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Submission to the Commerce Commission on the  
8 August 2008 Issues Paper as to Regulation of  
Mobile Termination

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# 1 Executive Summary

- 1.1 This is a submission by Kordia, CallPlus, Orcon, and Woosh. CallPlus is filing a supplementary submission as well.
- 1.2 Optimal regulation of termination rates will be important for competition in mobile and fixed line markets. For example, WiMAX operators can provide additional cellular networks (and therefore additional competition) if the regulatory environment is supportive.
- 1.3 While there is a threshold decision as to whether the Commission will instigate a Schedule 3 investigation to add services to Schedule 1, we welcome the approach in the Issues Paper of identifying particular issues before an investigation commences, even though they are matters for the investigation itself. This is a pragmatic approach and, as the Issues Paper notes, helps access providers to formulate Schedule 3A undertakings.
- 1.4 On that basis, we are clear about the services we submit should be designated. They are fixed-to-mobile (FTM), mobile-to-mobile (MTM) and mobile-to-fixed (MTF) termination services. The design of those services (e.g. as to the pricing model) are matters for the investigation itself. We will provide our initial views on the design, on the basis that we will provide further detail later. In particular, we note that design options (such as possible pricing models) should not be limited in the Commission's decision to investigate.

## **Our primary submissions:**

We support a Schedule 3 investigation into whether to add an MTM termination service as a designated service.

We also seek designation of FTM and MTF termination services.

We explain why it is appropriate to commence an FTM termination service investigation in the year after the Minister accepted the Vodafone and Telecom undertakings.

While the design of these MTM, FTM and MTF termination services is for the investigation itself, we overview our views in this submission. In particular we seek a bill-and-keep pricing model for both MTM and FTM termination. We rely in particular on Ofcom's 28 August 2008 mobile report, the EU's consultation and also 2007/2008 empirical and theoretical studies supporting a move from cost-based termination rates to bill-and-keep.

We expect to seek, as Vodafone successfully sought in its PSTN determination, restrictions on price discrimination by Vodafone and Telecom.

If however, contrary to our submissions, the FTM and the MTM pricing model is to be cost-based, we seek (a) cost-based pricing, based either on marginal cost or carefully implemented Long Run Incremental Cost and (b) asymmetric rates for new entrants, smaller networks, and carriers facing costs beyond their control. We expect to pay

around two to four cpm to terminate (and to be paid a higher asymmetric rate as terminating carrier, for an initial term).

The Issues Paper has identified bundling as a particular issue of concern. We agree. Bundling and cross-subsidisation is a central issue which carries a high level of market failure risk. The impact of anti-competitive bundling on the market is so important that we seek a review of bundling issues and solutions, similar to the approach in Ofcom's 28 August 2008 mobile report, and in the Commission's NGN Section 9A review. This can be undertaken separately from, or in coordination with, the Schedule 3 investigation.

- 1.5 On 28 August 2008, Ofcom released its comprehensive report on mobile services. The report notes that regulating termination rates has high priority:

*1.21 A particularly important question is how, if at all, the mobile termination rate regime should change after the current charge control ends in 2011. Now is the right time to engage in a strategic debate about the future of that regime. The growing debate about the possible changes to the structure of mobile termination (such as 'bill and keep' arrangements) deserves careful consideration.*

- 1.6 Now is also the right time for that strategic debate in New Zealand.

- 1.7 Up for consideration by Ofcom is whether regulation should move from a cost-based model to another model, such as bill-and-keep. Similarly in the 2008 EU review of termination rates. Both reviews raise prospective changes to costs-based billing models, if a bill-and-keep model is not adopted. The EU's Commissioner Redding seeks, by 2012, termination rates of around 1 to 2 Eurocents (2 to 4 NZ cents).

- 1.8 We consider the position is rapidly approaching, and may already be with us, by which all forms of termination (fixed or mobile) should be treated in the same way.

- 1.9 Several 2007 and 2008 empirical and theoretical studies identify more clearly the problems with high termination rates and on-net pricing, and that these problems apply even when termination rates are set on a cost-basis. There is now significant support for alternative pricing models, particularly bill-and-keep. For example, referring to the Calling Party Pays (CPP) model we have in New Zealand, one commentator concludes:

*Changing to a 'bill-and-keep' regime would avoid the bottleneck monopoly and associated distortions of conventional CPP regimes, yet enable operators and customers themselves to choose how to pay for calls— in effect, to choose between CPP and RPP [Receiving Party Pays].<sup>1</sup>*

- 1.10 Pricing models such as this, and other options, can be considered during an investigation.

- 1.11 We submit that it is appropriate to investigate FTM termination rates despite the Minister's decision in April 2007 to accept undertakings, for a number of reasons. They include:

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<sup>1</sup> Littlechild, Telecommunications Policy, 30(5-6), 242- 277

- 1.11.1 Since that decision, the severity of on-net pricing issues and the cost-based billing model have become apparent. The Ofcom and EU 2008 reviews have raised these issues, and recent studies acknowledge that these problems have only recently become apparent.
- 1.11.2 The undertakings expire in 2012. The first MTR review cycle (from initial request for investigation to the Minister's decision) took just under four years. On a "business-as-usual" basis it would be appropriate to recommence the cycle now (although we seek, as the undertakings clearly envisage, earlier changes to the termination rate regime).
- 1.11.3 Since the Minister's decision, termination rates have markedly dropped internationally. There are changed circumstances not envisaged at the time.
- 1.11.4 The debate during the investigation, and in submissions to the Minister, revolved around a notional regulated rate based on internationally benchmarked rates. The rudimentary rate used for counterfactual analysis escalated to the base rate for consideration. As we submit in answer to Question 5.1(f), if costs are the pricing model, then costs (LRIC) should be used to derive a notional price, not the much higher benchmarked rates. Actual cost (TSLRIC) can be proxied from various regulatory reports. To do so makes a considerable difference.
- 1.11.5 The August 2008 Ofcom review notes that it is time to take stock of mobile regulation as 2008 is on the cusp of the second mobile revolution, particularly in view of data and internet availability. Fixed and mobile convergence is now a reality. The distinction between fixed and mobile services is starting to blur. The same observations apply in New Zealand: the landscape has changed markedly since early 2007. For example, there is Vodafone's Home Wireless Service. It is timely to review mobile termination strategically, to include FTM, MTF and MTM termination. To do one without the others would not be possible without aberrant outcomes.
- 1.11.6 The existing rates have a minute-minimum charge. It is now recognised (it wasn't then) that the international approach is a per second charge. This makes a considerable difference to the true net termination rates (and, also makes the international benchmarking comparison inaccurate as they do not – usually - have per-minute minimums.
- 1.11.7 The undertakings do not cover traffic terminating from outside New Zealand. CallPlus, in its submission, notes MNO proposals that such calls attract a termination rate higher than domestically originated calls. The rates in the undertakings exceed cost anyway, and the MNO's cost of termination is no greater for calls originating offshore.
- 1.12 We agree with the Commission that strategic price discrimination issues (such as on/off-net pricing, "pocket pricing" and bundling) are major issues. We closely analyse the position below. We conclude that existing remedies, such as the Commerce Act, fail adequately to address these problems, which entail serious market failure. Where existing market forces or remedies fail to address the problem, regulation is appropriate. Strategic price discrimination supports both regulation and the approach to regulation (in

particular, it supports a bill-and-keep model or costs set at rates much closer to zero than at present).

- 1.13 In the Vodafone PSTN Vodafone determination, sought –and obtained – bill and keep in circumstances with direct overlaps with mobile termination pricing. (There are also relevant concessions on behalf of Telecom as well).
- 1.14 In addition, in a direct overlap with on/off-net pricing and other strategic price discrimination, Vodafone successfully sought a term of the PSTN determination that prohibited Telecom from price discrimination (they were not permitted to charge more for calls terminated on Vodafone’s network).
- 1.15 If the Commission decides to apply a price model based on cost, we submit that:
  - 1.15.1 Pricing should be based either on marginal cost or carefully implemented Long Run Incremental Cost;
  - 1.15.2 new entrants, smaller networks, and networks carrying cost beyond their control, should be able to recover higher termination rates.
- 1.16 We seek a Schedule 3 investigation into designating the MTF termination service. The components in, and cost of, this service are similar to the FTM service, yet Telecom proposes that calls be charged at rates significantly higher than the FTM rates in the undertakings. (The FTM undertaking rates of course substantially exceed cost anyway). This service is a wholesale input into a retail market in which access seekers and Telecom are competitors, and therefore, the pricing raises strategic price discrimination concerns.
- 1.17 MTF termination rates are another example of what happens when a service is not regulated.
- 1.18 In this submission we will deal with some key issues, and then answer the questions in the Issues Paper.

## **2 Why revisit FTM termination rates now?**

- 2.1 The Minister accepted Vodafone and Telecom undertakings in April last year. Is it too soon to revisit FTM termination rates? No, for the following reasons

### **Termination rates exceed cost**

- 2.2 As the Commission identified in its 2007 Telecommunications Market Monitoring Report (31 March 2008), the termination rates in the Undertakings considerably exceed cost, and some retail packages appear to be offered at or below wholesale cost.<sup>2</sup> That can be concluded even without regard to developing arguments that costs models are being incorrectly applied in, for example, Europe, and that even lower rates are appropriate.

### **Subsequent changes in international termination rates**

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<sup>2</sup> Commerce Commission 2007 Monitoring Report (March 2008) Paras 168-170

2.3 Other regulatory bodies (for example, the EU, Ofcom, and the European Regulators Group) have identified:

2.3.1 A new for overall mobile review

2.3.2 ongoing reduction in termination rates;

2.3.3 the wide margin internationally between actual rates and cost (the New Zealand rates are benchmarked off international rates); and

2.3.4 the developing debate (which has come to the forefront only since the Minister accepted the undertakings) that mobile termination:

(a) should move to bill-and-keep; or

(b) should be priced on marginal cost or carefully implemented Long Run Incremental Cost.

2.4 These reports are:

2.4.1 The 28 August 2008 Ofcom report, *Mobile citizens, mobile consumers – Adapting regulation for a mobile, wireless world*;<sup>3</sup>

2.4.2 The EU's 26 June 2008 *Draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU*<sup>4</sup> (and its accompanying *Explanatory Note accompanying document to the Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU*<sup>5</sup>); and

2.4.3 The European Regulators Group 12 March 2008 report, *ERG's Common Position on symmetry of fixed call termination rates and symmetry of mobile call termination rates*.<sup>6</sup>

**The understanding of the effects of high mobile termination rates has markedly developed in the last year**

2.5 At the time of the Schedule 3 mobile termination rate investigation, and the Minister's subsequent decision to accept undertakings, the extent to which cost-based termination rates and on-net pricing negatively impacted the market were largely unknown and not understood.

2.6 Since then, several 2007 and 2008 theoretical and empirical analyses have demonstrated considerable problems, supporting conclusions that (a) LRIC termination rates **cause** problems rather than solving them (so actual termination rates that exceed cost (as in New Zealand) are even worse and (b) other solutions such as bill-and-keep for mobile termination are required to substantially reduce market failure.

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<sup>3</sup> <http://www.ofcom.org.uk/consult/condocs/msa08/msa.pdf>

<sup>4</sup> [http://ec.europa.eu/information\\_society/policy/ecomms/doc/library/public\\_consult/termination\\_rates/termination.pdf](http://ec.europa.eu/information_society/policy/ecomms/doc/library/public_consult/termination_rates/termination.pdf)

<sup>5</sup> [http://ec.europa.eu/information\\_society/policy/ecomms/doc/library/public\\_consult/termination\\_rates/explanatory.pdf](http://ec.europa.eu/information_society/policy/ecomms/doc/library/public_consult/termination_rates/explanatory.pdf)

<sup>6</sup> [http://www.erg.eu.int/doc/publications/erg\\_07\\_83\\_mtr\\_ftr\\_cp\\_12\\_03\\_08.pdf](http://www.erg.eu.int/doc/publications/erg_07_83_mtr_ftr_cp_12_03_08.pdf)

- 2.7 In 2008, and for the first time, options such as bill-and-keep for mobile termination are now actively on the agenda for, at least, the EU and Ofcom.
- 2.8 There is a particularly useful summary of the position, and the recent analyses, in a January 2008 draft article by Harbord and Pagnozzi: *On-Net/Off-Net Price Discrimination and 'Bill-and-keep' vs. 'Cost-Based' Regulation of Mobile Termination Rates*<sup>7</sup>. As the authors note, in support of their conclusion that bill-and-keep rather than cost-based pricing for termination is to be preferred, based predominantly on 2007 papers by other economists:<sup>8</sup>

### **Call Externalities and Competition Between Networks**

*...the academic literature on network competition was until recently unable to explain the large price differentials for on-net and off-net calls observed in most European mobile markets. The standard conclusions were that purely cost-based access (i.e. termination) charges were welfare optimal, and that consequently fixed-to-mobile and mobile-to-mobile termination charges should be regulated at the same level. These conclusions have now been overturned in a number of recent papers which consider the effects of call externalities and network effects on competition and pricing in mobile markets. The inclusion of call externalities in the analysis has been found to have significant implications for welfare and optimal regulatory policy. As Armstrong and Wright (2007) have noted, "it is beyond doubt that call externalities are significant, since why else would anyone leave their mobile phone on to receive calls?" What wasn't clear until recently was the significance of call externalities for the analysis of price discrimination and competitive interaction in mobile markets. This section summarizes the results of a number of recent papers which analyze the interaction of call externalities with pricing and competition in mobile networks, including Jeon et al. (2004), Armstrong and Wright (2007), Hoernig (2007), Calzada and Valletti (2007), and Cambini and Valletti (2007). The key conclusions of this analysis are that call externalities create a strategic motive for off-net/on-net price discrimination which can lead to socially inefficient tariff structures, and create an entry barrier for small networks which are unable to profitably replicate incumbents' pricing strategies. Further, high mobile-to-mobile termination rates, coupled with high charges for off-net calls, can be used strategically by incumbent operators to either prevent entry or reduce competition from new entrants into their markets.*

- 2.9 The article concludes that even termination rates calculated on a LRIC basis (which is much lower of course than actual termination rates, including in New Zealand) are particularly damaging to competition from smaller networks and new entrants. Therefore, bill-and-keep should be the model instead:<sup>9</sup>

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<sup>7</sup> [http://www.market-analysis.co.uk/PDF/Topical/harbord\\_pagnozzi\\_b&k\\_22jan2008.pdf](http://www.market-analysis.co.uk/PDF/Topical/harbord_pagnozzi_b&k_22jan2008.pdf) . Although the article is in draft, and is partly based on research undertaken for H3G, the article provides valuable references to other articles as well as valuable observations.

<sup>8</sup> Harbord and Pagnozzi, Page 8

<sup>9</sup> Harbord and Pagnozzi at Page 6

*“Cost-based” regulation of termination rates is consequently exacerbating the incentives of MNOs to set off-net prices in excess of on-net prices, resulting in welfare losses from an inefficient pricing structure and barriers to entry and growth for smaller networks. Indeed, it is plausible that high off-net call charges are a distortion in the structure of prices potentially as serious as the distortion in prices that the regulation of mobile termination charges was designed to repair in the first place (i.e. the subsidy of mobile subscription via high termination charges), and are particularly damaging to competition from smaller networks and new entrants.*

*A move to “bill-and-keep” for mobile-to-mobile termination .... would likely result in a more efficient wholesale and retail price structure, help to eliminate barriers to entry caused by “tariff-mediated” network effects [that is, on-net versus off-net pricing differentials], and increase welfare and competition in the mobile market.*

- 2.10 Much of the difficulty stems from the European (and New Zealand) termination charging approach of imposing the termination charge on the caller (CPP or calling party pays) when (a) the terminating carrier (which inevitably has a monopoly in its terminating market) is not billing its own customer (i.e. there is no RPP or Receiving Party Pays). Littlechild, in his article, *Mobile Termination Charges: Calling Party pays versus Receiving Party Pays*,<sup>10</sup> argues in favour of bill-and-keep to avoid this bottleneck problem:

*In many countries there is widespread concern at the level of mobile termination charges. This is attributable to the bottleneck monopoly created by the Calling Party Pays (CPP) principle. It has led to increasingly severe price controls on termination charges. .... The Receiving Party Pays (RPP) principle, which applies in North America and several Asian countries, avoids the bottleneck monopoly problem. .... Surprisingly, CPP regulators have either ignored RPP or rejected it for various alleged disadvantages. These do not withstand investigation. However, in CPP countries there is still concern about the idea of paying to receive calls.*

*There is a way to get the benefits associated with RPP without this disadvantage. RPP is based on a ‘bill-and-keep’ regime. Some mobile operators in RPP countries are now offering customers the option of calling plans with free incoming calls. Changing to a ‘bill-and-keep’ regime would avoid the bottleneck monopoly and associated distortions of conventional CPP regimes, yet enable operators and customers themselves to choose how to pay for calls– in effect, to choose between CPP and RPP.*

- 2.11 The possibility of regulation enabling, or requiring, “payment” of termination charges by the terminating carrier (possibly by a bill-and-keep method) is something that should be up for review on a Schedule 3 investigation, given the problems with the model by which the full termination charge is billed to the originating carrier. It is also possible that the current problems are so serious that retail regulation (or a Section 30 condition in a determination, as Vodafone obtained from Telecom in relation to price discrimination in its PSTN determination) are appropriate.

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<sup>10</sup> Telecommunications Policy, 30(5-6), 242- 277

- 2.12 It is not necessary to conclude, prior to launch of a Schedule 3 investigation, what the pricing model should be. Rather, there is ample material, including from the empirical and theoretical studies, and from the Ofcom and the EU discussion papers, for the Commission to decide to investigate termination rates, leaving open the pricing model for review during the investigation.
- 2.13 That the EU and Ofcom have bill-and-keep, plus other pricing models, under review in their current investigations, indicates that the same should happen here.

**The Commission and the submissions to the Minister used benchmarked pricing, not actual cost-related pricing**

- 2.14 We consider that this is a particularly significant issue. We have provided the detail when answering Question 5.1(f) below.
- 2.15 In summary, the debate before the Commission and the Minister relied upon a notional termination rate derived for the limited purpose of the counterfactual analysis, from international benchmarks. However, (a) for the counterfactual, the correct factual was an estimate of actual cost (TSLRIC), which varies considerably from internationally benchmarked rates; (b) it was possible to estimate that factual more accurately and (c) by default, the notional rate taken from internationally benchmarked pricing (for the low-granularity purpose of a counterfactual analysis) became **the** rate for submission and consideration. This notional rate had a life beyond what was originally intended.
- 2.16 Whatever the position then, the Commission can now, based on subsequent regulatory studies and decisions of termination cost, more accurately assess termination cost on a LRIC basis, proxied from studies, regulatory submissions, benchmarked rates, etc.
- 2.17 The problem of using the equivalent of the interim pricing principle instead of the final pricing principle is particularly severe for mobile termination rates in view of the international disparity between cost and price. It leads to severe distorted outcomes.

**It's time to start another termination rate review cycle**

- 2.18 Starting another FTM termination rate regulatory cycle now is appropriate given the time lag between commencement and conclusion (around four years based on the last cycle).
- 2.19 This should be seen as a business-as-usual approach. The last FTM termination rate regulatory process started in July 2003 (with a request from TUANZ) and produced an outcome (undertakings accepted by the Minister) nearly four years later in April 2007. In the normal course of events, it is appropriate to start the cycle again now.
- 2.20 We consider that a Schedule 3 recommendation should be made to change the FTM termination rates before the term of the Undertakings expire (around 3.5 years away in March 2012). However, even assuming that change is appropriate only from March 2012, the investigation should start now, based on the timeframes, benchmarked off the nearly 4 years for the last regulatory cycle. (The decision as to whether new termination rates should commence before or in March 2012 does not need to be made now: it can be made in the final Schedule 3 report).

- 2.21 Even if the current process takes place more quickly than the last, there is still a considerable period between commencement of the investigation and the ultimate outcome (whether that ultimate outcome is a price determination, assuming Ministerial acceptance of a recommendation to regulate, or Ministerial acceptance of undertakings).
- 2.22 There is a likely additional factor adding to time, assuming the pricing model remains as proposed in the last MTR Reconsideration recommendation to the Minister: internationally benchmarked rates for the initial pricing principle (IPP) and TSLRIC for the final (FPP)). The disparity between the two is so great (and likely to remain so for some time despite declining termination rates) that substantial additional time is likely to be involved in determining price based on the FPP (TSLRIC). If the pricing model changes (e.g. to Bill-and-keep), significant time can also be expected.
- 2.23 The exception, which potentially could expedite resolution, is a Schedule 3A undertaking. What happened in the related area of roaming (where an Undertaking was provided that was well short of acceptability) indicates that a Schedule 3A Undertaking solution is a long shot.
- 2.24 Commencing a cycle now, leading to a recommendation as to termination rate regulation, is consistent with the approach that Ofcom is taking in its mobile review launched this year. Termination rates, as regulated in the UK, expire in 2011. As Ofcom notes in its 28 August paper, review of termination rates for the period from 2011 is a top priority of the review.

### **2008: the second mobile revolution (Ofcom)**

- 2.25 The Ofcom report is illuminating in another respect. It's time for a strategic review of termination. Additionally 2008 is a pivotal year (the second mobile revolution, according to Ofcom). As with Ofcom, we firmly submit that, for the same reasons, the Commission should take a strategic approach to termination in the Schedule 3 investigation, adding a coordinated Section 9A review if necessary. As Ofcom notes in its report:

*1.21 A particularly important question is how, if at all, the mobile termination rate regime should change after the current charge control ends in 2011. Now is the right time to engage in a strategic debate about the future of that regime. The growing debate about the possible changes to the structure of mobile termination (such as 'bill and keep' arrangements) deserves careful consideration*

- 2.26 Ofcom notes that 2008 sees a pivotal change in the mobile market, which calls for regulatory review:

**2.4 We are now on the cusp of a second mobile revolution. In 2008, data services and the ability to access the internet on the move look set to become as widely available as the ability to make phone calls or send texts.** We can already see that:

- more of us are using mobile data services, like mobile broadband and internet access;
- networks continue to evolve with the arrival of 3G technology (and beyond).
- mobile devices offer more capabilities and more varied services than at any other time – and this trend is set to continue;

- in some cases, the distinction between fixed and mobile services has already started to blur, which will have important implications for regulation; and
- services like mobile TV are emerging, blurring distinctions between telecoms and broadcasting.

2.5 This pivotal period – when we have already ‘gone mobile’ to a great extent, but the second wave of mobile data and internet services has yet to fully emerge – is a good time to take stock of the role of regulation. [highlighting added]

## Consistency

- 2.27 Dealing with MTM in the absence of FTM (and MTF) creates a risk of inconsistent and I distortionary outcomes.

## Fixed and mobile convergence

- 2.28 When the Minister accepted the undertakings, fixed and mobile convergence was an uncertain prospect. Now it is a reality. For example, there is Vodafone’s recently launched Home Phone Wireless product, which implements the Commission’s PSTN interconnection determination in favour of Vodafone as access seeker. Fixed and mobile convergence is set to become an expanding feature of the telecommunications landscape. This increasingly raises the question of whether the mobile termination rate regime (with its high termination rates even if the rates are fixed applying TSLRIC) is appropriate when PSTN interconnection applies a different model (e.g. bill-and-keep for calls intra-LICA). Existing distortions between fixed and mobile, and opportunities for arbitrage, become even more pronounced.
- 2.29 It is difficult even now to reconcile Vodafone’s approach on its Home Phone Wireless service, based on PSTN bill-and-keep principles, and its approach as to mobile termination rates
- 2.30 Then there are NGN considerations as well which are largely new since the Minister’s decision. We consider that Ofcom is right in reviewing termination rates in this developing context. Whether or not ultimately there should be change, there should be review of the position, taking into account these developments.

## Does the Minister’s decision preclude an investigation?

- 2.31 Under the Act, the Undertakings cannot preclude a Schedule 3 investigation which might have the ultimate effect of altering termination rates during the term of the Undertakings (March 2007 to March 2012).
- 2.32 In any event, the Deeds of Undertaking envisage and accommodate the prospect of this happening.

## International termination

- 2.33 The submissions from CallPlus identify issues as to termination of international calls on New Zealand mobile networks:

Mobile operators are proposing that internationally originated calls terminating on a mobile network in NZ should be charged at significantly higher rates than domestically originated calls.

- 2.34 The Vodafone and Telecom Undertakings require the agreed capped termination rates only in relation to calls originating in New Zealand. So there is no limit on what can be charged as to international calls inbound to mobile networks.
- 2.35 Yet the MNO's cost elements for terminating international calls are the same as the costs for terminating domestic calls. In any event, the capped termination rates considerably exceed cost. Designation of MTM and FTM termination services can rectify that anomaly, which has the significant impact on access seekers, as identified by CallPlus in its submissions.
- 2.36 Regulation can rectify this. The position with termination of international calls on mobile networks is also illustrative of what happens to termination rates when they are not regulated. The Commission can review and utilise this in the investigation.

### **3 The Vodafone PSTN Determination**

- 3.1 This is the determination underpinning Vodafone's Home Wireless Service. It has particular relevance to mobile termination services.
- 3.2 As the implications of this determination are a matter for the investigation itself, rather than for prior to its launch, we will only introduce the issues that flow from the determination at this stage. We would deal with these issues in more detail in an investigation.
- 3.3 When applying for the PSTN determination, Vodafone sought –and obtained – bill and keep in circumstances with direct overlaps with mobile termination pricing. (There are also relevant concessions on behalf of Telecom as well).
- 3.4 In addition, in a direct overlap with on/off-net pricing and other strategic price discrimination, Vodafone successfully sought a term of the determination that prohibited Telecom from price discrimination (they were not permitted to charge more for calls terminated on Vodafone's network).
- 3.5 We note that we may seek a term precluding price discrimination based on on/off-net pricing, "pocket pricing" and or other forms of price discrimination. This would be for the service description for Schedule 1, or for a determination.

### **4 Cost-based termination rates**

- 4.1 As appears from our summary above, we seek bill-and-keep. Otherwise, cost-based pricing is sought. The options (including bill-and-keep) are being reviewed by the EU and Ofcom, and have been the subject of a widely accepted ERG report.
- 4.2 Cost methodologies are being revisited, in view of the historically disparate outcomes applying the same models. Costs recovered from termination services may be narrowed. There would be a significant departure from the current principles by which the majority of joint and common costs are allocated to termination services. As Ofcom notes at Para 8.43:

The costs to be recovered from termination services might be narrowed, and/or the increment of traffic used to calculate 'incremental' costs might be narrowed (essentially the approach being discussed by the European Commission). This would be a change in the way that costs are currently shared between the caller and the recipient mobile customer, by shifting recovery of fixed and common costs away from the caller to the receiving party.

- 4.3 Hence, there is Commissioner Redding raising the prospect of European termination rates equivalent to 2 to 4 NZ cpm.
- 4.4 If the Commission launches an FTM and MTM Schedule 3 investigation, the European developments will, we submit, be a major consideration.

## **5 Asymmetric termination rates**

- 5.1 It is commonplace (for example, in most European countries) for MNOs to have different termination rates from other MNOs in the same market. That this is not heretical thinking for New Zealand is shown by the fact that the glide paths in each of the Vodafone and Telecom undertakings track toward termination rates of 14 cpm and 12 cpm respectively for the year ending March 2012. We already have asymmetric termination.
- 5.2 Our primary submission is that the Commission should recommend bill-and-keep regulation of FTM and MTM termination rates.
- 5.3 If however, the Commission instead applies cost-based rates, we submit that there should be asymmetric rates reflecting in particular:
  - 5.3.1 Problems for smaller networks and new entrants, such as strategic price discrimination (e.g. on/off net pricing). These can be alleviated by allowing them to apply relatively higher termination rates, at least for initial periods. This can be pro-competitive, as has been identified by many NRAs in Europe. Although the Commission, in its July 2008 discussion paper, argues that asymmetric rates should have limited application, the paper acknowledges they have a place where justified.
  - 5.3.2 The Commission in particular identifies that asymmetric rates may be suitable where an MNO faces exogenous costs, that is, higher costs outside its control<sup>11</sup>. Where a cost is endogenous, so that the MNO can control the cost, higher termination rates would not be permitted for this reason. Spectrum availability and cost is the example that it gives, an example that has New Zealand application. New Zealand has an excellent opportunity to see additional cellular networks facilitated by WiMAX providers. However, WiMAX technology typically operates at higher frequencies than the increasingly ubiquitous 850-900Mhz WCDMA, and potential WiMAX providers do not have suitable spectrum in lower frequencies. This of course forces them through a more expensive infrastructure deployment (more cell sites in particular). Enabling them to charge higher termination rates is pro-competitive.

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<sup>11</sup> EU Explanatory paper

- 5.4 Even if asymmetric termination rates are not ideal, they are one way of addressing market problems. As Professor Martin Cave noted<sup>12</sup>:

*If rates are too high, and if traffic is unbalanced, smaller operators are at a disadvantage*

*Responding to this by imposing asymmetric rates is not an ideal solution, but regulators may have no other powers*

## **6 MTM termination**

- 6.1 We support review of MTM termination, supported by the reasons developed above and below. Bill-and-keep, or costs-based pricing (with asymmetric rates) are sought, as noted above.

## **7 Vodafone's acknowledgement confirms that MTM bill-and-keep is appropriate**

- 7.1 Vodafone, with its considerable international experience and international data, as the world's largest MNO, has provided an acknowledgement that strongly supports MTM bill-and-keep. In its 29 May 2008 submission to the Commission<sup>13</sup>, opposing the launch of an investigation, Vodafone provides a fulsome analysis of relative termination rate payments between MNOs (between large and small; between new entrant and incumbent) and concludes<sup>14</sup>:

In general, therefore, it should be expected that traffic flows between network operators should largely balance over time. Further, where there is an imbalance in traffic flows, the level of imbalance is likely to be so small such that interconnection payments between connecting operators should represent a relatively minor cost to a mobile network operator doing its business. In these circumstances, it is hard to see why it would be necessary to regulate the terms and conditions over which MTM termination is provided between interconnecting operators.

- 7.2 The following conclusions flow inexorably from, and are based on, Vodafone's statement of the facts. Vodafone's facts point strongly toward regulation, not away from regulation.
- 7.3 The form of regulation, applying Vodafone's conclusion, would be bill-and-keep.
- 7.4 Vodafone note a "relatively minor cost" of interconnection payments between MNOs in view of the balance of traffic between MNOs regardless of relative size or relative time in the market (new entrant or incumbent). This minor cost would be considerably offset by the high cost associated with billing between MNOs. Such inter-carrier billing therefore has little practical benefit. To save that administrative cost with little benefit, bill-and-keep should clearly, applying the Vodafone position, be regulated as that eliminates the unnecessary cost.
- 7.5 Additionally, Vodafone's concerns that unregulated rates do not cause problems (and access seekers' concerns that there are in fact issues) are readily met by adopting Bill-and-keep (which, applying Vodafone's facts, would cause no difficulty).

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<sup>12</sup> Martin Cave, Conference on the Regulation of Mobile Termination Rates, Brussels, 30 January 2008

<sup>13</sup> <http://www.comcom.govt.nz//IndustryRegulation/Telecommunications/Investigations/MobiletoMobileTermination/ContentFiles/Documents/Vodafone%20M2M%20Submission.pdf>

<sup>14</sup> At Para 20

- 7.6 An unnecessary controversy thereby disappears. That also eliminates one of Vodafone's concerns: the cost and time of the Schedule 3 investigation

## **8 Strategic Price Discrimination (on/off net pricing, “pocket pricing” and bundling)**

### **Introduction**

- 8.1 The Issues Paper<sup>15</sup> raises strategic price discrimination as a consideration for this investigation. This is a particularly important reason why termination rates should be regulated (and why other steps should be taken, as we outline below when proposing a Section 9A review of bundling). In this part of our submissions we focus on the second form of discrimination identified in the Issues Paper: discrimination that affects new entrants and smaller networks such as on/net pricing, “pocket pricing” and bundling. Our submissions in this section of our report follow this structure:
- 8.1.1 An overview of the issues, such as the relationship, in this context, between the Commerce Act and a Schedule 3 investigation. Bundling, on/off-net pricing and “pocket pricing” are typically the subject matter of the Commerce Act;
- 8.1.2 The relationship between such strategic price discrimination and the Commerce Act. We deal with whether the Commerce Act can adequately deal with strategic price discrimination, taking into account the controversial Privy Council decisions, *Telecom v Clear*<sup>16</sup> and *Carter Holt Harvey v Commerce Commission*<sup>17</sup>, steps such as the 0867 appeal, and the reality and practicalities of Commerce Act action.
- 8.1.3 We outline a proposed framework for dealing with these issues. It is important to have clarity as to how strategic price discrimination is handled under each of the Commerce Act and the Telecommunications Act (including Schedule 3) as the considerations under each overlap yet differ.
- 8.1.4 We then deal with the question of whether concerns as to strategic price discrimination have a role under the Telecommunications Act and Schedule 3 (and what that role is).
- 8.1.5 We conclude that:
- (a) there are severe price discrimination problems;
  - (b) the Commerce Act cannot adequately handle strategic price discrimination problems (even if appeals such as the 0867 appeal lead to a different interpretation of Section 36);
  - (c) the inadequacy of competition law to deal with the market failure is a reason in itself to have sector-specific regulation;

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<sup>15</sup> At Paras 35 and 36

<sup>16</sup> [1995] 1 NZLR 385

<sup>17</sup> [2006] 1 NZLR 145

- (d) It is not necessary to spell out the issues in a decision to commence a Schedule 3 investigation, so long as strategic price discrimination is not precluded as an issue in that decision.

## **Overview**

- 8.2 The Issues Paper<sup>18</sup> raises strategic price discrimination as a consideration for this investigation. Two types of discrimination are noted in the Paper:
  - 8.2.1 Customers are exploited by price discrimination, with the result that total and/or consumer welfare are reduced. We expect this reflects the ability of the terminating carrier, in the CPP model where it inevitably has a monopoly in its terminating market, to charge rates that impact on the originating carrier's customers, without impact on its own.
  - 8.2.2 Strategic price discrimination used against other carriers, particularly those that are smaller and/or new entrants.
- 8.3 Here we focus on strategic price discrimination against other carriers. We consider that this form of discrimination is a particularly compelling reason to regulate termination rates, to regulate them at bill-and-keep or low cost-based levels, and to consider issues around bundling, as noted below.
- 8.4 Price discrimination of course is an issue for competition law (in particular, Sections 27 and 36 of the Commerce Act).

## **Commerce Act**

- 8.5 Before dealing with implications of strategic price discrimination for the Telecommunications Act, it is necessary to understand how such discrimination is handled under the Commerce Act. For example, if *ex post* Commerce Act remedies adequately handle strategic price discrimination, then *ex ante* regulation under the Telecommunications Act is not required.
- 8.6 The Issues Paper raises three types of strategic price discrimination although potentially there are more. Tests and rules have of course been developed under the broadly expressed Sections 27 and 36 of the Commerce Act (and comparable legislation offshore) to distinguish anti-competitive conduct from pro-competitive conduct. Relating those Commerce Act tests to the three types of discrimination identified in the Issues Paper:

### **On and off net pricing**

- 8.6.1 This raises predatory pricing tests, to distinguish anti-competitive from pro-competitive action. The *Carter-Holt v Commerce Commission* Privy Council decision (the leading New Zealand predatory pricing decision) is relevant here, and we return to that below

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<sup>18</sup> At Paras 35 and 36

- 8.6.2 The pricing of wholesale inputs (such as termination rates and roaming charges), and the relativity of those prices to retail market pricing, means that vertical price squeeze tests (such as imputation tests) may also be relevant. Other than the Data Tails litigation against Telecom, on which judgment is awaited, there is no significant price squeeze judgment in New Zealand.
- 8.6.3 That the wholesale input –such as termination rates – is regulated does not lead to the conclusion that there can be no price squeeze. What determines whether there is a price squeeze is the **relativity** between wholesale and retail prices, not the absolute price of one or other of these prices.<sup>19</sup>

#### **“Pocket Pricing”**

- 8.6.4 This expression is shorthand for alleged predatory pricing where prices are differentiated by customer segment or location. The example typically used in New Zealand is Telecom’s street-by-street price bundling to match Saturn’s HFC roll-out, which was reviewed by the Commerce Commission in 1998<sup>20</sup>. The Commission concluded, applying *Telecom v Clear*, that there were insufficient grounds to proceed under the predatory pricing tests (taking into account Telecom’s costs relative to its reduced bundled pricing).
- 8.6.5 Saturn (and therefore “pocket pricing”) is also an example of where there may be vertical price squeeze, based on the relativity of wholesale inputs. In the case of Saturn, the most relevant wholesale input charge was the high asymmetric termination rate payable for PSTN interconnection which Telecom was able to charge because of the 1994 *Privy Council Telecom v Clear* decision. An MNO dropping price by customer segment or location may breach a price squeeze imputation test, based on the relativity of wholesale inputs –such as termination rates – and retail pricing.

#### **Bundling**

- 8.6.6 The Issues Paper, at Para 36, identifies bundling as of increasing concern. We deal with bundling in more detail below. Bundles such as triple and quad play, and bundles suitable for SMEs and corporates, are a particularly big challenge for new entrants dealing with horizontally and vertically integrated incumbents. Bundles raise the overlapping areas of price predation and horizontal price squeeze.
- 8.6.7 Horizontal price squeeze issues in turn overlap with vertical price squeeze. The most relevant New Zealand regulatory analysis on horizontal price squeeze, and therefore vertical price squeeze, is the Commission’s December 2007 decision not to proceed against Telecom in relation to its bundling of tolls in broadband

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<sup>19</sup> For example, the Court of First Instance decision in *Deutsche Telekom v European Commission* (July 2008) is a case where it was held there was a price squeeze even though both the wholesale input price and the incumbent’s retail price were regulated. See also *Dwr Cymru* (described by Michael Wigley, *Margin/Price Squeeze: A landmark UK judgment* <http://www.wigleylaw.com/Articles/LatestArticles/margin-price-squeeze---a-landmark-uk-judgment/>)

<sup>20</sup> Commerce Commission Report, Termination Pricing of Fixed Telephony Services in Lower Hutt (30 July 1998)

packages.<sup>21</sup> The Commission of course applied, as it had to, the *Telecom v Clear* and *Carter Holt* Privy Council decisions.

- 8.7 Many commentators consider that the two Privy Council decisions (*Telecom v Clear* and *Carter Holt*) incorrectly apply Section 36.<sup>22</sup> The effect is a provision largely devoid of any teeth.
- 8.8 Given New Zealand-resident judges' resistance to the two Privy Council decisions, the replacement by the Supreme Court of the Privy Council as the final appellate court, and the 2001 Commerce Act amendment of Section 36, judicial change is possible, in appeals such as the current 0867 appeal.
- 8.9 If that change comes about, is that enough to obviate the need for regulation to deal with these strategic price discrimination issues?
- 8.10 For a number of reasons, strategic price discrimination will still be inadequately handled by the Commerce Act, even assuming judicial interpretation which expands the ambit of Section 36 to a maximum degree. In these submissions, we outline those reasons, not in any final form (as that requires more detailed analysis), but rather to raise issues which can be dealt with in more detail during a Schedule 3 investigation if necessary.<sup>23</sup>
- 8.11 Even if Section 36 receives a wide interpretation on appeal, it will always have a narrow ambit (such that strategic price discrimination in mobile justifies regulatory intervention). This is illustrated by considering, as happened in the *Carter Holt* Privy Council decision, the difference between Section 36 and European jurisprudence under the comparable provision, Article 82. It is unlikely that Section 36 can ever be interpreted to put the "special responsibilities" on those with SMP, that Article 82 imposes (and Article 82 has no "purpose" limb as well). As Bellamy and Child have said of the EU position in their text, *European Community Law of Competition* (6<sup>th</sup> edition, Oxford University Press, 2008):

*[SMP Firms] may be deprived of the right to adopt a course of conduct or take measures which are not in themselves abuses and which would even be unobjectionable if adopted or taken by non-dominant undertakings.*

- 8.12 The time and cost element of Commerce Act action is relevant and provides further reason why strategic price discrimination in mobile telecommunications calls for regulation. Action under the Act is rare, time consuming and expensive. Both 0867 and Data Tails are still not resolved, over 8 years after the relevant events. Only the

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<sup>21</sup> Commerce Commission, *Telecom Bundling of Broadband Service Investigation Report* (21 December 2007)

<sup>22</sup> particularly as to (a) the rigid application of the counterfactual test, and how it is applied; and (b) the interpretation of the "purpose" component of Section 36, to the effect that a firm with SMP is entitled to compete, like everyone else, with its competitors.

<sup>23</sup> For example, the Saturn case raises real questions as to whether total and/or consumer welfare interests were best served in the outcomes in that situation (likewise in the tolls and broadband bundling situation). It is said that the pricing effectively stopped Saturn in its tracks and stopped others from competing too, as the incumbent had sent signals to the market as to what it would do, faced with competition. That may satisfy Commerce Act tests (and, even, broader welfare tests if Saturn was an inefficient competitor).

Commission has issued proceedings, seeking penalties to be imposed on the incumbent. Affected parties such as competitors have not litigated, seeking compensation, generally driven by time and cost considerations. The tolls and broadband bundling investigation took nearly four years to conclude after the relevant events.

- 8.13 Whatever the theoretical rights, the practically available remedies are limited, as all, including incumbent carriers, are aware.

### **Is strategic price discrimination relevant in a Schedule 3 investigation?**

- 8.14 It is, as the Commission (and in turn, the Minister) must take into account the purposes in Section 18 of the Telecommunications Act. That includes promotion of competition for the long-term benefit of end-users, which extends to strategic price discrimination issues. As, in our submission, the *ex post* remedies in the Commerce Act do not adequately handle strategic price discrimination, such discrimination issues are appropriate reasons to support a recommendation to regulate under Schedule 3 (and to regulate on a particular basis such as Bill-and-keep rather than TSLRIC).

### **Conclusion**

- 8.15 We conclude that there is a strong case for regulating termination rates in view of strategic price discrimination, as the Commerce Act cannot in itself deal with the issues. Further, issues as to strategic price discrimination support approaches to regulating termination rates, such as bill-and-keep.

## **9 Bundling and cross-subsidisation: a horizontal problem unresolved by regulating termination rates**

- 9.1 By regulating termination rates (a vertical issue), the problems created by bundling (a horizontal issue) are potentially reduced – particularly if bill-and-keep is adopted. However, they are not eliminated. The Commission has invited submissions beyond the Issues Paper. We consider that anti-competitive bundling is a major source of problems, particularly for carriers facing vertically and/or horizontally integrated providers. This will only get worse over time, as bundling becomes even more prevalent.
- 9.2 Bundling of course can be pro-competitive. Distinguishing pro-competitive from anti-competitive bundling is complex and challenging.
- 9.3 The tolls and broadband bundling case is only one of many bundling situations that raise price squeeze and cross-subsidisation issues. Even if one or more wholesale inputs are regulated, an incumbent can cross-subsidise its services, with anti-competitive effect. There is a large risk that, left in the current situation (and even if appeals such as in 0867 result in a broad interpretation of Section 36), bundling in telecommunications will lead to severe market failure.
- 9.4 The separate CallPlus submission identifies current Vodafone bundles which appear to be problematic, for which there is no practical Commerce Act solution, it seems. Bundles around Vodafone's new Home Wireless Service and the cross-subsidisation in those bundles, is extremely challenging.

- 9.5 The problem, as to bundling, is readily identifiable, but the solutions are not. Comparing bundling issues with termination rates, the latter involves a largely linear decision (Should termination rates be regulated? If yes, on what pricing model?). Bundling, with myriad different combinations, and vertical plus horizontal overlaps, is complex. But that does not mean that a solution should not be sought, particularly as:
- 9.5.1 bundling is such a central threat to competition and the long term interests of end-users;
  - 9.5.2 the Commerce Act, at least in its current form, is inadequate to deal with bundling.
- 9.6 Schedule 3 is limited to consideration of whether specific changes to Schedule 1 should be made, such as addition of new regulated services. We have considered whether to request the Commission to include consideration of bundling-related recommendations in the Schedule 3 investigations. However, a better approach, in our view, would be for the Commission to commence a more wide-ranging review of bundling under Section 9A, just as it has commenced its NGN review. This can be done in coordination with a Schedule 3 investigation as to termination rates, or as a stand-alone review.
- 9.7 Ofcom's Future Broadband review (and its current Mobile review) provide good examples as to how this can be approached. The Future Broadband review covered a wide range of issues and concluded with regulatory signals as a precursor to further action.
- 9.8 A variety of options can be considered, ranging from identifying potential services to be regulated following a later Schedule 3 review,<sup>24</sup> through to recommendations to Government that Section 36 be amended, or sector-specific anti-trust legislation is passed, such as occurred in Australia with its telecommunications-specific anti-trust provision (Section 151AJ Trade Practices Act (Aust)). That provision applies in addition to the equivalent of Section 36 Commerce Act.<sup>25</sup> Other options include a Commission recommendation to Government that it legislate an equivalent of Australia's potent Competition Notice regime
- 9.9 A Section 9A review of this nature will be able to obtain wide ranging input and relevant data.
- 9.10 We are conscious that the Commission has a large work load, and it must prioritise. In our submission, the challenges posed by bundling are so significant that the Commission should take steps such as a Section 9A review. Bundling and cross-subsidies are pervasive and problematic issues throughout telecommunications

## 10 Mobile to Fixed Termination

- 10.1 This issue is dealt with in detail in the CallPlus submissions, where, CallPlus notes:

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<sup>24</sup> Telecom bundled services are services within Schedule 1, but not in a manner that resolves anti-competitive bundling as the service description envisages an access seeker getting the same service that Telecom itself retails, at retail-minus pricing.

<sup>25</sup> Which is Section 46 Trade Practices Act (Aust)

*Telecom is proposing that calls originating on a mobile network and terminating on a fixed network, which are chargeable to the terminating carrier (e.g. Mobile to 0800), are charged at a significantly higher rate than fixed to mobile termination rates. This gives an integrated fixed & mobile operator an artificial advantage when competing for these services.*

- 10.2 The cost of providing this service (and most of its components) overlap with the FTM termination service. Yet price is significantly higher than the FTM rates in the undertakings, which in turn considerably exceed cost. Even where FTM rates may be lower than the rate in the undertaking (for example, where an 0800 call is not involved), the rate may be excessive, relative to cost.
- 10.3 The MTF termination charge is a wholesale input in respect of a retail market supplied by Telecom and access seekers, thereby raising the strategic price discrimination issues noted above.
- 10.4 This pricing also illustrates what happens when there is no regulation in relation to these services.
- 10.5 It is appropriate to address MTF termination when dealing with MTM and FTM termination, for the reasons noted above, including to ensure consistency of approach. Reviewing this separately raises significant risk.

## **11 Answers to questions in the Issues Paper**

Q3.1(a) Is the market definition as outlined [in the issues paper] (market for mobile termination services) appropriate? If not, what is the appropriate definition/delineation?
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1. Based on Para 30 of the Issues Paper, and the analysis in the Schedule 3 MTR Reports, we expect that the Commission considers that the market is termination on an individual mobile network (not the market for termination services). This is the internationally recognised market, as it is only possible to terminate on the terminating carrier's network. Each terminating carrier is a monopoly.
2. In more detail, the markets are voice, data, and/or SMS termination on individual mobile networks for MTM and FTM either (a) combined or (b) separately. Similarly in relation to MTF termination.

Q3.1(b) Are there other markets that respondents consider the Commission should be taking into account?
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3. In our analysis above, we consider that the positions of both the calling and the receiving parties are material. Therefore the Commission should take into account the retail

markets separately for each of the calling and receiving parties (collectively or divided for voice, data and SMS (and including tolls in relation to FTM)).

4. Other markets such as markets related to fixed line are material.

Q.4.1(a) Is the approach that termination is likely to be a bottleneck appropriate (arguments have to take into account both retail and wholesale markets)?
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5. Mobile termination is an essential wholesale input that can only be provided by a monopoly, the terminating carrier on that network. This is a bottleneck service.

Q.4.1(b) What additional effects (e.g. on other markets) can arise if considering mobile termination services as an essential bottleneck?
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6. Under the current CPP model, a monopoly (the terminating carrier providing the bottleneck service) has few commercial constraints on how it charges a network whose customer (the calling subscriber) is not its own customer. As we note in the discussion above, this problem is alleviated by a different billing model such as bill-and-keep or where the model is partly or wholly RPP.
7. In CPP models, such as apply in New Zealand, the consequence is, typically (a) mobile termination rates well in excess of cost and (b) retail pricing strategies by incumbents which would not otherwise happen if the termination rate is at cost or set at zero (such as, in effect, in a bill-and-keep model). These strategies include large on-net and off-net differentials (with the on-net prices often set below both termination rate cost and actual price), bundling, cross-subsidisation and other forms of price discrimination. We expect, when new entrants open up their networks, that additional price discrimination is likely, based on geographic location (to meet network roll-outs such as occurred with the Saturn HFC roll-out).
8. As new entrants have existing concerns that incumbents will take such steps, with little prospect of redress (as illustrated by the lack of Commerce Act activity) competition is already dampened even before a network is rolled out.
9. We have addressed these issues in detail in the discussion at the start of our submissions.

Q.4.1(c) What factors can potentially lead to on-/off-net call discounts? Under what circumstances do discounts lead to predatory price discrimination?

10. See the answer to 4.1(b) and the extensive discussion of this topic at the start of our submissions.

Q.5.1(a) What effects on prices and average network costs can be expected if the geographical coverage for mobile services is increased and if new technologies are implemented (e.g. 3G networks)?

11. Implementing 3G networks should generally reduce network costs. Absent regulation, the duopoly conditions indicate that price reductions are unlikely. This would change when and if new networks commence. However, high wholesale input cost (such as termination rates) and issues such as strategic price discrimination are issues that are so severe that they can be fatal to additional competition in New Zealand. We have discussed this at the start of these submissions.

Q5.1(b) Can the decrease in fixed-to-mobile retail rates from 2004 to 2008 be explained by a pass-through from lower wholesale termination rates? Are there any other potential explanations for this decrease?

12. Pass-through is likely to be the dominant reason for reduced retail prices. Termination rates are one factor, among a number, in determining retail price.
13. However, pass through into retail prices is not the only measure of the extent to which lower termination rates promote competition. The Commission, in assessing pass through and the benefits for competition and the interests of end-users, should consider the wider impact of reduced termination rates. As the Commission noted in its MTR Reconsideration Report at Para 382

..the Commission's view remains that a regulated reduction of mobile termination rates is likely to be passed through in a number of forms to the benefit of end-users.....

14. ACCC came to the same conclusion when assessing termination rates<sup>26</sup>.
15. Importantly, pass through is but one matter to consider when considering Section 18 drivers. For example, as we discuss extensively at the start of this submission, reduced termination rates (or bill-and-keep) will reduce the severe effects of strategic price

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<sup>26</sup> ACCC, Assessment of Vodafone's mobile terminating access service Undertaking, Final Decision (March 2006), Page 80

discrimination, the impact of which has become much clearer since the Schedule 3 FTM investigation and the subsequent Minister's decision to accept undertakings.

Q.5.1(c) What are possible explanations for price differentials between business and residential customers?

16. See Q.5.1(b) and the extensive discussion at the start of these submissions. Direct price pass through is only one factor. Additionally there can be pro-competitive price discrimination in operation.

Q.5.1(d) What is the average duration of a phone call to mobile customers?

17. Vodafone and Telecom can and should provide this information.

Q.5.1(e) Are current wholesale voice termination rates for fixed-to-mobile services different to tariffs for mobile-to-mobile? If so, please explain the mechanism applied to the current tariff and why tariffs are different.

18. In its first submission in respect of MTM termination, Vodafone states that MTM termination rates are set at the same levels as FTM termination<sup>27</sup>.
19. In view of (a) our submission that alternative pricing models should be addressed (in particular, bill and keep) and (b) Vodafone's conclusion (addressed in detail above) in its first submission that MTM terminating traffic is close to symmetrical in each direction (so that net termination payments between the two networks would be minimal), Vodafone and Telecom should be required to disclose their actual billing arrangements. This should not attract confidentiality.
20. If necessary, the Commission should require this information to be disclosed going back some years so that the history can be understood. For example, there were bill-and-keep arrangements in earlier times (this was confirmed in the Vodafone PSTN determination). When and how bill-and-keep was replaced by billing of termination rates, is relevant to the investigation.
21. We address this issue at the start of these submissions.

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<sup>27</sup> Letter T Chignell to R Patterson dated 29 May 2008 (Para 58)

Q.5.1(f) Do you agree with the Commission's approach to benchmarking termination rates against cost-based rates set in other jurisdictions? If not please explain why and what the appropriate mechanism should be.
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22. We have extensively covered, at the start of our submissions, our views that a model other than a cost-based model should be used. In this section we consider the position on the assumption that cost based pricing should be used.
23. We do not agree with the approach of relying on benchmarked termination rates. We consider that it leads to significant error in outcomes, and has also led to issues in the Schedule 3 MTR investigation, the Minister's decision.
24. It is very important to be clear as to why internationally benchmarked rates have been used in investigations, as there can be confusion and mis-use of the information. We consider that inappropriate use has led to error.
25. Benchmarked rates are used as the factual (what would happen if there is regulation) to compare with the counterfactual (e.g. no regulation or an undertaking proffered by access providers). Of necessity, use of benchmarked rates in this way in an investigation is at a relatively low level of granularity. That low level of granularity is appropriate as the decision is a threshold one: should there be regulation? This does not require the level of analysis appropriate for determining actual price, although, as we note below, simply using international benchmarks for the counterfactual analysis is flawed
26. Detailed pricing decisions are made at initial pricing principle (IPP) or final pricing principle (FPP) level, after the service has been regulated and there is a determination.
27. If pricing is to be cost-based, similar international benchmarks are typically used for the IPP. However, a greater level of granularity in approach, and choice of different percentiles, is likely to be appropriate. Thus the price at this stage may differ from the price derived for the factual to be used in the investigation.
28. The ultimate price, under the FPP, is typically TSLRIC.
29. Emerging from this are several key points.

30. First the real factual for the counterfactual analysis should be actual cost (TSLRIC) not some sort of inadequate proxy for TSLRIC (such as benchmarked rates). The final pricing principle (the ultimate outcome of regulation) is TSLRIC. That surely is the factual. The aim should be to get an estimate of what that rate might be.
31. As is widely accepted, there is considerable disparity between international termination rates and underlying cost. International rates do not come close to being an appropriate proxy for TSLRIC.
32. There are studies and regulatory decisions of TSLRIC, which enable a much more accurate assessment of the true factual. Internationally benchmarked rates may have a role, particularly where they are based on regulatory LRIC analysis. However, use of those rates must be carefully qualified and adjusted. For the purposes of the investigation, the Commission should take the approach of relying in particular on actual cost data, not price. This will lead to a more accurate factual.
33. It is apparent that the termination rate derived in investigations – for the purpose of the counterfactual analysis - becomes the “received wisdom” as to what the rate should be going forwards. This rate pervades the general approach and has a life beyond its humble origins. Thus, for example, the submissions to the Minister – which led to acceptance of undertakings – revolve around that rate derived only for the purpose of the counterfactual. No one questioned whether actual costs (the FPP rather than the IPP) should drive the approach.
34. The disparity between benchmarked rates and actual cost is so marked that the analysis beyond the Schedule 3 MTR investigation becomes problematic.
35. In summary, LRIC data should be used where possible, and the relevance of the data at each step should be carefully assessed. Data for a counterfactual does not automatically translate to IPPs or FPPs, or to negotiations to obviate regulation.

Q.5.1(g) Do you agree with the principle described that tariffs for services with bottleneck characteristics should be set at efficient underlying long-run costs? If not, on what basis should access tariffs to these bottlenecks be set?
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36. We don't agree and deal with this extensively at the start of these submissions. Our primary submission seeks bill-and-keep.

Q.5.1(h) On what principle do you bill termination rates for data and for voice services (e.g. per minute, per second, per unit, etc)?

37. Termination rates should be billed on a per second basis.

Q.6.1(a) To what extent are price reductions in the wholesale market for termination likely to be passed through to retail markets?

38. See 5.1(b) above.

Q.6.1(b) Would a difference in price reduction pass-through be expected between different customer groups (e.g. business or residential customers)?

39. See 5.1(b) and (c) above.

Q.6.1(c) How long is any pass-through likely to take?

40. See 5.1(b) above.

Q.6.1(d) Are there other actions that could be taken to encourage reductions in mobile termination rates to be passed through to end-users?

41. See 5.1(b) above. Changing the pricing model for termination rates to bill-and-keep will make a major pro-competitive difference. We deal with this extensively at the start of our submissions.

Q.6.1(e) What are the potential effects on other markets such as the fixed termination market, SMS termination and data traffic?

42. See the discussion at the start of these submissions.

Q.6.2(a) To what extent are commercial negotiations being undertaken for mobile termination services?

43. It is not realistic to expect any change from the rates in the undertakings as the terminating carriers are monopolies in their own markets (and there is a duopoly).

Q.6.2(b) What is the likelihood of commercial agreements being reached for mobile termination services, and the likely outcome of commercial negotiations?

44. See Q6.2(a)

Q.6.2(c) What is the most appropriate counterfactual for the services?

45. Until 2012 (when the undertakings expire) the rates in those undertakings, for MTM and FTM. Beyond 2012, absent regulation, significantly higher rates are possible given the monopoly conditions. The separate CallPlus submissions give two examples of how rates are fixed where there is no regulation.

Q.6.3(a) What is the likely factual? How would the service(s) compare to the services available under the counterfactual (in particular, in terms of pricing)?

46. If, in the investigation, cost-based pricing remains an option, then the factual revolves around the closest available proxy for TSLRIC (which is not internationally benchmarked termination rates alone). We deal with this extensively at Q5.1(f). In addition, the factual includes asymmetric termination rates, as outlined at the start of our submissions.
47. We consider however, that the primary factual is bill-and-keep, as we discuss in detail at the start of our submissions.

Q.6.3(b) How would the introduction of new specified or designated services lead to long-term benefits for end-users, which would not otherwise have been forthcoming? What empirical evidence is available to support such scenarios?

48. The termination must be designated as price is critical. We outline in detail the answer to this question at the start of our submissions.

Q.6.3(c) What is the interrelationship between the voice and SMS services? How does the price of one service affect the other?

49. Close. The high price of voice services increases SMS usage. This is abnormal compared to other countries and reflects high prices.

Q.6.3(d) To what extent would the introduction of new specified or designated services make new entry more viable?

50. We discuss this in detail at the start of our submissions.

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