

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



**Submission on Draft Determination on Cost Allocation
for Number Portability**

7 February 2005

I Summary

1. Vodafone agrees with the cost allocation the Commission proposes. There are some matters of detail where we think more information will be required in the final determination.
 - We agree in principle with using subscriber numbers to allocate the industry common costs of system setup. We think that there is a need for clarity on what this will mean in practice, for example, when subscriber numbers will be measured, and what exactly will be counted. We also think the Commission should clarify the liability of new entrants to contribute to the costs of the IPMS each year at the same time as it considers the information on market shares.
 - We agree that each operator should meet its own system setup costs. This seems to us to be a sensible way to spread the fixed costs of introducing portability as widely as possible, while recognising the incentive problems that arise if carriers can recover their costs from other carriers.
 - We are comfortable with DNOs charging RNOs for per-line setup costs in order to ensure a more efficient level of porting activity. As the Commission identifies, there is some risk that DNOs will have the ability to stymie porting through charging high rates. Possible solutions include reciprocity requirements on charges, or a price cap. But we would prefer that the Commission not intervene until there is a problem identified in practice rather than in theory.
 - We agree with the Commission's proposal that any extra call conveyance costs lie where they fall. In our view the special case of donor rerouting referred to by TelstraClear can be dealt with by bilateral agreements if necessary.
2. As we said in our submission on the Commission's decision to investigate the functions and standards application, we think it would be helpful if the timetable for that application and this cost allocation determination were aligned.

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III Introduction

3. This is Vodafone's submission on the Commerce Commission's Draft Determination on the allocation of the costs of local and mobile number portability.
4. Nothing in this submission is confidential.
5. In section IV we examine the Commission's objectives and principles for cost allocation, in section V we look at the Commission's proposed allocation, and in section VI we respond specifically to the Commission's questions.

IV Objectives and principles

6. In this section we consider the Commission's proposed cost allocation principles. We generally agree with the Commission's principles, but we think that the Commission is missing a couple of important points:
- In our view two more principles are needed, one to cover how to allocate fixed costs, and one to recognise that the overall objective of introducing portability is to reduce the costs of switching for end-users.
 - We are concerned about the use of the principle of "aligning costs with benefits", since it does not seem to us to add to the existing principles and it seems to risk unfocused assessments of the perceived fairness of different cost allocations.

The cost allocation principles need some enhancement

7. Sections 18 and 19 of the Act require the Commission to pick the means for allocating the costs of number portability that will best promote competition in telecommunications markets for the long-term benefit of end-users. This assessment must involve consideration of the efficiencies that are likely to result from the potential methods of cost allocation.
8. The Commission states four principles that drive its choice of cost allocation method. We agree with three of these four principles. The principle of 'alignment of costs with benefits' is referred to in more detail below.
9. The principles we agree with are:
- Cost causation – Charges to porting customers should reflect the costs to society of providing porting. This will ensure that the right quantity of porting is undertaken. This implies that all the customer setup costs and any additional conveyance costs should be allocated to porting customers or to the RNO.
 - Cost minimisation – Operators need to be incentivised to minimise the total costs of providing number portability. This implies that operators should bear their own costs in the first instance (although they will recover those costs from end-users in the long-run).
 - Practicality – The system needs to be easy to implement, simple to enforce and minimise incentives to rent-seek or game the decision-making process. This implies that no carrier should bear any other carrier's costs unless some mechanism can be found to avoid the incentives to overstate costs. This is especially an issue for the fixed setup costs of each operator, and perhaps for the per-line setup costs for a DNO.
10. We think an additional principle is needed to cover fixed costs:

- Wide spread of fixed costs – For any costs that are not ‘caused’ by any party, the widest feasible spread of costs is likely to be the most efficient (since this will minimise negative consequences for economic efficiency). This includes both the shared industry IPMS build costs as well as each operator’s setup costs.
11. In common with TelstraClear (para 52c), we consider that there must be an overriding principle:
- The cost allocation overall must reduce barriers to customer switching – This is the key intended impact of number portability. Unless number portability reduces the barriers to switching between operators, it will generate no net benefits. Since there is an externality said to be associated with portability (it increases the level of competition), it could be argued that porting customers should not bear all the costs of porting numbers.

There are two difficulties with applying these criteria

They conflict with each other in theory

12. This is obvious from even the minimal discussion above. For example:
- Requiring operators to bear their own costs will minimise the costs of introducing portability, but will not necessarily ensure allocatively efficient decisions on whether portability is introduced or on the consumption of porting. This seems to be Telecom’s point (in paras 14-23).
 - Requiring RNOs to meet the full costs of introducing portability may mean that it is only introduced if the expected benefits to RNOs exceed implementation costs. But it would probably mean that switching costs for customers would not fall, in conflict with the overriding principle.

There is limited evidence to resolve the conflicts in practice

13. Resolving the conflicts depends on evidence about the relative importance of the different effects. The adoption of number portability in the first place is based on the belief that the benefits to competition will be significant. But there does not seem to be any evidence on the size of the different effects in New Zealand. There is evidence that the distribution of costs can vary significantly between different countries.
14. To us these two points explain why Telecom and TelstraClear can disagree with each other on cost allocation:
- Telecom emphasises the importance of allocative efficiency. It argues that spreading operator specific setup costs across all operators will signal whether the parties actually expect to make sufficient use of number portability to justify its expense. And that if customers face the actual costs of porting they will ration their consumption appropriately.

- TelstraClear emphasises the importance of productive efficiency and the impact on switching costs. It argues that if each operator bears its own costs the total costs will be minimised, and if customers do face the full costs of porting, they will port in insufficiently large numbers, jeopardising the competition benefits that were the justification for specifying number portability in the first place.

We are cautious about the “alignment of costs with benefits” principle

15. The Commission (para 57), Telecom (para 11) and TelstraClear (para 54) all refer to the principle that those who benefit from number portability should pay for it. The Commission calls this “alignment of costs with benefits”.
16. We do not understand exactly what this principle means. But we are not convinced it is a useful principle for cost allocation. It sounds too much to us like it risks broad equity assessments of who ‘benefits’ from portability and therefore how costs should be allocated. The best test of whether a party benefits or not is normally whether that party is prepared to pay for the benefit.
 - If the principle means that customers or RNOs should face the costs of their decisions so that the level of consumption of porting is appropriate, then it is equivalent to the cost causation principle.
 - If the principle means that customers or RNOs should not face the full costs of portability (because otherwise number portability will never be introduced) then it is equivalent to the principle that the cost allocation must ensure that switching costs are actually reduced.
 - If there are some costs that are not ‘caused’ by any party (like fixed setup costs) then spreading them widely across all customers is likely to be the most efficient, as we suggested in the discussion above. This spread of costs has nothing to do with the fairness or otherwise of the split of assumed ‘benefits’ from number portability. It is because a wide spread of costs avoids impacts on behaviour that could cause economic efficiency losses.

V Allocation of costs

17. In this section we look at the Commission's proposed cost allocation:
- We agree with the cost allocation proposed as being likely to lead to the least cost implementation of number portability, consistent with the objectives of section 18 and the principles discussed in section IV.
 - We look at the Commission's suggestion of enabling DNOs to charge RNOs for per-line setup costs. Allowing charging is consistent with allocative efficiency but risks DNOs stymieing porting by charging too high a price. A reciprocity requirement could be one solution: simply requiring DNOs to bear their own costs could be another. But we would not favour Commission intervention until a problem emerges. RNOs can come back to the Commission for a clarification or reconsideration of the determination if there are problems with DNO charging.
 - We have some suggestions for how exactly the process of cost allocation should work and what 'subscriber numbers' should mean. We think more clarity is needed on how new entrants will become liable to contribute to the industry shared costs.

We support the cost allocation rules proposed

18. We agree with the Commission's proposed cost allocation. In summary, given the lack of evidence on the relative size of the relevant effects:
- It is reasonable to think that the competition benefits from portability justify not charging porting customers or RNOs the full costs of porting, and especially not charging them directly for the fixed setup costs.
 - It is reasonable to think that operators will inflate estimates of their own costs if they do not have to bear them. This effect seems to us to be likely to be stronger than the incentive on carriers to argue for increased functionality so as to raise other carrier's costs. In our view, this latter problem can be dealt with in the working groups.
 - It is reasonable to spread the shared costs of system setup across operators on the basis of subscriber numbers. This will spread costs as widely as possible, while having each operator bear its own costs will retain the incentive for carriers to manage their own costs.

System setup costs are the biggest issue

19. System setup costs make up by far the largest portion of the costs of LMNP. These are made up of:
- the shared industry costs of the LMNP solution (around \$2 million),

- the shared industry costs of ongoing maintenance (around \$0.150 million a year), and
 - the operator-specific costs each operator faces in setting up their own networks to integrate with the IPMS. This is by far the largest category of costs. It will cost us many millions to implement number portability on our network.
20. A cost causation approach could allocate these costs to RNOs (assuming they would pass them on to porting customers). This could possibly work if RNOs were in a position to decide how much they were willing to pay for portability in advance of the decision on whether to implement number portability. This seems to be the foundation of Telecom's argument (paras 14-23) that costs should be allocated amongst beneficiaries.
21. In our view this approach might be appropriate if:
- A decision had yet to be made on whether it was worthwhile to introduce number portability or not – Allocating setup costs to RNOs could help to ensure that the decision of whether to proceed with portability was based on a full assessment of the likely costs.
 - There were no significant externalities from the introduction of portability – If Type 2 benefits were likely to be small then ensuring that those that want portability pay for it could be efficient.
22. But we think this approach suffers from many flaws:
- It may not reduce barriers to customer switching, i.e., it could defeat the purpose of introducing portability – As LECG and AAS found in the NAD Cost Benefit Study, if the full costs of porting are allocated to porting customers (or equivalently RNOs), there are unlikely to be static efficiency benefits from introducing LMNP in New Zealand.
 - It misunderstands cost causation – The setup costs of number portability are not 'caused' by the decision of any given customer to switch. They would not be avoided if no customers decided to port their numbers. So these costs should be recovered in the way that least distorts decision-making, and spreading them across all customers is one way to do that.
 - It conflicts with the principle of cost minimisation – As noted above, if one operator can pass its costs on to another, its incentives to control those costs are much reduced. This is not to say, of course, that we would not appreciate it if other carriers wished to contribute to our costs, but only to point out that other carriers are not as well placed to control our costs as we are.
 - It conflicts with the principle of practicality – Telecom proposes (para 23) that the Commission could estimate the costs of introducing portability on each carrier's network. In our view there is no better way to

guarantee ongoing dispute about the cost allocation for number portability than to require carriers to contribute to each other's costs.

23. The Commission's proposal is to allocate shared costs based on market share and have each operator face its own costs. This seems to us to be a sensible way to spread the costs of portability widely, recognising that cost causation is not the primary issue in this case. It will ensure a wide spread of costs, it will ensure operators have incentives to control costs, and it is practically very simple to implement.

Enabling DNOs to charge their per-line setup costs seems appropriate

24. We agree with the Commission's proposal to have DNOs recover per-line setup costs from RNOs. Charging RNOs would be consistent with cost causation principles, and enabling RNOs to protect porting customers from those charges will likely lower the costs of customer switching.
25. The Commission expresses some concerns that DNOs could frustrate the take-up of portability by setting high per-line setup charges, thus making it uneconomic for an RNO to port in customers. Possible solutions would be a requirement that charges be reciprocal, a low price cap on DNO charges or a requirement that each DNO meet its own costs.
26. In line with our general approach of regulatory forbearance, we suggest that the Commission not intervene in this area before:
 - there is evidence of a problem other than in theory,
 - industry participants have had an opportunity to negotiate a commercial solution, and
 - an access seeker has complained about DNO per-line setup charges to the Commission and asked the Commission to reconsider the determination, or the circumstances for a clarification of the determination exist.

Call conveyance costs can happily be left where they fall

27. We agree with the Commission that each operator should bear any additional costs it incurs in connecting calls to numbers that have been ported. These costs should be minimal due to the use of a centralised system in any case.
28. TelstraClear says that in the special case of donor re-routing DNOs should be able to recover these costs from RNOs (para 82). We agree in principle with TelstraClear, but we think that this special situation can be dealt with by bilateral agreements between the parties if necessary. There is no need for Commission determination on this issue.

Need to be clear on basis for splitting industry common costs

29. The Commission proposes to split the industry shared setup costs and the ongoing maintenance costs in line with subscriber numbers. The object is to ensure a wide spread of those costs across all end-users of telecommunications services.
30. We are comfortable with this approach. We think that more detail is needed on how this approach will work.
 - We need to be clear what 'subscriber numbers' actually means. One option would be a measure of average active voice connection numbers over the course of each calendar year.
 - We need to agree on how the process will work. One approach would be for the Commission to collate the relevant connection data each year and issue some advice to all participants on the relevant division of costs for that year.

Need to be clear on allocation of costs to new entrants

31. A process is also needed to determine who qualifies as an access seeker or access provider for LMNP as there are changes in the industry over time.
32. We suggest that the Commission consider any questions of eligibility of operators to contribute to the costs of the IPMS each year at the same time it considers the information on market shares.
33. In some cases an operator may not qualify as an access seeker (and presumably therefore would not be allocated any of the shared costs of the IPMS). In these cases a contract could be used to allocate the costs of the IPMS contribution between the new entrant and the network operator whose network the entrant uses. We are especially concerned that resellers or MVNO entrants who may not allocate to customers numbers from their own number ranges contribute to the costs of LMNP as they gain market share.

VI Responses to questions

In this section we respond to the Commission's questions.

1. *Has the Commission identified correctly the costs associated with number portability and who incurs them?*

2. *Is the classification of costs appropriate?*

3. *Are the cost drivers and the magnitude of individual costs accurate?*

While the classification and magnitude of costs obviously can not be determined with complete accuracy until the solution has been finally agreed, we are comfortable with the Commission's presentation as a basis for determining the broad allocation of costs.

In contrast with Telecom's approach, we particularly support the delineation of fixed costs into shared industry costs and operator-specific setup costs.

4. *Which mechanism could be implemented to provide an incentive for the minimisation of per-line setup costs?*

We discuss this issue in more detail in paras 24 to 26. We do not think that there is a clear need at this point for more extensive regulatory intervention on the charges DNOs might set for per-line setup costs.