



COMMERCE COMMISSION

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Executive Summary and recommendations on whether the mobile termination access services (incorporating mobile-to-mobile voice termination, fixed-to-mobile voice termination and short-message-service termination) should become designated or specified services

The Commission: Dr Ross Patterson (Telecommunications Commissioner)
Anita Mazzoleni
Gowan Pickering

Recommendation of the Telecommunications Commissioner:

For the reasons set out in paragraphs 531 to 781, while there are grounds to recommend the mobile termination access services should be made a designated access service on the basis of the proposed regulatory change set out in paragraph 366 (the **proposed regulatory change**), the Telecommunications Commissioner recommends that the Final Undertakings are accepted under Schedule 3A of the Act as an alternative to the proposed regulatory change.

Views of two other members of the Commission:

Associate Commissioner Pickering concurs with the recommendations of the Telecommunications Commissioner.

Commissioner Mazzoleni's view is that the mobile termination access services should be regulated as a designated service on the basis of the proposed regulatory change set out in paragraph 366.

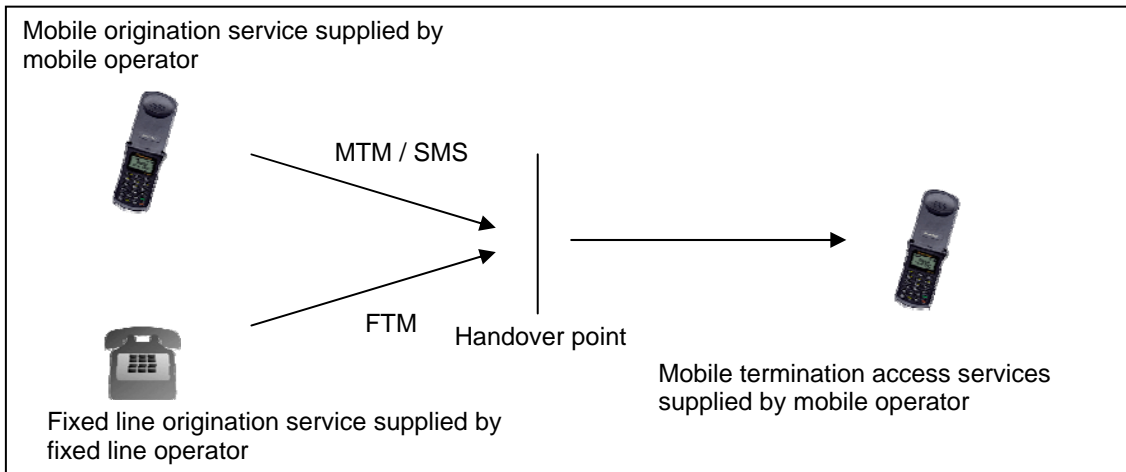
Date: 22 February 2010

EXECUTIVE SUMMARY

Introduction

- i. In the mobile termination access services (**MTAS**) Investigation the Commerce Commission (the **Commission**) has considered whether or not to recommend to the Minister for Communications and Information Technology (the **Minister**) that the MTAS should become a regulated service under the Telecommunications Act 2001 (the **Act**).¹ As part of the MTAS Investigation the Commission has also considered whether the Final Undertakings submitted by Telecom and Vodafone² should be recommended for acceptance as an alternative to regulation.
- ii. This Final Report provides the recommendations of the Telecommunications Commissioner and the views of two other members of the Commission, as required under section 10(1)(b) and clause 4(3)(d) of Schedule 3 of the Act. These recommendations, views and the reasons, are set out immediately following this Executive Summary.
- iii. The MTAS is a wholesale input used by fixed-line and mobile networks to complete calls and short-message-service (**SMS**) to other mobile networks. For the purposes of this Investigation, MTAS incorporates mobile-to-mobile (**MTM**) voice termination, fixed-to-mobile (**FTM**) voice termination and SMS termination.
- iv. The MTAS is depicted in Figure 1 below. The call or SMS originates on the fixed or mobile network to which the calling party is connected. The call or SMS will at some stage be handed over to the mobile network on which the receiving party is located, and will be ‘terminated’ or completed on that network.

Figure 1: Mobile termination access services



- v. Adding the MTAS as a regulated service under the Act would enable the Commission to set the prices and terms on which mobile network operators (**MNOs**), such as Vodafone, Telecom and 2degrees terminate calls and SMS on their networks.

¹ The Commission has concluded that the format of regulation to be considered is designation, which would involve setting both price and non-price terms for the MTAS.

² Telecom’s Undertaking of 11 February 2010 and Vodafone’s Undertaking of 16 February 2010, collectively referred to as the **Final Undertakings**.

- vi. Currently the terms and prices on which the MTAS are provided are governed by Deeds entered by Telecom and Vodafone, and commercial interconnection agreements.
- vii. This Executive Summary sets out the Commission's conclusions in relation to the MTAS Investigation. Detailed reasons for these conclusions are set out in the body of this Final Report.

Market definition and competition assessment

- viii. The Commission has concluded that the following markets are relevant to the MTAS Investigation:³
 - the wholesale MTAS market;⁴
 - the retail mobile services market; and
 - the retail FTM/tolls market.
- ix. The Commission has concluded that mobile network operators (**MNOs**) are subject to limited competition in the wholesale market for MTAS on their respective networks (paragraphs 334 to 335 of this Final Report).
- x. In the retail mobile services market, the Commission notes that the entry of 2degrees into the market is a positive development. However, the Commission still has a number of competition concerns in relation to this market.
- xi. The larger MNOs often set retail prices for calls and SMS that remain on the same network at a level that is considerably lower than for calls and SMS between networks (referred to as **on-net discounting**). Such on-net discounting makes it more attractive for subscribers to belong to a large network.
- xii. The Commission has concluded that a combination of wholesale mobile termination rates (**MTR**)⁵ that are significantly above cost, with significant on-net discounting, creates a barrier that restricts the ability of a small entrant MNO to compete with the larger MNOs. This conclusion applies to both MTM voice and SMS services.
- xiii. The Commission has also concluded that, faced with this barrier, the entry of 2degrees is unlikely to materially constrain the other MNOs in the retail mobile services market in New Zealand.
- xiv. The competition problem that the Commission has identified in the retail FTM / tolls markets is the barrier to competition created by above-cost MTRs. The difficulties faced by fixed-only operators in supplying FTM calls are particularly evident where integrated operators have offered retail FTM prices close to or below the wholesale MTRs.

³ See paragraph 122 for the full definitions of the markets assessed in this Final Report.

⁴ MNOs and fixed network operators must purchase the wholesale service of MTAS to be able to provide their customers with the ability to make calls or send SMS to the customers of other MNOs.

⁵ The wholesale charge to terminate calls and SMS on a mobile network.

Summary of Final Undertakings and likely outcomes under regulation and without regulation

- xv. For the purposes of this Schedule 3 Investigation, the Commission has used a range of cost benchmarks in order to determine the likely MTRs that would be set under regulation. The Commission considers that cost-based MTRs for FTM and MTM in New Zealand are likely to lie within a range of between 5.4cpm and 8.3cpm.⁶ The Commission has also allowed for a reduction in these costs over time during the five year period being considered.
- xvi. The Commission's assessment has considered two scenarios in relation to glide-paths:⁷ one in which the cost-based MTR is achieved immediately on the completion of the STD, which is assumed to be from the start of 2011 (ie no glide-path); and, one in which the cost-based MTR is achieved from the start of 2012 (ie a regulatory glide-path of 12 months).
- xvii. The SMS termination rates offered by Vodafone and Telecom have also been reduced during this investigation. The current wholesale SMS termination rate is 9.5 cpSMS. The wholesale termination rates for SMS contained in the Final Undertakings are 0cpSMS where traffic is within 7% of balance; 2cpSMS for traffic balances of 7% to 12%; and 4cpSMS for traffic imbalances in excess of 12%.
- xviii. Based on benchmarking, the Commission has used a cost-based MTR for SMS termination of 0.95 cpSMS as the likely outcome under regulation, reducing over time.
- xix. Figure 2 and Table 1 illustrate the differences between the MTRs for voice that were offered under the Final Undertakings, compared to the MTRs that are likely to apply under regulation and the MTRs that would likely to be charged without regulation.⁸

⁶ The Commission's benchmarked MTRs, for voice and SMS, relate to benchmarked MTRs for 2009.

⁷ A glide-path is a regulatory provision for a transition from one price to another.

⁸ Figure 2 and Table 1 do not include the terms of commercial interconnection agreements (ICA), such as the 2degrees / Vodafone ICA. The terms of ICAs have, however, been considered as a part of the assessment in this Final Report.

Figure 2: Comparison of MTRs for voice under the Final Undertakings, and likely outcomes under regulation and without regulation (all rates on a second+second basis)

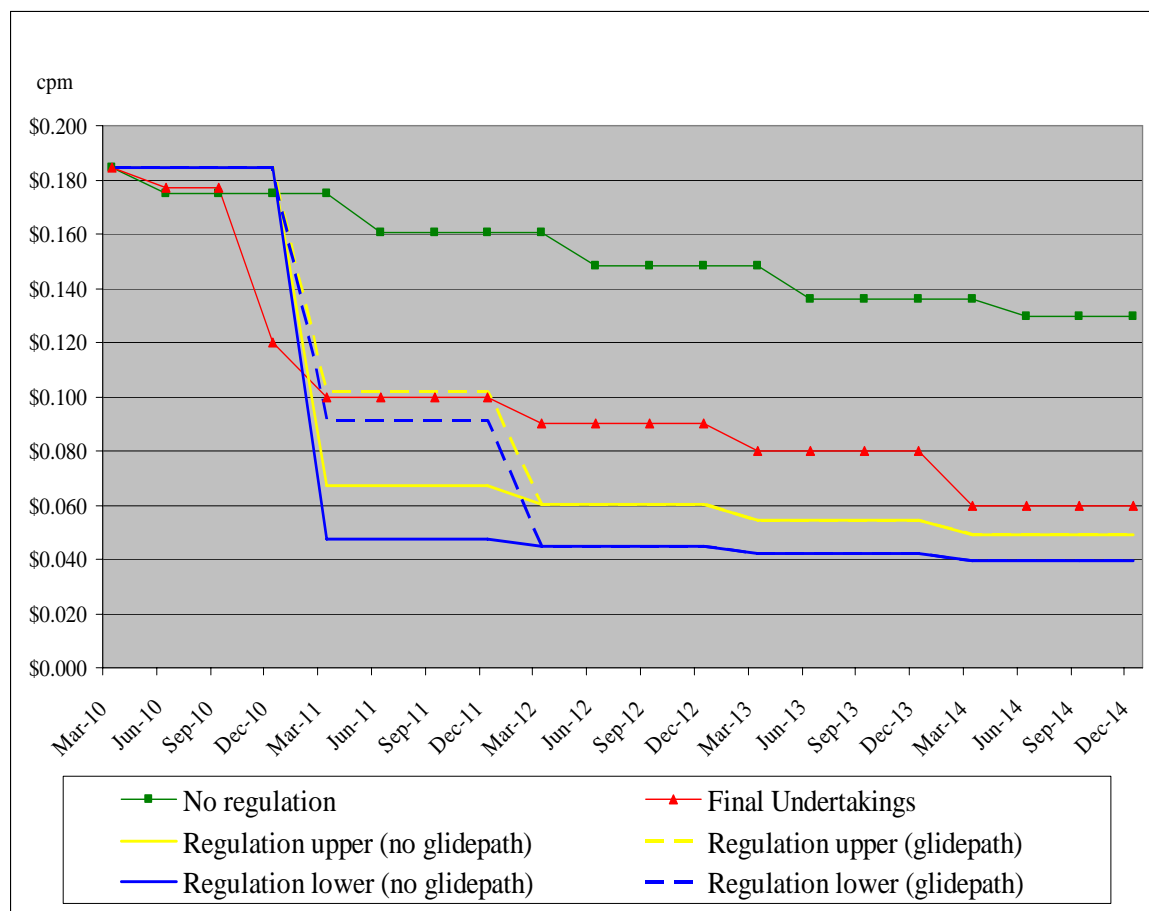


Table 1: MTRs for voice under the Deeds and Final Undertakings, and likely outcomes under regulation and without regulation (all rates on a second+second basis)

	2010	2011	2012	2013	2014
Existing FTM Deeds					
Telecom Deed	17.53	15.38	14.76	n/a	n/a
Vodafone Deed	17.90	17.34	16.30	n/a	n/a
Final Undertakings	16.47	10.00	9.00	8.00	6.00
Likely outcomes under regulation					
Upper bound (no glide-path)	18.45	6.72	6.05	5.45	4.90
Upper bound (with glide-path)	18.45	10.18	6.05	5.45	4.90
Lower bound (no glide-path)	18.45	4.77	4.49	4.22	3.96
Lower bound (with glide-path)	18.45	9.14	4.49	4.22	3.96
Likely outcome without regulation	17.72	16.42	15.14	13.91	13.11

Assessment of whether there are grounds to recommend regulation of the MTAS

- xx. The Commission has assessed whether regulation of the MTAS (at prices based on benchmarking the costs of providing the MTAS in other countries⁹) or the outcomes that would likely occur without regulation, based on current MTRs, would best or be likely to best give effect to the promotion of competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand.
- xxi. Based on this assessment, the Commission has concluded that there are grounds for recommending regulation of the MTAS,¹⁰ as regulation is likely to promote competition in both the retail mobile services market and the retail FTM/tolls market, and will produce significant net long-term benefits for end-users in New Zealand.
- xxii. The Commission has concluded that regulation is likely to remove the barrier to efficient entry and expansion in the retail mobile services market described above, and will allow an entrant MNO such as 2degrees to vigorously compete for subscribers. (The estimated benefits in the retail mobile services market are set out in paragraphs 628 to 646 of this Final Report).
- xxiii. The Commission has also concluded that regulation of the MTAS is likely to promote competition in the retail FTM/tolls market by enabling fixed-only operators to compete more effectively with integrated fixed-mobile network operators, and result in more competitive outcomes for end-users. (The estimated benefits in the retail FTM/tolls market are set out in paragraphs 691 to 706 and Table 25 of this Final Report).

Assessment of whether undertakings should be recommended for acceptance as an alternative to regulation

- xxiv. Having concluded that there are grounds to recommend regulation, the Commission has then assessed whether regulation of the MTAS (at prices based on benchmarking the costs of providing the MTAS in other countries) or the Final Undertakings offered by Telecom and Vodafone (summarised at paragraphs 783 to 835 and Table 31 of this Final Report), as an alternative to regulation, would best or be likely to best give effect to the promotion of competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand.

Recommendations of the Telecommunications Commissioner and views of two other members of the Commission

- xxv. Section 10(1)(b) of the Act and clause 4(3)(d) of Schedule 3 of the Act require that this Final Report include the Telecommunications Commissioner's recommendation and the views of two members of the Commission (other than the Telecommunications Commissioner) regarding the recommendation. These are set out in the *Recommendations and Reasons* section of this Final Report.

⁹ The Commission has benchmarked against the costs of providing the MTAS, based on a forward-looking cost-based methodology, rather than against regulated prices. The Commission's final benchmarking set is provided in Table 13 of this Final Report.

¹⁰ The full text of the proposed regulatory change that the Commission has assessed in this Final Report is set out in paragraph 366.

RECOMMENDATIONS AND REASONS

Introduction

- xxvi. In this Recommendations and Reasons Section, the Commission sets out its recommendations as to whether:
- there is a case for regulation of the MTAS; and
 - if so, whether the Final Undertakings are acceptable as an alternative to regulation (together with any of the recommendations open to it pursuant to the Act).

Framework for assessment

- xxvii. The Act requires the Commission to make recommendations in the MTAS Investigation which it considers best gives or are likely to best give effect to the promotion of competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand.¹¹ In making these recommendations, the Act requires that the Commission consider the efficiencies that will result, or will be likely to result, from its proposed recommendations, as well as submissions received.
- xxviii. When faced with possible recommendations which the Commission is satisfied may each promote competition in telecommunications markets for the long-term benefit of end-users, it must make the recommendation which it considers best or is likely to best give effect to the stated objective of promotion of competition.

Recommendation of the Telecommunications Commissioner

- xxix. For the reasons set out in paragraphs 531 to 781, while there are grounds to recommend the mobile termination access services should be made a designated access service by adding the item set out in paragraph 366 to Subpart 1 of Part 2 of Schedule 1 of the Act (the **proposed regulatory change**), I recommend that the Final Undertakings are accepted under Schedule 3A of the Act as an alternative to the proposed regulatory change.

Reasons of the Telecommunications Commissioner

- xxx. For the reasons set out in this Final Report and outlined below, I am of the view that acceptance by the Minister of the Final Undertakings is likely to best give effect to the purpose of promoting competition in telecommunications markets for the long term benefit of end-users of telecommunications services within New Zealand.

Glide-path

- xxxi. As my assessment, in paragraphs xxxvii to liv, has taken into account the effect of a glide path on the Commission's analysis of the proposed regulatory change and the Final Undertakings in this Final Report, I have set out my views on the appropriateness of a glide path for the MTAS Investigation in the following paragraphs.

¹¹ See sections 18 and 19 of the Act.

- xxxii. I have considered the effect of a regulatory glide-path on the analysis of the factual of regulation. Glide-paths are commonly used by regulators to balance the short term welfare gains of immediate price reductions with the long term interests of protection of efficient investment incentives. Glide paths allow time for operators and customers to adjust to new price levels and structures,¹² and allow operators sufficient time to unwind business decisions made in reliance on a previous regulatory approach.¹³ It is unusual for regulators to impose new pricing without a glide-path.¹⁴
- xxxiii. In considering whether a glide-path would be appropriate for New Zealand, I have taken into account specific New Zealand conditions, discussed at paragraph 516.
- xxxiv. In weighing these factors, I conclude that where there is a transition from one 'quasi-regulatory' regime (i.e. under the Deeds) to another 'regulatory' regime (ie under regulation), all other things being equal, a three year glide-path would be appropriate. In this case, however, having regard to the specific market conditions described at paragraph 516 I would reduce the glide-path to 2 years. Under the Schedule 3 process, the new regulatory regime is not expected to come into effect for a period of approximately 12 months. I would regard this 'forbearance' year as the first year of the glide-path (ie from 2010 to 2011 - which would involve a two-thirds reduction to a cost-based level, as discussed in paragraph 518). The regulatory period would then have a one year step representing the remaining one third reduction (ie from 2011 to 2012). This is the 'regulatory glide-path' scenario set out in this Final Report.
- xxxv. In coming to this view, I have placed significant weight on the fact that business decisions have been made by operators based on the agreement reached in 2006 (as reflected in the Deeds). In this case, it is in the best long term interests of end users that a transition period be allowed where investment and other decisions have been made on the basis of an existing regulatory regime.
- xxxvi. In the assessment that follows, I have therefore had regard to the analysis in this Final Report that relates to the scenario that includes a regulatory glide-path.

Assessment

- xxxvii. As set out in paragraph 781 of this Final Report, the Commission has concluded that 'when compared to the prevailing MTRs (and those which are estimated to apply in the future in the absence of regulation) cost-based regulation of the MTAS is likely to promote competition in both the retail FTM/tolls market and the retail mobile services market, and produce significant net long-term benefits for end-users in New Zealand.'
- xxxviii. In Section VI of this Final Report, the Commission has compared cost-based regulation of the MTAS with the Final Undertakings, for the purposes (as provided by clause 3 of Schedule 3A) of deciding whether to accept an undertaking and recommend that the Minister accept the undertaking, together with any of the recommendations listed in clause 3(2)(b) of Schedule 3A. To make such a recommendation, the Commission must

¹² Ofcom, *Mobile call termination statement*, 27 March 2007.

¹³ ACCC, *Mobile Services Review: Mobile Terminating Access Service – Final decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile termination access service*, June 2004.

¹⁴ Analysys Mason, *Final report for Vodafone: Assessment of the position of the Commerce Commission of New Zealand in determining MTAS prices*, 27, July 2009

be of the opinion that acceptance of the Final Undertakings would better give effect to the purpose set out in section 18 than cost-based regulation.

- xxxix. In my view, the first threshold question to consider in deciding whether to recommend acceptance of the Final Undertakings is whether the competition issues which the Commission identified in the Draft Report and throughout the MTAS Investigation would be addressed if the Final Undertakings were accepted. The Commission has concluded its concerns would be addressed by cost-based regulation; clearly if those concerns remained unaddressed with the Final Undertakings in place, it could not be said that acceptance of the Final Undertakings would better meet the purposes of section 18 than cost-based regulation.
- xl. In the MTM market, the competition issue of concern to the Commission was the combination of above cost MTRs and significant on-net discounting, where over 80% of MTM voice traffic and a higher proportion of SMS traffic was on-net, which had the effect of limiting an entrant's ability to compete effectively. The Commission has concluded at paragraph 806 that while the MTRs in the Undertakings 'exceed the Commission's benchmark range of cost-based MTRs, the MTRs in the Undertakings generally lie within the range of estimated on-net rates over the period. This indicates that a small entrant such as 2degrees should be able to offer retail off-net MTM services - where it originates the call on its own network, and terminates the call on Vodafone's or Telecom's network at the MTR contained in the Undertaking - at prices that are comparable to the average retail on-net prices of Telecom and Vodafone.'
- xli. The conclusions at paragraph 806 are premised on an assumption that on-net rates will fall by an amount of 5% annually for the next five years. I am satisfied that the assumption of a 5% annual reduction in retail on-net prices in New Zealand is reasonable. As noted at paragraphs 617 to 627, while there may be more significant reductions in retail off-net prices, I do not think that a steeper fall in retail on-net prices is likely in the current New Zealand market..
- xlii. Further, when comparing benchmarked MTM rates in this Final Report with the Final Undertakings (such as in Figure 24), I do not consider that the differential is sufficiently material to warrant rejection of the Final Undertakings, having regard to my conclusion that the MTRs in the Final Undertakings will allow a small entrant to compete with the average retail on-net prices of Telecom and Vodafone.
- xliii. In relation to SMS, the Final Undertakings offer a Bill and Keep pricing structure, with the actual MTR payable dependant on the traffic imbalance between networks. If traffic is balanced, or within an imbalance of 107%, no termination fee is paid. As noted in paragraph 814, even at a traffic imbalance of 145%, the average termination rate paid under the Final Undertakings would be 0.98cpSMS, compared with the Commission's cost-based benchmark of 0.95cpSMS.
- xliv. 2degrees has in its submissions to the Commission characterised SMS as 'a key platform to market entry'¹⁵ and 'an essential mechanism for market entry'.¹⁶ At the MTAS conference 2degrees explained that 'SMS is critically important for us to get into the

¹⁵ 2degrees, Submission on Draft Report, page 8.

¹⁶ Ibid para 1.19.

market because what you find is that the mobile services that are offered in New Zealand are a combination of voice and text.¹⁷

- xliv. A termination charge of zero up to a 107% traffic imbalance, and which does not reach the level of the Commission's cost-based benchmark until an imbalance of 145% (which early indications of traffic imbalance suggest are unlikely to be reached) would remove any likelihood of the continuation of the foreclosure effect of on-net SMS bundles referred to by 2degrees.¹⁸
- xlvi. The Commission accordingly concluded at paragraph 823 that 'the MTM and SMS termination rates proposed by Telecom and Vodafone in the Final Undertakings should enable a small entrant such as 2degrees to enter and expand in the retail mobile services market.'
- xlvii. In relation to the FTM market, the competition issue of concern to the Commission was that above-cost MTRs have the potential to place non-integrated fixed line operators at a significant competitive disadvantage in the retail FTM/tolls market, as it creates the potential for integrated operators to effectively cross-subsidise the provision of fixed-line services. While the rates in the Final Undertakings are higher than the Commission's benchmarks, the Commission has concluded, as set out in paragraph 833 that the reductions provided by the Final Undertakings will likely enable a non-integrated fixed line operator to compete with the current retail on-net prices, such as those offered by Vodafone.¹⁹
- xlviii. The analysis in Section VI of this Final Report shows that, in the FTM market, if the factual included a regulatory glide-path as discussed in paragraph 518, as I believe it should, the Commission's modelling suggests that the Final Undertakings would deliver between 78% and 99% of the consumer surplus benefits of regulation, and between 88% and 102% of the total surplus benefits of regulation.²⁰ The percentage of benefits of regulation differ depending on whether one adopts the upper or lower bound benchmark and a 0% or 25% waterbed effect. For example, adopting the upper bound benchmark with a 25% waterbed effect, the FTM MTRs in the Final Undertakings would deliver 99% of the consumer surplus benefits and 102% of the total surplus benefits of regulation.²¹ In my judgment acceptance of the Final Undertakings will in the longer term deliver greater benefits to end-users of telecommunications services generally compared to the short term static benefits suggested by the FTM model.
- xlix. Further, when comparing benchmarked FTM rates in this Final Report with the Final Undertakings (such as in Figure 25), I do not consider that the differential is sufficiently material (particularly having regard to my views in paragraph xlviii) to warrant rejection of the Final Undertakings, having regard to my conclusion that the reductions provided by the Final Undertakings will likely enable a non-integrated fixed line operator to compete with the current retail on-net prices, such as those offered by Vodafone.

¹⁷ Transcript p105, 123 – 125.

¹⁸ 2degrees, Cross Submission on Draft report, pages29-33

¹⁹ See paragraph 832 for an example of such retail on-net FTM prices.

²⁰ Under constant elasticity demand conditions.

²¹ Under constant elasticity demand conditions.

1. It is therefore clear that the competition concerns identified by the Commission would be addressed in a timely manner by acceptance of the Final Undertakings. It being the case that both cost-based regulation and acceptance of the Final Undertakings will address those competition concerns, it is necessary to consider which of those two options will better meet the section 18 purpose of promoting competition in telecommunications markets for the long term benefit of end users of telecommunications services within New Zealand.
- li. As a general principle, it is recognised that it is the operation of competitive forces which provides the best allocation of economic resources, and delivers the lowest prices, highest quality and greatest consumer choice. Regulation is imposed to attempt to replicate competitive outcomes in markets where competitive pressures are weak or non-existent. Where regulatory intervention is required, it is in my view in the best long term interests of end users that the least intrusive means to address an identified problem is applied, so that market forces can continue to operate in areas outside the scope of the intervention. This concept is recognised in Europe in the concept of proportionality (any regulatory intervention should be proportionate having regard to the issue being addressed and the options available to address the issue). In my view, a proportionate intervention in the MTAS market by acceptance of Final Undertakings which I am satisfied address the Commission's concerns will best promote competition for the long term benefit of end users. Such an intervention will provide greater certainty to end users and the industry in a faster timeframe than regulation can offer and without the inherent risks often associated with any regulatory process.
- lii. It is also in the long term interests of end-users in all telecommunications markets in New Zealand that the undertakings regime in Schedule 3A is effective, and that operators know that undertakings are likely to be accepted by the Commission if they address competitive concerns identified by the Commission in future Schedule 3 investigations. As noted in the Explanatory Note to the Telecommunications Amendment Bill, the process was described as an alternative mechanism that avoids the need for regulation. In my view, a conclusion in this case that regulation would better meet the section 18 purpose than acceptance of the Final Undertakings on offer, when I am satisfied that the Final Undertakings address the Commission's competition concerns, would undermine the undertakings process and consequently would not best serve the promotion of competition for the long-term benefit of end-users.
- liii. An industry solution which addresses the competition concerns which the Commission has identified is in my view to be preferred to regulation. In this case a number of undertakings were received from mobile operators over the course of the regulatory process. Earlier undertakings did not address the competition issues, and in the Draft Report none of them were recommended for acceptance. Now that the Final Undertakings do address the competition concerns, it is appropriate in my view that they be accepted by the Commission, and be recommended for acceptance by the Minister in accordance with clause 3(2)(a) of Schedule 3A.
- liv. In summary, I am satisfied that the Final Undertakings will best address the competition concerns identified by the Commission. Under those circumstances, a more intrusive intervention (such as recommending regulation) is neither necessary (to address those

concerns) nor in the best interests of giving effect to the promotion of competition for the long term benefit of end users.

Views of Associate Commissioner Pickering

- lv. I fully concur with the recommendations of the Telecommunications Commissioner in paragraph xxix and his reasoning, as set out in paragraphs xxx to liv above.

Views of Commissioner Mazzoleni

- lvi. I fully concur with the analysis set out in this Final Report. However I do not concur with the recommendation to accept the Final Undertakings from Vodafone and Telecom. My view is that the MTAS should be added to the Act as a designated service. In my view, for the reasons set out below, regulation as a designated service is the outcome that will best promote competition in telecommunication markets for the long term benefit of end users, and therefore the one that meets the statutory test.
- lvii. The case having been made for a regulated outcome, as fully set out in this Final Report, my comments are limited only to assessing whether the difference between the Final Undertakings and regulation best promotes competition.
- lviii. I fully appreciate that there are benefits in recommending acceptance of the Final Undertakings. This will deliver an earlier reduction in MTRs compared to finalisation of an STD which is assessed to be completed 3 months later (paragraph 518). The trade-off for this benefit is that MTRs will remain up to 110% above current estimates of benchmarked TSLRIC (referred to herein as TSLRIC) MTRs during the period of the Final Undertakings, and remain 20-50% above these at the end of the Final Undertakings in 5 years.
- lix. I also note that the Final Undertakings are expected to deliver at least 70% of the benefit in the FTM market that regulation is expected to achieve. In my view however, the level of above TSLRIC MTRs in the Final Undertakings leaves in place a barrier to efficient competition in both the MTM and FTM markets. This barrier is removed under the pricing principle proposed for the regulated outcome.
- lx. The Draft Report concluded that the critical point of the Commission's concerns with mobile termination is to remove barriers to efficient entry and expansion, as only then will the benefits of competition for mobile services be available to New Zealand end users. In my view some unique features have developed in the New Zealand mobile market that mean there will continue to be a barrier to competition where MTRs remain above TSLRIC at the level permitted by the Final Undertakings. These are well set out in this Final Report, so only the conclusions relevant to my recommendation are restated here.
- lxi. In the New Zealand MTM market an extremely high level of mobile traffic occurs on the same network. Currently on average more than 80% of all voice and 90% of SMS traffic is made and received on the same network. As this Final Report describes, this is significantly higher than other OECD countries. This position has resulted from the tariff structures of the large mobile networks, which each have an equivalent share of the market (by customer). This is because there has been a correspondingly high differential between the prices that the large mobile networks charge themselves when on net calls are terminated on their own networks, compared to the prices they charge for off net calls

terminated on their networks by other networks. Such tariff mediated network externalities, including on net price discrimination, are neither unusual nor necessarily a cause for concern. However, in New Zealand, not only the level of on net traffic, but also the differential between on net and off net prices, is significantly higher than other OECD countries.

- lxii. In New Zealand SMS has more extreme features than for voice, with the current differential between on net and off net SMS pricing being many times that for voice. New Zealand also has one of the highest levels of SMS usage in the OECD (paragraph 235). SMS is therefore a critical product offering for any network and if an entrant is to be able to compete for SMS customers and thereby the wider mobile market, it must be able to offer SMS off net prices no higher than the on net SMS prices of the large networks.
- lxiii. For these reasons, the current New Zealand mobile market is largely closed (paragraph 306) with only 20% of mobile voice calls and 10% of SMS made across other mobile networks. This is an average, and off net traffic on one network is less. The asymmetry in network sizes, and particularly the significantly low level of off net traffic in New Zealand, has the effect of making expansion by a new entrant very difficult.
- lxiv. The consequences of the current environment are also well articulated in this Final Report - currently more than two thirds of New Zealanders pay some of the highest mobile prices in the OECD. Important developments occurred in 2009. Although later than many countries, 3G services are now capable of being offered to all New Zealand end users and new market entry occurred with a third network operator and MVNOs securing resale agreements with incumbent networks. These developments suggest that competition has arrived, particularly as new entrants must price at least equivalently to current mobile service providers in order to compete for customers and, provided there are no barriers, price and innovative service competition should now occur.
- lxv. However, currently a fixed or mobile network operator's wholesale costs, particularly termination, can exceed, often significantly, retail prices for the majority of mobile traffic. Competitors cannot offer competitive prices in these conditions nor survive (paragraph 584), without cross subsidisation and New Zealand end users will remain with the same services and prices as currently experienced. Commendably, the Final Undertaking prices go some distance to rebalance this situation. Nevertheless, where wholesale MTRs exceed TSLRIC, any mobile provider attempting to efficiently compete for customers will face a barrier in the form of wholesale MTRs above those that the terminating party incurs when providing the same service to itself. In the MTM market, if a competitor is not to be marginalised it must be able to compete for all traffic, not just the significantly small volume in New Zealand that currently flows off net. Furthermore, the terminating network can always maintain a price barrier which cannot be efficiently competed away, maintaining prices above those that would otherwise be achieved in a competitive market.
- lxvi. Where MTRs are above cost in the MTM market, this Final Report observes that large network operators are unlikely to retaliate to vigorous competition by dropping on net prices to cost because the size of such reduction would be substantial. I have significant difficulty with the outcome if the assumptions upon which this observation is premised do not play out. Firstly, it assumes a greater level of confidence in estimates of on net prices

than this Final Report indicates (paragraphs 462, 464 and 590). Regard also needs to be had to the response likely from each large network, rather than simply a weighted average response. It is conceivable that the market outcome from vigorous competition once barriers are removed could exceed estimates at paragraph 625. Furthermore, in my view it is not in the long term benefit of end users in telecommunication markets that if average on net prices were to reduce to the extent that the small network is not able to compete effectively the Commission will consider whether further regulatory attention is warranted (paragraph 880). Given the Commission has been concerned about competition issues in this market since 2004, it is unacceptable to not now correct this issue once and for all. As the parties concur, TSLRIC termination prices do this. However, MTRs proposed in the Final Undertakings, which are up to 110% above current estimates and which remain 20-50% above current estimates at the end of the Final Undertakings, are high enough to retain the barrier to competition (paragraph 476).

- lxvii. Exactly the same situation currently occurs in the FTM market. Fixed only networks pay above TSLRIC MTRs for all calls to mobile networks whilst integrated operators pay MTRs only for off net calls to another mobile network. The consequence of this currently is limited competition as integrated operators offer retail prices below wholesale MTRs whilst fixed line operators ability to compete prices down to the cost of supply is limited by above cost MTRs.
- lxviii. The size of the barrier, being the differential between likely TSLRIC MTRs and those in the Final Undertakings, is a significant improvement from the current position. However, in the tightly held New Zealand market described above, competitors will need a level playing field, or very close to it, from which to be able to efficiently compete for customers. In this situation MTRs above TSLRIC to the degree in the Final Undertakings will continue to impede competition.
- lxix. In coming to this view I am not required to make any decision on glide-paths, something which will need to be addressed in setting the IPP. However, I note that asymmetric MTRs have been implemented in favour of new entrants by overseas regulators to overcome less difficult entry environments than described above. In these circumstances glide-paths are used to phase out asymmetric rates over a period of up to 4 years. In my view such a glide-path should also provide another scenario for the factual. This would provide benefits additional to those set out in this Final Report.
- lxx. Equally in my view there is no downside from TSLRIC MTRs:
- All 3 mobile network operators have spent considerable sums on money on their infrastructure and it is the foremost role of a regulator to ensure incentives to invest are encouraged. TSLRIC MTRs ensure dynamic efficiency by providing a return of and on capital invested, whilst MTRs above these in the Final Undertakings provide additional compensation and the adverse effects on competition as outlined above. TSLRIC MTRs also ensure allocative and productive efficiency whereas MTRs in the Final Undertakings allow costs to remain higher than would otherwise be competed away.
 - All parties made it clear that a move to TSLRIC MTRs would cause significant change to current mobile offerings especially for the majority of New Zealand prepaid customers. In my view any difference in impact on this from regulation

compared to the Final Undertakings will be addressed by the unimpeded competition that will eventuate when barriers are removed.

- In my view the benefit from removing barriers to competition in the mobile market far outweigh any potential consequence for the undertakings regime, if any. The undertakings regime is available for all situations where undertakings provide a better outcome than regulation.

lxxi. Therefore whilst undertakings will deliver a reduction in MTRs some months earlier than a regulated outcome, the consequence is that MTRs will remain up to 110% above current estimates during the period of the Undertakings, and remain 20-50% above these at the end of the Undertakings in 5 years. In my view the barrier arising from the level of above TSLRIC MTRs in the Final Undertakings continues to ensure a playing field that is not level and this will impede the benefits competition will otherwise deliver to New Zealand end users. Thus in my view the outcome that best meets the statutory test is regulation as a designated service on the basis of the proposed regulatory change set out in paragraph 366.

DATED this 22nd day of February 2010



Dr Ross Patterson
Telecommunications Commissioner