

**VODAFONE NEW ZEALAND LIMITED SUBMISSION TO
THE COMMERCE COMMISSION**



**Telecommunication Act 2001: Schedule 3 Investigation into
Regulation of Mobile Termination Access Services**

Written Opening Statement

31 August 2009

[PUBLIC VERSION]

INTRODUCTION

Vodafone welcomes the opportunity to provide this opening statement.

In total, the changes to MTAS rates proposed by the Commission in its draft report will put at risk over \$500 million in revenue for our business over 5 years. There is no other way of looking at this: this amount will have a material impact on our business plans and capacity to invest in New Zealand. This sort of change cannot be undertaken lightly by the Commission, and must be supported by solid analysis and evidence.

For consumers, the options being considered in this investigation also have the potential to:

- generate reduced prices for some groups of consumers, such as potentially fixed-line consumers and possibly on-account mobile subscribers;
- generate higher prices for retail mobile consumers – especially low-spend pre-pay consumers, some of whom may choose to no longer keep a mobile subscription;
- lead to mobile consumers having to pay to receive calls on their network;
- lead to the prevention of on-net pricing discounts being offered to consumers, such as BestMate; Family and TXT2000.

These changes could be fundamental to the way telecommunications markets work in New Zealand for many years to come. They cannot be based on unreliable estimates of the costs faced by mobile operators when providing services; and without due consideration being given to whether such changes will promote competition and actually generate a net benefit for consumers.

In this opening statement, we first of all address fixed to mobile (FTM) MTAS, then mobile to mobile (MTM) voice MTAS and finally SMS MTAS. We then set out our conclusions.

FTM VOICE TERMINATION

One of the critical features of the MTAS debate is that it is set in the context of the MTR Deeds given by Vodafone and Telecom in favour of the Crown. These deeds required Vodafone and Telecom to immediately reduce their MTAS rates, and then pass-through the entire cost savings from MTAS cost reductions to their retail FTM subscribers. These deeds are a form of quasi-regulation which are binding on Vodafone and Telecom, and continue until March 2012.

At the outset, therefore, it is important to note that FTM termination is effectively regulated already. While the service is not designated under the Telecommunications Act, and the prices contained in the

MTR Deeds were not determined by the Commission, Vodafone and Telecom are none-the-less both already subject to binding price control obligations for the service.

Accordingly, whether FTM termination rates should be subject to some form of price control is not at issue in this investigation. What is at issue is whether the existing price control arrangements under the MTR Deeds should be over-turned in favour of some other alternative – in this case either an undertaking or prices set by the Commission under designation.

Over-turning the existing MTR Deeds in favour of designation will generate a number of detrimental consequences for consumers and the industry in general. It will:

1. Remove the obligations on Vodafone and Telecom to drop FTM termination rates on 1 April 2010 (and indeed in any subsequent periods, as set out in the Deeds). From the moment designation occurs until prices are determined via the Commission, mobile operators will not be subject to any constraint on their pricing of FTM termination services;
2. Create significant uncertainty for all industry players – both access providers and access seekers – as to what prices will be beyond 2010 when regulated prices are finally determined;
3. Immediately remove the 100 per cent pass-through obligations that apply to both Telecom and Vodafone under the MTR Deeds. This is especially significant given the high market share that Telecom has in the FTM retail market; and
4. Undermine the confidence of access providers to willingly reduce prices for potentially regulated services in the future. The MTR Deeds involved Vodafone and Telecom “front-ending” reductions in FTM termination rates, where they traded off a larger decrease in FTM termination rates in the early period of the MTR Deeds in exchange for certainty over the rates that could be set in later years. This involved some sacrifice – and some immediate benefit to consumers – as these were immediate reductions that could not otherwise have been achieved under designation until the Commission had completed a price setting process, such as a standard terms determination (STD). Will access providers ever be willing to front-end price reductions in a form of voluntary undertakings again when they see how regulatory settings can be over-turned after they have made their sacrifices and kept to their side of the bargain? In this regard, it should be noted that acceptance of an undertaking by the Minister does not preclude the Commission from commencing another Schedule 3 investigation on the same service at a later stage in the future.

Given these detriments will follow from over-turning the Deeds and designating FTM termination, the Commission needs to convince itself that there is an urgent need to intervene in this market. It must also be sure that the evidentiary basis upon which it makes decisions to intervene is reliable. It is not enough, in this instance, for the Commission to reach a view that FTM termination should in principle be

regulated using rough estimates of the cost of providing the service, and later figure out the specific details about what price should be. The act of designation will, itself, generate a number of undesirable consequences for consumers and the industry at large because it will over-turn the existing MTR Deeds.

We believe that, when adjustments are made to the analysis contained in the Draft Report, the Commission will find there is no clear and present need to urgently intervene to over-turn the Deeds. Our evidence in support of this view is set out below.

The Commission's case for designation

The Commission's case for designation in the Draft Report rests on a set of simple propositions. In particular, the Commission finds that FTM termination is a wholesale input into the downstream retail service of FTM calls. It believes that if the price of FTM termination exceeds the cost of providing the service, then this will:

- keep the retail price for FTM calls higher than it would otherwise be, with consequential losses in consumer welfare and allocative efficiency; and
- distort the playing field between integrated fixed-mobile operators and fixed-only operators, in a way that adversely impacts on competition in downstream fixed-line markets.

Importantly, however, the Commission understands that reductions in FTM termination rates may cause detriments for mobile consumers, as reductions in FTM termination revenue will lead mobile operators to respond in ways that can cause detriments for retail mobile consumers. For instance, mobile operators may respond by increasing prices for retail mobile services (or reduce the extent to which they reduce prices in the future).

Therefore, the case for regulation depends on two crucial findings:

1. Whether the price of FTM termination is substantially above the underlying cost of providing the service; and
2. Whether reducing the price of FTM termination further would generate substantial benefits for fixed-line consumers that would outweigh the detrimental consequences for consumers of retail mobile services.

On the first point, the Commission estimates a benchmark cost of FTM termination of 7.2cpm, declining at 10 per cent per annum in future years. This is key to its findings that the price of FTM termination contained in the MTR Deeds and the undertakings is substantially in excess of cost.

On the second point, the Commission has constructed a cost-benefit model that can be used to estimate the net benefits of regulation under various assumptions. The key findings of the Commission's cost benefit analysis are that:

- FTM pass through will begin at 85% under regulation in 2011, and increase to 100% by 2015; and
- the waterbed effect is between 0 and 50%, i.e., the mobile operator will seek to recover up to (but not more than) 50% of its reduced termination revenues through its retail charges.

A lot rides on these findings. Even small changes in each of these areas can produce significant differences in outcome.

Assuming a waterbed effect of 50%, the Commission's cost-benefit model (when populated with its own assumptions on all other parameters) shows a net benefit arising from FTM MTAS regulation of \$51 million over 5 years.¹ This amounts to about \$2.60 for each New Zealander each year – not quite enough to buy a Big Mac at most McDonalds restaurants.

In our view, and as we have demonstrated in our submissions, all of these key findings are subject to question when the facts are considered. We conclude:

- the Commission's benchmark estimates of the cost of providing FTM termination are not sufficiently robust or reliable;
- the Commission's key findings exaggerate the benefits of regulation and diminish the costs of regulation; and
- the extra Big Mac for each New Zealander that 'might' be generated by regulation is not sufficient to warrant urgent action to over-turn the MTR Deeds.

¹ Nb. this estimate adjusts for the error found by Covec in relation to the Commission's modelling of the waterbed effect. In this regard, Covec found that "[t]he Commission fails to allow for elasticity of mobile subscription demand when calculating the increase in retail mobile prices that will occur under the waterbed effect. The result is that the increase in mobile prices is under-estimated and the results produced by the waterbed model do not accord with the Commission's own assumptions. Correcting this error alone eliminates about half of the Commission's estimate of the net consumer benefits of regulation. See: Covec, MTAS Regulation Quantitative Analysis, 27 July 2009, page 4.

The Commission’s cost benchmark is not sufficiently robust or reliable

Given the hundreds of millions of dollars of revenue that rests on its assessment of the cost of providing mobile termination, we believe the Commission should go to considerable lengths to ensure it has developed an estimate of providing the MTAS in New Zealand that is reasonable, accurate and robust.

Some may take the view that robust benchmarking analysis is not required in a Schedule 3 investigation, because we are only at the threshold stage of deciding whether a service should be designated. However, the Commission is making decisions on regulatory prices now, as this process involves a decision as to whether to accept undertakings provided by parties and/or overturn existing price control arrangements. This decision is, in large part, driven by the benchmarking exercise. We are not saying that the Commission must do more than would be required in applying the IPP, but we do not believe the Commission should do less.

At the outset, Vodafone is greatly concerned that the Commission has not sought to use any New Zealand data to estimate the cost of providing mobile termination in this country.

Instead, it simply looks at a small sample of countries that have constructed a forward-looking econometric cost model overseas, and benchmarks against them without conducting any serious examination of whether the countries in question have characteristics that drive MTAS cost (such as population density; geographic terrain etc) that are similar to those that exist in New Zealand. Further, it doesn’t seek to make any adjustment to overseas cost estimates to take account of those factors that are likely to be different in New Zealand. Instead, it simply:

1. Converts the overseas cost estimates into NZ currency using ten-year average exchange rates; and
2. Then ranks the estimates from lowest cost to highest cost and simply picks the middle number.

The middle estimate from this small sample is Israel at 7.16 (or 7.2) cpm.

Country	Cost estimate
France	4.83
Malaysia	5.23
Australia	6.54
Sweden	6.96
Israel	7.16
Norway	9.53
Netherlands	10.44
Denmark	11.77
UK	12.52

Picking the “middle card out of the pack” says little about the cost of providing mobile termination in NZ. The country that NZ is essentially benchmarked against (Israel) is vastly different to NZ in a number of ways. Any reasonable person can see that Israel is likely to be an unreliable guide to estimating the cost of providing the service in New Zealand.

Importantly, overseas cost estimates range from 4.83cpm in France to 12.52cpm in the UK. The wide range suggests there is a lot of variation in the cost of providing mobile termination in different countries – choosing the middle country seems an entirely random way of estimating costs in a particular jurisdiction. It also shows how imprecise the technique can be. For instance, if the UK regulator (Ofcom) used the Commission’s method to set voice termination rates, it would have set a rate for voice termination (at around 7.1cpm) that was only a little greater than half what its cost model estimates that cost to be in the UK (i.e. 12.52cpm).

Unless the Commission does more work to improve the accuracy of its cost benchmarking technique, it is at serious risk of mis-estimating the cost of providing mobile termination in New Zealand. Under-estimation in particular will impact on mobile operators, where the dynamic impacts of below cost estimation will be seriously detrimental.

Eight of the nine regulators against whom the Commission benchmarks set prices greater than cost

Of equal concern for Vodafone, the Commission has chosen to benchmark against raw cost estimates from overseas cost models rather than the price set by regulators in the relevant jurisdictions that have constructed the cost model. The extent to which overseas regulators set prices above their raw cost estimates is shown below.

There are usually two reasons for regulators to choose prices that differ from assessed costs.

The first reason is based on recognition that large swings in MTAS rates have detrimental effects on operators and consumers.

Country	Cost estimate	Regulated price ²	Per cent mark-up
France	4.83	13.05	170%
Malaysia	5.23	5.23	0%
Australia	6.54	10.14	55%
Sweden	6.96	8.14	17%
Israel	7.16	9.1	27%
Norway	9.53	11.91	25%
Netherlands	10.44	18.09	73%
Denmark	11.77	12.86	9%
UK	12.52	13.35	7%

Noting these concerns from regulators in the European Union, the United Kingdom, France, The Netherlands, Spain, Hungary and Australia, Analysys Mason say that:

² Prices sourced from Covec, *Benchmarking Mobile Termination Rates*, 6 May 2009. P.25, Table 7.

“...[the Commission] should implement a gradual reduction of MTRs over time, in order to avoid any sudden distortional effects on the market, ultimately to the detriment of both operators and consumers.”

The second reason is some regulators have insufficient faith in the cost modelling exercise to adopt it as the MTAS rate. The ACCC has recently recognised that its own cost model estimate is lower than what is achievable in the real world:

“...the ACCC is of the view that practical realities experienced by a hypothetical new entrant rolling out a new network warrant a conservative approach to setting an indicative price for supplying the MTAS. As such, the ACCC considers that the WIK model provides an estimate of the TSLRIC+ somewhat lower than that achievable in reality.”

Despite this clear note of caution, and the fact that the ACCC settled on a regulated rate 1.5 times the cost estimate, the Commission has chosen to benchmark against the less than reliable cost amount. We cannot see how the Commission can include a cost amount when the regulator itself has insufficient faith to adopt it as the MTAS rate.

If nothing else, the Commission must adjust the figure it uses for Australia to reflect the ACCC’s concerns about the reliability of results from its own model. The appropriate benchmark rate for Australia should be 10.14 cpm rather than the 6.54 cpm used in the Draft Report.

We submit that benchmarking against rates overseas regulators could have chosen, but decided not to use, cannot be the right approach. It is unusual, and unprecedented when compared to the Initial Pricing Principles set out in the regulated services set out in Schedule 1 of the Act which require benchmarking against prices, not costs. It is also inconsistent with the Initial Pricing Principle proposed by the Commission itself for voice MTAS in its Draft Report.

The Commission mis-applies its own benchmarking technique

Even if the Commission’s benchmarking technique were to be appropriate, evidence provided by Analysys Mason and Covec shows that the Commission has mis-applied its own technique. In particular:

- Analysys Mason advises that the model it constructed for the French regulator ARCEP is not a forward-looking cost model as prescribed by the Commission’s technique. Instead it is an historic cost model, and Analysys Mason advise it should be excluded from the Commission’s benchmarking analysis for this reason;
- both Analysys Mason and Covec draw attention to a recent forward-looking cost model developed in Hungary that meets the requirements specified by the Commission for inclusion in its benchmarking analysis. The Hungarian regulator has estimated a TSLRIC of 11.04cpm using its own cost model; and

- Covec advises that Greece has also recently completed a cost model that meets the Commission's requirements for inclusion in its benchmarking set. The Greek regulator has estimated a cost of 10.28 cpm using its model.

Summary on cost benchmarking

Analysys Mason, the experts that have constructed seven of the nine cost models relied on by the Commission in its benchmarking exercise, had this to say about the Commission's analysis:

"The Commission's benchmark analysis of MTAS costs is simplistic and produces a result that risks being inaccurate: it is based on a limited sample of benchmarked MTAS costs, characterised by a large variance and, without any adjustments to take into account the limited comparability of the countries included in the benchmark. Further, the erroneous exclusion of relevant benchmark data for Hungary and the inclusion of France (with a different costing methodology compared to the one recommended by the Commission) has a significant impact on the result."³

"...we believe the approach taken by the Commission to estimate the MTAS cost for New Zealand is flawed."

These are powerful criticisms. We don't believe they can be ignored. Analysys Mason also recommends:

"...using more prudent approaches, such as the "top of the range" or the 75th percentile"

Overall, we believe the Commission should benchmark against the 75th percentile of prices set by regulators overseas rather than the median of raw cost numbers. If it does this, our submissions show this would give rise to a benchmark estimate of **14.3cpm**.

³ Analysys Mason, Assessment of the position of the Commerce Commission of New Zealand in determining MTAS prices, 27 July 2009, p.4

Country	Cost estimate (NZD cpm)	Regulated MTR (NZD cpm)
Australia	10.13	10.13
Austria	n/a	10.76
Denmark	11.77	12.83
Greece	10.28	16.33
Hungary	11.04	15.68
Israel	7.16	9.09
Malaysia	5.23	5.23
Netherlands	10.44	18.01
Norway	9.53	11.93
Spain	n/a	13.84
Sweden	6.96	8.12
UK	12.52	13.36
Median	10.21	12.38
75th Percentile	10.89	14.30

Alternatively, if the Commission is to continue to benchmark against raw cost numbers, it simply must show more caution when using these estimates to recommend over-turning the MTR Deeds and rejecting undertakings put forward by Vodafone and Telecom. In this regard, it should take heed of Analysys Mason’s advice to use the 75th percentile of these estimates or the “top of the range”. This was certainly the approach taken by the ACCC in Australia when it relied on benchmarking before constructing its own Australia-specific cost model. Under this approach, the resulting benchmark estimate would range between 10.89cpm and 12.52cpm.

In any case, even if the Commission sticks with its existing costing methodology, it must correct its analysis to exclude France from its benchmarking analysis, and include Hungary and Greece. Even at the median of the improved data set, the rate would be **10.21cpm**.

The Commission must correct its assumptions in its cost benefit modelling

The second fundamental lynchpin of the Commission’s draft view that FTM termination should be regulated is that its modelling suggests reductions in FTM termination rates will generate gains for fixed-line consumers that outweigh the detriments for mobile consumers.

At the outset, it is important to note we think the Commission is right to have constructed a cost-benefit model for FTM termination. It is also right to find that the net benefit for consumers depends on the extent to which gains for fixed consumers outweigh losses for mobile consumers.

The model reveals an important truth. Dropping termination rates *per se* does not generate gains in consumer welfare. While doing so may generate allocative efficiency gains if prices are above cost, it

will only generate gains in consumer welfare if the gains for fixed-line consumers outweigh the losses for mobile consumers. In simple terms, reducing FTM termination rates generates a transfer of wealth from mobile operators to fixed operators. Whether consumers as a whole will be better or worse off depends on the extent to which fixed operators would use more of this wealth to compete for fixed-line consumers than the mobile operators would use it to compete for mobile consumers. If the fixed-line market is less competitive than the mobile market, then one can expect mobile operators would use this revenue to compete harder to offer lower retail prices for mobile consumers than fixed operators will use it to compete for fixed-line customers through lower FTM and other retail prices.

We believe evidence of price movements in the retail mobile market in the later parts of this statement demonstrate mobile operators are competing hard to provide greater value to consumers. It is not obvious that the fixed side of the market is operating to pass-through reductions in costs to their consumers.

The Commission’s cost benefit model attempts to capture these effects:

- net consumer effects are driven by the relative size of the FTM pass-through and waterbed effects. The lesser the FTM pass-through, and the greater the waterbed effect, the lesser would be the expected net gain (and the greater the possibility of a net detriment) from reducing FTM termination rates; and
- allocative efficiency gains are captured by the closer alignment of prices in the model with estimated costs.

Whether consumers gain on balance, and whether allocative efficiency is improved, depends on the assumptions made for key parameters in the model. We have submitted extensively on the assumptions made by the Commission in the Draft Report. We do not intend to repeat these here. For the purposes of assisting the Commission to better analyse this matter, a comparison of the Commission’s key views on various parameters and our evidence in response is summarised below.

Commission view	Vodafone evidence
Cost is 7.2cpm based on cost benchmarking	An appropriate cost benchmark lies between 10.21 and 14.3cpm, based on evidence provided by Analysys Mason and Covec
Cost is expected to decrease at 10 per cent per annum (based on the cost path estimated by the Swedish regulator)	The Commission should benchmark against cost paths where they are available from the other models against which the Commission conducts its benchmarking. In this regard, Covec finds that 5 of the 9 countries benchmarked by the Commission set out cost paths, with a median decrease of 4.7 per cent per annum
FTM pass-through will be 85 per cent immediately	<ul style="list-style-type: none"> • Between 2006 and 2008, Orcon, CallPlus,

<p>under regulation in 2011, and rise to 100 per cent by 2015.</p>	<p>WorldxChange and Woosh - some of the loudest voices to be heard in this debate – only passed through approximately 30% of the reductions they received in FTM termination rates. This is particularly surprising when Telecom, the major fixed operator, for much of that time passed through 100%;</p> <ul style="list-style-type: none"> • Between 2004 and 2009, Telstra in Australia passed through less than 17% of the reductions they received in FTM termination rates, and they are now starting to raise FTM prices; • In the United Kingdom, Ofcom has observed pass-through rates by fixed operators of 64%; • In Europe, pass-through has been estimated by the EC to be around 20%. <p>Further, Covec estimates that pass-through has been only around 41 per cent in the past, rather than 75 per cent as the Commission suggests.</p> <p>We recommend the Commission use a FTM pass-through assumption of 40 per cent in its cost benefit model.</p>
<p>Mobile operators will absorb at least 50 per cent of lost FTM termination revenues within their business. Hence, it assumes a waterbed effect of no more than 50 per cent.</p>	<p>Based on material provided by Covec, we estimate the level of the waterbed effect to be at least 75 per cent. This is supported by recent empirical studies by Genakos and Valetti and by Veronese and Pesendorfer.</p>
<p>There should be no glide path</p>	<p>In order to manage the detrimental effects of large and unanticipated reductions in FTM termination rates on retail mobile consumers (especially low-spend pre-pay customers), the Commission must adopt a glide path of at least three years.</p>
<p>Net consumer gain of regulation compared to our most recent undertakings: \$56 million⁴</p>	<p>Net consumer loss of regulation compared to our most recent undertakings: between \$47.8 and \$50.5 million if our preferred assumptions are applied.</p>

Of these assumptions, those made in relation to the extent of FTM pass-through are most troubling for Vodafone.

Here are the facts:

- While termination rates have fallen from 50cpm in 1998 to 15cpm in 2009, fixed operators increased their margins on FTM calls from 6cpm to 13.96cpm – in other words, this contribution

⁴ See footnote 1

margin, or retention by fixed operators, has **increased** over this period **from around 10% to around 50%**.

- Under the Commission’s optimistic projections for pass through under regulation, this retention by fixed operators will get even worse, **increasing to over 80% by 2015**.

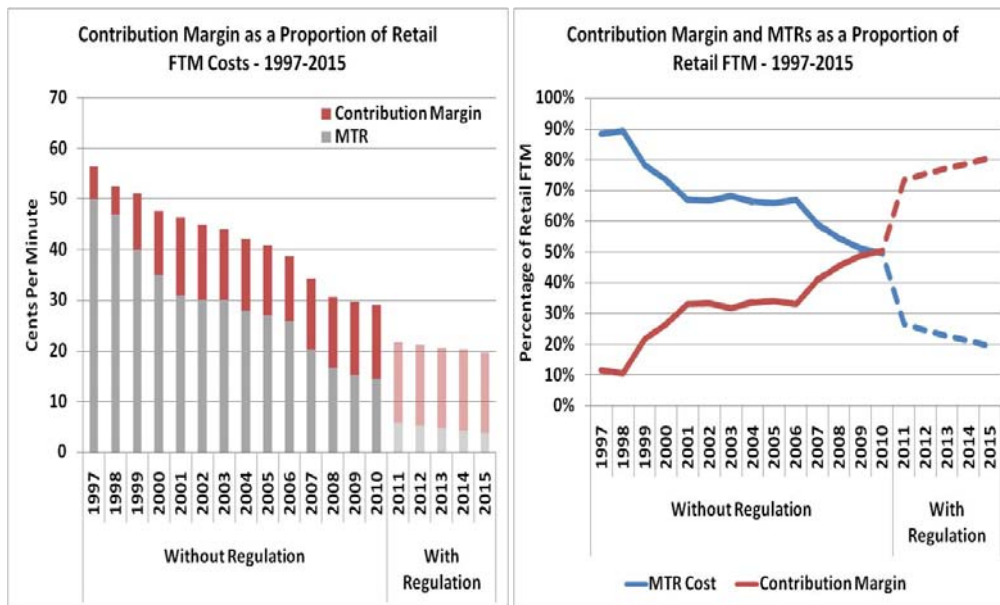


Figure 1– Comparison of falling FTM mobile termination rates over time with growing fixed-line operator margins

There’s an English phrase to describe this: “trousering”. These figures tell us that the fixed operators are major beneficiaries of MTAS rate reductions. Do we really think that if we throw more MTAS rate reductions at them they will change their approach and start passing them through to consumers?

The ACCC, in 2004, had equivalent levels of optimism as the Commission about pass-through levels. This confidence was beginning to evaporate recently, however, when it said⁵:

“...the ACCC is disappointed it appears there has been no significant reduction in [Australian] FTM prices has emerged (sic) despite earlier expectations...Indeed, the Commission has observed an increase in Telstra’s residential FTM retail prices since 2007.

⁵ ACCC, Draft MTAS Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011, November 2008, pps. 18-19

...

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

We say the Commission’s view of what the fixed operators will do with their MTAS savings is hopelessly optimistic in light of actual evidence. Even when the market leader was forced to pass-through 100% of its MTAS cost savings, the other New Zealand fixed operators were parsimonious. It will hardly help the situation when Telecom is no longer required to pass-through 100% of its MTAS savings, which will be the case if Telecom’s MTR Deed falls away following regulation.

We have referred to the sensitivity of benchmark rates to produce significantly different outcomes. This is also the case with the Commission’s assumed pass-through rates. If the Commission had chosen the same level of pass-through as the United Kingdom at 64%, which is a high level of pass-through as compared to other countries, the Commission’s model would have shown consumers would be better off under Vodafone’s and Telecom’s initial undertakings than under the FTM MTAS regulation proposed by the Commission in its Draft Report.

Summary on FTM

Given the existence of the MTR Deeds, significant detrimental consequences will follow designation. The Commission must demonstrate a greater degree of care and rigour with its analysis in this investigation as compared to a typical Schedule 3 investigation. There are major concerns around cost benchmarking and the parameters used in the cost-benefit model. These assumptions underpin the Commission’s conclusions. When more appropriate assumptions are made, there is no reliable evidence to suggest that FTM termination rates should be designated in a way that over-turns the existing form of quasi regulation contained in the MTR Deeds.

MTM VOICE TERMINATION

Perhaps not since local loop unbundling was considered for regulation in 2003 has there been such public attention to a telecommunications regulatory issue as there has been to the MTAS investigation. This sort of public attention is in some ways not surprising; yet when one looks more closely at the facts, unjustified. It is not surprising because, as we have indicated in our submissions, there was clear room for improvement in the mobile market back in 2004. It is unjustified, however, as the market has changed considerably since then. We believe public perceptions about the competitiveness of the mobile market are lagging well behind the events that are now happening in the market. We believe these perceptions are also being fuelled by an exhaustive campaign by a particular new entrant that is

trying to convince consumers they are paying too much in order to encourage them to switch networks now that they have entered the market.

While snappy PR campaigns represent good marketing, the Commission must rise above assertion and look closely at the facts at issue in this investigation. Good regulatory practice focuses on logic and evidence, and is not seduced by assertion that doesn't match underlying facts.

2degrees has taken two approaches to convincing the public and the Commission that there is a need to intervene in the mobile market and reduce MTM voice termination rates to zero. At a public level, it has argued that voice termination rates in New Zealand are some of the highest in the world; and that retail prices are some of the worst. It suggests these two are linked, and that the Commission should drop MTM termination rates in order to stimulate better pricing outcomes for consumers. At a theoretical level, it argues that on-net price discounts available to New Zealand consumers from the existing operators are a barrier to its ability to compete in the retail mobile market. It claims this will lead to traffic flow imbalances between its network and that of existing mobile operators that will generate a substantial net cost to its business. It claims reducing MTM termination rates will ease this barrier to its ability to enter and effectively compete in the market.

The facts do not support either the public perception argument or the theoretical assertion points made by 2degrees. Our submissions provide detailed evidence that demonstrate our position. We do not intend to repeat all these submissions in our written opening statement. However, we do believe it is important to draw attention to the following key pieces of evidence:

- MTM voice termination rates are not presently high by world standards. Indeed, the rates available to 2degrees under its interconnection agreement with us (and which are now available to any other new mobile entrant) are some of the lowest in the world;
- The retail mobile market is, despite popular perceptions, beginning to demonstrate signs that it is becoming one of the more competitive markets in the world. New Zealand is now at or around the top half of OECD benchmarks, and our average revenue per voice call and SMS are some of the lowest in the Vodafone group of operating companies;
- There is no evidence of any link between lower termination rates and better retail prices for consumers. Indeed, the US, with zero termination rates, is consistently one of the worst performing countries in OECD benchmarking;
- Our on-net pricing offers for voice are not extensive, and mostly limited to small closed user group plans such as BestMate and Family. There is no widespread open user group on-net voice offering such as TXT2000 for voice, and the majority of our pre-pay customers do not subscribe to an on-net bundled offering;

- Slashing MTM termination rates will change the profitability of different types of consumers at existing retail prices. In particular, low-spend pre-pay customers (who tend to receive more calls than they make) will be particularly disadvantaged by rapid overnight reductions in MTM voice termination rates;
- Given that voice traffic flows tend to balance out over time between interconnecting operators, reductions in MTM voice termination will be likely to have a minimal impact on net termination payments (and hence the profitability) of interconnecting mobile operators; and
- Even if traffic flows do for some reason slip out of balance, the extent of [] **VNZAP** contained in our interconnection deal with 2degrees provides ample protection to ensure new entrants should expect to be [] **VNZAP** of termination revenue rather than [] **VNZAP** as 2degrees suggest.

When one looks closely at the facts existing in mobile markets in New Zealand rather than the assertions of one particular party, it is clear that regulation to rapidly reduce MTM voice termination rates will do little to promote competition overall. It may lead to improved market outcomes for high-spend customers who become more attractive because they make more calls than they receive. Conversely, however, it will lead to poorer market outcomes for low-spend pre-pay consumers who will become less attractive once termination rates fall because they receive more calls than they make.

Voice termination rates in New Zealand are not amongst the highest in the world

For MTAS termination on the Vodafone network, 2degrees pays [] **VNZAP** and everyone else pays 15cpm, charged on a minute plus second basis. This equates to approximately [] **VNZAP** and 7.55 euro cpm for everyone else.

The European Commission has recently noted that⁶:

“Mobile termination rates varied widely in the EU in 2008 from 2.00 euro cents per minute (in Cyprus) to 15 euro cents per minute (in Bulgaria). Mobile termination rates (on average 8.55 euro cents per minute)...”

We have already set out our view that a more appropriate benchmark MTAS rate in the New Zealand context would be 14.3 cpm, which lies below the current average mobile termination rate in Europe.

Clearly, however, voice termination rates in New Zealand – and especially those for a new entrant to the market seeking to interconnect with our network – are some of the lowest in the world.

⁶ See Telecoms: Commission acts on termination rates to boost competition, at www.europe.xorte.com/0,3,Telecoms-EC-Acts-on-Termination-Rates-to-Boost-Competition,9614.html

The retail mobile market is far more competitive than many think

Contrary to the suggestions of some, the retail mobile market in New Zealand is far more competitive than many think. Amongst other things, we have observed in our submissions that:

- In the period between 2004 - 2005 and 2008 - 2009, Vodafone's retail price per minute for voice calls has **reduced on average 18% per annum** and retail price per SMS has **reduced on average 29% per annum** – at the same time as the consumer price index has risen by 15.51% over this entire period;
- During the same period, voice usage per customer per annum grew by 74 per cent;
- Our voice revenues per minute are lower than those in our sister operating companies in [] VNZCOI;
- Against OECD benchmarking, New Zealand reached the top half in all three user categories in August 2007 – and these high-ranking EasyPlans have recently been further improved;
- Competitive forces have increased recently with the launch of Telecom's 3G network and 2degrees' network;
- Customers can now more easily switch between network operators due to the compatibility of the three network technologies, the absence of SIM-locking (which exists in many other jurisdictions, such as Australia, the UK and Ireland) and the advent of mobile number portability; and
- New Zealand is the only operating company in the Vodafone group with 3G network coverage out to as much as 97 per cent of the population.

All of these factors suggest the retail mobile market in New Zealand is far more competitive than some would have you believe. We are certainly now not one of the least competitive markets in the world.

There is no linkage between MTAS rates and retail mobile charges

Vodafone has consistently shown in submissions that there is no apparent link between lower termination rates and improved OECD rankings. Some of the best performing OECD performers (such as Denmark and the Netherlands) have consistently had higher voice termination rates than those in New Zealand; while some of the worst OECD performers (such as the US, Korea and Spain) have had termination rates below those here in New Zealand.

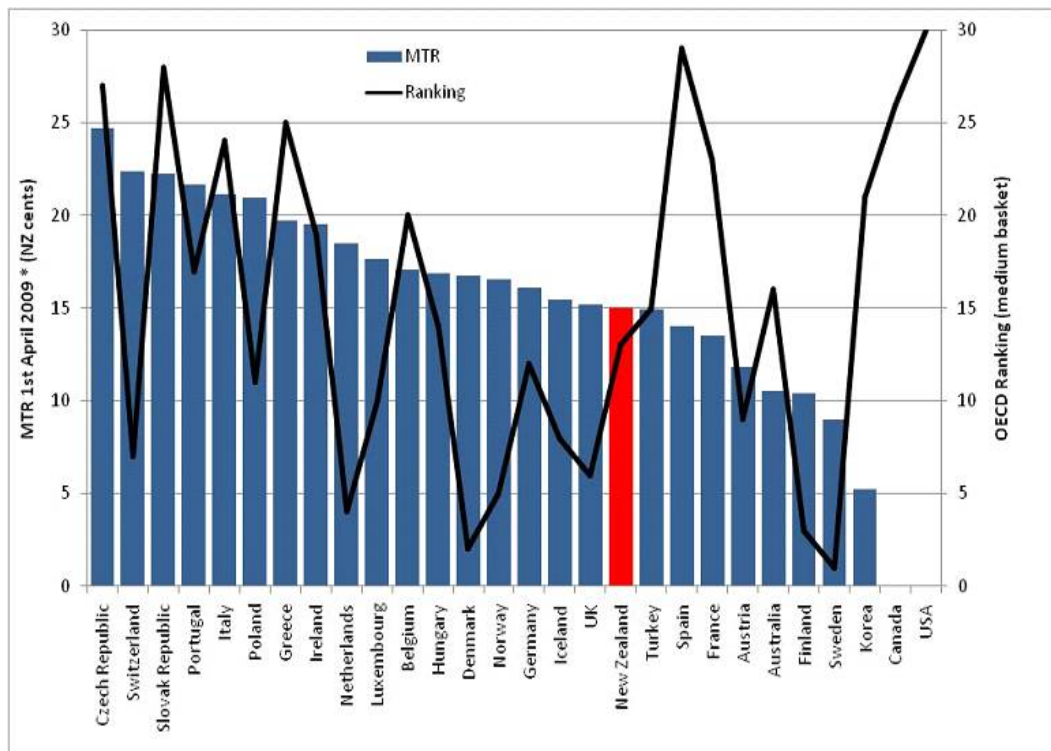


Figure 2 – comparison of OECD benchmarking for the medium user group (February 2009) and mobile termination rates⁷ in these countries

This is now further supported by evidence coming out of Europe which shows no empirical linkage between lower mobile termination rates and better retail prices for consumers.

⁷ Source of mobile termination rates: i. European MTR rates were sourced from ERG (09) 23 MTR Snapshot – 1 January 2009 from http://erg.ec.europa.eu/documents/docs/index_en.htm. ii. Australian MTR figure obtained from MTAS pricing determination 2009-2011 <http://www.accc.gov.au/content/index.phtml/itemId/848783>. iii. Korean MTR rate is from The Mobile Termination Issues Paper August 2008, The Commerce Commission iv. All rates were converted using ten year exchange rates for the period 15-01-1999 to 14-01-2009, and were obtained from oanda.com

Our on-net pricing offers for voice are not as extensive as you may think

The more theoretical argument put forward to support a conclusion that high MTAS rates impact on mobile competition is the existence of differential on-net pricing. For a new entrant facing one or more incumbents that have differential on-net pricing, a higher proportion of that new entrant's outgoing traffic will be off-net as compared to the incumbents.

The argument follows that a new entrant will therefore have greater exposure to high MTAS rates (it will be a higher cost to its business), which in turn will mean that it is more difficult for the new entrant to compete with the incumbents.

In order for this argument to hold, however, a new entrant must be unable to compete with on-net price discounting without having to introduce low any-net price offers.

In the first instance, it is important to note that on-net price discounting occurs throughout the world. As we have shown in our submissions, it has often been introduced by new entrants into mobile markets (as 2degrees appears to have done here in New Zealand with its half price voice rates under its "magic top-up plan"). It is also prevalent in those countries that operate under a BAK regime, as set out in our cross submission on the Commission's Draft Report.

In New Zealand, the extent of on-net price discounting for voice is mainly limited to closed user group offerings such as BestMate and Family that are targeted to groups of 2 or 4 consumers. Importantly, a large proportion of our customers do not subscribe to an on-net pricing bundle. Of our subscribers :

- less than [] VNZCOI pre-pay customers subscribe to BestMate;
- there are approximately only [] VNZCOI "Family" hubs; and
- over [] VNZCOI active pre-pay customers do not subscribe to an on-net bundling offer.

It is undoubtedly the case that some of Vodafone's on-net plans have enjoyed phenomenal success in the market. Customers are embracing the savings that BestMates and Family provide, and that is driving an increasing proportion of traffic on-net. However, a new entrant will be able to compete with these plans. Both are examples of closed user groups, but those groups are small. Small groups, like a family unit or a small business, can be co-ordinated and installed on another network. If this is the case, then there's nothing holding back a new entrant from competing for these groups.

Reductions in MTM voice termination rates will influence the way mobile operators compete for different types of consumers

MTAS rates for mobile operators are a cost, but they are also a source of revenue.

If traffic is in balance between two mobile operators, then whether MTAS rates are high or low will make little difference, as payments will net out.

If traffic is not in balance, it is most likely because of the relative mix of customers on the two mobile networks (rather than, for example, the relative size of the networks). A network with a mix of predominantly high-spending on-account customers will tend to have net outgoing traffic volumes, as compared to a network with a mix of predominantly lower-spending pre-pay customers.

To the extent that reductions in MTM MTAS rates will promote competition, it will be for those high-spending on-account customers. These customers will be more attractive to mobile operators than they are today.

Conversely, lower-spending pre-pay customers will be less attractive to mobile operators than they are today. These customers will be more difficult to serve profitably if MTAS rates fall, which may result in price rises for these customers.

Accordingly, whether lowering MTAS will promote competition in the mobile market is far from certain. The fact that 2degrees has entered the market, with significant investment, without knowing whether MTAS rates will be regulated (or at what rate), suggests that existing MTAS rates are not a barrier to entry or expansion.

Slashing MTM voice termination rates will hurt low-spend pre-pay consumers

There are a large number of low-spending pre-pay customers on the Vodafone network. Nearly [] VNZCOI of Vodafone's customers spend less than \$1 per month. Another [] VNZCOI of Vodafone's customers spend between \$1 and \$10 per month.

Although the direct returns for Vodafone in serving these customers are very low, it still makes commercial sense for Vodafone to continue to serve these customers because of the interconnection revenue that Vodafone makes for incoming calls to these customers. The traffic patterns of low-spending pre-pay customers show that they receive more calls than they make.

Sharply lower MTAS rates will reduce the interconnection revenue available to Vodafone from serving these customers. Doing nothing will not be an option. We will have to consider increasing retail charges or introducing other charges for these customers, to compensate for the loss in interconnection revenue. If [] VNZCOI customers spend less than \$1 per month, how many of them will remain if they are required to pay more?

We could look at the USA for an indication of the answer to this question. In that country, with zero MTAS rates, the penetration rate is approximately 87% as compared to over 100% in New Zealand. One reason for the difference in penetration rates is that pre-pay customers often face a minimum monthly

charge. In the United States, AT&T charges US\$25 (NZ\$38.06⁸) top ups for pre-pay consumers to be used within 30 days.

Impact of bill and keep

This impact is exacerbated by bill and keep (BAK), a pricing methodology proposed by 2degrees that has a number of nasty side effects for consumers, such as the advent of having to pay to receive calls on your mobile phone. The consequences can also be particularly severe for low-spend pre-pay consumers.

Earlier this year, the UK Competition Commission categorically rejected arguments for BAK⁹:

“...under [BAK] MNOs would no longer receive revenue from the caller’s MNO to cover the cost of terminating M2M calls. This could have a number of detrimental consequences:

(a) MNOs may become less willing to serve customers who receive more calls than they make because a [calling party pays] system, combined with [BAK] would make them less valuable. The impact on the pre-pay sector could be significant.

(b) ...

(c) Alternatively, MNOs may increase the prices of other services or subscription fees. The former is likely to depress the consumption of such services below efficient levels, and the latter is likely to reduce demand for subscription, again with the pre-pay sector likely to be particularly affected.”

Traffic flows should be balanced between large and small operators

A key assumption that underlies the arguments for BAK is that the existence of differential on-net pricing will mean that the incumbent’s mobile customers will be disinclined to call the new entrant’s customers. This will result in asymmetric traffic flows between the two networks, which will further disadvantage the new entrant.

We doubt this assumption is correct. Vodafone has had differential on-net pricing for a number of years; so has Telecom. However, traffic has been largely in balance over those years.

⁸ At 10 year exchange rate of 1.5225

⁹ UK Competition Commission, Determination between Ofcom and Hutchison 3G UK Limited and Ofcom and British Telecommunications plc, under section 193 of the Telecommunications Act in regard to Mobile Phone Wholesale Voice Termination charges, dated 16 January 2009, at para [14.79]

But even if we can expect [] **VNZAP** traffic flows between Vodafone and 2degrees (or any other new entrant), we have said that we will offer the 2degrees interconnect deal to any other new mobile network entrant if regulation doesn't eventuate. [

] **VNZAP**

A retail pricing issue

In any case, even if competition is potentially damaged by differential on-net rates, the central concern is a retail pricing issue. The Commerce Act is the appropriate legislation to deal with retail pricing behaviour, not the Telecommunications Act.

Lack of a cost-benefit model

When all of these factors are taken into account, we find it inexplicable that the Commission has failed to produce a cost-benefit model for MTM MTAS, in the same way as it did for FTM MTAS. The counterfactual of the 2degrees deal, and its availability to other new mobile operator entrants, makes it particularly hard to fathom that competition will be promoted by regulating MTM MTAS. We expect this to be clearly revealed in a cost-benefit model.

SMS TERMINATION

The investigation into SMS termination is particularly perplexing in the sense that the situation here in New Zealand does not seem to be one where there are poor retail outcomes for consumers that need remedying by regulation. At the retail level, there is no evidence to suggest that SMS prices are high, or that usage levels are low. Vodafone's average revenue per SMS was [] **VNZRI** cpt in 2008-09, and fell at a compound average growth rate (CAGR) of 29 per cent between 2004-05 and 2008-09. At the same time, growth in usage has been strong with a CAGR of 37 per cent over the same period.

[

] VNZRI

*Figure 3 – average revenue per outgoing SMS and usage for the period
2004-05 to 2008-09*

By world standards, New Zealand's retail SMS outcomes are demonstrably some of the best in the world. Evidence provided during this investigation shows that our average revenue per SMS is lower (and our usage levels per customer higher) than that in any of our operating companies in the [] VNZCOI.

[

] VNZCOI

Figure 4 – revenue per outgoing SMS in New Zealand, [
] VNZCOI (New Zealand in red)

[

] VNZCOI

Figure 5 – SMS usage per customer in New Zealand, [
] VNZCOI (New Zealand in red)

It is hard to see, therefore, that retail consumers are spending too much for SMS services and consuming too little.

The concern in this investigation instead revolves around *how* consumers are enjoying these low prices and high usage levels. The concern is that consumers are mostly enjoying the benefits of increased usage and lower prices through large discounts for on-net SMS services. While low on-net SMS prices are clearly providing benefits for consumers, it is feared the combination of on-net discounts and existing SMS termination rates will prevent new entrants from entering the market and competing on their merits.

Throughout this investigation, there have been strong opposing conceptual views around SMS termination. On the one hand, we have argued that the nature of SMS communications – where a communications event (or conversation) occurs by consumers taking turns sending and receiving SMS from each other – means that traffic between interconnecting networks will naturally tend to balance out. Intuitively, this is demonstrated by a typical SMS communication event/conversation between consumers on different networks:

2degrees customer (2D): *What are you doing tonight?*

Vodafone customer (V): *Heading to the pub. Want to join us?*

2D: *Sounds good. Where and when?*

V: *The Botanical at 8. See you there.*

Such a communications event involves 4 SMS being sent, but no net interconnection payment being made between the interconnecting operators (assuming SMS termination rates are set symmetrically between mobile operators). This is in contrast to voice communications where the same conversation above would all occur through one phone call. Further, one party would make the call and, under a calling party pays regime, pay for it all. And a net interconnection payment would be made between the network whose customer makes the call and the network whose customer receives it.

The different nature of the retail voice and SMS communications services makes voice and SMS termination conceptually different, and must be analysed as such. Importantly, the nature of SMS communications almost guarantees that SMS traffic flows between consumers will be largely in balance. We have previously provided evidence that shows this has been the case in our interactions with Telecom over the years, where every off-net SMS our consumers' send tends to attract [] VNZRI of an SMS on average in return.

This natural reciprocity has implications that we do not believe have been properly assessed by the Commission. Most importantly, it means that the level of SMS termination rates *per se* are never likely to be a barrier to entry. Reducing SMS termination rates will likely have an immaterial impact on the profitability of a new entrant, because net payments between mobile operators – large and small – are likely to be low because of the low level of out of balance traffic. [

] VNZRI This response effect associated with off-net SMS helps explain why mobile operators are able to set any-net SMS rates that appear to be below SMS termination rates.

While we have provided evidence around SMS traffic flows in New Zealand, our rivals have relied on a conceptual argument to indicate that, if they set low off-net retail SMS rates to match our low on-net rates, then the relative difference in off-net rates on our respective networks will mean their customers will send more off-net SMS to us than they receive from us. Because of this, they say, SMS termination rates are a material factor in their ability to compete, because out of balance traffic levels can be large in these circumstances.

The logic of this argument is as follows. Suppose Vodafone charges an off-net SMS rate of 1cpt (ignoring GST), but charges an SMS termination rate of 6cpt. If a new entrant wants to offer its customers the ability to pay the same low rates we offer consumers to make on-net SMS, the argument runs that the new entrant must set an off-net rate of 1cpt for messages sent to Vodafone consumers. Given the 6cpt termination rate, this implies a loss of 5cpt (i.e. 1cpt retail revenue minus 6cpt interconnection cost) for each off-net text.

We have consistently argued that this form of analysis ignores the revenue the new entrant will experience whenever an SMS is sent back to it. If symmetric SMS termination rates are set, then each return SMS will provide 6cpt in interconnection revenue to the new entrant. Overall, therefore, the new entrant can easily match the 1cpt on-net rate because the profitability of sending an off-net SMS equals (1cpt retail revenue minus 6cpt in interconnection costs plus 6cpt in interconnection revenue when an off-net SMS comes back).

The counter to the argument around balanced traffic flows is that consumers on existing networks won't SMS consumers on a new entrant's network if their off-net SMS rates are set too high. Vodafone understands this argument. If it were true, however, one should expect to see that traffic flows between interconnecting networks would be out of balance when one party offers low on-net SMS rates and the other network operator offers low any-net SMS prices. As history would have it, this can be tested in New Zealand given the different types of bundled offerings that Telecom and Vodafone have launched into the market. In 2004, Telecom launched \$10TXT capped at 500 SMS per month. This enabled consumers to make up to 500 SMS to any network for \$10 per month (or effectively 2cpt if the bundle was used to the full). At the same time, Vodafone offered no SMS bundles – our billing systems did not enable us to do so.

Since 2004, Vodafone has launched a number of different on-net SMS bundles into the market, including:

- Free text weekends in May 2005;

- TXT2000 in July 2006;
- BestMate in November 2006; and
- Family in late 2007.

If the arguments presented around the effects of on-net discounting were to be supported by the evidence, we should expect to see traffic flows between interconnecting networks swing significantly whenever these offers were launched into the market. In Figure 6 below, however, we show the level of out of balance SMS between Telecom and Vodafone since \$10TXT was introduced in late 2003 (12 month rolling averages). This shows that, despite the launch of these various on-net discount offerings in the presence of a strong any-net text offering, traffic flows between our networks have remained largely unchanged.

[

] VNZRI

Figure 6 – Vodafone incoming to outgoing SMS ratio (12 month rolling average)

This is further supported by Figure 7 which shows the remarkable way in which traffic flows between our networks seem to move in sync with each other.

[

] VNZRI

Figure 7 – Vodafone SMS incoming and outgoing

Put simply, the evidence does not support the contention that on-net price discounting for SMS by one network operator, and low any-net SMS prices by another operator, leads to significant traffic flow imbalances between networks.

Intuitively, this shouldn't be surprising if one remembers the unique nature of SMS communication, as discussed above. SMS communication simply won't work as a service if one party keeps sending texts to their family and friends off-net, but never gets communications in return.

The evidence also shows that despite the launch of our excellent on-net offers, our total level of off-net SMS messages has not fallen. Figure 8 shows off-net SMS has grown steadily by over [] VNZRI per cent per annum since 2003. Strong on-net SMS bundles do not stop consumers sending off-net SMSs.

[

] VNZRI

Figure 8 – Off-net SMS

Where there are two conflicting conceptual arguments, we believe the Commission must look closely at the evidence to see what is most likely to be the true story. During this investigation, we have provided evidence to show that net traffic flows over the years between Telecom and Vodafone have been largely invariant to different on-net and off-net pricing offers. We have demonstrated this again above. In

contrast, our rivals have provided no data to support their assertions. They have relied instead on conceptual arguments and stylised examples to show what *might* happen if SMS termination rates remain at current levels.

Where the Commission is faced with sound conceptual intuitive arguments that are supported by facts, and an alternative conceptual argument that is not supported by any evidence, then we believe it must find in favour of the former. Evidence and fact must trump assertion.

It is this understanding of the nature and dynamics of SMS communications that has led almost all regulators in Europe (with the exception of France) and in Australia not to regulate SMS termination rates. We believe the Commission should follow the same approach here in New Zealand.

Finally, even if there were to be some concerns around the combination of on-net price discounting and market SMS termination rates, we would note that:

1. We have provided evidence during this investigation that shows SMS termination rates in New Zealand are some of the lowest of any of our operating companies in the world. In this regard the SMS termination rates agreed to with 2degrees are essentially as low, or lower than, [

] VNZCOI

Figure 9 - SMS Termination Rate comparison with Vodafone European Operating Companies

2. The extent of take-up of our SMS bundled offerings is not as extensive as the Commission may be thinking. Of our entire customer base of 2.5 million, less than [] **VNZCOI** subscribers have a BestMate and there are less than [] **VNZCOI** Family hubs. Both of these are closed user group offerings of only 2 or 4 on-net consumers that can easily be matched by a new entrant. Further, less than [] **VNZCOI** of our customers subscribe to TXT2000 and less than [] **VNZCOI** to TXT600. This means that over [] **VNZCOI** per cent of our customer base does not purchase a bundled SMS offering. Even if it was true that on-net pricing was difficult for a new entrant to compete with, it still has a substantial proportion of our subscriber base available to it to compete for that do not purchase an on-net SMS bundle from us;
3. Any-net SMS bundles are already prevalent in New Zealand, and have been for some time. Telecom launched \$10TXT many years ago, and its XT network now provides any-net deals. We offer 600 any-net texts to our on-account customers for only \$12.95 per month. The Commission seems to think that if SMS termination rates are dropped to very low levels, a new entrant will be able to launch low any-net bundles that will prevent us from taking advantage of on-net price discounting to a larger customer base. The reality, however, is that as discussed above Telecom has been offering this kind of deal since 2004 with its \$10TXT offering. We haven't stopped providing on-net discounts just because this offer has been put into the market by Telecom in the past. Why should the Commission think we will do so in the future just because 2degrees starts offering the same sort of plan? We simply don't see what will change just because SMS termination rates fall; and
4. Perhaps most importantly, any new mobile network entrant can interconnect with us on the same price terms as we have agreed with 2degrees. [

[] **VNZAP**. The evidence provided in this statement shows this kind of traffic imbalance has not occurred in New Zealand in the last six years despite Vodafone and Telecom having different types of SMS bundled offerings in the market. Indeed, if, as our experience shows, each off-net text generates [] **VNZRI** of a text in return, 2degrees should make a [] **VNZAP** cpt every time its customers send an off-net SMS ([] **VNZAP** as a simplistic comparison of retail prices and only SMS termination costs would imply). In contrast, if SMS termination rates are reduced [] **VNZAP** to 1cpt, then this should make an off-net SMS loss-making at an interconnect level if it only generates [] **VNZRI** of an off-net text in reply. A new entrant should expect to be better off with our commercial deal than the Commission's proposed regulatory solution.

Ultimately, reducing SMS termination will have little impact on the profitability of a new entrant due to the limited extent of out of balance traffic between mobile operators. In that sense, regulating SMS termination will have no impact on the state of competition in the retail mobile market.

If traffic flows are balanced, why not just go with low rates (or BAK)?

One question often raised in this debate is if SMS traffic flows are largely in balance, why not just move straight to BAK? [

] VNZAP

More importantly, BAK without limits runs the risk of creating distorted incentives for interconnecting mobile operators. By reducing the price of SMS termination to zero, it means interconnecting mobile operators have no disincentive to send large volumes of SMS traffic to their rivals who will face the cost of carrying this SMS traffic for their customers. Of particular concern in this instance is the risk of SMS spam, which is SMS traffic that does not trigger a natural response.

Spam of any sort imposes a number of costs on consumers of identifying and deleting messages, being distracted from other activities by unwanted messages, and legitimate messages being mistakenly identified as spam. These costs will be magnified for SMS spam, as people tend to be near to their mobile phone most of the time and respond to message alerts quickly. If SMS spam becomes widespread, people will start to disregard new SMS message alerts, making it more difficult to contact people via text messages and reducing the value of the system as a means of communication.

Spam therefore imposes negative externalities on consumers. There is unlikely to be any social benefit from SMS spam, only costs. Even if the actual cost of SMS termination was zero, a termination rate set at a level that would prevent these external costs from being felt by consumers is optimal if it costs less than the cost of spam.

The French regulator ARCEP recognised the costs of SMS spam in its 2005 consultation on SMS termination (p.86):

The Authority acknowledges that if the tariff on an SMS reaches a very low level, close to being free, it would cause a high risk of spamming, i.e. sending of unsolicited messages. Ill-intentioned businesses could take advantage of the low cost of SMS Push to undertake profitable direct marketing campaigns, in violation of the principle that a customer shall not receive such messages without giving specific permission. In particular, it is unclear whether SMS providers are able to check their business partners or clients beforehand so as to prevent such practices.

For this reason, ARCEP set a rate of 3-3.5 euro cpt for SMS spam (or approximately 6.8-7.9 NZ cpt), rather than a price at simple cost based levels.

In its cross-submissions, 2degrees has indicated the risk of this occurring is mitigated by the existence of the Unsolicited Electronic Messages Act. We would note this same legislation applies to email communications. It is clearly not effective in preventing email spam, which currently runs at over 90 per cent of all email communications under current BAK internet arrangements.

Near zero termination charges for SMS make unsolicited SMS more likely. In contrast, higher SMS termination rates can act as an effective barrier to SMS spam because the reciprocity in communication that exists for legitimate SMS is absent for SMS spam. Since SMS spam messages will not usually elicit a reply, they will not be part of a two-way exchange of messages, and therefore will face a higher effective termination rate than non-spam messages.

Overall, there are good reasons for believing the price of SMS termination should lie above estimates of the cost of providing the service. Doing so will:

- not be likely to inhibit competition in the retail mobile market due to the two-way nature of SMS communications, and the probability that sending an off-net text will likely generate a reply text – thereby making the impact of above-cost termination rates on the cash-flows of interconnecting parties negligible; while
- have the effect of discouraging SMS spam.

We believe the Commission should take this factor into account when determining the appropriate price for SMS termination – including in any pricing principle it may develop for a regulated SMS termination service.

Summary on SMS

In summary, Vodafone believes the market for SMS currently works amazingly well. Retail prices – both for on-net and off-net traffic – are in rapid decline, while SMS volumes are growing strongly. New Zealand has some of the lowest SMS prices in the world, and some of the highest usage levels. Substitute services for SMS are emerging that are available on web-enabled phones that will apply even greater competitive pressure on mobile operators in years to come. Further, SMS spam is virtually non-existent here in New Zealand. In this context, the market for SMS services in New Zealand does not appear to be one that needs fixing.

SMS termination rates are not likely to be a barrier to entry for a new entrant. The nature of SMS communication means traffic flows are likely to largely be in balance – this has certainly been the practice in New Zealand in the past between Vodafone and Telecom. Even now, where Vodafone has a range of SMS bundles for pre-pay users that are on-net while Telecom's are off-net, traffic flows

between our networks are largely in balance. Accordingly, net payments between Vodafone and any new entrant are likely to be insignificant.

Reducing the price of SMS termination to the Commission's estimates of the TSLRIC of providing the service is likely to cause more harm than it will cause good:

- It will likely provide prices for new entrants that will make SMS interconnection less profitable for them; and
- It will remove a deterrent to SMS spam.

We believe the market works fine as it is such that there is no need for further intervention in this market.

CONCLUSION

From the commencement of our business in this country, Vodafone has had a strong preference for commercial agreements over regulatory outcomes. Regulatory processes for us epitomise long-term uncertainty. The prolonged process of preliminary assessment, investigation, recommendation to Minister, decision by Minister, determination of terms, and then price reviews can take years, as we have seen. In a fast-moving and competitive industry such as telecommunications, this can be an eternity - business decisions with medium and long-term consequences need to be made every day. When faced with a regulatory process over a service as important as MTAS, an extra risk factor needs to be factored in by operators when they make these decisions. This can be enough to force an operator to delay or cancel plans or investments which they wouldn't have done if they had long-term certainty over MTAS rates.

Therefore, when the opportunity for a commercial agreement presents itself, we have generally gone to considerable lengths to agree terms. This has been demonstrated many times, including interconnection agreement and the national roaming agreements we have entered into with 2degrees.

In this regard, we particularly highlight the MTR Deed that Vodafone entered into, in favour of the Crown. This was entered into to avoid the need for regulation. It was a negotiation; we compromised and as a direct result the Minister declined to accept the Commission's recommendation to regulate.

Disappointedly, many of the commercial deals we have entered into in the past – especially around MTAS services – have not been respected by the Commission:

- The Commission is now looking at recommending over-turning the MTR Deeds less than half-way through their operation; and
- The Commission has changed its view on the appropriate cost benchmark for the MTAS shortly after we agreed voice termination rates with 2degrees that, in total, provided superior terms for

2degrees than the Commission's benchmark cost estimate of the time. In this regard, we agreed to charge 2degrees [] **VNZAP** only one month after the Commission published an indicative MTAS cost benchmark of 10.76cpm in its MTAS Issues Paper report. We further agreed to let 2degrees [] **VNZAP**.

The failure of the Commission to respect commercial deals we enter, or to stand by its published estimates of benchmark costs, has made us particularly wary of offering further commercial agreements to the Commission in the form of undertakings. That said, we still have an over-riding preference for commercial deals over and above direct regulatory outcomes that involve long-drawn out processes to resolve.

Vodafone would be prepared to make revised undertakings for the MTAS services. However, before doing so, we would require a greater show of commitment and certainty from the Commission than has been displayed in recent times. In particular, we want the Commission to finalise its views on key issues, such as:

- The appropriate benchmark costs for the MTAS; and
- The appropriate parameters for key cost-benefit model assumptions such as FTM pass-through; the waterbed effect; and cost decreases over time.

We also wish for the Commission to finalise cost-benefit models for each of the three services in this investigation.

We then want the Commission to give parties a final opportunity to see its views, and consider whether they are prepared to make undertakings that lead to better outcomes for consumers than regulation based on the Commission's own analysis.

We want another opportunity to provide revised undertakings after that point, without fear that the Commission will change its views before making a recommendation to the Minister and shift the goal posts on us again.

In this regard, we have asked the Commission to consider an additional step in the undertakings process that provides a final opportunity to provide final undertakings after the Commission has reached a final view on these key parameters, but before it makes a final recommendation to the Minister.

We are grateful that the Commission has left room for discussion of this issue during the conference, and look forward to discussing that issue.

The ideal outcome for everyone – consumers, access providers and access seekers – is that we can resolve the issue of MTAS rates once for all. The industry has been debating this issue for too long; and

the inability to tie down this issue once for and all is creating great uncertainty for all concerned. This, in turn, is likely to create a dampener on investment incentives and create long-term dynamic detriments for consumers.

We look forward to seeking to find a constructive and final position on this issue that can resolve the issue of appropriate MTAS rates for a considerable period into the future. Then the industry can get on with doing what it should do best – competing with each other to provide high quality services to consumers at affordable prices – without having to divert considerable resources and expertise away from these tasks to engage in endless regulatory debates.