve service levels, or enhance

¹² "Assessment of Vodafone's mobile terminating access service (MTAS) Undertaking, Final Decision", ACCC, March 2006, at p80.

¹³ Australian Competition Tribunal: Application by Vodafone Network Pty Ltd & Vodafone Australia Limited [2007] ACompT 1, at pp89-90.

¹⁴ ACCC, *The Optus 2007 Undertaking in relation to the Domestic Mobile Terminating Access Service Public Version, Final Decision*, November 2007, at p25, adopting the ACCC's comments in the MTAS Final Report at p 223.

competition through price reductions to other services) will likely substantially understate the competitive benefits achieved.

31. What is of more concern is the harm that pricing mobile termination at above-cost rates will likely cause the industry, as it will artificially incent investment in mobiles technology, and disincent investment in competing technologies, such as the fixed network. In TelstraClear's view, it is the impact of this distortion on competition that the Commission should closely examine.

Origination of traffic

32. TelstraClear supports mobile termination regulation of voice traffic from other New Zealand networks, irrespective of where the traffic was originated made.
33. The existing fixed-to-mobile agreements between Telecom, Vodafone and the Crown are limited to traffic originating in New Zealand. Under these agreements, fixed calls that originate internationally, but are put through a domestic carrier's network, are not captured. This is despite there being no technical difference in the termination of a call from a New Zealand network to the terminating mobile carrier.
34. Given that the costs to terminate traffic, irrespective of where it originated, between TelstraClear and a mobile carrier are no different, it is unclear why such traffic should not be captured within the cost-based regulation of mobile termination between New Zealand carriers.

Vodafone – proposed differential between FTM & MTM rates

35. Vodafone's undertakings propose different termination rates between fixed and mobile calls between 2009 and 2012, with termination rates from other mobile networks being higher than termination from fixed networks during that period.
36. The UK Competition Commission, in their recent determination on mobile termination in the UK identifies the arbitrage issues that have arisen, including call masking and rerouting of traffic to benefit from differential mobile termination rates, leading to inefficient and distortionary outcomes in the market.¹⁵
37. The UK Competition Commission identify that¹⁶

...even if an MNO installed equipment to identify the originating network of individual incoming calls, we were told that arbitrage would be a problem. Vodafone said that FNOs could readily find ways of effectively disguising calls originated on their network as mobile-originated calls—for example, by using mobile gateways. Such a reaction would lead to network congestion and the avoidance of lawfully levied F2M MCT charges. It told us that in France, where a bill-and-keep system (between MNOs) applied until the end of 2004, up to 80 to 90 per cent of F2M calls of alternative FNOs (other than the incumbent) were routed through GSM gateways which led ARCEP to withdraw the bill-and-keep system and introduce cost-based MCT rates. It also pointed out (as did a number of the other Interveners) that H3G had itself recognized this problem.

¹⁵ Competition Commission, Reference under section 193 of the Communications Act 2003, *Mobile phone wholesale voice termination charges, Determination*, 16 January 2009, see section 14

¹⁶ Competition Commission, Reference under section 193 of the Communications Act 2003, *Mobile phone wholesale voice termination charges, Determination*, 16 January 2009, para. 14.47

38. TelstraClear supports a single cost-based mobile termination rate, irrespective of the originating network technology. The only legitimate reason for a departure from a single cost-based termination rate would be a differential cost associated with terminating traffic from a particular network. There is no evidence that any differential exists.

Certainty

39. It has been argued that the potential regulation of mobile termination undermines the certainty provided by the current agreement with the Crown. However, both agreements specifically contemplate ongoing review of mobile termination by the Commission.

40. The Telecom agreement states that:

- 6.3 The obligations under this deed expire at midnight on 30 June 2012 unless terminated earlier by law or in accordance with clause 6.3 below.
- 6.4 This Deed will terminate immediately if:
- 6.4.1 The Telecom Fixed to Mobile Termination Service becomes, or becomes part of, a designated service under the Act.
 - 6.4.2 The Telecom Fixed to Mobile Termination Service is registered as an undertaking in accordance with schedule 3A of the Act.
 - 6.4.3 Either the Telecom Fixed to Mobile Termination Service or Fixed to Mobile Service is included in an undertaking under part 2A of the Act.
 - 6.4.4 Anything is done by or on behalf of the Crown or any regulator that has the same effect as any of the clauses 6.4.1 to 6.4.3.

41. Similarly, in the Vodafone agreement:

- 2.2 This deed expires at midnight at 31 March 2012 (the **Expiry Date**), unless terminated earlier by law or in accordance with clause 2.3 below.
- 2.3 This Deed will terminate immediately if the Mobile Termination Service, or a telecommunications service that is substantially the same as the Mobile Termination Service:
- (a) becomes a designated access service under the Telecommunications Act 2001 and Vodafone is an access provider; or
 - (b) is the subject of an access undertaking submitted to the Commerce Commission by Vodafone and accepted by the Minister of Communications under Schedule 3A of the Telecommunications Act 2001.

42. Both agreements can be terminated at such time as either a new service is specifically designated under Schedule 1 of the Act. Inclusion of a new service under Schedule 1 would occur through a recommendation to the Minister of Communications, following a Schedule 3 review concluding that the mobile termination service should be regulated under the Act.

43. These agreements were made outside Schedule 3A of the Act that allows access providers to submit an access undertaking.

44. The wording of the agreements specifically contemplate that a Schedule 3 investigation, in respect of fixed-to-mobile termination, could be undertaken during the course of the agreements which are scheduled to expire in 2012.
45. For this reason, TelstraClear disagrees that this investigation, and the potential regulation of mobile termination, has introduced any uncertainty that would not have reasonably been contemplated as the time the agreements with the Crown were reached.

New Zealand Communication's Undertaking is deficient

46. The undertaking provided by New Zealand Communications is limited in scope to mobile-to-mobile termination. It does not deal with fixed-to-mobile termination, a central component of mobile termination access services currently being investigated by the Commission. Accordingly, TelstraClear recommends that the Commission does not accept the undertaking.

Bill and Keep

47. New Zealand Communications proposes a pure bill and keep arrangement. It is efficient for parties to incur the cost that termination imposes on another network. While symmetric traffic flows between two providers would effectively net out any termination cost between those parties, there is a material risk that asymmetric traffic flows drive costs into one terminating network, without compensation for the costs imposed by the other party.
48. The UK Competition Commission identify that¹⁷

...even if an MNO installed equipment to identify the originating network of individual incoming calls, we were told that arbitrage would be a problem. Vodafone said that FNOs could readily find ways of effectively disguising calls originated on their network as mobile-originated calls—for example, by using mobile gateways. Such a reaction would lead to network congestion and the avoidance of lawfully levied F2M MCT charges. It told us that in France, where a bill-and-keep system (between MNOs) applied until the end of 2004, up to 80 to 90 per cent of F2M calls of alternative FNOs (other than the incumbent) were routed through GSM gateways which led ARCEP to withdraw the bill-and-keep system and introduce cost-based MCT rates. It also pointed out (as did a number of the other Interveners) that H3G had itself recognized this problem.
49. In France, Bill and Keep was limited to mobile-to-mobile traffic, and resulted in an artificial cost structure which gave incentives to sell call termination on competitor's mobile networks, resulting in asymmetric traffic flows, and imposing costs on networks without compensation that was inconsistent with the principle of cost causation. As a result, ARCEP discontinued Bill and Keep and introduced cost-based mobile termination.
50. New Zealand Communications' undertaking for Bill & Keep for mobile-to-mobile traffic risks the same outcome that led the French regulator to favour cost-based regulation in 2004.

¹⁷ Competition Commission, Reference under section 193 of the Communications Act 2003, *Mobile phone wholesale voice termination charges, Determination*, 16 January 2009, para. 14.47

New Zealand Communications' undertaking does not cover wholesale providers

51. New Zealand Communication's undertaking also proposes to exclude wholesale customers. In section 5.2(b) New Zealand Communications' undertaking states that:¹⁸

For the avoidance of doubt, the amendments set out in the clause 5 (Amendments to the Telecom Interconnection Agreement) do not apply to: ...

(ii) Mobile-to-Mobile Events which are made by a customer of a telecommunications provider who provides their services to that customers through a wholesale agreement with Telecom or NZ Comms; or

(iii) Mobile-to-Mobile Events which originate from or are delivered to a mobile number that is not a Telecom mobile number of a NZ Comms mobile number.

52. TelstraClear provides mobile services to its customers via a wholesale agreement with Telecom New Zealand.
53. New Zealand Communications proposes terms that would deny wholesale MVNO customers access the terms of the undertaking proposed, and would then face a likely different unregulated termination rate to terminate traffic on to New Zealand Communications' mobile network.
54. Such an approach would significantly undermine the potential for wholesale MVNO providers to develop competitive offerings in competition with carriers. Different wholesale charging structures between New Zealand Communications and carriers (where New Zealand Communications proposes Bill and Keep) and New Zealand Communications and wholesale MVNO providers (which would in effect be unregulated) would be likely to arise.
55. New Zealand Communications has historically put forward arguments that the regulation of mobile-to-mobile termination is necessary to allow all competitors, including New Zealand Communications as a new entrant, to fairly compete in the mobile market. It has argued that closed network pricing is a barrier to entry and competition.
56. However, New Zealand Communications undertaking seeks to exclude both wholesale customers and termination from fixed carriers from the same terms it expects, and would in effect raise barriers to entry for any party other than New Zealand Communications in the New Zealand mobile market.

Termination of an undertaking

57. New Zealand Communications proposes that:

In relation to Vodafone-NZ Comms Mobile-to-Mobile Events and On-net Mobile-to-Mobile Events, the Vodafone Interconnect Agreement may only be terminated on 6 months notice given by either party to the other, such notice may be given whether either party has committed a material breach of any of its obligations under the Vodafone Interconnection Agreement and such breach remains in-remedied 30 days following the written notice of breach.

¹⁸ New Zealand Communications, Undertaking to the Commerce Commission under Schedule 3A in respect of mobile termination services, clause 5.2(b)

58. TelstraClear is concerned that, by virtue of a breach of the undertaking, if accepted by the Commission, that the undertaking could be terminated within six months.
59. There is a significant risk that any long term competitive protection and end-user benefits afforded by an undertaking could be terminated, without any backstop regulation in place to protect access seekers.