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Dr Ross Patterson
Telecommunications Commissioner
Commerce Commission
Wellington

By email: ross.patterson@comcom.govt.nz

PUBLIC VERSION

Dear Ross,

MTAS investigation – comments on draft reconsideration report

This letter is Vodafone's response to the Commission's draft reconsideration report (the Draft Report) of 12 May.

Before we get to the comments on the Draft Report itself, it is important to advise that we have decided to withdraw Talk from sale from Thursday 20 May in light of the Commission's recently expressed concerns.

The Commission clearly has the view that Talk is a critical constraint to competition in the mobile market. In its Draft Report, the Commission was of the view that 2degrees could not compete with Talk, that it would drive our interconnection traffic with 2degrees out of balance, and that it would materially impact our average on-net prices and therefore fall foul of the Commission's "cross-check" on MTRs and lead to regulation of mobile termination rates.

In the circumstances, although we do not agree with the Commission's views on Talk (as discussed further below), we do not wish to continue to offer a product which the regulator believes to be anti-competitive. The ongoing criticism from competitors and lobby groups generated by the Commission's commentary is also potentially damaging to our business and our brand.

For us, Talk was an add-on designed to increase mobile voice usage and ARPU for some users in the prepay segment of the market. It was one of many offers we will launch this year as we seek to compete for call minutes with landlines and deliver better mobile value for our customers.

PUBLIC VERSION

As previously advised, we will also announce our new prepay plan on Thursday and begin advising customers about the Bestmate cap, but the []VNZCOI. Given the timing, I would appreciate it if you did not release the public version of this letter until after that announcement is made.

These changes obviously do not alter the requirement for the Commission to complete its Final Report for the Minister. To help the Commission with that, in this letter I make four main points:

- 2degrees is not having any trouble competing. It has accumulated prepay customers extremely quickly. We stand by our statement that its share of prepay customers is substantially above the 4% the Commission calculates. Voice interconnection traffic between us and 2degrees is []VNZAPI. The Commission's "cross-check" theory that 2degrees will face interconnection outpayments is []VNZAPI.
- Talk would not have made as much difference to the prepay segment of market as the Commission has assumed. It also was not expected to lower our average on-net prices significantly. And, 2degrees or Telecom could profitably offer an any-net Talk product should they wish to.
- The Commission has not paid sufficient attention to retail plan changes other than Talk in its Draft Report. In line with the Commission's guidance, we are raising our average on-net prices in prepay this year through the cap on Bestmates, which would have more than off-set any small decrease from the introduction of Talk. As noted above we are also announcing a new prepay plan with lower any-net calling rates which themselves are higher than the average on-net rates. These changes are just as relevant as Talk given the scope of the Minister's request. In order to have a basis for the conclusions it has reached about average on-net pricing, the Commission would have had to have analysed all of the changes. It has not yet asked for the information to do so.
- The undertakings remain the outcome that best provides for long-term benefits for end users. The undertakings will generate reductions in mobile termination rates more quickly with a minimum of additional debate, and better recognise the negative impacts for mobile operators and customers from sharp reductions in prices.

There are also some other concerns about the process and content of the Draft Report to which, in my view, the Commission needs to give some attention. I address these at the end of this letter.

I refer to these points in turn below.

2degrees is not having any trouble competing

The level of termination rates today is not impacting on 2degrees' ability to compete. There are two issues here:

- 2degrees is extremely successful at accumulating customers in the retail market. It is difficult to argue that the current level of termination rates is retarding its ability to compete when it has accumulated such a substantial proportion of prepay customers in just over six months.

- In practice, 2degrees continues to be a []VNZAPI of voice interconnection traffic from Vodafone. The Commission’s theory is that this []VNZAPI. The retail “cross-check” is based on this theory. This theory therefore seems to be []VNZAPI.

We stand by our statement that 2degrees is doing far better than the Commission’s estimate of 4% market share.

On 12 February, 2degrees reported it had 206,000 prepay customers who had used their phones in the last 30 days. The equivalent figure for Vodafone was []VNZRI, and our estimate for Telecom is 1.04m. This means 2degrees had just over []VNZRI% share of the prepay segment at that time. 2degrees is a very successful late entrant.¹

In the last quarter, we estimate Telecom lost 24,000 prepay customers, Vodafone lost 4,000 and 2degrees gained 172,000.² The level of termination rates is not affecting 2degrees’ ability to compete.

The Commission has set out its theory that 2degrees will be a net payer of interconnection because it will have to offer any-net calling at the same prices as our on-net calling in order to attract customers. []

]VNZAPI

¹ The Commission argues we are overstating 2degrees’ success by calculating customer numbers based on 180 day active customers as at the end of March. Presumably this statement from the Commission is based on actual information from 2degrees that is not disclosed in the Draft Report. So the numbers in this paragraph are calculated based on the disclosed figures from 2degrees on 30 day activity on 12 February. The Telecom figure is an estimate, but the Commission can find out the exact figure by asking Telecom.

² This calculation requires an estimate of 2degrees’ churn. We have assumed that 50% of the customers added 6 months prior have churned in month 7, and that churn has then smoothed gently down to a 30% churn level, []VNZCOI. Obviously the Commission can check this by inviting 2degrees to provide the actual figures.

Talk would not have changed the competitive picture as much as the Commission thinks

The Commission's preliminary view is that Talk would have had a very significant impact on the mobile market and that 2degrees would not have been able to profitably compete with it. The Commission's analysis greatly overstated the case against Talk. While Talk itself is no longer in the market, I think it is worthwhile to point out some of the concerns we had with the Commission's approach, primarily related to the lack of empirical evidence that the Commission has for the points of view it expresses in the Draft Report, and how that contrasts with the actual data we hold.

The two main points here are:

- The Commission's "imputation test" needs revision. The Commission understated revenues, over-estimated likely bundle utilisation, and over-estimated the likely level of off-net calling. When done properly, the hypothetical any-net Talk add-on would be profitable for 2degrees, although there are still questions about whether it would actually need to launch such a product in order to compete.
- Talk would not have reduced our average on-net rates very much even if we managed to reach our optimistic business case assumptions. [

]VNZRI

1) The Commission's "imputation test" for Talk was wrong

We know of no reason why 2degrees could not offer a similar on-net and landline add-on to Talk profitably and competitively. The Commission states that this would not be an attractive offer for customers. We strongly disagree with the Commission's assumption here and cannot see any reasonable basis for this view. We see no evidence at all in the Draft Report to support the Commission's conclusion.³

In addition, 2degrees could have made many other offers that might have been just as attractive to customers. For example, given that 2degrees' headline voice rates are lower than ours, we would expect it to be able to offer less value in a Talk-like bundle and still attract customers. For the Commission to be judging which of these retail offers is likely to be most attractive to customers without presenting any evidence at all seems questionable indeed.

Nevertheless, the Commission assumes 2degrees cannot compete with a like add-on, and therefore creates a hypothetical any-net Talk add-on that it thinks would be competitive. The Commission uses an imputation test to show that this hypothetical add-on would not make any money for 2degrees.

³ The Commission also paints an inaccurate picture of the number of people a Talk subscriber could call. Since Talk included landlines, our offer allowed a customer to call []VNZRI active Vodafone mobile customers plus 1.9m landline numbers. The equivalent offer from 2degrees would cover 206k mobile customers plus 1.9m landline numbers. The totals would be []VNZRI compared with 2.1m, not 2.4m vs 200k as the Commission describes it.

The Commission has erred badly in its “imputation test” of the economics of this hypothetical plan. It has understated revenue, overstated the likely utilisation rate of the bundle, and over-stated the proportion of calls that will be off-net.

Revenue from Talk itself was \$10.67 net of GST. Vodafone also expected to earn revenue from other activities of those customers who subscribed to Talk, including:

- outbound calls to Telecom mobiles, which were not included in the bundle,
- outbound texts and PXT,
- calls to voicemail, data services, and international roaming, and
- inbound revenues from voice and text.

The Commission does not count all other revenues and dismisses revenues from inbound voice saying they “may be expected to be relatively low”. This is simply wrong: prepay customers are more likely to be net call recipients (our customers’ usage demonstrates this), and Talk was intended to boost call volumes, generating more return calls.

Furthermore, customers who took up Talk would be higher value prepay customers with greater likelihood of earning these extra revenues. The []VNZCOI customers who subscribed to Talk on 13 April had an average outbound ARPU in the period leading up to their Talk subscription of \$[]VNZCOI excluding GST. This means that the Commission has understated revenue from customers who took up Talk by a factor of at least []VNZCOI. It also demonstrates what we expected, that Talk would only appeal to some customers in this segment of the market: most prepay customers simply do not wish to commit to that level of expenditure. Analysis done in the development of Talk revealed that []VNZRI of our []VNZRI prepay customers have a voice ARPU less than \$[]VNZCOI a month for landline and on-net calling.

The Commission’s 90% assumption of Talk bundle utilisation is unsupported with evidence and not in line with our experience, or with the evidence from early subscribers to Talk. The []VNZCOI customers who subscribed to Talk on 13 April 2010 used on average []VNZCOI% of their bundle of minutes in the following month on calls to Vodafone numbers and landlines. This seems high relative to some of our other bundles so it would have been interesting to see how utilisation changed over time. But we would not expect to see anywhere near 90% utilisation on average.⁴

The Commission also assumes that only 20% of calls will be on-net if 2degrees were to offer the hypothetical any-net Talk add-on. Again, the Commission presents no evidence to support this assumption.

⁴ Some other examples include our Mega Plan, which has []VNZCOI% utilisation for the on-net bundle and []VNZCOI% for the any-net portion, TXT2000, which has []VNZCOI% bundle utilisation, and Your Time 200, which the Commission asked about previously and for which we have now secured data – this add-on has []VNZCOI% utilisation. Utilisation might be expected to start out higher and decline over time.

The reality is that calling circle sizes are small, especially in prepay.⁵ Small calling circles mean that 2degrees can more easily compete with on-net offers, and, coming back to the assumptions the Commission has made, they also mean that a higher proportion of total minutes will be on-net, even for operators with small market shares. In addition, the evidence is that even operators with small market shares commonly have a high proportion of calls on-net. We include in the appendix to this letter some evidence on the relationship between on-net calling and market shares. Based on that data, it would not be unusual for even an operator with only 10% market share to have 50% of its traffic on-net.

2) Talk would not have reduced our average on-net prices significantly or driven our interconnection traffic with 2degrees out of balance

The Commission had the preliminary view that Talk was “likely to have a significant impact, both in terms of penetration in the retail market, and in terms of competition”.⁶ The Commission forecasted that Talk would be taken up widely across the Vodafone prepay customer base. Talk would certainly have appealed to a segment of our base: as explained above, it is likely to be most appealing to higher-spending prepay customers with significant voice usage.

The Commission also seems to doubt our calculation that Talk will have only moved our average on-net rates by []VNZCOI this year. There are two reasons why this number is so low. First, Talk just would not have generated sufficient minutes to make a material difference. [

]VNZRI An example will demonstrate the first point.

- As the Commission notes in para 134, we carried around []VNZRI on-net minutes on our network in 2008, or around []VNZRI minutes a month.
- In our Talk business case we estimated that customers would use on average []VNZCOI minutes a month of the Talk bundle for on-net calling, and that there will be []VNZCOI of these customers by the end of Talk’s first year. This makes an average of only []VNZCOI minutes a month, assuming customer numbers grow linearly to the []VNZCOI target.

The Commission should not forget about changes to plans other than Talk

The Commission said very clearly in its Final Report that industry average on-net prices should not be lowered if the undertakings were to be accepted. In line with that guidance we are capping Bestmate with the effect of removing millions of on-net minutes currently used by a small minority of our prepay customers who have Bestmate. This also has the effect of raising average on-net prices in the prepay segment.

⁵ For example, active Vodafone prepay customers called an average of fewer than []VNZCOI other Vodafone mobile numbers in April 2010. With a calling circle size that small, we expected a number of Bestmate customers to subscribe to Talk instead. We reasoned that they could still call their Bestmate usage and have some minutes left over for other calling, including to landlines, which was the new element in Talk.

⁶ Draft Report para 118.

The Commission paid a lot of attention in its Draft Report to one single plan – Talk, which was expected to lower our average on-net rates a little, but it paid no attention at all to the other changes we are making to increase average on-net retail rates. It also dismisses consideration of 2degrees’ on-net text pricing out of hand.

The Commission was specifically asked by the Minister to consider the impact of current and future offers. In order to do that the Commission needs to analyse the impact of all relevant offers. This is particularly since we are introducing a 1,000 minute cap on Bestmates because of the Commission’s concerns.

We are also introducing a new prepay plan with any-net calling rates at 49 cents a minute, and we have []VNZCOI. Although neither offer was anticipated to impact on our average on-net rates, the first should at least reduce Commission concerns about off-net/on-net price discrimination in prepay.

The Commission criticises our assessments of the impacts of our plans on average on-net revenues in para 137 of the Draft Report. We respond to those points in turn here.

- The Commission says that forward-looking estimates are subject to considerable uncertainty. We agree. The estimates in our 3 May letter are not forward-looking. As we said in that letter, they are based on the actual figures for the year ending June 2009, the last set of figures we submitted to the Commerce Commission.
- The Commission says we do not know the impacts on the industry average on-net price. We agree. As we stated in our letter, the estimates we make are of the impact on Vodafone’s average on-net rate, not at the industry level.
- The Commission assumes that Talk would have had a 90% utilisation rate, with no evidence to support this assertion. As noted above, we disagree based on our experience.
- The Commission says that Talk would have generated a relatively high number of minutes per subscriber and therefore would have had a disproportionate impact on average on-net rates. []VNZRI Talk would have had only a small impact and would, in any case, have been more than off-set by the impact of capping Bestmate.

More broadly, the Commission’s overall position on the cross-check seems difficult to justify. In my view the Commission can not say a) that the average on-net “cross-check” is an important part of the analysis, b) that Talk would have had a major impact on industry average on-net rates (paras 124-136), and then c) deny that anyone, or at least not Vodafone, is able to estimate that impact reliably, or at all (para 137).

Given that the Commission is holding us to the average on-net standard as an important part of setting termination rates, it would be unreasonable for it to maintain that no one, or only the Commission, is able to estimate that rate. We can not make retail pricing decisions if we do not know with a reasonable degree of confidence the likely impact on our business of such offers. This is an area where we have experience and empirical data but the Commission does not. And it creates a

real uncertainty for us about what the regulator will make of our retail offerings regardless of the analysis we perform.

Fundamental concerns

The Commission's reconsideration process is happening very quickly. As you know, there is no legislative scope for a review of the quality of the Commission's work. This makes it all the more important for the Commission to do a good job.

We have a number of concerns about the process and the content of the Commission's analysis as revealed in the Draft Report. We have had very limited time in which to complete this submission, and so we do no more here than list our concerns in the expectation that the Commission will address these issues in its final reconsideration report.

Some of the issues are covered in the preceding discussion:

- The scope of the Commission's analysis is effectively restricted only to Talk, despite the other offers that are relevant and apparently covered by the Minister's request.
- The Commission does not present any evidence itself on crucial points, like why 2degrees is required to offer an any-net Talk add-on in order to compete with Vodafone and attract customers. Establishing that an any-net Talk offer is essential would normally be a pre-cursor to an imputation test.
- The Commission is using an imputation test to shed light on whether 2degrees could profitably offer an any-net Talk add-on, but it does not appear to have any evidence at all for the assumptions it has made in the test. In particular, it has no evidence to support its views on the revenues available from prepay customers who also subscribe to its hypothetical add-on, on bundle utilisation of that add-on, or on the proportion of calls that will be on-net within usage covered by that add-on.

We also have some other concerns, again here listed without detail because we have so little time:

- The Commission focuses its analysis narrowly on the Talk add-on. At times it comes close to saying that there is a separate prepay mobile market, although this would be in conflict with the determined market definition. And the Commission does not consider at all the wider implications for consumers of rejecting the undertakings in terms of impacts in the fixed to mobile market, for SMS services, or for the retail mobile market as a whole. The Commission's conclusion appears to be, that a partial imputation test for a single prepay voice add-on, with relevance only to a segment of high-value prepay customers, can be determinative of the scope for competitive retail entry, competitive rivalry and expansion in the retail mobile market as a whole. The Commission appears to have lost focus on its objective to assess whether or not designating MTAS services promotes competition for the long term interests of end users and has instead assessed simply whether it thinks a particular market participant could compete with a specific retail offering.
- The Commission's Final Report led us to expect that, so long as industry average on-net retail prices fell no faster than 5% a year, the Commission would continue to view the undertakings

as a better solution than regulation.⁷ The Commission now appears to be saying that it meant no such thing. In particular, paras 127 and 142 of the Draft Report surprise us: if the Commission did not mean us to rely on its analysis of the average on-net prices in the Final Report, it should have clearly stated this. We are capping our Bestmate product in order to meet the Commission's standard, and so these changes of view by the Commission (if that is what they are) are no small matter for us and for what we offer our retail customers.

- The Commission has not reassessed the comparison between the undertakings and regulation. It did conclude, only three months ago, that the undertakings delivered most or all of the benefits of regulation at lower cost. There does not seem to be anything in the Draft Report that would change that assessment of the benefits and costs. The Commission's focus appears to be narrowly on whether 2degrees can compete with Talk rather than whether the undertakings or regulation will best promote competition.
- The Commission's analysis appears to be trying to do Commerce Act work with Telecommunications Act tools. If the Commission believes that the Talk add-on was inappropriately squeezing 2degrees' margins, that allegation is more appropriately addressed under the Commerce Act rather than the Telecommunications Act.

A lot of these difficulties are driven by the Commission's preferred timeframes. Five working days is not sufficient for us to either properly engage experts or to fully consider the new issues now raised in the Draft Report. We encourage the Commission to revert to more orthodox consultation timeframes to allow for natural justice in a process which allows for no merits review.

We find it hard to see how the Commission itself could make a proper assessment of the market effects it is interested in, or appropriately consider submissions received in the timeframes given. Instead what we see is a focus on a narrow retail price offering, not an assessment of its impact on the market in question. This is, we think, a product of the unreasonable timeframes imposed both on us and on the Commission.

We have asked Covec to address any issues it can identify in the time available. We understand that it has had time to look at only one issue in any depth, and even then, not to the level of analysis it says is necessary. It has, however, identified some other issues and advised it would need more time to undertake the necessary investigation. Vodafone asks the Commission to consider Covec's need for another two weeks to give us the opportunity to put relevant evidence in front of the Commission before it comes to a view in its Final Report.

Service description

The Commission altered the service description in the Final MTAS Report and has repeated this revised description in the Draft Report. Again we have had insufficient time to look at this, but we do have three brief comments to make on this issue:

- We continue to hold to our view that that the Commission has failed to demonstrate that there is sufficient reason for including internationally-originated calls or SMS in the service

⁷ For example, paras 624 and 880 of the Commission's Final Report.

description. While Vodafone was willing to include SMS and ITM calls in its undertakings as part of the overall package, we do not believe that there is any justification for regulating those services. Regulation of ITM rates does not provide long-term benefits to end-users in New Zealand, and there has never been any competitive problem demonstrated in relation to SMS services.

- The Commission has changed the initial pricing principle from “[b]enchmarking against MTAS prices in comparable countries”, a formulation that was consistent with other regulated services like fixed interconnection, to “[b]enchmarking against the costs of providing similar services in comparable countries”. This formulation seems to give weight to arguments expressed in the MTAS investigation that the Commission’s cost benchmarking approach was not then consistent with the initial pricing principle.
- The Commission previously stated that it would benchmark against comparable countries that result from the application of the initial pricing principle “to networks that are similar to the access provider’s mobile network”. Again, this is consistent with the wording of the pricing principle for fixed interconnection. However, the drafting in the Draft Reconsideration Report removes these words. The Commission now appears not to think that it is important to benchmark against networks that are similar to access providers’ networks, although the reason for this is unclear.

Conclusion

The Commission should not have been concerned about Talk. 2degrees is plainly not having any difficulty competing for prepay customers, and it is not exposed at all to termination rates []VNZAPI.

It is dangerous for the Commission to make assumptions with no evidential basis about retail customer behaviour. This is not its expertise and the assumptions do not fit with our experience of retail customer behaviour. The Commission does need to consider all relevant retail offers rather than focusing all attention just on one offering in one segment of the market, and it does need to give us a clear standard that we can use in our retail pricing if, as it seems to indicate in the Draft Report, the average on-net test is not a clear standard we can rely on. As set out briefly above, in our view there are some fundamental difficulties with the Draft Report as the Commission seems to have substituted its assigned task with a high level review of one retail offer.

The best way to lower mobile termination rates quickly remains the undertakings. But the undertakings do not bind the Commission. If monitoring reveals real concerns with the way the retail mobile market is developing, the Commission has left it open to reconsider the termination rate issue at some future point. The alternative to a speedy and simple undertakings process is a painful and drawn-out standard terms determination. The undertakings mean lower mobile termination rates faster.

I want to make two concluding comments.

First, the Commission’s analysis and much of the public commentary on termination rates gives the impression that 2degrees only needs lower rates for its competitive future to be secure. In our

experience of building and running a mobile network, there are many other important factors. These include differentiated products that appeal to customers, a strong brand, attractive devices, a quality network, good customer service, sophisticated distribution and committed long-term shareholders. Vodafone and BellSouth took around a decade to make a profit in New Zealand. Focusing so much attention on differences of a few cents in termination rates or on one particular offer that appeals to only part of the prepay segment seems extravagant in that light.

And finally, the Commission's "cross-check" involves setting retail mobile prices to some extent. This does not seem an appropriate use of the Telecommunications Act powers. The Commission denies that the "cross-check" amounts to retail price control. But it seems to Vodafone that the Commission is imposing a floor on mobile retail prices below which Vodafone is not allowed to price for any given level of termination rates. We are capping Bestmate in order to comply with this "cross-check". As a consequence of the Commission's concerns about the retail Talk offer, we have removed it from the market.

I therefore want to extend again the invitation to meet with you to discuss our retail plans once this process is completed. It seems that our plans to reduce effective mobile prices are in conflict with the Commission's views about the appropriate development of the mobile market.

Please feel free to contact me by email on hayden.glass@vodafone.com or by phone on 021 689 176 should you wish to discuss the issues raised in this submission further.

Yours sincerely,



Hayden Glass
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Appendix – Relationship between market share and the level of on-net calling

[

]VNZCOI