



**SCHEDULE 3 INVESTIGATION INTO
REGULATION OF MOBILE TERMINATION
ACCESS SERVICES**

**SUBMISSION ACCOMPANYING PROPOSED
UNDERTAKING
PUBLIC VERSION**

12 January 2009

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EXECUTIVE SUMMARY

- 1 In November 2008 the Commission decided to investigate mobile termination access services (**MTAS**). The timeframe for submission of an undertaking under Schedule 3A of the Telecommunications Act 2001 (**Act**) is by 12 January 2009. The purpose of this submission is to provide a brief explanation of the terms and reasoning behind Telecom's proposed Undertaking (**Undertaking**), which accompanies this submission.
- 2 Telecom is naturally disappointed that the Commission has felt the need to commence an investigation into MTAS. This investigation has been initiated against the background of previous mobile termination investigations and, in Telecom's view, without rigorous evidence or significant new circumstances to support a further investigation.
- 3 Moreover, following those prior Commission investigations, Telecom entered into the mobile termination rate deed with the Government for fixed-to-mobile termination services (**MTR Deed**) for a period of 5 years in good faith. This investigation, less than two years into compliance with those commitments, significantly undermines that earlier outcome.
- 4 Since entering into the MTR Deed, Telecom has operated entirely in accordance with its commitments, reducing wholesale termination rates by 4cpm and retail fixed to mobile (**FTM**) prices by even more. Telecom's agreement with the Government therefore resulted in clear benefits to end users.
- 5 Telecom's MTR Deed also includes a retail pass-through mechanism, which is beyond the scope of the regulatory regime, and therefore was not achievable through regulation alone. In contrast, evidence from overseas jurisdictions, including evidence cited by the Australian Competition & Consumer Commission (**ACCC**) only six weeks ago¹, shows that wholesale termination rate regulations have not resulted in corresponding retail price reductions. The New Zealand position has been commented upon favourably by the ACCC in its recent report, which cites the deeds agreed in New Zealand as an approach that Australia should consider in preference to regulation.
- 6 Telecom's Sample Interconnection Agreement (Mobile) (**Sample Interconnection Agreement**) also mirrors the FTM termination rates in the mobile-to-mobile (**MTM**) termination rates, and we consider these commercial commitments deliver certainty to both the industry and end users.

¹ Draft MTAS Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011, November 2008 (**Draft MTAS Pricing Principles Determination**).

- 7 In this light, the Commission's decision to undermine the integrity of the agreement made by the Crown with Telecom in 2007 and Telecom's MTM commitment, alongside the substantial costs for all participants in a third mobile termination investigation, is concerning.
- 8 Telecom continues to believe that the mobile termination rates included in the MTR Deed and Sample Interconnection Agreement remain appropriate. A reason put forward by the Commission for the investigation is that those prices "are significantly in excess of cost-based benchmarks".² The Commission appears to have already jumped to the conclusion that cost-based pricing is efficient and would meet the purpose of the Act. However, the linkages between the mobile termination rates and the downstream fixed and mobile retail markets, which the Commission has recognised in the past, means that the efficient price will be greater than a cost based price. The ACCC acknowledges this point, however, the Commission seems to ignore it.
- 9 Furthermore, even if it is assumed that the efficient price is a forward looking cost based price, the rates in the MTR Deed lie within a range of forward looking cost based rates reported by the European Regulators Group (**ERG**). This evidence contradicts the Commission's assertion that current prices "are significantly in excess of cost-based benchmarks". The current MTR Deed rate of 16cpm is greater than the Commission's choice of 10cpm from a benchmark. However, in the current context it is inappropriate for the Commission to fix on a single price point as a required outcome, particularly when the 10cpm figure is at the lower end of the ERG range. The MTR Deed price points are also consistent with the benchmark data.
- 10 Neither the view of the ACCC on the ineffectiveness of wholesale regulation nor the ERG evidence of the range of forward looking cost based rates were considered when the Commission made its decision to investigate. Both support staying with the MTR Deed. If the Commission continues its investigation and moves away from the MTR Deed, then this evidence supports Telecom's second preference of adopting the MTR Deed rates into our Undertaking and applying them to the following services:
- (a) MTM termination; and
 - (b) FTM termination.

² Reasons for Commerce Commission decision to investigate mobile termination access services, 6 November 2008, p3.

- 11 The Undertaking goes further than the MTR Deed and the Sample Interconnection Agreement by extending the glide path of those mobile termination rates for another two years to 11 and 10 cpm respectively, which we consider to be consistent with the termination rate glide path set out in the MTR Deed and Sample Interconnection Agreement.
- 12 In addition, Telecom has offered a lower short-message-service (**SMS**) interconnection price of 3.5 cents per text, which is a considerable reduction from the existing SMS termination rate of 9.5 cents per SMS.
- 13 For the reasons set out above, in our view, Telecom's Undertaking offers an appropriate alternative to regulatory intervention under the Commission's Schedule 3 investigation and accords with section 18 of the Act. Offering this Undertaking does not however alter Telecom's position that the best outcome for end users is to continue with the current MTR Deed with its retail pass through guarantee.

BACKGROUND

Chronology of events leading to this investigation

- 14 In April 2004 the Commission announced it intended to investigate mobile termination rates. A final report was released in June 2005.
- 15 In August 2005 the Minister rejected the Commission's recommendation and asked it to reconsider.
- 16 In April 2006 the second final report (**Reconsideration**) was completed. At the end of the Reconsideration process, the Commission recommended regulation of FTM rates to the Minister.
- 17 In early 2007 the Ministry of Economic Development engaged with both Telecom and Vodafone.
- 18 In April 2007 Telecom entered into the MTR Deed on terms agreed with the Minister which committed to:
- (a) Reducing FTM rates, with a glide path from 17 cpm – 12 cpm for the period from March 2007 – March 2012; and
 - (b) Additionally a voluntary pass through mechanism.
- 19 In April 2007 the Minister rejected the Commission's recommendation to regulate in favour of the MTR Deed alternative.

- 20 On 8 May 2008 the Commission announced that it was considering whether to investigate, under Schedule 3 of the Act, subjecting MTM termination rates for both voice and SMS to regulation.
- 21 On 14 May 2008 the Commission wrote to interested parties informing them that if, following the receipt of initial views from interested parties, there appeared to be reasonable grounds, it would commence an investigation.
- 22 On 8 August 2008 the Commission published its Issues Paper to test further whether there were reasonable grounds to commence a Schedule 3 investigation. While the Issues Paper focused on MTM termination rates, it also asked for submissions on whether other related markets should be taken into account, such as FTM.
- 23 On 6 November 2008 the Commission announced its decision to investigate MTAS incorporating:
- (a) MTM voice termination;
 - (b) FTM voice termination; and
 - (c) SMS termination.

Current position

- 24 As illustrated above, there has been significant history to this investigation. The current Schedule 3 investigation is the third of its kind in a five year period. The continued regulatory consideration of mobile termination rates is of concern, particularly in the context of Telecom's commercial agreements, including the MTR Deed agreed with the Government.
- 25 In the MTR Deed Telecom agreed to a glide path for FTM rates and it included an arrangement to pass through those reductions to retail FTM prices, which (as set out above) is beyond what the Commission can require under the Act.³
- 26 Telecom entered into the MTR Deed on terms agreed with the Government, and made a number of concessions, to avoid the pitfalls of regulation. This further investigation by the Commission sends a negative signal to the industry as it materially increases the uncertainty around any future agreements.

³ The Commission's jurisdiction under the Act is limited to regulating telecommunications services "between service providers" and not the regulation of retail prices.

- 27 Since agreeing terms with the Government and entering into the MTR Deed, Telecom has operated entirely in accordance with its commitments to reduce FTM rates. The rate has decreased by 4cpm⁴ and there is a glide path for further reductions. Retail FTM prices have reduced by even more. The glide path Telecom committed to was in line with the Commission's estimate, at the time, that the cost of FTM mobile termination rates in New Zealand would be 15 cpm trending down to 12 cpm in five years time. Telecom voluntarily flowed through similar MTM termination rates under its Sample Interconnection Agreement. Accordingly, the outcome under the commercial arrangements is a very favourable one from an end user perspective.
- 28 In contrast, evidence from overseas jurisdictions, including evidence cited by the ACCC⁵, shows that wholesale termination rate regulations have failed to result in corresponding retail price reductions.
- 29 The ACCC's Draft MTAS Pricing Principles Determination comments favourably on this model by citing the commercial deeds agreed in New Zealand as an approach that Australia should consider in preference to regulation (page 19):

The Commission considers that the approach adopted in New Zealand may also be appropriate. In New Zealand any reduction in mobile termination rates by any MNO is required to be passed through to fixed customers in full under voluntary deeds made between MNOs and the New Zealand Government.

- 30 In this light, the Commission's decision to undermine the integrity of the agreement between the Government and Telecom in 2007 is perplexing. A regulatory outcome will not advance the position of end users, and the Commission's decision to undermine the Government's agreement means innovative regulatory solutions are much less likely in the future.
- 31 Telecom has, nevertheless, proposed an Undertaking to be available to all Access Seekers as an alternative to a further costly and extended Schedule 3 process. While this Undertaking does not deliver as much benefit to end users as the continuation of the MTR Deed regime, it is still more favourable for end users than a Schedule 3 process. The terms of, and rationale behind, our proposal are set out in more detail below.

⁴ Telecom offered to reduce its mobile termination rate from 20 cpm initially with annual decreases over a 5 year period to 12 cpm.

⁵ Draft MTAS Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011, November 2008, p19: "While the Commission appreciates that there are other costs associated with delivering FTM services, the Commission is of the view that the degree of pass through of FTM retail prices remains lower than could be expected given the reductions in MTAS prices."

TERMS OF THE UNDERTAKING

Overview

- 32 Under the Undertaking, Telecom undertakes to the Commission that (during the period that the Undertaking has effect) Telecom will provide to Access Seekers the "Services" (as defined) on the terms and conditions as set out in Annexure 1.
- 33 The Undertaking complies with the requirements of Schedule 3A of the Act, in particular it meets the criteria set out in clause 4 (i.e. it complies with the Act, the standard access principles and any limits on those principles). The Undertaking also meets the requirements set out in clause 5, as it:
- (a) Is signed/executed by Telecom;
 - (b) Specifies the terms and conditions of the supply of the service;
 - (c) Specifies the date by which those terms or conditions must be complied with by Telecom;
 - (d) Specifies a mechanism for the resolution by the Commission or a suitably qualified and experienced independent person of any issues or disputes that arise after the Undertaking is registered; and
 - (e) Provides for any other prescribed matters (in this case there are none).
- 34 We set out below the approach that Telecom adopted to developing this Undertaking:
- (a) The price terms included in the Undertaking are based on Sample Interconnection Agreement and the MTR Deed. We explain below our rationale behind the proposed price terms in the Undertaking; and
 - (b) The non-price terms in the Undertaking are based on Telecom's Sample Interconnection Agreement. We have highlighted some of the key non-price terms.
- 35 While the Commission may have a working understanding of the terms, Telecom believes an opportunity to clarify any aspect of the proposal may be useful. Telecom therefore requests the opportunity to meet with the Commission and interested industry players to clarify the terms and structure of our proposal.
- ### Price terms
- 36 Telecom considers that the current termination rates agreed with the Government deliver significant benefits to end users and meet the section 18 purpose

statement of the Act. Accordingly, as set out above, the Undertaking adopts the FTM and MTM termination rates under the MTR Deed and Sample Interconnection Agreement.

37 In addition, Telecom has offered a lower SMS interconnection price of 3.5 cents per text, which is a considerable reduction from the existing SMS termination rate of 9.5 cents per SMS.

38 Set out in the following section is a more detailed analysis to support the termination rates included in our Undertaking.

Rationale for termination rates

39 A reason the Commission put forward for commencing another investigation into mobile termination rates was that the "current wholesale MTRs, as set out in the Deeds of Undertakings between the Minister and Telecom and Vodafone are significantly in excess of cost-based benchmarks."⁶

40 However, the Commission cannot presume that cost-based pricing for mobile termination rates promotes the purpose of the Act. That conclusion could only be reached after carrying out a full cost benefit analysis that takes into account the effect of such a change on fixed and mobile retail markets. Such an exercise is necessary if the Commission continues with its investigation.

41 The Commission would need to identify the full range of costs and benefits of a change in the mobile termination rate before it could determine whether a mobile termination rate less than the MTR Deed prices would be more efficient. Whether or not this is the case depends, amongst other things, on the demand elasticities for the services as well as the extent to which a regulated change in the mobile termination rate will pass through to the downstream retail markets compared to the counterfactual of the MTR Deed.

42 However, Telecom submits that on the evidence now before it the Commission can and should accept the MTR Deed is appropriate and terminate its investigation or, in the alternative, accept Telecom's proposed Undertaking.

43 The latest available evidence confirms the pricing in the MTR Deed is robust. Even though Telecom has not claimed that the wholesale rates in the MTR Deed were cost-based, Telecom considers that the current wholesale rates are well within an international benchmark of mobile termination rates, and they are certainly not "significantly in excess of cost-based benchmarks".

⁶ Reasons for Commerce Commission decision to investigate mobile termination access services, 6 November 2008, p3.

Efficient mobile termination rates and cost based pricing

- 44 In its November 2008 *Draft MTAS Pricing Principles Determination* , the ACCC notes:⁷

In relation to the MTAS the Commission is of the view that a TSLRIC approach provides a guide as to the lower bound costs of providing the service. As noted above, costs incurred in a competitive market may be efficient, even if above the cost estimated using a pure TSLRIC approach. In the absence of actual costs, TSLRIC generally provides a reasonable lower bound estimate of the cost of the MTAS.

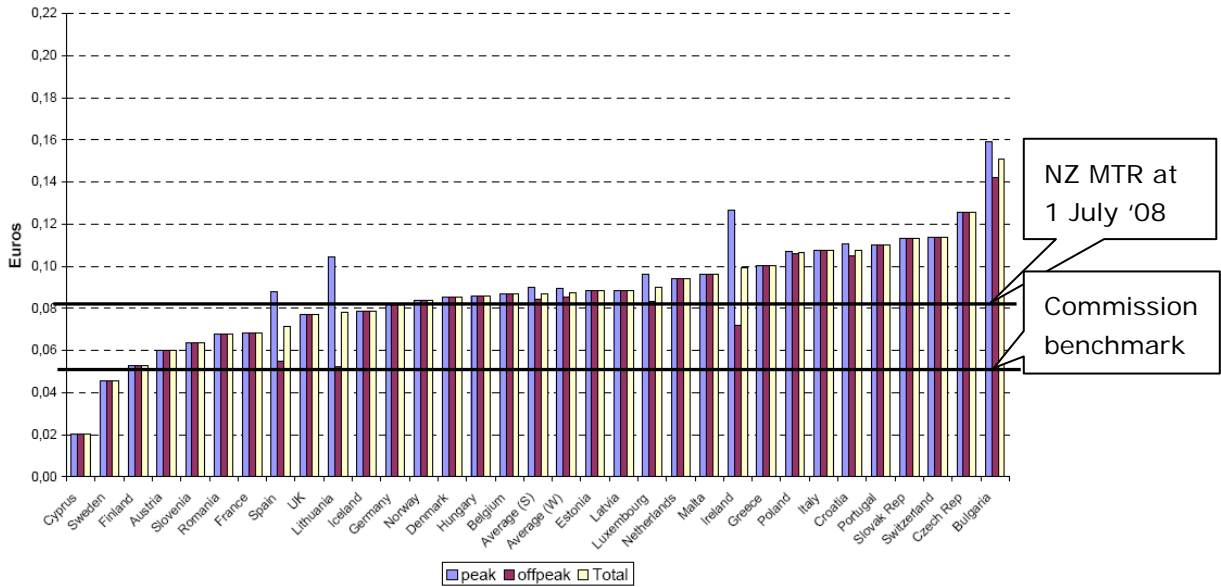
- 45 In other words, the ACCC is saying a mobile termination rate that is greater than the TSLRIC based price may be efficient. This conclusion is not surprising given the linkages between the mobile termination rate and the downstream retail fixed and mobile markets, which the Commission has recognised. The mobile termination rate will influence the retail prices for fixed and mobile services, which in turn will determine demand for these services. A lower mobile termination rate may lead to lower retail prices, whereas for other services a lower mobile termination rate may lead to higher retail prices, in particular for mobile services. These offsetting effects, amongst other things, will determine whether a lower mobile termination rate is more or less efficient than the rates in the MTR Deed.
- 46 It is for this reason that the Commission cannot simply assume that a mobile termination rate that is less than the prices set out in the MTR Deed is more efficient.

MTR Deed mobile termination rates consistent with other jurisdictions

- 47 The Commission claims that the mobile termination rates in the MTR Deed are “significantly in excess of cost-based benchmarks”. The mobile termination rates included in the MTR Deed compare favourably with rates reported by the ERG. It is also consistent with a benchmark of forward looking cost based prices from these European countries.
- 48 New Zealand mobile termination rates are within the ERG range of mobile termination rates:

⁷ See p11 for the specific quote which the ACCC reiterates on p20.

Average MT Tariff per country July 2008



49 Telecom’s current price of 16 cpm and the Commission current view of the benchmark price are shown on the graph.⁸ This clearly shows that both price points are within the range. Further, the MTR Deed provides that the termination rate will continue to reduce. It will be at or below 15 cpm by the time of any Commission determination.

50 Of the thirty one countries listed in the ERG report, ten regulate mobile termination rates based on forward looking costs.⁹ These countries are listed below and prices are converted into New Zealand dollars.

⁸ The currency conversion rate is an average of the exchange rate over 10years of 0.51 €/NZ\$.

⁹ The selection of jurisdictions that use forward looking cost based pricing is based on Cullen-International, Western Europe, Cross-country analysis, Table 26 *Mobile call termination – Cost accounting system*, which can be found at:

<http://www.cullen-international.com/documents/cullen/prindex.cfm>

	\$NZ
Austria	0.1177
Belgium	0.1702
Denmark	0.1671
Germany	0.1602
Greece	0.1966
Italy	0.2107
Netherlands	0.1841
Norway	0.1645
Sweden	0.0892
UK	0.1509

- 51 The current MTR Deed rate of 16 cpm is within the bounds of this range as there are seven jurisdictions with a rate that is greater than this figure. This does not support the Commission's proposition that the MTR Deed rates are "significantly in excess of cost based benchmark". Furthermore, the Commission's suggested benchmark price of just over 10cpm is at the low end of this range with only one jurisdiction regulating rates on average less than this figure.

Comparing like services

- 52 A further factor the Commission must take into account when comparing termination rates in New Zealand with international benchmarks is the issue of service definition. Mobile termination services are defined from a Point Of Interconnection (**POI**) towards the mobile handset, however, there are differences between countries in relation to which POI is used. For example the New Zealand model, as is currently applied and is set out in our Undertaking, is for the mobile network to connect at fixed network POIs and bear the costs of call transport to the Mobile Switching Centres (**MSC**). This cost is then recovered in the mobile termination rate. Conversely, the approach in Australia is to define the mobile POI as being at the MSC and require the fixed network operator to bear the national transport cost when a call originates in a different Call Collection Area.

Rationale for glide path

- 53 Telecom considers that a glide path is appropriate to minimise disruption to the market by allowing prices to trend down over the term of the Undertaking. This allows time for the adjustment of prices in downstream markets, and reflects the gradually declining input costs of providing termination services.

Non-price terms

Based on Sample Interconnection Agreement

- 54 The Undertaking includes a complete set of terms for the supply of the relevant termination services and so is capable of acceptance by the Commission.

Annexure 1 draws heavily from the Sample Interconnection Agreement, which is available on Telecom Wholesale's website.

- 55 The Sample Interconnection Agreement itself draws heavily on the terms and conditions that are set out in the Interconnection Terms that comprised Appendix 2 of Commerce Commission Decision 477 (as clarified). The Interconnection Terms broadly form the basis for all of Telecom's interconnection arrangements for voice calls and text messages. Those terms therefore are an appropriate basis for the drafting of the Undertaking.
- 56 Telecom also considers that adopting the relevant terms and conditions in its Sample Interconnection Agreement is a suitable approach as the industry is familiar with them.
- 57 In preparing the Undertaking, changes have been made to the Sample Interconnection Agreement to:
- (a) Include terms appropriate to an undertaking as opposed to an agreement;
 - (b) Limit the Undertaking to the "Services" - i.e. FTM, MTM and SMS and some incidental services that are required in order to effect the interconnection of the Telecom network and the Access Seeker network.

Reciprocity

- 58 Under the Undertaking, the rights and obligations of Telecom and the Access Seeker are for the most part reciprocal.

Acceptance by Access Seekers

- 59 Access Seekers are service providers who provide a properly executed Deed of Acceptance in the form prescribed in Appendix B of Annexure 1. Under the Deed of Acceptance, the Access Seeker agrees (among other things) that it will comply with all the obligations of an Access Seeker as set out in the Undertaking.