



Vodafone New Zealand Limited

20 Viaduct Harbour Avenue

Private Bag 92161

Auckland, New Zealand

Reception +64-9-355 2000

Facsimile +64-9-355 2006

Wednesday 26th May 2010

Dr Ross Patterson
Telecommunications Commissioner
Commerce Commission
Wellington

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

PUBLIC VERSION

Dear Ross,

Cross-submission on MTAS

This letter is Vodafone's response to points raised by others' submissions on the Commission's Draft Reconsideration Report on MTAS (the Draft Report).

We still consider the undertakings to be the solution that best meets the section 18 purpose. They remain the fastest way to reduce termination rates with the least additional effort from all parties. The alternative of regulation will mean significant additional argument and time-consuming debate while termination rates remain at their current levels. This is an unattractive solution for all parties, but there are no shortcuts in the regulatory process. The Commission can not avoid the necessity of following the required statutory steps. If time is genuinely of the essence, as 2degrees argues, this just reinforces the merits of the undertakings.

I cover four points arising from other submissions below:

- We disagree with 2degrees' suggestion that outlawing on-net pricing is appropriate. This would not best promote competition or consumers' best interests, and it is outside the Commission's Telecommunications Act remit in any case.
- We support the views of Telecom and 2degrees that reductions in MTRs are unlikely in themselves to affect the level or prevalence of on-net pricing. We present some evidence on this point.
- We share Telecom's view that a standard terms determination process for MTAS will be an arduous and time-consuming process.

PUBLIC VERSION

- We disagree with 2degrees' suggestion of adding LRIC pricing to the service description for MTAS. The Commission's own consultants agreed that pure LRIC pricing was not appropriate in their advice on the MTAS Final Report. We also restate our view on glidepaths.

Retail price controls are inappropriate

It is disappointing that the Commission did not permit an extension of time to enable serious economic analysis of the Draft Report. We think it would have assisted the Commission to understand why its concerns about our Talk offer were unwarranted.

The Commission told us that because of the limited scope of the reconsideration and because Talk has been withdrawn, the Commission did not think the economic analysis was required.

Our point is that, properly considered, Talk was not a barrier to entry or to expansion by 2degrees and analysis of the evidence would have enabled this to be proven. We expect that the Commission will still give proper consideration to the evidence we did provide which demonstrated why the Commission was wrong to consider Talk as a barrier, or as evidence of an anti-competitive approach to on-net pricing.

In the Draft Report the Commission noted that, even with Talk withdrawn, we could introduce further pricing which was a barrier to expansion. Further economic analysis might also have helped the Commission with its analysis of our future plans and the plans of other operators.

It is important also that we are clear on Talk. Vodafone withdrew Talk because the Commission viewed it as anti-competitive. The Commission was wrong to think so but we do not want to be viewed as anti-competitive, regardless of whether that view is justified.

The Draft Report clarified for us what the Commission wanted. Despite its previous statements, the Commission's concern in the Draft Report was not primarily about average on-net prices at all. We have made it clear that we think the best option for end-users is acceptance of the undertakings. Although we are now uncertain about what the Commission considers is and is not acceptable when it comes to on-net pricing, the Commission can be reassured that we are exercising caution to ensure that none of our offers could be mistaken for barriers to entry or expansion. For these reasons, the assumptions that the Commission now says underlay the initial recommendation continue to be valid and have not and will not be undermined.

All that said, the Commission is clearly concerned about behaviour in the retail mobile market. 2degrees seems to be arguing for a ban on on-net pricing. Telecom suggests guidelines under the Commerce Act. Our view is that the Commission should be cautious about trying to control retail mobile prices, either directly or through the MTAS process.

We continue to question whether the Commission is best placed to determine the best mobile pricing model for mobile customers. From comments in the Draft Report, it seems the Commission agrees that competition between operators is likely to do a better job than Commission analysts of

delivering products consumers wish to buy at less than the prices they are willing to pay. The Telecommunications Act does not contemplate Commission intervention in retail pricing.

Removal or significant restriction on on-net pricing would impact negatively on competition in New Zealand, including 2degrees and almost every other operator, and would not be in either the short-term or long-term interests of end users. This issue is dealt with in the short paper that Covec has submitted.

But if the Commission is to control retail prices, it is implicit from what we have said above that it needs to be very clear about what is and is not acceptable.

Experience with Commission guidance on retail prices thus far does not fill us with confidence. The Commission's guidance in its Final Report clearly intimated to us that we should not cut our average on-net prices by more than 5% a year if we wanted the undertakings to be accepted. We are complying with this standard. But the Commission has now indicated in its Draft Report that we should not have relied on these statements. The Commission's guidance has already led us to change our retail prices to cap our Bestmate product, a change that the Commission may now be indicating was unnecessary. This lack of certainty is creating real difficulties for us in our attempts to compete and clarity would be very welcome.

Reductions in MTRs are unlikely in themselves to affect the level or prevalence of on-net pricing

Both Telecom and 2degrees argue in their submissions that reductions in MTRs may not make any difference to the prevalence of on-net pricing. We agree, and have included some evidence on this point in the appendix. Again, there is some guidance on this in the Covec paper.

A standard terms process will be contentious

We share Telecom's view that a multi-access provider, multi-access seeker standard terms process that covers fixed-to-mobile, mobile-to-mobile, and SMS interconnection will be very challenging. Telecom and Vodafone came to agreement for the purposes of the final undertakings on all material non-price terms. But 2degrees never agreed to the non-price terms, and Telecom and Vodafone both did so on the understanding that such agreement did not bind them in the context of a standard terms determination.

Supporters of regulation state that time is of the essence for termination rate reductions but seem to under-estimate the difficulty of the standard terms process, perhaps because there are few regulated services with multiple access providers. It may also be that they have not appreciated the statutory process that the Commission must follow.

Depending on the timing of a Ministerial decision, if there were to be regulation it could easily involve all operators and the Commission in detailed debate for the rest of this calendar year and part of 2011. If there were a judicial challenge to the Commission's work, or a price review following the initial price setting process, termination rates might not finally be settled until late 2011 or early

2012. This contrasts with a simple implementation from 1 October of lower voice rates and near zero SMS rates under the undertakings.

Appropriate pricing for MTAS service

2degrees has suggested that the Commission alter the service description to allow pricing of MTAS at LRIC, if there were to be regulated price-setting. 2degrees appears to be concerned that rates in New Zealand will get out of line with international comparisons if European countries use pure LRIC price-setting methods and the Commission does not.

We disagree with 2degrees' suggestion. We do not propose here to debate the ins and outs of recovering common costs from termination rates since the restricted nature of the current reconsideration process does not seem to contemplate such a fundamental change to the service description. But we note that the Commission has already rejected pure LRIC, having considered some of the issues it raises in the Final Report. WIK described the European Commission's approach on pure LRIC as "ill-founded" in the report it wrote for the Commission.¹ We think there are real questions about whether pricing at LRIC is consistent with the Commission's section 18 purpose.

We have said at various times in the MTAS process that, if termination rates were to be regulated, TSLRIC would be the most efficient pricing solution. The Commission has quoted us, apparently with approval, in its Final Report.

Our support for TSLRIC as a pricing principle, however, does not remove the uncertainty about what a reasonable estimate of TSLRIC actually is for a New Zealand mobile network operator. We note that the Commission's benchmark set of cost model results has a very wide range, and WIK's advice that in its experience cost modelling estimates could vary by up to 30% just on underlying cost differences between countries.

Our support for TSLRIC should also not be taken to mean that an immediate move to TSLRIC is the best balance of consumer interests, were there to be regulation of termination rates.

The speed of transition between higher and lower rates was obviously an important issue for the Commission in its Final Report, and it would also be a critical issue for any regulatory price-setting process. Regulators use glidepaths in making substantial changes to termination rates, a point the Commission accepted in its Final Report.

We have previously submitted that the Final Pricing Principle, as drafted, may not give the Commission the flexibility it needs to consider glide paths following designation. Our previous submission was that in order to ensure that the Commission is entitled to consider the issue of glide paths as an implementation issue, glide paths should be expressly referred to as part of the FPP.²

¹ WIK-Consult, *Commentary on issues raised in submissions regarding the Commerce Commission's MTAS investigation and during the conference on 2 and 3 September 2009*, February 2010, para 10.

² See paragraphs 232-233 of our submission on the Draft Report.

As you will know, OfCom's latest effort on termination rates confirms that substantial falls in termination rates have major impacts for consumers. There are gains to fixed customers through reductions in fixed-to-mobile prices to the extent that reductions in MTRs are passed through by fixed operators. OfCom saw both benefits and costs for mobile users: it speculated that lower termination rates might mean more intense mobile competition that would benefit some mobile users, but also pointed out that some mobile customers may be priced out of the market entirely as a result of the so-called "waterbed effect".

The Commission mis-characterises the waterbed effect in its Final Report. It appears to believe that the effect is simply caused by mobile operators putting up their prices or reducing them less quickly in order to recover revenue they lose from MTR reductions. Those in favour of MTR regulation point out how unlikely it is that, in light of current mobile competition, any operator would be able to put its prices up profitably regardless of the level of termination rates. At a general level, we agree. Mobile prices continue to fall rapidly, with flat or falling ARPUs and significant increases in usage generating big reductions in effective prices per minute and per text.

But the waterbed is not directly a financial effect. The waterbed is really about how substantial changes to mobile operators' business models flow through into retail pricing.

When incoming revenues are reduced substantially, operators need to adjust their business models. The waterbed effect is caused by a softening in competition for mobile customers for whom incoming revenues are a high proportion of ARPU. Operators have less to gain from competing for customers who would previously have generated high inbound revenues. This could lead to a number of effects, including shorter-credit expiry, flag-falls or minimum top-up requirements that are common in other countries, and in theory will disproportionately impact on those customers who generate high inbound revenues today.

The economic basis for the waterbed effect explains why the effect prevails to some extent regardless of the market structure. These issues were extensively debated during the first MTR Schedule 3 investigation, and a great deal of effort was spent by all parties on assessing the likelihood and scale of any increases in retail pricing that might result from significant MTR reductions.

The need for operators to adjust their business model and the consequent negative impacts on existing "marginal" subscribers, along with the other negative impacts of MTR regulation, help explain why glidepaths are standard practice internationally when imposing reductions in termination rates. We note, for example, that OfCom's most recent proposals would see reductions in rates introduced over a four year period starting 1 April 2011.

Other issues

We share the sentiments of the Business New Zealand submission, and we appreciate the extra time the Commission made available to consider it. The Commission will not need reminding that we too

object to the reconsideration timeframes, to the lack of any review of the quality of the Commission's work, and to any inappropriate Commission intervention in the retail market.

We also share the views of the Business Roundtable on the primary of the statutory purpose. As we noted in our submission, we think that in its Draft Report the Commission may have substituted an analysis of what approach to MTAS would best promote competition with an analysis of a single prepay add-on.

We have not dealt specifically with the Drop the Rate Mate submission as it does not appear to raise anything of relevance for the Commission's consideration. The issues with the poll question are obvious and we cannot see that it has any evidentiary value at all in terms of guidance on what will best promote competition, even leaving aside the statistical questions raised by the sample size and method.

2degrees also talks a lot about "geographical monopolies", and has presented evidence gleaned from surveys of school students. Our survey data is nowhere near as skewed as the numbers 2degrees presents, even for students. And it would be a mistake to assume that even such geographical differences as exist are driven just by on-net pricing, as opposed to being influenced by brand, availability of services, network quality and distribution footprints, for example.

Conclusion

Nothing in the submissions causes us to change our view that the Commission's best course is to recommend the undertakings. They offer lower termination rates more quickly, and a more certain path of pricing for the industry. The Commission can continue to monitor the retail market, and reconsider its approach to MTAS pricing should it conclude that that is warranted. The alternative is a drawn-out and contentious regulatory process that will leave termination rates where they are for considerably longer. If this process is about ensuring 2degrees' success, the Commission need not be concerned: 2degrees is clearly having no trouble competing, and our special termination rate deal with them means they are not exposed to termination rates in any case.

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

Yours sincerely,



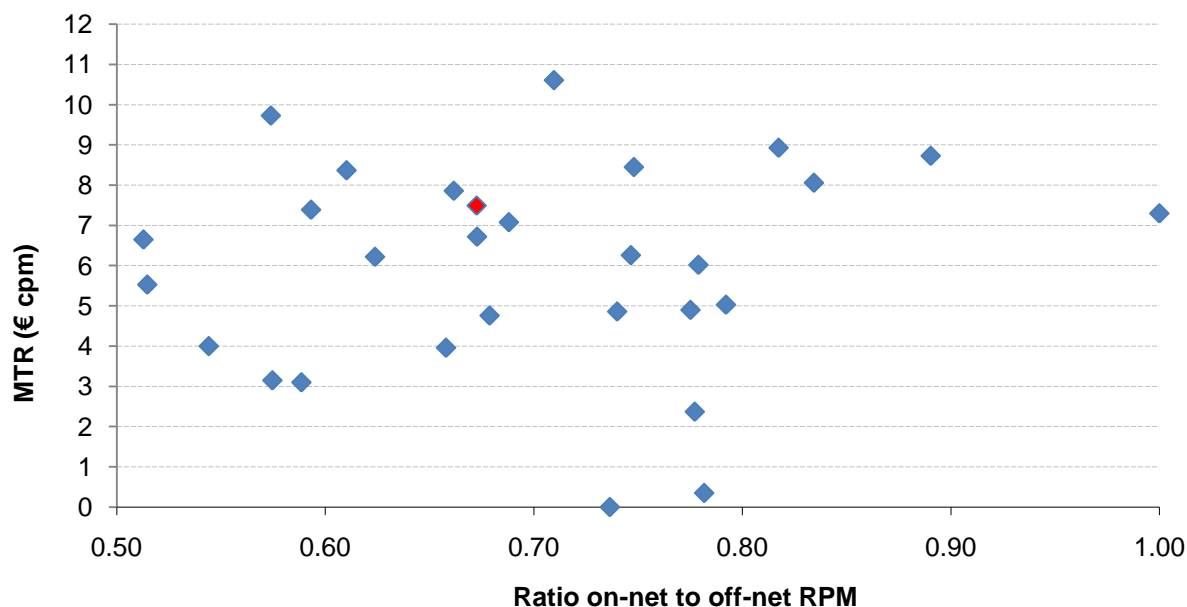
Hayden Glass
Public Policy
Vodafone New Zealand Limited

Appendix – Relationship between MTRs and on-net pricing

The first chart below compares MTRs in 29 OECD countries with the ratio of average on-net to off-net retail prices for plans with differential on-net and off-net pricing.³ It shows no clear pattern of higher MTRs being correlated with on-net to off-net differentials. Interestingly it shows that countries with very low MTRs, for example Canada and the US, have an on-net/off-net retail price plan ratios that are not dissimilar to New Zealand’s ratio, which is shown in red. This suggests caution in assuming causality between MTRs and on-net off-net pricing.

Teligen’s data includes only the largest two mobile operators in each market. As on-net/off-net price differentials have often been employed by new entrants in OECD markets the Teligen data will exclude the plans of many of these operators, and therefore may understate the extent of on-net/off-net price differentials.

Average MTRs compared with level of on-net discounts in plans in Teligen dataset



The on-net price per minute is calculated on the retail price for the medium OECD usage profile, assuming that all calls in that profile were on-net only. The total price for this usage is then divided by the medium OECD usage minutes to give an average price per minute. The same approach was applied to calculating the off-net price per minute. The ratio is calculated as on-net average price per minute divided by off-net average price per minute.

³ The data does not include Iceland.

The second chart show the prevalence by country of on-net pricing plans amongst the two largest operators in each market. The Teligen data base includes 2,297 tariff plans for February 2010. Of those plans, 637 or 27% contain an on-net discount. New Zealand's (Vodafone's and Telecom's) plans including an on-net discount are lower at 22%, again shown in red. The prevalence of on-net plans is shown in the chart below mapped against average MTRs.

The conclusion is the same. There does not appear to be any relationship between the level of MTRs and the prevalence of retail plans with on-net discounts.

Average MTR compared to percentage of plans in Teligen dataset with on-net to off-net price differential in 29 OECD countries (based on Feb 10 dataset)

