



MTAS INVESTIGATION

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A EXECUTIVE SUMMARY

Telecom's latest undertaking is a pragmatic way forward

- 1 There has been very little new material provided in the latest round of submissions – they have largely covered ground already well-trodden over the past five years of mobile termination investigations. However we detect a certain note of frustration in those submissions at the length of time the various processes have taken to reach a point of final conclusion. In particular, we note the concerns raised by other parties regarding the importance of regulatory certainty and the call for quick resolution of the issues raised in the MTAS Investigation.
- 2 Telecom's undertaking, provided to the Commission on 28 July 2009 (**July Undertaking**), is an appropriate and pragmatic way forward to address these concerns. It allows the industry to move forward with certainty, avoids the direct and unforeseen costs of regulation, provides market certainty much sooner, and delivers benefits to end-users earlier compared to a regulatory process. The Commission should place high value on sensible commercial activity and outcomes, even if they result from a regulatory threat. Not needing to regulate is perhaps the ultimate success of a regulatory regime.
- 3 The intention of Schedule 3A of the Telecommunications Act (**Act**) is for industry proposals to be encouraged and facilitated. The Commission has also indicated that it has a preference for commercial solutions.¹ Here it has a real chance to make the undertakings regime a success. The Commission should appropriately look for opportunities to promote alternatives to regulation, which can produce faster and better outcomes, and we encourage it to do so.
- 4 Vodafone has said it is open to looking at other undertakings that have a better correspondence to costs. Therefore it should give genuine consideration to Telecom's July Undertaking, given that it leverages off the work the ACCC has undertaken in relatively similar circumstances this endorses the proposed rates as being a fair and reasonable solution relative to regulation.
- 5 Like Vodafone, we believe a workshop would be useful. In particular, it could be used to further industry consensus on appropriate Undertakings with leadership from the Commission.

We agree with Vodafone's concerns with the Commission's benchmarking, lack of a glide path and cost benefit analysis

- 6 As Vodafone has noted in paragraph 7 of its submission on the Commission's Draft Recommendation:

¹ See Commerce Commission Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, dated 31 July 2009, paragraph 152.

“The Commission’s Draft Report is supported by three key pieces of work: [a] cost estimate based on benchmarking against overseas countries where it attempts to establish and estimate of the actual cost of providing mobile termination services in New Zealand ...; [c]ost benefit modelling analysis ...; and [o]ther analysis in which it takes the result of the cost benefit analysis and other analytical elements to build the case in support of its recommendation to the Minister.” (Emphasis removed)

- 7 Telecom agrees with Vodafone that the Commission has not justified its view that mobile termination rates (**MTRs**) are too high, therefore driving high consumer prices, and accordingly requiring regulation. These concerns are further magnified by the Commission’s failure to provide for a glide path to ensure that there are no sudden distortional effects on the market.
- 8 This seems to pay little regard to the fundamental principle of good regulatory practice, i.e. that regulation should only be implemented where there is evidence of a durable market failure, both evidence that it has persisted and reasonable confidence that failure will not be eroded over a reasonable timeframe, and where the benefits of doing so clearly outweigh the costs of regulation. The Commission has not clearly demonstrated the justification for its preliminary decision to regulate the four services that are currently under investigation.
- 9 In fact there is evidence from the OECD’s international benchmarking that the monthly cost of cellphone use in New Zealand is in fact below the OECD average across all three usage baskets.² Based on the same benchmarking, the United States average cost of cellphone use is more than two and a half times more expensive than New Zealand for a medium usage basket. The importance of these two observations is that in the US the use of bill and keep, (**BAK**) implies generally an MTR of zero.

Way forward

- 10 Telecom would like to register its concern that this process may not be receiving the degree of attention and respect that the issues deserve. The regulation proposed by the Commission will transfer a significant amount of wealth from one consumer group to another. While there is a disagreement about whether it is reasonable to expect that the regulation will do anything else, there is a broad consensus that this transfer will happen. In short, the proposed intervention by the Commission will harm some consumer groups and benefit others.
- 11 Some of the customers affected will be Telecom customers, and we take that issue very seriously.

² Organisation for Economic Co-operation and Development’s 2009 Communications Outlook.

- 12 In this context we have been disappointed by aspects of the Commission's process, including rushed timeframes, parallel information gathering processes, and a very incomplete cost benefit analysis (**CBA**).
- 13 Submissions that advance self interest without any analytical foundation, such as those suggesting equating the mobile termination rate (**MTR**) and the fixed termination rate and those simply denying the waterbed affect, also do the process and New Zealand consumers a disservice.
- 14 We are looking forward to a workshop and conference process that works through the hard issues of whether regulatory intervention will do anything beyond transfer wealth between consumer groups, including the prerequisites to regulation of improving competition outcomes and delivering a clear net benefit to New Zealand, in a credible and serious way.

B TELECOM'S JULY UNDERTAKING IS A PRACTICAL AND EFFICIENT SOLUTION TO DELIVER REGULATORY CERTAINTY AND OUTCOMES FASTER

Commission's commitment to commercial solutions

- 15 We note that a number of parties are calling for "immediate" regulation of MTAS Services and asking for the Commission's current process timeframes to be shortened. The undertakings regime offers a desirable alternative way forward to regulatory intervention.
- 16 We note the Commission's statements that in order to be able to recommend that the Minister accept undertakings, they would have to deliver comparable benefits to end-users over the assessment period, taking into account quantitative and qualitative factors. The Commission will take into account the advantages offered by any undertaking, including the potential delivery of outcomes similar to those available under regulation, the avoidance of direct costs of regulation and the regulatory process, timing advantages, and certainty for markets. In particular the Commission recognises an undertaking is capable of providing earlier delivery of benefits to end-users³.
- 17 As noted in our earlier submissions and here, we have serious concerns with the Commission's analysis in support of regulation in the Draft Recommendation and therefore weight cannot be placed on the benchmarking or CBA carried out by the Commission. The Commission itself acknowledges that regulation will result in higher mobile retail prices and that this will result in over 30,000 mobile subscribers being forced off existing networks. Regulatory interventions of this sort, and with these sorts of expected consequences, should not be imposed lightly.
- 18 The alternative of undertakings is also supported by the Commission's stated preference for commercial solutions⁴. We strongly support this principle - the Act and the Commission should facilitate commercial outcomes rather than prescribe less flexible solutions. Commercial solutions are likely to offer better net benefits over time relative to regulatory intervention. It is therefore important that the Commission keeps an open mind to alternatives to regulation by providing Mobile Network Operators with adequate opportunity to submit amended undertakings and the Commission gives sufficient regard to them.

³ Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, 31 July 2009, see paragraphs 70-71 and 187.

⁴ Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, 31 July 2009, see paragraph 152.

Why Telecom's July Undertaking delivers benefits faster relative to regulation

- 19 Having reviewed the submissions of other parties, Telecom further considers that its July Undertaking represents the best way forward for the industry. The Undertakings mechanism avoids the costs of regulation and potentially enables an accelerated take-up of services, provides market certainty much sooner, and delivers benefits to end-users earlier compared to the Commission's regulatory process⁵, which requires the additional step of a standard terms determination (STD) process.
- 20 Because Telecom's July Undertaking is based on the outcome determined by the ACCC, the Commission and the industry can have confidence that the rates in it are fair and reasonable. The Australian market is relatively similar to the New Zealand one, as set out in our previous submission. The rates Telecom has proposed represent a reasonable balance between fair compensation for network investments and short term gains for some consumers. Despite some industry comments to the contrary⁶, Telecom *is* serious about this offer.
- 21 The Commission will be aware of the rates in the secret deal between Vodafone and 2 Degrees and whether these indicate rates that are also reasonable in terms of Telecom's offer to reduce the MTRs. The Commission can review if the rate Telecom is proposing of 10.6 cpm is close to the rate for termination on Vodafone's network in that deal. The MTRs proposed by Telecom are also very close to the rate the Commission determined in its first benchmarking exercise.
- 22 Just as the proposed regulation will have an impact on consumers through the waterbed effect (as acknowledged in the Commission's modelling), the adoption of Telecom's July Undertaking can also be expected to result in a (smaller) change in the size of the market, and as a result of those changes in customers and/or volumes to a reduction in profits for all operators. Telecom believes that the achievement of regulatory certainty for all operators will minimise the adverse consequences for some consumers.

Telecom's July Undertaking supports regulatory certainty

- 23 A key concern for Telecom is to obtain regulatory certainty as soon as possible. This process has continued over a five year period and, while we have had to get on with decisions despite this, uncertainty inevitably creates delay and excessive conservatism. These will both have negative consequences for end users. Timely resolution should be highly valued by all and the benefits of approaches that take longer for a decision or are more prescriptive (and therefore less responsive to change) should be heavily discounted. This is something that the Commission should recognise and work by. We note that at the 10th Annual Telecommunications & ICT Summit, Commissioner Mazzoleni indicated that the

⁵ We note for example the comments made by Vodafone on regulatory certainty - see its submission of 28 July 2009, paragraphs 306-308.

⁶ See http://www.nzherald.co.nz/telecom/news/article.cfm?o_id=207&objectid=10587488

Commission would factor in the benefits of being able to arrive at final outcome earlier than would be possible under the regulatory processes.

- 24 Telecom notes that the recent Discussion Paper *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*⁷ emphasises the importance of "the Commission's strategy of proactive engagement with stakeholders to enhance mutual understanding **and promote regulatory certainty in telecommunications markets**"⁸ (Emphasis added).
- 25 There appears to be little to be gained from dragging this process out for another 15 months or so through the completion of the Schedule 3 process, regulation and then the STD process. Even after these steps are completed there may still be additional uncertainty through the final pricing principle (**FPP**) process after regulated prices have been set under the initial pricing principle (**IPP**) in the STD process. Adopting Telecom's July Undertaking would avoid this problem and allow the industry to move forward together. The mobile market is working well in Australia, and adopting their approach should deliver similar benefits here.

Workshop to resolve any remaining inconsistencies

- 26 Vodafone continues to believe that a workshop would be useful to resolve any remaining inconsistencies and the Commission should use the conference as much as possible, to seek views and clarify any non-price issues. Telecom supports this position.

C COMPETITION

Market is competitive

- 27 Telecom agrees with the tenor of Vodafone's submission that the retail mobile services market is competitive⁹. As we have previously submitted, mobile markets are workably competitive and as such there is no need for regulation to promote competition under section 18 of the Act.¹⁰ This approach is endorsed by the Commission, which states¹¹:

"the objective of regulation is to produce outcomes that are consistent with a workably competitive market."

⁷ Commerce Commission, 31 July 2009, paragraph 8.

⁸ Ibid at paragraph 8.

⁹ At paragraphs 309-336 of the Vodafone submission dated 28 July 2009.

¹⁰We note that the Commission's recently released consultation paper on input methodologies endorses some of these concepts and quotes the same excerpt from *Re Queensland Cooperative Milling Association Limited* that the *Epic* case referred to above cites in its definition. The Input Methodologies Paper also notes that the New Zealand Courts have expressly endorsed the Australian jurisprudence.

¹¹ Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, 31 July 2009, see paragraph 139.

28 The recent Judgment by the Supreme Court of Western Australia, *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor*¹² has provided a clear definition of the meaning of “workable competition”. The Court notes that there is a distinction between the concepts of “perfect competition” and “workable competition”.¹³ In essence pure competition is the theoretical ideal of competitive equilibrium, whereas “workable competition” is more real world focused.

29 The Court then defines a workably competitive market as follows¹⁴:

“...an economist's understanding of a workably competitive market, is not a fixed and immutable condition with any absolute or precise qualities, but a process which involves rivalrous market behaviour: Re Queensland Cooperative Milling Association Limited. As such, a workably competitive market will react over time and according to the nature and degree of various forces that are happening within the market. There may well be a degree of tolerance of changing pressures or unusual circumstances before there is a market reaction. The expert evidence and writings tendered in evidence suggest that a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency.” (Emphasis added)

30 There is also the following statement¹⁵:

“...in a workably competitive market past investments and risks taken may provide some justification for prices above the efficient level...”

31 As noted by Vodafone, the mobile retail markets are characterised by a high level of competitiveness. Telecom particularly draws the Commission’s attention to the comments at paragraph 313 and 314 where the comparison with Scandinavian mobile markets, characterised by a large dominant Mobile Network Operator with greater than 50% market share, and New Zealand where there is intense rivalry between Telecom and Vodafone, and increasing competition from TelstraClear and a range of MVNO service providers. Telecom notes that the rivalry is particularly strong because both major players have markedly different cost structures and competitive advantages to leverage off.

32 Not only are prices (both retail and MTR prices) tracking down over time, but there has also been vigorous non-price competition in response to consumer demand for new and improved products and for other enhancements such as

¹² [2002] WASCA 231.

¹³At paragraph 124.

¹⁴At paragraph 128.

¹⁵At paragraph 144.

improved coverage, greater roaming capability, and faster, more reliable networks. This consumer demand has generated ongoing investment.

- 33 Added to this, 2 Degrees has now entered the market with cost structures which are different from those of Vodafone and Telecom. 2 Degrees has chosen to build its own limited network in selected locations¹⁶, and to access Vodafone's network (subject to confidential commercial arrangements) in others in order to achieve national coverage. As one would expect in the circumstances, 2 Degrees is competing vigorously for market share with innovative pricing plans. CallPlus too operates in the market with a different cost structure. The Commission suggests that MVNOs are unlikely to increase competition to the same extent as a facilities based entrant. In fact, in New Zealand as elsewhere, the mobile telecommunications value chain is increasingly subject to competition at a number of different levels. Telecom agrees with the tenor of Vodafone's submission at paragraphs 315 and 316 that MVNOs are increasing the intensity of competition in the New Zealand market.
- 34 Such an overall market (which encapsulates the MTR services) is caught by the concept of "rivalrous behaviour" referred to above.
- 35 Further, even if MTR prices are above cost, this does not mean that that there is not "workable competition". Above costs MTRs on a stand alone basis are also not an indicator of an absence of workable competition due to the two-sided nature of the market and the more general need in a competitive market to recover common costs from relatively inelastic demand.¹⁷
- 36 The Commission has erred by failing to take account of the two-sided nature of the market and by attempting to assess the market against the theoretical standard of "perfect competition" by focusing so heavily on the MTRs.
- 37 In addition, if the Commission were to regulate to mimic "workable competition", it would almost certainly apply a glide path to bring prices down over a period of time as being preferable to shocking markets with sudden drops in prices. Telecom addresses this point further below.
- 38 As an aside, the standard of "workable competition" would also implicitly support benchmarking against real world pricing, rather than benchmarking against theoretical prices. Further, the Commission's proposal to regulate MTRs will have adverse consequences for consumers given the interdependency of pricing in the two-sided market as reflected by the waterbed effect. The Commission's own estimate recognises this although, as noted in submissions from Telecom, NERA,

¹⁶ Auckland, Wellington, Christchurch and Queenstown.

¹⁷ Issues associated with the two-sided nature of the mobile telecommunications market have been discussed in Telecom's earlier submissions. The issue has been accepted by the Commission in their acknowledgement that there is a waterbed effect, and taken into account in the Commission's CBA.

Vodafone, and Covec, the Commission's CBA likely underestimates the full impact of regulation on the interdependent pricing of market offerings, or of potential harm of inappropriate regulation to consumer groups.

Response to 2 Degrees' assertion that there are barriers to entry

- 39 The NERA report attached examines the Concept Economics report prepared for 2 Degrees and analyses a range of issues including their assertion that above cost MTRs are barriers to entry.

Ongoing competition

- 40 There has been a suggestion by Concept Economics that Telecom has recently launched its first 3G cellular network and that development in New Zealand has been sluggish. This conclusion has not been well researched. Telecom had New Zealand's first 3G network when it launched the "T3G" EVDO network in 2004 – very soon after some of the technology world leaders Concept cites. This early adoption of 3G was because of the significant competitive pressures Telecom was facing and continues to face in this market.

D PRICING PRINCIPLES

FL-LRIC and TSLRIC – Inaccurate pricing principles

- 41 Telecom has read the submissions presented to the Commission by 2 Degrees, TCL, and Orcon/Kordia/Woosh on the Commission's proposal as to the preferred IPP and secondly to use TSLRIC, BAK, or a blend of TSLRIC and BAK as the preferred FPP.¹⁸
- 42 The proposed IPP is benchmarking against MTAS prices in comparable countries that result from the application of forward-looking cost-based pricing methods. However, Telecom remains gravely concerned with the Commission's use of benchmarking to FL-LRIC cost-based pricing methods as set out in the Draft Recommendation. Telecom supports the criticisms of the Commission's benchmarking process as set out in the Vodafone submission, and supported in the Analysys Mason and Covec reports which accompany it.
- 43 The IPP appears to be unworkable for the reasons Vodafone outlines in paragraph 118. The Commission's best alternative is to take the observation from the most comparable country and apply that. Telecom's July Undertaking represents a reasonable compromise between the precipitous drops to MTRs well below those actually prevailing in comparable countries, which the Commission proposes, and holding to the status quo of Vodafone. It is linked to the outcome of a thorough process conducted by the ACCC.
- 44 2 Degrees has noted that it considers that the Commission should move toward the European Commission's (**EC**) use of the FL-LRIC approach as the preferred

¹⁸ Draft Recommendation paragraphs 437-439.

basis for determining cost.¹⁹ Telecom rejects this view and continues to have concerns about the Commission's use of TSLRIC without adjustment to reflect the risk and uncertainty of the uptake of technologies.

Mobile markets are characterised by very significant sunk costs, competition across service and product capabilities, development and innovation – FL-LRIC is therefore inappropriate

45 Mobile telecommunications is characterised by very significant sunk costs across a wide range of services.

46 We note that paragraph 2.40 of the Commission's recently released discussion paper on input methodologies states:

"Marginal cost pricing, however, is unlikely to yield sufficient revenues to recover the efficiently incurred costs of production when there are substantial economies of scale and/or scope."

47 Long run marginal cost pricing is least damaging as a means of recovering sunk costs in the context of industries in which entities invest in mature long-lived production technologies where the investment is determined more by the technology and production costs than by competition across technical innovation and service or product capabilities. Examples of this are the traditional areas such as UCLL where variants of TSLRIC pricing have effectively become standard regulatory practice (although they are not without controversy). One of the reasons for this is that there is less likelihood of variance in the forward-looking outcomes being modelled.

48 FL-LRIC pricing is far worse in the context of recovery of sunk costs in the context of industries in which entities invest to compete across service and product capabilities, development and innovation. In such instances, market participants compete to define the market for customers rather than competing in the market for customers. Examples of this might be mobile voice and data, fibre to the home/premises/node in which TSLRIC pricing and its variants are likely to understate the true costs - since the forward looking outcomes being modelled are highly uncertain and risky. As a result, TSLRIC is not the most appropriate approach for an FPP, although it does have the benefits of being well-understood and transparent.

49 Telecom urges the Commission to consider that elements of these risks can and should be taken into account in applying TSLRIC. From a practical perspective this could be done by:

- (a) Increasing the tilt factor associated with mobile assets and

¹⁹ See paragraphs 2.1-2.5 of its submission.

(b) Modelling a WACC augmented in order to take account of the full spectrum of risks²⁰.

50 While these adjustments do not represent an exhaustive list of the factors which need to be considered, Telecom considers that these will address the most material deficiencies of TSLRIC in relation to the regulation of MTAS.

FL-LRIC is not clearly best practice and remains untested

51 Furthermore, it is incorrect to suggest that if New Zealand were not to adopt the EC recommendation in respect of FL-LRIC pricing that it would be out of step with international best practice. If the Commission were to review and analyse the consultation and decision-making process which led to the EC recommendation, it would see that consultation was divided and the EC recommendation was not given a clear mandate. In fact only 5 of 27 countries supported the proposal with others abstaining. This recommendation remains untested in practice. Accordingly this precedent and the price path it supposes should not form any kind of precedent for New Zealand.

52 In the telecommunications market, the use of TSLRIC methodologies is generally used by the Commission in accordance with international “best practice”. TSLRIC seeks to match long-run marginal costs at anticipated service levels across economic life of assets. TSLRIC pricing was developed for, and has been widely used, in the context of regulating incumbent telecommunications operators and opening the existing telecommunications networks up to competition. The copper-based technology of the existing networks particularly has changed relatively slowly, particularly in the “last mile” link between customer and the exchange.

FL-LRIC does not lead to dynamic efficiency

53 FL-LRIC is inappropriate simply because it excludes a range of common and other costs from consideration in estimating the cost of mobile termination. This is done presumably on the basis that these costs are recovered from the costs charged to users by the originating platform and should not be allocated against the costs of termination. This approach ignores the fact that marginal cost pricing does not lead to dynamic efficiency as noted above despite the fact that the Commission’s practice is to give preference to dynamic efficiency²¹. This approach also ignores issues around the two-sided market dynamics discussed in Telecom’s submission. A possible result of regulating MTRs based on FL-LRIC is that when constructing and setting prices for market offerings, Mobile Network Operators will need to amend the structure of those offerings to reflect the changed incentives – the waterbed effect.

²⁰ Telecom refers the Commission to its *Submission on Commerce Commission Revised Draft Guidelines for Estimating the Cost of Capital* 18 August 2009 which addresses these issues in more detail.

²¹ Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, 31 July 2009, paragraphs 135 and 182.

Asymmetric MTRs do not correspond to the relative costs

54 Telecom finds it hard to believe that 2 Degrees would still be advocating for regulation if the secret deal was so much better for it than regulation would be as Vodafone claims. 2 Degrees is unambiguously worse off with lower FTM prices so, based on the comments set out in Vodafone's submission in relation to these arrangements, this agreement must be offering favourable MTM prices, perhaps with asymmetric rates. Such deals can create distortions in the market and do not correspond to the relative levels of costs between the networks as per Telecom's previous submission.

BAK

55 2 Degrees submits at length on its preference for BAK²². 2 Degrees' submissions are however incorrect. 2 Degrees submits that there is no demonstrable harm from BAK, but in fact the reverse is true. At the risk of oversimplifying the issue, the following example illustrates the point:

- (a) In the absolute absence of a waterbed effect,²³ the optimal MTR must be priced at cost in a CPP environment in order to maximise total welfare irrespective of where that cost sits – any MTR less than cost results in a transfer of producer surplus to consumers, and in a loss by the Mobile Network Operator. Where the waterbed effect is greater than zero, as the Commission acknowledges that it is likely to be in its CBA, this effect is magnified due to the network effect.²⁴ On a stand-alone basis in a CPP environment, BAK clearly results in harm to a Mobile Network Operator.
- (b) The corollary of this is that pure BAK, in which the MTR is set to zero, will only maximise total welfare in a CPP environment where the originating network and the receiving network have closely matched and reciprocal call volumes. In any situation where call volumes diverge from being reciprocally matched, BAK manifestly will result in demonstrable harm to one party and a benefit to the other party.

56 Telecom continues to be of the view that it may be appropriate to consider BAK over the longer term, but that it is not appropriate in the New Zealand context at the present time. We refer the Commission again to paragraphs 34 to 44 of Telecom's submission of 13 February 2009 and to Appendix 1 which sets out additional detail. Telecom's earlier submission also noted a range of implementation issues. This is also supported by Vodafone's submission of 13

²² See section 5 of its submission.

²³ As noted above, the Commission has in the past considered the issues, and acknowledged and accepted that the waterbed effect has an impact on mobile call termination and economically efficient pricing structures.

²⁴ The network effect referred to is the network externality internalised by the mobile network operator, and which gives rise to the waterbed effect – a consequence of the two-sided market dynamics referred to in Telecom's 28 July submission and in early submissions on this point. Ofcom have recognised the existence of the network effect justifying a mark-up on cost of mobile termination in the past. (See Ofcom's document *Mobile Call Termination* 27 March 2007 in Annex 16).

February 2009 and the accompanying literature review prepared for Vodafone by Frontier Economics which echo many of the themes set out in Telecom's submission.

- 57 Telecom supports the Commission's view as expressed in the Draft Recommendation that BAK pricing is not appropriate at the present time and the views of Vodafone, TelstraClear and CallPlus that BAK is not an appropriate pricing principle for adoption in the New Zealand environment at the present time. The Commission should continue to reject the arguments for BAK by 2 Degrees and the similar support noted in the Orcon/Kordia/Woosh submission.

E BENCHMARKING

Commission needs to revise its benchmarking approach

- 58 Analysys Mason has suggested that the Commission²⁵:
- (a) Develop a cost model with the objective of calculating the actual cost of providing MTRs in New Zealand; or
 - (b) At least revises its benchmarking analysis by revisiting the list of countries considered and defining the reference MTAS cost using more prudent approaches, such as the "top of the range" or the 75th percentile instead of the current selection based on the median.
- 59 We strongly support Analysys Mason's criticism of the Commission's benchmarking, and we agree with the suggestion that the Commission revise its benchmarking analysis. Telecom's previous submissions, supported by NERA, have consistently drawn attention to the fact that the Commission's benchmarking is inaccurate and unreliable.
- 60 However we consider that it is unrealistic to develop a comprehensive cost model of mobile termination in New Zealand at this stage of the process. This process is best suited to the FPP stage (if any) of the process. If the Commission wishes to continue down the path of regulation, it should do so on the basis of a more accurate and reliable benchmarking approach which takes account of the issues of comparability and the risks of regulatory error. It is entirely appropriate in the context of applying the FPP that prices are set by reference to a model which can take into account the characteristics of the New Zealand market such as terrain, population density, and average income.

Benchmarking based on untested hypothetical cost models and do not take account of New Zealand conditions

- 61 As Vodafone notes in paragraph 7, and details further in the body, of its submission, it is apparent that the Commission has determined to regulate based

²⁵ See submission dated 27 July 2009, Executive Summary.

largely upon a conclusion that MTR costs are too high. As Vodafone and Analysys Mason point out, the Commission's Draft Recommendation is supported in part by a cost estimate based on untested theoretical cost models which do not take account of New Zealand conditions. Accordingly, the Commission's benchmarking leads to cost estimates significantly lower than real cost.

- 62 As Telecom, NERA, Vodafone, Covec, and Analysys Mason have all pointed out, the models used are very sensitive to assumptions made on country-specific inputs. In fact, the differences between the outputs of the models used in the Commission's analysis alone suggest that the results are not applicable to New Zealand.
- 63 Further, the results of these cost models have for the most part not been adopted by the relevant regulators as the appropriate regulated prices for their jurisdictions. The Commission is proposing to read more into these cost models than their authors were prepared to.
- 64 The conclusions of the Analysys Mason report are highly critical of this approach to benchmarking. Telecom endorses this view and urges the Commission to take note of Analysys Mason's suggestions to correct the inaccuracies in its approach.

Commission needs to adopt 75th percentile to avoid regulatory error

- 65 Telecom endorses the comment by Analysys Mason that, if the Commission persists in using models from other jurisdictions to estimate MTR costs without adjustment for local conditions, then the estimates derived from those models should be applied with appropriate care.²⁶ For instance, as proposed by Analysys Mason,²⁷ if cost estimates rather than actual regulated prices are to be used, they should be selected at or near the 75th percentile of the range of observations in order to avoid the asymmetric risk of regulatory error. This is an approach which has been accepted by and used by the Commission in the past. Telecom refers the Commission again to the submissions it and NERA have also made on the Commission's benchmarking.

Selection of the median in the benchmarking range risks setting MTRS too low to ensure recovery of investment costs

- 66 The Commission has indicated that it will consider network complementarities and externalities, opportunities for leverage, and infrastructure revenue recovery.²⁸ We support Vodafone's comments that by choosing the median in the benchmarking range and using costs rather than prices applied by overseas regulators that the Commission risks setting MTRs too low and therefore Mobile

²⁶ *Assessment of the position of the Commerce Commission of New Zealand in determining MTAS prices* - Analysys Mason 27 July 2009, page 6 paragraph 9. See also Vodafone's submission at paragraph 118.

²⁷ *ibid* page 8 paragraph 13.

²⁸ Discussion Paper – *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector*, 31 July 2009, see paragraph 184.

Network Operators potentially cannot recover the costs of investment, which may in turn disincentivise investment.²⁹

F GLIDE PATH

- 67 As discussed above, certain parties seek rapid changes to the MTRs. While Vodafone and Analysys Mason support a glide path³⁰ - that the Commission should implement a gradual reduction in MTRs over time to avoid any sudden distortional effects on the market, ultimately to the detriment of both operators and consumers.
- 68 Telecom supports Vodafone's submission, and the Analysys Mason's material, on the need for a glide path. They reinforce Telecom's position that regulators generally take account of the fact that immediate reduction in MTRs will affect the mobile market through cost shocks for consumers and investment plans committed to by Mobile Network Operators.³¹ Analysys Mason notes³² that a glide path avoids sudden distortional effects on the market which ultimately operate to the detriment of mobile network operators and consumers. The Commission should take careful note of its view, first as leading mobile telecommunications cost modellers who developed a number of the models on which the Commission has relied for cost benchmarking purposes, and second, as advisors to regulators in a number of countries generally considered to be similar to New Zealand.
- 69 There is clear evidence demonstrating that a glide path should be considered. Accordingly the Commission should provide for a glide path in relation to any regulation of MTRs and should not be persuaded by the arguments put forward by TUANZ, CallPlus, 2 Degrees and Orcon/Kordia/Woosh in their respective submissions that price movement should take place with the minimum delay.
- 70 Vodafone has suggested that a three year glide path would be appropriate. Telecom would agree if there were to be a change from current rates down to the 5.8 cpm the Commission proposes. However, if there are more moderate and realistic changes in MTRs, as Telecom has proposed in its July Undertaking, then a glide path over somewhat less than two years, to January 2011, would be sufficient.
- 71 If the Commission considers that it needs to be clearly specified as part of the IPP to avoid any doubts as to its jurisdiction to include a glide path then we would also welcome that clarity.

²⁹ See Vodafone's submission dated 28 July 2009, paragraphs 131 – 135.

³⁰ See submission dated 27 July 2009, Executive Summary.

³¹ See Vodafone submission dated 28 July 2009, paragraph 50.

³² Analysys Mason, paragraph 22.

G CBA

Counterfactual

- 72 Telecom supports Vodafone's submission in relation to shortcomings in the Commission's selection of the counterfactual.
- 73 Telecom remains of the view that the appropriate counterfactuals are:
- (a) The current MTR Deeds entered into by Telecom and Vodafone; and
 - (b) The commercial offerings by Telecom and by Vodafone to 2 Degrees.
- 74 The undertakings proposed by Telecom should represent a second factual which could then be assessed against both the Commission's factual and the counterfactual. The Vodafone submission refers in some detail to the commercial arrangements agreed between it and 2 Degrees. The Commission should take a clear position on its approach to the secret deal between 2 Degrees and Vodafone.
- 75 The counterfactual should fully describe the situation that will exist in the absence of either regulation or one of the undertakings being accepted. To the extent that in some of these scenarios there may be confidential information, that should be dealt with by protecting some contents of the CBA spreadsheet. Where an offer is only available to one part of the market, the value of that offer should be scaled back so the model reflects the average effects over the entire market.
- 76 Telecom notes that, if the commercial arrangements between Vodafone and 2 Degrees are better than any rate which might ultimately be set by regulation, then regulation will not affect it. If this is not the case, then regulation will override it.
- 77 Telecom urges the Commission to review its position in relation to the appropriate counterfactual scenario against which to assess regulation and to adopt as a counterfactual the actual content of the current MTR Deeds entered into by Telecom and Vodafone and the commercial offerings by Telecom, and by Vodafone to 2 Degrees.
- 78 The Commission needs to consider the possibility of transit happening to arbitrage the differential in MTRs offered to various parties in the presence of either an undertaking or regulation. Vodafone has said that 2 Degrees might prefer to stay on the secret deal even in the presence of regulation. For example at paragraph 361 Vodafone discloses the differential in the two rates for MTM traffic in the secret deal. The figure cited of \$2 million between now and March 2012 allows an estimate of the rate differential given the stated assumption of the same traffic patterns as exist today between Telecom and Vodafone. Given this differential, we can conclude that Vodafone would send its traffic via Telecom towards 2 Degrees in the presence of regulation even if 2 Degrees wished to stay on the

secret arrangement. This observation does not change the evaluation in the CBA – rather it is simply an observation that traffic will follow the lowest rate.

- 79 Vodafone makes much of the observation that 2 Degrees will be worse off under regulation and that therefore regulation should not be applied because it will disadvantage 2 Degrees. This argument is flawed on two counts. 2 Degrees continues to argue for regulation. This regulatory rent-seeking implies that 2 Degrees' assessment is clearly that regulation would be better than the deal it currently has. Secondly, the Commission should not be evaluating either undertakings or proposed regulation on the basis of the effect it will have on 2 Degrees or any other party. The Commission should be considering the impact, over the long term, on end users.

CBA overstates benefits for FTM and ignores MTM and SMS

- 80 Telecom agrees with Vodafone's submission, and Covec's supporting report, that the CBA overstates the benefits for FTM and its failure to carry out a proper CBA for MTM and SMS mean its justification for regulation is flawed:

- (a) The Commission's CBA does not provide a robust justification for regulation;³³
- (b) It contains a range of errors, and overly optimistic assumptions which overstate the benefits of regulation of FTM termination rates;³⁴
- (c) No CBA is carried out to quantify or justify regulation of MTM termination rates;³⁵ and
- (d) No CBA is carried out to justify the regulation of termination rates for SMS text messaging.³⁶

- 81 The risk of inappropriate regulation also has an impact on economic efficiency – Telecom supports Vodafone's submission that the Commission has underestimated the impact of the waterbed effect.³⁷ This will limit the access of some consumers to mobile telecommunications by forcing other adjustments to pricing bundles.

- 82 In this regard, it is clearly not appropriate for the Commission to consider distributional effects such as benefits for high value mobile customers and losses for low value mobile customers, as Vodafone recommends it do. The Commission's CBA models the loss of 30,000 customers as a result of regulation –

³³ See Vodafone's submission dated 28 July 2009, generally through paragraphs 166-238.

³⁴ See Vodafone's submission dated 28 July 2009, generally through paragraphs 197-223.

³⁵ See Vodafone's submission dated 28 July 2009, paragraphs 276-380.

³⁶ See Vodafone's submission dated 28 July 2009, paragraphs 368-372.

³⁷ See Vodafone's submission dated 28 July 2009, paragraphs 197-223.

a figure which increases materially if some more realistic input values are used. Telecom agrees with the tenor of Vodafone's submission that the Commission has underestimated the harm for mobile consumers from reductions in FTM termination rates. However, there should be no overlay on the CBA for expected income or some demographic metric of customers who will be advantaged relative to those who will be disadvantaged. The modelling of changes in total surplus is all that is required. The promotion of competition for the long term benefit of end users is likely to make some customers worse off in order to benefit other customers, but it is the overall effect that matters.

H MARKET DEFINITION

2 Degrees and TUANZ explicitly support the Commission's failure to adequately take into account the two-sided market in the market definition

2 Degrees incorrectly rejects network externalities

- 83 In 2 Degrees' submission paragraphs 2.21 to 2.31 deal with the question of whether network externalities are relevant in New Zealand and discuss the relevance of the waterbed effect. 2 Degrees seems to suggest that network externalities only exist during the early stages of the roll-out of a mobile network, and as a result the fact that mobile penetration is high in New Zealand argues against their continued existence. In fact, Ofcom³⁸ and other regulators have accepted that mobile telecommunications markets in particular exhibit network effects³⁹. Network effects will always exist in telecommunications, regardless of penetration levels, as network effects simply reflect the fact that demand is a function of the number of other connected consumers.
- 84 Furthermore, the 2 Degrees argument is a static one, whereas the real world is dynamic and experiences shocks. For example, the Commission itself acknowledges that regulation will result in higher mobile retail prices and that this will result in approximately 30,000 mobile subscribers dropping off the network. This will result in a loss of welfare for the remaining subscribers to both fixed and

³⁸ Ofcom have recognised the existence of the network effect justifying a mark-up on cost of mobile termination in the past. (See Ofcom's document *Mobile Call Termination* 27 March 2007 in Annex 16).

³⁹ In mobile telecommunications, a call originator is able to subscribe for access to the mobile network platform in one or more bundles which include a range of goods and service prices designed to attract particular sets of calling preferences. Subscription to the platform ensures access for a call originator to a range of other subscribers to the same platform, or accessible through interconnection agreements between the platform operator and competing platform operators. Subscription to the platform also enables a call receiver to receive calls from other subscribers to the same platform or with access to that platform through interconnection agreements through the platform operator and competing platform operators. In New Zealand, the prevailing approach to billing in-country calls between platforms, CPP, is accompanied by a fee paid by the originating subscriber's platform operator to the receiving subscribers' platform operator which is recovered from the originating subscriber. The interaction between caller on one side of the platform and the recipient on the other side of the platform gives rise to a call externality which is internalised by the platform operator.

mobile networks (as well of course in a loss of welfare for those who have dropped off).

- 85 Mobile telecommunications service providers enable access to a telecommunications platform and an associated range of connected products or services which enable two or more user groups to access that platform. This gives rise to the two-sided market or two-sided platform network effect described in Telecom's previous submissions. The classic, static, one-sided market definition analysis does not enable a comprehensive analysis of two-sided markets without some amendment. The existence of network effects in New Zealand arise from the two-sided nature of the market, and are affected by factors such as the nature of competition and the structure of market offerings.
- 86 2 Degrees provides no substantive support for its argument that network externalities are not relevant in New Zealand. 2 Degrees has not taken proper account of the two-sided nature in the market or the fact that telecommunications demand is a function of the number of other consumers connected.
- 87 In the mobile telecommunications industry the reality of high sunk costs, rapid technological change, service and coverage based as well as price based competition, and the special characteristics of two-sided markets⁴⁰ need to be taken into account in defining the relevant markets. Accordingly, by arguing against the relevance of network effects, and supporting the Commission's focus on the cost-based MTRs, 2 Degrees repeats the Commission's error in defining an unduly narrow market and as a result forms a mistaken conclusion as to the effect of MTRs on competition and entry. Telecom strongly disagrees with this view and refers the Commission to its earlier submission on the Draft Recommendation and to the NERA report accompanying it.

Other parties fail to take into account the waterbed effect and adopt one sided market analysis

- 88 TUANZ also agrees with the market definition set out in the Draft Recommendation and endorses the Commission's resulting competition assessment. Telecom understands that TUANZ continues to hold the previously submitted view that there is no "waterbed" effect in mobile telecommunications.⁴¹

⁴⁰ Although the Commission has excluded the two-sided market issue from the market definition, these issues are partially taken into account in respect of the incorrect market definition by the waterbed effect set out in the CBA.

⁴¹ Draft Report On Whether Mobile Termination Should Become A Designated Or Specified Service - Submission From The Telecommunications Users Association Of New Zealand, 27 November 2004 at page 3- "TUANZ also agrees with the Commission that the "waterbed effect" is unlikely to occur if mobile termination is regulated, because the dynamics of a competitive market should prevent significant changes to subscription and handset subsidies."

- 89 By accepting the Commission's analysis, CallPlus and Orcon/Kordia/Woosh are also making the same error as the Commission.
- 90 The market definition set out in the Draft Recommendation adopts a standard one-sided market approach. This classic market definition analysis implies a structure in which an upstream producer combines tangible and intangible goods, services and labour to create a market offering that is sold to a downstream entity, which further transforms it in some way to add value before on-selling it to the end user. The focus of the market definition analysis is the market in which the upstream producer and the downstream customer transact.
- 91 Telecom welcomes the fact that the Commission has acknowledged the two-sided nature of the market, by recognising the waterbed effect in the CBA – and accordingly to some account addresses the network effects in the market. Unfortunately, the Commission has not adequately recognised the two-sided nature of the market and has determined markets which are artificially narrow – so narrow that competition is neither technically or commercially possible. This does not however imply, as 2 Degrees, other submitters, and the Commission seem to conclude, that this narrow market is a bottleneck.
- 92 The waterbed effect is observable as a consequence of the network effects. Contrary to 2 Degrees and TUANZ views, network effects and the waterbed effect do operate in New Zealand for the reasons set out below.
- 93 In the Covec document prepared for Vodafone, titled *Further Analysis of FTM Pass-through* dated 11 August 2009, Covec analyses the rate of pass-through of each of the fixed line operators over a specified period, and uses these as an estimate of the pass-through of MTR changes into FTM prices. Covec acknowledges that this approach holds all other factors constant. In fact Covec's estimate is largely meaningless because by doing so it fails to take into account the fact that there is a cluster market for PSTN services.⁴² The fact that the fixed line operators largely compete on the basis of bundles of goods and services means that a change in input costs will not directly translate into a change in the price of one component of that bundle. Pass-through operates in the manner suggested by Covec only when a single retail product is being provided using the input which is changing in price.

Nature of market offerings – clusters and bundles

- 94 In telecommunications, market offerings are typically marketed, delivered and consumed in clusters or bundles, and delivered by multi-service providers as the outputs from multiple production processes. Not only does this present problems for the analysis of cost in relation to specific bundled offerings, but market

⁴² See the *Draft Report*, Commerce Commission 30 June 2009 at Figure 7 and as narrated in paragraph 312. In Figure 7 the line representing *Resold Telecom Lines* and the line representing *Toll by-pass customers* are converging. This clearly indicates that fewer customers are splitting their purchase of tolls and access.

analysis based around the nature and extent of competition is made more difficult. The classic, static, one-offering market definition analysis does not enable a comprehensive analysis of two-sided markets characterised by clustered or bundled offerings without some amendment, because the commercial pricing of bundles is set with a view to ensuring market uptake by a target segment of the consumer population. As noted in Telecom's earlier submission in relation to two-sided markets, the key issue for a platform operator is pricing market offerings to attract the maximum subscribers, based on the features attractive to the target demographic.

- 95 The commercial pricing process typically seeks to match the demand for a product and service bundle with the price points for the target demographic. In mobile telecommunications in New Zealand, competition takes place over a range of price and non-price features. As previously submitted, key areas of competition are non-price features. Given the rapid technological change in mobile telecommunications, in order to compete effectively, a market participant will have to continue a high level of investment, and will accordingly have high sunk costs to recover. As a result, the commercial pricing process matches demand issues against the level of sunk and operational costs to be recovered.
- 96 The result in mobile telecommunications is that product and service bundles are constantly being adjusted to meet changes in demand and competition for customers. Economists typically analyse and describe this process using a range of formal tools, including the waterbed effect to capture some aspects of the two-sided market phenomena. The reality is, just as foregone investment opportunities are largely invisible to the Commission in the absence of analysis and information, so too is the operation of the waterbed effect. It is not the case, as TUANZ and others have submitted, that the waterbed effect does not exist.
- 97 Equally, accepting the two-sided market hypothesis does not mean that the Commission is precluded from regulating the price of a cost element within that market. If, following a proper analysis, including a correct approach to market definition, a proper competition analysis, and sound benchmarking, the Commission can demonstrate that there is evidence of market failure and that the benefits of regulation clearly outweigh the costs of regulation then the Commission has a case to intervene.
- 98 From the discussion above it can be noted that there are significant scale economies and complementarities in demand, and scale and scope economies in supply which affect the structure of pricing, construction of bundles, and actual choices made by consumers and service providers. The existence of these strong complementarities mean that a narrow market definition for mobile call termination will mean that each Mobile Network Operator will always have 100% share of its relevant market and that competition is practically and technically impossible.

- 99 In fact the elasticities associated with such a narrow market will by definition be very low due to the existence of complements, the presence of a limited number of substitutes and the resulting increase in the costs of switching, even if that were technically feasible.
- 100 If the defined service is enlarged to include the complementary services such as call origination and platform access, the Mobile Network Operators have less market power – in fact, in Telecom’s view the (properly defined) mobile market in New Zealand is workably competitive. The implication of this is that a bundle of complementary goods and services will constitute a market if the scope economies on the demand and supply side are strong enough.
- 101 This accords with classic economic theory – even in oligopolistic competition, a Mobile Network Operator offering a range of complementary goods and services will set prices lower than the relevant number of operators each selling the same goods individually (even if that were technically feasible). The corollary is that a Mobile Network Operator marketing a bundle of goods and services and recovering sunk costs or facing fixed costs will charge higher mark-ups in the services for which demand is more inelastic. The key point to be taken from this is that a high mark-up on cost in relation to a single service, forming part of a bundle of complementary goods and services in the face of scope economies on the supply side does not of itself mean that there is an exercise of significant market power.
- 102 Telecom urges the Commission to reject the submissions made, particularly by 2 Degrees and TUANZ, in respect of its market definition, and to reconsider its approach to market definition by adopting a definition consistent with its acknowledgement of the two-sided nature of the market. In mobile telecommunications, the market for FTM, MTM services should be defined to include the complementary services such as call origination, platform access, and call termination - the complementary effects on the demand side, and scope economies on the supply side can be shown to be strong enough to give rise to a single mobile market.

SMS market definition

- 103 Telecom agrees with Vodafone that the Commission’s market definition of the SMS service should look at close substitutes such as mobile IM. However the market is likely to be a cluster market of mobile services given that customers do not generally have one mobile only for texting, another only for IM, and a third only for voice calls.
- 104 If a more correct approach to market definition is carried out, a different view of competition results when carrying out the appropriate analysis. It is not necessarily the case, when the correct analysis is carried out, that variances from long run marginal cost based pricing in the narrowly defined MTAS markets

identified by the Commission signal a competition problem which requires regulatory intervention.

I COMMISSION'S JURISDICTION DOES NOT EXTEND TO RETAIL PRICE REGULATION

The Act's jurisdiction and policy is for regulation at the wholesale level only

- 105 There is a strong push by some parties for retail regulation, in particular in respect of on-net and off-net pricing.
- 106 We also note the additional Kordia, Woosh, CallPlus and Orcon submission on restricted information released under the Commission's confidentiality order.⁴³ That submission goes further to propose that a margin squeeze imputation test be incorporated into the regulated service.
- 107 As Telecom has previously submitted, the regulation of retail pricing is beyond the scope of the Commission's jurisdiction and the policy of the Act, which is to regulate supply between service providers. The Commission does not have an unfettered discretion to impose conditions or restrictions on Mobile Network Operators. Instead the Commission's powers in the Act need to be interpreted in light of the section 18 purpose statement, which is clear that the statutory framework provides for the regulation of wholesale services⁴⁴ and does not extend to regulating the terms on which a Mobile Network Operator supplies services to its own retail customers.
- 108 The Commission cannot use powers that have been granted for a particular statutory purpose (regulating services "*between service providers*") for some other purpose that has not been provided in the Act (regulating at the retail level or de facto achieving that outcome).
- 109 In addition, there are good reasons for the policy in the Act not to regulate at the retail level. Regulating wholesale prices, or encouraging more efficient wholesale pricing through regulatory threats, means that retail prices will ultimately become efficient. Provided there are sound wholesale practices, with the assistance of regulation where demonstrably required, the retail market does not require such intervention. It would be a mistake to react on an ad hoc basis here to resolve purported anti-competitive practices using *ex ante* regulatory tools.
- 110 For these reasons we consider that retail pass-through and on-net/off-net price regulation cannot be regulated as part of the Commission's MTAS Investigation. In addition, we support the Commission's previous comments that its primary concern is the promotion of competition at the wholesale level and that the

⁴³ Submission dated 12 August 2009.

⁴⁴ Section 18 is clear that the purpose of the Act is to promote competition by regulating the supply of certain telecommunications services "*between service providers*".

Commission expects increased wholesale competition to benefit end-users by leading to lower retail prices.⁴⁵

Regulation of on-net pricing is not necessary – there is no problem

- 111 We also refer to our previous submissions as to why regulation of on-net/off-net pricing is not required⁴⁶. On-net pricing is simply a marketing strategy. Telecom with its XT network has chosen to adopt a different marketing strategy that significantly reduces the scope of on-net pricing on its network, except for customers who wish to take up the option of “My Favourites”. In contrast on-net pricing is a strategy that 2 Degrees has included for its customers with its “Magic Top Up” providing half price calling to other 2 Degrees customers for thirty days.
- 112 As the attached report *Review of the Concept Economics Report* prepared for Telecom by NERA explains, there are many examples of entry in the face of both above cost MTRs and on-net/off-net price differentials. Paragraph 2.1 and Appendix A to the NERA report sets out detailed examples from Ireland, France, Germany, Italy, Portugal, and Spain which support this position.
- 113 Quite simply, there is no on-net pricing problem. As Telecom has noted in previous submissions, 27 out of 30 OECD countries have some form of on-net mobile pricing. We can further point to the OECD/Teligen mobile tariff benchmarking model. That model assumes that 69% of mobile-to-mobile calls⁴⁷ will be on-net and was based on benchmarking typical traffic patterns for European mobile users. This proportion is higher (and in many cases much higher) than the market share of the largest operator in each OECD mobile market in Europe⁴⁸. Showing that the OECD expects that there will be a higher proportion of mobile calls made on-net than would be indicated purely by market share.

J SCOPE OF THE COMMISSION’S CURRENT INVESTIGATION

Commission’s investigation is limited in scope

- 114 The Commission’s current investigation is limited to mobile termination rates:
- (a) FTM;
 - (b) MTM;

⁴⁵ See the Commission’s comments on the undertakings it received, dated 25 March 2009, pages 16-17.

⁴⁶ *Investigation Into Regulation Of Mobile Termination Access Services: Submission On Draft Report*, Telecom, 28 July 2009 at paragraphs 73-76

⁴⁷ The “Low user” basket has 48% Mobile on-net and 22% Mobile off-net so proportion is $48/(48+22) = 69\%$.

⁴⁸ As reported in Table 12 of the Commission’s Draft Report. The simple average for Europe is 48%.

- (c) SMS.

The Commission has included within its investigation termination of internationally originated traffic.

Internationally originated traffic

115 Noting the Commission has also included MTR of internationally originated traffic. Telecom agrees with Vodafone's position that the Commission needs to demonstrate that regulation of internationally originated traffic is within the section 18 purpose statement of the Act "*... to promote competition... for the long term benefit of end-users... within New Zealand...*". (Emphasis added)

116 Regulation of such traffic does not deliver benefits to New Zealand end users - indeed it is likely to harm them through the watered effect. Telecom does not obtain the benefit of regulated rates for terminating traffic to mobiles overseas. Termination rates are based on rates negotiated with overseas partner carriers. While regulated rates are likely to have some influence, they are not the principal determinant of price – that is typically based on reciprocal trades of value. In many cases Telecom will not even be interacting with the Mobile Network Operator providing the termination. We will have arrangements of various kinds with international transit providers who provide services defined across a range of call types and destinations. Factors such as the volume of minutes and the rates we can provide in return play an important part in determining the price we pay. Any perception that we obtain directly the benefit of changes in regulated international MTRs would be false.

Mobile to toll-free and transit

117 In addition some parties have argued that mobile to toll-free calls should be included as part of the MTAS Investigation. CallPlus suggests that the service description in the Act incorporates voice calls where the calling pays principle is reversed to enable a consumer service (i.e. calls to toll free).⁴⁹ TUANZ also takes issue with the charge for origination of calls from mobiles to toll free numbers.⁵⁰

118 Telecom does not consider that the reasons the Commission previously cited for not investigating mobile origination⁵¹ have materially changed:

- (a) The retail market was competitive and has become more so over the last five years.
- (b) Toll-free subscribers can choose to block calls from mobiles. TUANZ refers in its submission to a survey it has conducted amongst its members. Assuming the survey is robust, it showed that there was a difference of only

⁴⁹ See the CallPlus submission dated 27 July 2009, section 3.4.

⁵⁰ See TUANZ submission dated 28 July 2009, page 2.

⁵¹ See Commerce Commission *Decision Not to Investigate Regulation of Mobile Origination 29* November 2004.

9.5% between members who allowed calls from landlines compared to those who allowed calls from mobiles also. This shows that end users are able to block calls (because some do), but most choose not to (indicating that price is not a material problem for most).

- (c) There is even greater substitutability for mobile to toll-free calling now than there was five years ago. Most enterprises have developed far more sophisticated extranets to take care of many customer support issues. These also represent an alternative to mobile toll-free where the enterprise has chosen not to accept such calls. One response to the TUANZ survey also cited the option of using VoIP calling as a further alternative.
- (d) Mobile origination continues to grow, and according to TUANZ it has a 75.5% market penetration amongst TUANZ members.

119 The transit exclusion which Telecom has applied in its July Undertaking, and which CallPlus in particular has objected to⁵², is an artefact of the tri-partite nature of regulation and the undertakings process. Where an undertaking is entered into with one mobile operator but not the other, an arbitrage situation can be created if transit is allowed. This could expose Telecom to significant financial disadvantage as the natural hedge of in-payments and out-payments largely offsetting for MTM traffic would no longer apply. When the whole industry is applying the same rates the non-transit provisions would not be required, although in that circumstance they would have little effect anyway.

120 At this late stage it would be inappropriate to launch an investigation into additional services such as mobile to toll-free and transit services (the Commission would need to go through proper process as required to launch the current investigation – i.e. establish that there are reasonable grounds for a Schedule 3 investigation and Mobile Network Operators would need an opportunity to submit Undertakings etc). Further, in order to propose regulation of the service, the Commission would need to undertake a robust competition and CBA analysis to establish that there are material benefits in regulating the service.

K PROCESS CONCERNS

121 Telecom feels the need to note it has some concerns with the Commission's process to date. In particular,:

- (a) Constrained timeframes for submissions;
- (b) On-going information requests, which may potentially impact on the Commission's thinking and/or CBA, after the release of the Draft Recommendation; and

⁵² See the CallPlus submission dated 27 July 2009, section 3.5.

(c) Confidentiality issues on the status of information provided to the Commission, requests for more information from other parties, and various separate submission processes on restricted information required to be released to the Commission – all in parallel to the substantive process.

- 122 It is unclear at this stage what the Commission's intentions are in respect of the additional information provided. Furthermore, given the concerns with the Commission's analysis in the Draft Recommendation on a number of issues, it indicates that a new CBA is required for all services currently being considered for regulation. In which case it is essential that interested parties are able to comment on such additional analysis. Currently interested parties are submitting on the CBA in the Draft Recommendation which is both incomplete and potentially out of date. We ask that the Commission provides additional guidance on how this key issue is to be resolved in time for the conference.
- 123 In addition, there has been a call by certain parties for additional services to be added to the MTAS Investigation at this stage in the process. This is a challenge to the Commission's scoping of the investigation at the beginning of the process and it is now too late in the process.
- 124 While we understand the drive for regulatory certainty, if the Commission intends to regulate the MTAS Service, natural justice, proper consultation and robust regulatory decision-making require that interested parties are provided with a reasonable opportunity to make submissions before such a significant decision is made.
- 125 We look forward to a workshop and the conference process to work through the hard issues of whether regulatory intervention will do anything beyond transfer wealth between consumer groups, including the prerequisites to regulation of improving competition outcomes and delivering a clear net benefit to New Zealand, in a credible and serious way.