

Competitive Effects of 'Talk'

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1 Introduction

1. The recommendation in the Commission's Draft Reconsideration Report of the mobile termination access services (MTAS) investigation is that the Final Undertakings put forward by Vodafone and Telecom should not be accepted, and instead the relevant services should be made designated services under the Telecommunications Act. This reverses the Commission's earlier recommendation that the undertakings should be accepted, and appears to have been reached primarily on the basis of the Commission's analysis of Vodafone's new 'Talk' prepay add-on, which offers a fixed bundle of 200 minutes of calls to Vodafone mobiles and landlines per month for \$12.
2. At Vodafone's request we have examined some aspects of the Commission's analysis in the Draft Reconsideration Report of competition issues relating to Talk. This note summarises our findings and has been prepared independently in accordance with the High Court's Code of Conduct for Expert Witnesses.
3. The Commission's conclusion relies on two key assumptions. The first is that, due to its smaller number of subscribers compared to Vodafone at present, 2degrees will need to offer calls to any network for the same effective per-minute price as the Talk add-on, in order to be able to compete in the mobile market (paragraph 10):

The Commission's preliminary view is that a plan such as the Talk Add-on plan is likely to increase the difficulties an entrant faces in competing. In order to be able to compete with the new Talk Add-on plan, an entrant may be forced to offer off-net calling at a retail price as low as 7.7cpm (or lower if utilisation is higher than the level assumed in this Draft Reconsideration Report). This represents a significant reduction in on-net retail prices, and a significant widening of the differential between on-net and off-net prices.

4. The second key pillar of the Commission's reasoning is that offering an any-net version of Talk would cause 2degrees to have a net outflow of interconnection traffic and, under the termination rates in the Final Undertakings, this would be an insurmountable financial burden preventing 2degrees from gaining market share in the mobile market (paragraph 11):

Given the wholesale MTRs contained in the Final Undertakings, which remain above the Talk retail price until 2014, and that the entrant will incur other costs that would also need to be recovered from the retail price (such as the costs of call origination and marketing), the Commission's preliminary view is that if the Final

Undertakings are accepted, the new Talk plan will retain the barrier to expansion that the Commission was seeking to address during the MTAS Investigation.

5. To provide support for its analysis (and the first key assumption in particular), the Commission refers at several points in the Draft Reconsideration Report to statements made by us earlier in the MTAS investigation that it would be more difficult for an entrant to compete with blanket on-net pricing compared to closed-group on-net pricing such as Vodafone's Bestmate add-on (for example, paragraph 119):

As noted by Vodafone's economic advisors during the MTAS Investigation, blanket flat-rate plans that offer calls to anyone on-net will make it significantly more difficult for a small entrant to compete:

"The task would be very much tougher for a new entrant if these voice plans were available to **anyone** on-net. Under the current structure of prices, it is not necessary for an entrant to offer low any-net pricing to compete with the existing on-net pricing."

6. Given the limited time available for submissions on the Draft Reconsideration Report, it has not been possible for us to fully analyse the Commission's analysis and conclusions regarding Talk. In this note we therefore do not attempt to critique the Commission's "imputation test" of Talk to assess whether an entrant would lose money by offering a broader (any-net) version of Talk pricing. Consequently, we offer no views on the assumption that an any-net version of Talk will lead to a net outflow of calls.
7. Instead we provide a high-level assessment, in light of our earlier comments about on-net pricing, of the Commission's assumption that, given Vodafone's Talk offer, a smaller competitor will need to offer an any-net version of Talk to be able to compete in the mobile market. This includes identification of a number of empirical issues that we believe must be examined to fully understand the competitive implications of Talk.
8. Given more time for submissions, it would have been possible to:
 1. Undertake the empirical analysis required to establish the relevance of Talk in terms of its attractiveness or not to a significant fraction of consumers in the mobile market given their voice calling usage and the alternative offers that currently exist in the market.
 2. Examine the calling patterns of consumers who would use an add-on like Talk, to assess the basis for the Commission's assumptions that it will be necessary for a small network to offer an any-net version of Talk to compete in the mobile market, and that an any-net version of Talk will lead to significant interconnection imbalances.
 3. Analyse the nature of competition in the retail mobile market to determine whether Talk raises any concerns given the purpose of the Telecommunications Act as set out in section 18.

4. Critique in detail the Commission's imputation test of an any-net version of Talk and examine the profitability of such a plan for a smaller network.
9. These are important aspects of the Commission's reconsideration but it simply has not been possible to undertake the necessary analysis within the timeframe provided.¹ We are also concerned that the Commission has not allowed itself sufficient time to undertake this work and question whether these important decisions for end users should be made in such a context. We would welcome the opportunity for further time to consider and undertake this work which we believe will be useful for the Commission's decision making.
10. Before our discussion, we think it appropriate to make a general comment that we find the Commission's analysis in the Draft Reconsideration Report to be surprisingly narrow given the statutory requirement of the promotion of competition for the long-term benefits of end-users. The analysis overwhelmingly focuses on Talk and lacks a realistic assessment of the state and nature of competition in the retail mobile market. It does not appear that the Commission has used a reasonable model of the way that mobile networks compete in conducting its analysis. Rather than considering competition at the level of customers or groups of customers and the multi-dimensional aspects of this competition, it concentrates on a single add-on plan and the ability of a small entrant to compete with that add-on. In our view, the appropriate focus is the overall process of competition in the mobile market, taking account of the relevant empirical realities about consumer behaviour in that market.

2 Discussion

11. Our comments about on-net pricing quoted in the Draft Reconsideration Report were in the context of the competitive effects of closed-group on-net pricing such as Vodafone's Bestmate add-on. We argued that, since calling circles tend to be small, it would not be difficult for a small entrant to compete with such plans. Talk is not a closed-group plan, so the key question at issue here is: Does Talk make it much more difficult for an entrant to compete in the mobile market, everything else equal?
12. There are many different ways in which on-net pricing plans can be designed, but in general the response of consumers to a pricing plan will depend on all features of the plan design and their assessments of alternative available plans, not just the effective per-minute price they obtain at a certain level of usage that appears to be the focus of the Commission's analysis. In particular, we must have regard to the main features of Talk, namely:
 1. Calls to landlines, as well as to Vodafone mobiles, are included in the bundled minutes.
 2. A customer who purchases the Talk add-on must commit to a monthly spend of \$12 in return for a fixed bundle of 200 minutes to be used within the month. Talk

¹ We expect the required analysis could be completed within two weeks.

does not offer a low per-minute price from the first minute of usage.

3. Talk is limited to voice and does not include SMS, MMS and video calling, for example.
13. Point 1 means that, regardless of its own size, a mobile competitor can offer a plan similar to Talk that includes calls to 1.9 million fixed-line numbers.² Fixed network termination costs 1 cent per minute, allowing a significant contribution margin over the MTR to be made on these calls even under an assumption of high utilisation of Talk minutes. If the number of callable lines matters for the attractiveness of the plan, the ability to call landlines helps to offset this for any size mobile network.
14. Point 2 reflects the fact that Talk is targeted at relatively high usage prepay customers, and will not be attractive to low usage customers. At Vodafone's headline prepay price (89 cents a minute), customers would have to make more than about 13 minutes of calls to Vodafone and landline numbers a month to find Talk worthwhile. The actual level of usage at which Talk becomes attractive to an average subscriber will likely be significantly higher due to use of other offers such as Bestmate and \$2 for 2 hours and the fact that Talk is billed on a minute + minute basis.
15. We note that bundle offers such as Talk are typically designed to *increase* revenues from a particular group of customers. If Talk is well designed then many customers who choose it will end up spending more in total per month than they otherwise would. This choice makes Talk consumers better off (since they would not have chosen it otherwise), and generates additional revenue for the operator.
16. Point 3 also means that Talk will only be attractive to a subset of the prepay segment as some consumers will find other plans more attractive given their usage level and calling pattern. Taken together, points 2 and 3 mean that Talk will only be a viable option for part of the pre-pay segment of the mobile market. Exactly how much of the market is an empirical question that we have not attempted to answer as the time available is too short to undertake the required detailed analysis of the consumption patterns of existing mobile subscribers.³
17. The three key features of Talk listed above make it clear that Talk is quite different to a simple offer of, say, 10 cents per minute for all on-net calls (from the first minute) versus, say, \$1 per minute for all off-net calls including to fixed lines. Such a plan is what we had in mind when we made our earlier statements about the competitive implications of on-net pricing. Compared with Talk, this type of pricing would likely

² *Annual Telecommunications Monitoring Report 2009*, Commerce Commission, April 2010.

³ We note that the Commission appears to consider that Talk will be attractive to most or all Vodafone prepay customers, yet it does not appear to have any empirical evidence or analysis to support this conclusion. Aside from the empirical question, the Commission's competition analysis is also flawed because it only considers incremental revenues and costs associated with one particular add-on, rather than all the incremental revenues and costs associated with customers who use that add-on.

have much broader appeal, and would make a larger mobile network more attractive than a smaller one, everything else equal.⁴

18. In contrast, Talk is an offer targeted at a subset of a segment of the mobile market, and is not restricted only to on-net calling. We therefore do not consider that our earlier comments about the ability of an entrant to compete with on-net offers translate into the strong conclusions the Commission has reached about Talk in the Draft Reconsideration Report.
19. The issue of the size of calling circles is also relevant to the analysis of Talk. If people only call a small group most of the time, a large network offering Talk is not very much more attractive than a small network offering an identical plan, if a consumer's calling circle belong to the same network. Put another way, it is not the absolute size of the network that matters so much as the network to which one's calling circle belongs. The calling patterns of users of Talk are an important issue that needs to be addressed through empirical analysis before any strong conclusions can be reached about its competitive effects.⁵
20. To summarise, Talk has characteristics that make it significantly different from simple blanket on-net pricing. In addition, a number of important empirical issues regarding Talk have not been addressed by the Commission, and we have also not been able to examine these issues in the time available:
 1. The level of usage at which Talk becomes attractive to an average Vodafone prepay customer, and how many customers exceed this usage level.
 2. The fraction of Vodafone's prepay customers for whom Talk will be an attractive option, taking into account (1) above and also preferences for alternative add-ons such as Bestmate.
 3. Calling patterns of Talk customers, including their propensity to make off-net calls under an any-net version of Talk, and the typical size of their calling circle.

⁴ However, the magnitude of such network effects will depend on calling patterns; see below.

⁵ The calling patterns of prepay customers in particular need to be examined.