TelstraClear Limited

Schedule 3 investigation into
regulation of mobile termination

Submission on
Commerce Commission
Draft Report

PUBLIC VERSION

28 July 2009

Executive Summary

(i) TelstraClear remains concerned with the state of the mobile termination market in New Zealand, and supports the Commission's recommendation in its draft report that wholesale mobile termination should be regulated under the Telecommunications Act.

(ii) TelstraClear agrees with the Commission's comprehensive analysis, which concludes that the net benefit from regulation of mobile termination rates will significantly outweigh the potential benefit of accepting alternative undertakings provided earlier this year by Telecom New Zealand, Vodafone and 2 Degrees Limited.

(iii) The Commission's analysis in the draft report also clearly demonstrates the significant chasm between the previous draft undertakings put forward by Telecom, Vodafone and 2 Degrees, and the likely benefit of cost-based regulation. Absent new undertakings being provided that significantly address that gap, TelstraClear strongly supports the Commission finalising its recommendation to the Minister of Communications to regulate.

(iv) It is clear that the proposed mobile termination rates provided in Telecom and Vodafone's undertakings through to 2013/14 would entrench rates materially higher than benchmarked cost-based mobile termination rates in comparable international jurisdictions.

(v) TelstraClear remains of the view that the acceptance of these undertakings would risk locking in wholesale mobile termination rates significantly above cost for a further five years, perpetuating the competition issues the Commission has identified in its original decision to investigate mobile termination services.

(vi) Arguments have been put that regulated mobile termination rate reductions do not get passed through to New Zealand end-users. TelstraClear considers that this ignores both commercial reality and market-based evidence. Wholesale mobile termination rates above cost reduce the ability of competing carriers to deliver compelling packages in competition with those mobile carriers who are able to cross-subsidize their own bundles with revenue from above-cost mobile termination, thereby denying New Zealand end-users with choice.

(vii) The trade-off that Telecom and Vodafone ask for - a small reduction in mobile termination rates with a narrow pass-through mechanism - will clearly not deliver the benefits that the Commission have identified in its cost-benefit analysis in the draft report.

(viii) The pro-competitive benefits of cost-based mobile termination have been evident since the Commission's initial Schedule 3 investigation in 2004. For that reason, TelstraClear supports the rapid finalisation of the Commission's recommendation to the Minister.

Introduction

1. TelstraClear welcomes the opportunity to comment on the Commission's draft report on the Commission's Schedule 3 investigation into the regulation of mobile termination.

2. TelstraClear remains concerned with the state of the mobile termination market in New Zealand. TelstraClear was supportive of the Commission's recommendation in its mobile termination reconsideration report[1] issued in April 2006, that the Minister regulate fixed-to-mobile termination under the Telecommunications Act. TelstraClear remains of the view that the Commission should regulate termination of traffic on to mobile networks, whether they originate from fixed or mobile networks.

3. TelstraClear has submitted on the Commission's mobile termination investigations since 2004. In that time, rates have remained significantly above cost, based on international benchmarks. The Commission's draft report reflects the significant consultation and analysis undertaken over that period, and the comprehensive submissions made by all parties during these investigations. For that reason, TelstraClear's submission is limited to addressing specific aspects of the Commission's draft report.

Confidential Information

4. This submission is public. TelstraClear has also submitted a confidential version containing commercially confidential, "Commission only", information under the MTS Confidentiality Order dated 6 November 2008. TelstraClear has identified this information in square brackets [ ]TCLCO, which has been removed from this public version.

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

Pass-through

5. In assessing the relevant retail markets, the Commission has defined a national retail market for FTM and toll call services (the "retail FTM/tolls market"). TelstraClear agrees with the Commission's analysis that "above-cost MTRs will continue to dampen competition in the supply of retail FTM calls, as fixed operators will be limited in their ability to compete with the integrated suppliers."

6. In the draft report, the Commission notes that:[2]

> Although prices for FTM and toll services have been declining, they remain significantly above the Commission's estimate of the cost of providing these services. This is likely to be in part due to fixed competitors being constrained in their ability to compete retail prices down towards the cost of supply, which is what would be expected in a workably competitive market.

7. While TelstraClear supports the Commission's preliminary conclusion, we note that increasingly customers purchase bundles of services from a single provider, which is likely to include voice access, internet access (broadband or dial-up) and calling services (tolls and FTM).

8. In its draft report, the Commission has adopted an assumption of 75% pass-through, up from 68% pass through in the Commission's reconsideration report. TelstraClear is concerned that a narrow view of pass-through, limited to the retail FTM/tolls calling market, is likely to ignore the commercial reality that services are purchased as bundles, rather than as a stand-alone service.

9. This view is consistent with the ACCC's conclusions on the likely extent of retail pass through of wholesale termination savings. In designating MTAS in Australia back in 2004, the ACCC identified that: [3]

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

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

> "Further, the Commission does not believe that the extent of FTM pass-through should be seen as the only measure of the extent to which a lower price for the MTAS promotes competition in the market within which FTM services are provided, or the LTIE [long-

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2 Commerce Commission, *Draft Report on whether the mobile termination access services (incorporating mobile-to-mobile voice termination, fixed-to-mobile voice termination and short-message-service termination) should become designated or specified services*, 30 June 2009, para. 340

3 P. 129
http://www.accc.gov.au/content/item.phtml?itemId=551419&nodeId=869923e2dc6450fb03830deb9aca5c19&fn=Final%20report%E2%80%94mobile%20terminating%20access%20service%20(Jun%2004).pdf

term-interests of end-users] more generally. ..... A reduction in the MTAS rate alone might put in place necessary preconditions for improved competition and efficient use of and investment in infrastructure. Putting into place those preconditions can itself be in the LTIE, even if there is no certainty that the necessary preconditions will be taken advantage of.

Secondly, to the extent that such preconditions are taken advantage of, improved competition can manifest itself in many forms other than just price reductions. In particular, improved competition may be associated with improvements in the quality of services provided (which may increase the cost of providing FTM call services). Further, lower input costs may be passed-through in the form of reductions in the price of other services provided in the bundle of pre-selected fixed line services. ...”[4]

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

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

We consider that the pass through provisions in the undertaking deprive access seekers of the flexibility to determine competitively the individual price elements for services within the basket of services that are supplied within the fixed-to-mobile market, and the form in which pass through will take place. This approach retards allocative and dynamic efficiency, inhibits competition, is not in the long-term interests of end-users and, in our view, is not reasonable.”[5]

12. The ACCC has also identified that “[t]he extent of pass-through is not the only measure of the extent to which a lower price for the MTAS promotes competition in that market or the LTIE more generally. Improvements in the quality of services provided or reductions in the price of other services provided in the bundle of pre-selected fixed line services can also promote the LTIE”.[6]

13. Most recently, the ACCC, in the re-declaration of the MTAS noted that:[7]

Further, actual improvements in competition may emerge in a range of other ways, including price reductions in limited segments of the FTM services market. Alternatively, price reductions may be passed through in the form of lower prices for other services provided in the market within which FTM services are provided (for example, prices for NLD or IDD call services). Finally, rather than 100 per cent pass through of price reductions, improved competition may manifest itself in the form of improved quality of service.

14. In providing its offer to the Minister in lieu of designation of the fixed-to-mobile termination service, Vodafone argued that “[t]he reality, based on both historical New Zealand data and international experience, is that pass through rates will not increase voluntarily and the Commission's assumption that pass-through will increase to 100% from the current 68% - simply because of regulation – is lacking in credibility. ”[8]

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[4] “Assessment of Vodafone's mobile terminating access service (MTAS) Undertaking, Final Decision”, ACCC, March 2006, at p80.

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

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

[7] ACCC, Mobile Terminating Access Service, *An ACCC Final Report on reviewing the declaration of the mobile terminating access service,* May 2009, p. 26.

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

15. The Issues paper noted that to assess the potential allocative and productive efficiencies, one of the three isolated effects that would need to be taken into account is the price effect on the retail level, which would reflect the wholesale price effect and the level of pass-through.

16. Given the nature of retail mobile bundles, TelstraClear considers that it is inappropriate to focus solely on the extent of pass-through based on retail termination rates. At a retail level, mobile services are generally sold as a bundle. This will often include a handset, access and calling services. Likewise in the fixed market, mobile termination is not commonly purchased as a standalone service. The total package price to the consumer reflects the total value of the bundle sold. Pricing of individual components with a retail bundle may be designed to attract customers, rather than reflecting the underlying cost of delivering the service component per se. For that reason, differential pricing between termination of calls on or off net may reflect the marketing proposition, rather than simply reflecting the cost of mobile termination as a stand-alone service.

17. The genesis of competition in the New Zealand market was toll by-pass services, which saw an expansion of toll-calling and significant reduction in prices. Customers would often purchase tolls packages from a separate provider to their voice services. At that time, wholesale access to Telecom's network was not available.

18. With the availability of regulated wholesale access services, the market focus has now shifted to delivering bundles of services to customers, and most TelstraClear customers now purchase bundles of services that can include voice access, internet access, toll-calling / FTM and television services. This is delivered using either TelstraClear's own network or via wholesale access.

19. As a result, the market for stand-alone toll / FTM services is declining, as providers increasingly deliver 'whole-of-customer' solutions. For example, TelstraClear's stand-alone toll-bypass/FTM customer base has gone from [ ] TCLCO to [ ] TCLCO. Accordingly, TelstraClear believes that any analysis should rightly consider the bundle, and look at issues such as service improvement and other value-adds, rather than FTM prices alone.

20. However, even on a stand-alone basis, retail FTM rates continue to materially reduce, as the Commission's draft report identifies. As part of its analysis, the Commission's draft report provides the results of a search of industry websites for the standard 'headline' retail FTM rates. TelstraClear considers that these rates are likely to significantly overstate FTM rates within the market. For example, in the residential market, TelstraClear offers Home-to-mobile 'Yak Paks' which provide a set number of minutes to make fixed to mobile calls at any time, for a fixed charge. [9] In competing for business customers, TelstraClear's whole-of-business offers must be competitive as a total bundle, including fixed-to-mobile calling. Discounting of rates in the business market frequently occurs.

21. TelstraClear has analysed the movement of its retail FTM rates over time.

9 See http://www.telstraclear.co.nz/residential/homeplan/calling-plans/home-to-mobile-yak-paks.cfm

22. [

]TCLCO

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23. [

] TCLCO

24. In May, the ACCC issued the MTAS declaration final report, with a decision to extend the MTAS declaration for five years until 30 June 2014. The ACCC concluded that continued MTAS declaration will "maintain conditions conducive to competition in the market within which FTM services are provided".[10]

> The MTAS is an essential input into the provision of FTM calls.
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> .....
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> Declaration, combined with an appropriate pricing principle, will eliminate the ability of vertically integrated carriers to raise the costs of their rivals. This is likely to promote competition to provide FTM services by creating a situation where any provider of FTM services, either a market incumbent or a new entrant, will be in a position where they can obtain access to termination services at cost reflective prices. This should provide the opportunity for resellers of FTM services, as well as existing (and potentially new)

[10] ACCC, Mobile Terminating Access Service, *An ACCC Final Report on reviewing the declaration of the mobile terminating access service*, May 2009, p. 26.

carriers, to provide FTM services at well below prevailing prices. This would represent an improvement in the necessary preconditions for competition.

25. TelstraClear recommends that the Commission utilise a broad approach to encouraging increased competition in the market for fixed network services. Attempting to assess that increased level of competition through focus on retail stand-alone mobile termination services, which are not purchased independently of a retail bundle, rather than considering the full dynamics of the market (including the ability of providers to improve service levels, or enhance competition through price reductions to other services), will likely substantially understate the competitive benefits and pass-through achieved.

Origination of traffic

26. TelstraClear supports mobile termination regulation of traffic from other New Zealand networks, irrespective of where the traffic was originated, consistent with international agreements within the Government's statement of economic policy.

27. In its draft report, the Commission's preliminary view is that "the service description for the MTAS should include internationally-originated and VOIP-originated calls and SMS, where these are handed over at a MSC in New Zealand."[11]

28. The existing fixed-to-mobile agreements between Telecom, Vodafone and the Crown are limited to traffic originating in New Zealand. Under these agreements, fixed calls that originate internationally, but are put through a domestic carrier's network, are not captured. This is despite there being no technical or cost difference in the termination of a call from a New Zealand network to the terminating mobile carrier.

Bill and Keep

29. TelstraClear supports the Commission's draft recommendation to regulate the MTAS service on a forward-looking cost basis.

30. New Zealand Communications proposed a pure bill and keep arrangement in its undertaking. It is efficient for parties to incur the cost that termination imposes on another network. While symmetric traffic flows between two providers would effectively net out any termination cost between those parties, there is a material risk that asymmetric traffic flows drive costs into one terminating network, without compensation for the costs imposed by the other party.

31. The UK Competition Commission identified that[12]

> ...even if an MNO installed equipment to identify the originating network of individual incoming calls, we were told that arbitrage would be a problem. Vodafone said that FNOs could readily find ways of effectively disguising calls originated on their network

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[11] Commerce Commission, *Draft Report on whether the mobile termination access services (incorporating mobile-to-mobile voice termination, fixed-to-mobile voice termination and short-message-service termination) should become designated or specified services*, 30 June 2009, para. 923

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

as mobile-originated calls—for example, by using mobile gateways. Such a reaction would lead to network congestion and the avoidance of lawfully levied F2M MCT charges. It told us that in France, where a bill-and-keep system (between MNOs) applied until the end of 2004, up to 80 to 90 per cent of F2M calls of alternative FNOs (other than the incumbent) were routed through GSM gateways which led ARCEP to withdraw the bill-and-keep system and introduce cost-based MCT rates. It also pointed out (as did a number of the other Interveners) that H3G had itself recognized this problem.

32. In France, Bill and Keep was limited to mobile-to-mobile traffic, and resulted in an artificial cost structure which gave incentives to sell call termination on competitor's mobile networks, resulting in asymmetric traffic flows, and imposing costs on networks without compensation that was inconsistent with the principle of cost causation. As a result, ARCEP discontinued Bill and Keep and introduced cost-based mobile termination.