



16 December 2009

Dr Ross Patterson
Telecommunications Commissioner
Commerce Commission
44-52 The Terrace
Wellington

Dear Dr Patterson

Process for the final stage of MTAS investigation

Introduction

1. We refer to the Commission's letter of 3 December 2009 noting the preliminary view that further revised undertakings consistent with the Telecom 28 October proposal would be "*capable of being closely considered for being recommended for acceptance*".
2. We respond with divided emotions. Of all of New Zealand's telecommunications carriers, 2degrees is perhaps the most eager to see a prompt reduction of mobile termination rates, whose current levels are an impediment to enhanced competition and consumer welfare. The indication in the Commission's letter that new, lower rates may be implemented in the very near future is therefore attractive. However, we are very disappointed to read that the Commission is inclined to accept undertakings for rates that are well above cost and will not be reduced to cost for many years to come, if at all. That is a particular concern given the harm of closed-net pricing.
3. The letter suggests a new approach to benchmarking under which one new country (with higher prices) is added to the benchmark set; there is a new banded approach to the benchmarks having the effect of widening the potentially acceptable cost bands; there is also a new, above-cost and extended glide-path; and there is a "recalculation" of the "cross-check" of on-net rates for "consistency".
4. These changes reduce the difference between the new benchmarks and the Telecom proposal.
5. 2degrees has reviewed the letter carefully and considers that:
 - (a) The Commission's new approach is inconsistent with or ignores much of the evidence submitted during the 17 month consultation since the initial Mobile Termination Issues Paper, and is inconsistent with the section 18 Telecommunications Act purpose.
 - (b) It is unclear how voice rates which are over 150% of the Commission's new benchmarks and remain in excess of benchmarks for most of the 5 year term of the proposed undertakings would be in the long term interests of end-users or the market.

- (c) It is unfortunate that these issues were not fully canvassed at the MTAS conference (notwithstanding prior submissions on many of them from the incumbents).
6. At this late stage, and with little reasoning given, it is hard for 2degrees to comment fully. But here we try to do so.

Flaws in the letter's approach

7. 2degrees considers the new preliminary view is flawed:
- (a) **It reaches critical conclusions without a full welfare analysis:** Telecom and Vodafone criticised the Commission for not conducting a full welfare analysis. To address this, Concept Economics submitted a welfare analysis setting out the benefits of regulating mobile-to-mobile termination rates. There is no evidence that the Commission has considered that evidence. We struggle to see how the Commission can reach a conclusion about the efficiency of above-cost commercial offers without a more detailed analysis. Indeed, significant evidence was provided to show distortions of above-cost termination rates but no harm was shown of below-cost termination rates. The letter is silent on the harm of closed-net calling and the singular failure to provide end-users with the benefits of “*any-to-any connectivity*” (a critical finding of the Ministerial Report in 2000). It is no coincidence that the MED has used the same language in relation to the Ultra-Fast Broadband project. Concept also provided evidence of the harm and distortions (in favour of large mobile networks) of closed-net pricing especially when combined with above cost termination rates, harms and distortions which were recognised in the Commission’s draft report. The apparent readiness to sanction above-cost rates for the next five years would preserve those distortions to the detriment of end-users and competition and would be to the benefit of large mobile networks.
 - (b) **Benchmarks and cost:** As was commonly accepted at the conference, benchmarking is an imprecise exercise. The sudden inclusion of an additional country seemingly in an effort to ‘shoehorn’ Telecom’s October rates into a justifiable range is perplexing to 2degrees. Around half the world’s consumers enjoy mobile termination rates at very low or zero rates yet none of these countries were included in the benchmarking. Again, at this stage in the process to “throw in” one additional high priced country is at best highly unsatisfactory, especially when there is significant evidence that many regulators consider that their own cost estimates are too high. This is particularly perplexing given the evidence of the Commission’s own experts, WIK-Consult, at the MTAS conference that costs in NZ would be **lower** than the NZ6.5 cents they modelled for Australia for 2009. The Telecom proposed voice rates are almost **twice Australian costs**.
 - (c) **The “cross-checks” are inflated and at best set a ceiling well above cost:** As previously submitted, if the Commission were really seeking a proxy for “costs” (on which the incumbents have not once advanced a view), the most accurate starting point would be the “best prices” for the “best customers” of the lowest-cost provider. We consider the aggregation process, both within and between providers, and the inclusion of subscription revenue, renders a number which is the “highest possible” ceiling. Cost based termination rates in other markets are generally based on the costs of an efficient operator because inflating prices to allow for inefficient operators merely rewards those inefficiencies with subsidies from other networks’ customers. So, if one were minded to take an on-net retail pricing approach, which has inherent

limitations, a more appropriate calculation would use average on-net retail prices for prepay users of the lowest-cost provider only. In addition, and as already submitted, the Commission's arbitrary 18% cost of sales allocation is, in our view likely to significantly underestimate the real avoided costs of wholesale provision.

- (d) **The glide-path approach is inconsistent with the previous approach:** There is no justification for a glide path to cost approach. It delays the benefit of regulation (either voluntary or enforced) to the detriment of competition and consumers. There was no glide path for the regulation of Telecom's fixed PSTN which resulted in nearly a 60% reduction in rates overnight. No evidence has been shown of any harm associated with that reduction yet significant benefits resulted from the action. Clear evidence was presented that glide paths are generally appropriate for new entrants who are often allowed to charge higher rates than incumbents in early years as they have lower economies of scale (and so a higher cost per minute), not to give a "soft landing" for incumbents. Again we are disconcerted at the apparent "about face" by the Commission - we understood it to be strongly against glide-paths. It is even more perplexing when significant expert evidence has been provided by 2degrees on this point.
- (e) **Price Symmetry:** 2degrees has long argued that asymmetric rates in favour of new entrants is of less appeal only in circumstances where termination rates are cost based. If the market is distorted in favour of large networks through above cost termination rates then, in order to minimise those distortions it would be appropriate to allow a new entrant to enjoy termination rates at a higher level to the incumbents. The Commission appears to be promoting industry agreement at above cost termination rates that favour large mobile networks without allowing higher asymmetric rates for the new entrant, justifying this by pointing out that it would create market distortions. 2degrees find the Commission's position odd in that distortions in favour of incumbents are appropriate yet those in favour of new entrants are worthy of elimination.
- (f) **Text rate proposals are not Bill and Keep despite the convenient headline:** The Commission seems of the view that Telecom's "netting off" of text charges within a closely defined range constitutes a form of Bill and Keep. 2degrees has made it clear that Bill and Keep means a price of zero. The European Regulatory Group (ERG) defines Bill and Keep as "*a wholesale billing regime under which each network bears the cost of terminating traffic coming from other carriers*". It is clearly not conditional on near equal volumes of traffic being sent and received otherwise high and above cost charges should apply. As far as 2degrees is aware, no other mobile termination regime relies on traffic flow balances to determine prices. New Zealand would be introducing a globally unique methodology that is likely to introduce unintended consequences at the retail level, which may serve to incentivise operators to increase retail prices rather than lower them. This risk was highlighted in the paper submitted by Dr Eric Ralph and Ms Emma Lanigan on 16 October 2009. (Again, there is no evidence the Commission has considered this evidence.) Bill and Keep means a price of zero, any methodology that charges for traffic is not Bill and Keep and is likely to create market distortions. The Commission appears to fundamentally misunderstand the concept and has made no reference to the evidence presented on this point.
- (g) **Timing:** The letter suggests benefits from early implementation of the Telecom proposal. We note that the Commission's original expected timeline (as published 16 December 2008) was for a final report to be submitted to the Minister in August 2009.

As previously submitted the legislature anticipated that there would be a clear “drop-dead” date for the offering of undertakings. That has not occurred here and to suggest there are benefits when *the undertakings process alone* has gone on for 10 months is deeply disturbing. It not only undermines the current process but sends a very strong message for any future regulation that incumbents will be rewarded for gaming and delaying the process. Given the levels proposed, and our view of the likely TSLRIC rate, we do not consider that these undertakings offer a benefit compared to regulation, indeed the reverse is true.

- (h) **NZ lags well behind international best practice:** MTAS is regulated in 27 of 30 OECD countries. New Zealand is significantly out of step with the rest of the developed world and will fall further behind if MTAS remains unregulated. In the absence of regulation, the above-cost prices could be locked in for five years, while regulated rates and costs tumble around the world. If the Commission is minded to recommend that the Telecom proposal be adopted, it should recommend regulation as well (which the Act anticipates).

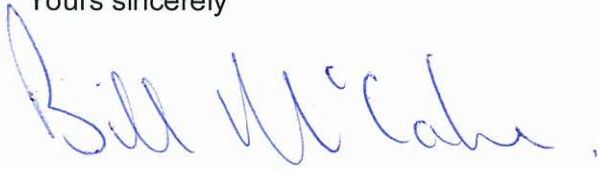
Next steps

8. 2degrees considers it likely that Vodafone and Telecom will offer revised undertakings consistent with the Telecom proposal, providing for “bundling” of MTAS services and requiring reciprocity.
9. We have concerns about the Commission’s new approach for the reasons noted above, but in the circumstances it does not seem productive to engage further at this stage.
10. However, if the Commission is determined to recommend acceptance of Voluntary Undertakings we urge the Commission to, as a minimum:
 - (a) Insist on Mobile to Mobile text pricing on a pure Bill & Keep basis;
 - (b) Insist on separation of MTAS Undertakings such that SMS, FTM and MTM voice services are capable of acceptance individually;
 - (c) Consider acceptance for a period of no more than 3 years; and
 - (d) Recommend designation of Mobile Termination Access Services in conjunction with Voluntary Undertakings as contemplated by the Act.
11. The Telecom proposal does not address the distortions created by closed-network pricing. Consequently a form of retail control, or continued monitoring to ensure on-net retail prices do not fall below a level equal to double the prevailing termination rates, may also be necessary for networks with substantial market power. Without such control competition will simply not develop in some market segments.
12. We reiterate that Vodafone sought and obtained retail price controls from the Commission for its Homezone service to ensure that *“if Telecom can require callers to Vodafone local numbers to pay higher rates than callers to other local numbers, there could be a significant disincentive to take up Vodafone’s local service. Hobbling Vodafone’s local service before it begins is unlikely to promote competition for the long-term benefit of end-users”* and that without similar controls retail distortions will

remain, to the detriment of competition and end users. 2degrees reserves its position in this regard.

13. In the circumstances, there is no need for 2degrees to provide an undertaking. 2degrees confirms that all previous undertakings are withdrawn.

Yours sincerely



Bill McCabe

Two Degrees Mobile Limited