Supplementary Submission by AAPT Limited

in response to the

Australian Competition and Consumer Commission's

Draft Decision on

the Mobile Services Review:

Mobile Terminating Access Service

21 June 2004

AAPT Limited's Supplementary Submission to the Australian Competition and Consumer Commission's *Mobile Services Review: Mobile Terminating Access Service Draft Decision*

1. Introduction

AAPT welcomes the opportunity to make this supplementary submission in response to the Australian Competition and Consumer Commission's (the ***Commission***) *Moblie Services Review: Mobile Terminating Access Service Draft Decision* (the ***Draft Decision***). AAPT apologises for the delay in making this submission. This delay was caused by AAPT's need to understand the large number of supplementary submissions made by both Optus and Vodafone, which appeared on the Commission's website long after the 30 April 2004 closing date for submissions. Further, AAPT notes that while it would have liked to have commented on Telstra's submission, because this document only became available on the Commission's website over the past week, AAPT has not had adequate time to assess the claims made by Telstra.

In this submission:

- **AAPT emphasises that at the present time the Commission does not need to make any definitive or final judgement about the glide path or the 12 cent per minute (*cpm*) access price set for 2007.** If the Commission continues declaration and adopts a cost-based pricing principle, it should immediately implement its proposed pricing schedule and the initial glide path, and consider whether any adjustments should be made to the glide path or the final cost-based price in the future.

- **AAPT responds to a number of claims made in the submissions by Vodafone and Optus about costs, profits and mobile subscription rates.**

2. The Current Decision for the Commission

In the Draft Decision the two questions that had to be considered by the Commission were:

1. whether or not it should continue declaration of the mobile terminating access service (the ***service***); and

2. if it did declare the service, what the most appropriate pricing principle was for it to employ.

The Commission concluded in its Draft Decision that declaration of the service was definitely in the long-term interest of end-users (LTIE) and that it was most appropriate to employ a cost-based pricing principle. AAPT reiterates its support for the reasoning and methodology employed by the Commission in reaching these decisions.

In addition to answering the above two questions, the Commission went a step further and considered what the level of the appropriate cost-based price would be for the service. The Commission answered this question by recommending a two-and-a-half year staged reduction in the price for the service, leading to a final cost-based price of 12 cpm by 1 January 2007. Whilst AAPT has previously indicated that in its opinion the glide path and price are conservative, it wishes to emphasise here that it does not believe that the Commission at this point in time is required to make any definitive judgment about either the glide path or the final cost-based price.

AAPT suggests that if the Commission does decide to regulate the service using cost-based pricing principles, it should immediately implement the proposed glide path of the Draft Decision. It can then consider at a later time whether or not any changes are required to the glide path or the final cost-based price. AAPT believes that this action will:

- allow the Commission to begin to realise the competitive and efficiency benefits it highlighted would arise from setting the appropriate access charge;
- provide the Commission with the necessary flexibility in adjusting the price so that it will ultimately reflect the underlying cost; and
- may create incentives for effected parties to provide the regulator with the appropriate cost information or cost-based models.

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The last of the above points is probably the most significant. It suggests that by simply implementing the currently proposed glide path, the Commission may be able to place the onus on the MNOs to provide it with the relevant information or costs. For example, once the glide path reaches a level where the MNOs believe that price is below the cost of the providing the service, they will have an incentive to pass on cost information or formulate a cost-based model to illustrate this point to the regulator. Conversely, if the staged reduction in price occurs and none of the MNOs are prepared to provide information to the regulator to challenge the access charge, then this strongly indicates to the regulator that the price of the service is likely to be above true cost. While both Optus and Vodafone have objected to the Commission's international benchmarking approach and have provided evidence of what they claim are higher cost-based estimates for mobile termination across other countries, it is interesting to note that neither has volunteered their own cost information or established a cost-based model to estimate the cost of mobile termination in Australia.

Such an asymmetric information problem where the principal (in this case the regulator) is unable to observe the actions or glean the relevant information from the agent (the MNOs) is unfortunately not uncommon in the regulatory environment. In the UK, for instance, the *Review of Charge Control on Calls to Mobiles*, 26 September 2001, highlighted that MNOs were uncooperative in providing the relevant cost information to the regulator, so that it could estimate the long-run incremental cost-based (*LRIC*-based) price. The *Review* noted that:

> Reconciliation with accounting-based figures has not, however, been possible, because the MNOs have supplied neither detailed accounting information nor top-down models. Furthermore, little evidence has been supplied by the MNOs to inform the data and assumptions of the bottom-up model. The robustness of the model's results would have been improved by the provision of such information. Nevertheless, the figures in the LRIC (Long-run Incremental Cost) model represent the best estimates available for the cost of mobile termination and form a reasonable basis for setting charge caps.[1]

3. AAPT's Responses to Claims made by Optus and Vodafone

Amongst the arguments of Optus and Vodafone, there have been a number of claims made by both parties in relation to cost, profit and mobile subscription rates. This Section briefly assesses some of the claims that the two parties have made.

3.1 Cost

AAPT responds to claims made by Optus and Vodafone about:

- Cost pass through;
- Cost and its impact on competition and market structure; and
- International benchmarks and cost estimates.

3.1.1 Cost Pass Through

Vodafone claims that AAPT has admitted that it does not pass on the cost savings from decreases in the mobile terminating access charges to its end-users. For example, in the *Submission to the ACCC by Vodafone — Response to ACCC Draft Decision Mobile Termination Access Service*, 30 April 2004, Vodafone outlined at page 5 that:

> …Telstra and AAPT have openly acknowledged in their submission to the Commission that they do not pass reductions on to consumers…

This claim was repeated by Peter Stiffe, the Head of Regulatory Affairs at Vodafone, in 'Last-gasp Pleas on Mobile Fees' by Katrina Nicholas, *Australian Financial Review*, 21 May 2004.

AAPT has never made any such acknowledgement. In relation to the fixed-to-mobile market AAPT has actually observed that, "overall fixed-to-mobile prices have declined",[2] and more significantly that:[3]

[1] This quote from the *Review of Charge Controls on Calls to Mobiles* is reproduced on page 148 of the Office of Communications (Ofcom), *Wholesale Mobile Voice Call Termination*, 1 June 2004.

[2] *Mobile Services Review 2003 Submission by AAPT*, 13 June 2003, page 25.

> AAPT can confirm that its fixed-to-mobile price have generally tracked downwards in line with lower termination rates.

The statements and observations AAPT has in fact made in relation to the failure of a firm to provide cost pass through to end-users in retail markets, are that:

- the overall price decrease in the fixed-to-mobile retail market has been inconsistent across customer classes. For example, AAPT notes that:[4]

  > Published prices for consumers and small businesses have increased, while the prices offered to larger corporate accounts have been reduced.

- the decrease in the mobile terminating access charge may not be exclusively passed on to end-users in the form of lower prices. Instead, AAPT highlights that it may be passed on to consumers in the form of "increases in quality or the diversity of goods and services."[5] Further, even if there is no immediate decrease in price to end-users, AAPT outlines that the lower termination is likely to still facilitate entry to the market, which will ultimately be in the LTIE. Based upon this reasoning AAPT concludes that:[6]

  > AAPT expects that regulation will be in LTIE even in the absence of a guarantee that cost savings will immediately be passed through to end-users in the form of lower retail prices for fixed-to-mobile and mobile-to-mobile calls.

- if the downstream retail market is characterised by an oligopolistic market structure where there is a dominant firm, it is possible that cost pass through may not occur. This type of outcome, which is summarised in the *Microeconomics* text by Pindyck and Rubenfeld at pages 450-1,[7] relies upon there being:

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3 *Mobile Services Review 2003 Submission by AAPT*, page 26.

4 *Mobile Services Review 2003 Submission by AAPT*, page 25. Also see the AAPT presentation, *What form of regulation would be most appropriate*?, ACCC Mobile Services Review Public Forum, 11 September 2003, available at, http://www.accc.gov.au/content/item.phtml?itemId=397855&nodeId=file3fadd8994fcaf&fn=Session2_AAPT.pdf

5 *Mobile Services Review 2003 Submission by AAPT*, page 26.

6 *Mobile Services Review 2003 Submission by AAPT*, page 30.

7 R.S. Pindyck and D.L Rubenfeld, *Microeconomics*, Prentice Hall, New Jersey, Fifth Edition, 2001.

- a dominant “leader” firm that sets a price in the market which allows it to maximise profits; and

- a competitive fringe that is capacity constrained comprised of a number of small “follower” firms that simply take the price set by the dominant firm as given, and supply the remaining demand in the market.

AAPT alludes to the potential for such an outcome when it maintains that:[8]

> It is possible that where the dominant telecommunications company fails to pass through the cost savings on FTM retail services, a competing firm without substantial market power may also fail to pass through the rate reductions. For example, if a competing firm is relatively small in the market, and believes that a price reduction would either not change, or even decrease, its market share or profit, it may choose to maintain price at the initial level.

As AAPT actually states that it does pass on the cost savings to end-users, and none of the above statements indicate an “open acknowledgement” that it does not do so, it appears that Vodafone has either misinterpreted AAPT’s observations, or has chosen to deliberately misrepresent them for the purposes of furthering their own arguments.

3.1.2 Input Costs and its Impact on Competition and Market Structure

The Vodafone Submission, 30 April 2004, appears to display a misunderstanding of the important role that input costs play in influencing competition and market structure.

Vodafone asserts that a reduction in the charge of the service will not promote the state of competition or the price of any fixed-to-mobile services. The reason for this is that Vodafone claims that effective competition has nothing to do with the input costs faced by the firm. For example, it states at page 30 that:

[8] *Submission by AAPT in response to the Australian Competition and Consumer Commission’s Draft Decision on the Mobile Services Review: Mobile Terminating Access Service*, 30 April 2004, page 9.

> Promotion of competition says nothing about altering the input cost of a business. Rather the promotion of competition and or the extent to which businesses compete is more in relation to market structure

This statement appears to contradict basic economic theory, which consistently highlights the important role of input costs in influencing competition and market structure. For example:

- for a perfectly competitive market outcome each firm must have access to the same technology, which implies that each firm faces the same input costs;
- certain types of input costs can even create the conditions for the existence of a natural monopoly, natural duopoly or even natural oligopoly outcome in an industry; and
- lower input costs will decrease the barriers to entry to the industry. A new entrant facing lower input costs is likely have a greater chance of long-term success in a market, as it can charge a lower price than would otherwise be the case, while still making a normal rate of return.

3.1.3 International Benchmarks and Cost Estimates

The supplementary submission by Charles River Associates (***CRA***) on behalf of Optus submitted evidence that compared to Australia there were higher cost-based estimates for the mobile termination service across a number of European countries.[9] One of the estimates CRA provided was for Finland, where it claimed there was a cost-based termination price of 16 cpm.

However, AAPT believes that this information provided by the CRA about Finland is inaccurate as:

- this 16 cpm price is a mobile-to-mobile termination price that does not appear to be based on any cost estimate, but instead, a commercial agreement reached between the three MNOs in Finland that was subsequently approved by the

[9] Charles River Associates, *The Use of Benchmarking in Regulating Mobile Termination Rates*, 28 May 2004, Table 3, page 25.

regulator. The regulator simply appears to have overseen the process to make sure that it was satisfied the interconnection fee was cost-oriented and non-discriminatory;[10] and

- there is no cost-based estimate for the fixed-to-mobile terminating service, because there is no regulation of fixed-to-mobile services in Finland. As noted in a *European Telecoms Newsletter*, the Finnish Communications Regulatory Authority (***FICORA***) was strongly criticised by the European Union (***EU***) Commission on 5 January 2004 for continuing to exclude the fixed-to-mobile wholesale market from regulatory remedies.[11]

Vodafone claimed in its original submission in response to the Draft Decision, 30 April 2004, that a report by Ovum, *Mobile Termination Rates*, January 2004, "indicates that the mobile termination costs are around 8 euro cents per minute." However, whilst Ovum does quote an 8 euro cent per minute figure, in the study this just represents the average cost estimate across a number of different regulatory cost models for the mobile termination service.[12]

3.2 Profit

In their submissions, Optus and Vodafone consistently claim that they are not making any long-term profits in providing services to the mobile market. AAPT assesses these claims. In particular it looks at:

- the possibility that rent from the mobile termination market is being dissipated through an inefficient retail distribution network; and

- claims made by Vodafone that it is disadvantaged from not being a vertically-integrated operator.

[10] "TeliaSonera Finland in mobile-to-mobile Termination Agreements", TeliaSonera Press Release, 3 March 2003. Available at http://presstjanst.telia.se/press/Article.jsp?category=81&selected=2&article=7815
[11] European Telecoms Newsletter available at http://aporter.pair.com/newsletter/79911_1.pdf
[12] Ovum, *Mobile Termination Rates*, January 2004, Figure 4.

3.2.1 Rent Allocation

In each of the initial submissions in response to the Draft Decision, Vodafone and Optus have suggested that, even if both are earning profits from charging an above cost price for the service, these profits are being competed away in the competitive retail market that exists for mobile services. For example, Vodafone states at page 16 that:

> If the outbound market is considered to be effectively competitive (which Vodafone strongly believes is the case), then it cannot be true that a mobile operator is dominant in providing termination services, as any economic rents that may be earned in the termination service are competed away

and Optus states at page 8 that:

> …to the extent that mobile termination charges are above cost we are forced to use the proceeds to fund lower prices in the retail mobile marketplace. Indeed, competitive pressures require us to do this as all operators we compete with also have a termination revenue stream which they similarly use to fund such retail pricing.

Similarly, Optus quotes on pages 8-9 from the work of Wright (2002), who states at page 315 that:

> …due to competition to capture this lucrative termination revenue, cellular firms may well have competed away much of the termination revenue under dispute.[13]

This leads Optus to conclude at page 9 that:

> …competition to capture the subscribers and the termination revenue will mean that mobile operators will invariably compete away the termination revenue, giving them no competitive advantage in fixed-to-mobile services.

[13] J. Wright, "Access Pricing under Competition: An Application to Cellular Networks", *The Journal of Industrial Economics*, 2002, pp 289-315.

Aside from the obvious allocative inefficiency concerns such cross-subsidised pricing raises, AAPT suggests that this pursuit of the "lucrative termination revenue" may actually be creating a further inefficiency.

It is a common error in the analysis of economic rents that rents are necessarily allocated to the shareholders of firms by way of higher dividends. Rents are often allocated in other ways, usually to constituencies that can assist the firm in earning the economic profit. In the history of telecommunications it is widely recognised that a large share of the economic profit from monopoly was distributed to employees in the form of restrictive work practices, and that this secured the support of labour organisations for the perpetuation of the monopoly.

In the case of mobile services, AAPT hypothesises that the attempt to obtain this lucrative termination revenue, combined with the inability to earn any significant economic rent, may be illustrative of nothing more than a variant of rent-seeking behaviour on the part of the MNOs. That is, the MNOs are incurring significant administrative expenses in their attempt to increase the number of subscribers to the mobile network. AAPT suggests that the economic rents earned from charging an above-cost price for the service are being transferred and partially dissipated to fund an inefficient distribution chain at the retail level for mobile services. Such a transfer of funds is evident from:

- the submission to the ACCC by the distribution retailer Allphones, which basically outlines that it relies on Optus and Vodafone maintaining termination revenues to maintain its distribution outlets; and

- a recent Business Review Weekly article, which lists John Illhan, the thirty-nine year old founder of the mobile distribution company Crazy John's, as being in the rich 200 with an estimated wealth of $300 million.[14] Further, over the past year Crazy John's has been able to expand from 30 to 99 stores, and it is estimated that over the 2004-5 financial year turnover will increase from $200 million to $280 million.[15]

[14] 'The Richest List of All' by Robert Skeffington, *Business Review Weekly*, 20 May 2004.

Posner (1975) outlines that in the extreme case of rent-seeking behaviour, the contest by the firms to achieve the monopoly rents actually leads to all rents becoming costs to society.[16] Whilst AAPT does not contend that this extreme outcome is occurring in this instance, we maintain that to the extent that MNO do not show any substantial economic profit, this may be indicative of a further inefficiency arising through rent-seeking behaviour.

3.2.2 Profitability for Mobile Only Operators

In the initial submission in response to the Draft Decision, Vodafone appears to highlight the financial difficulties associated with it being a mobile network operator that, unlike Optus and Telstra, is not a fixed-line carrier. For example, on page 29, it states that:

> Vertically integrated carriers will not be subject to the same commercial and financial pressures to increase their mobile outgoing and subscription prices to ensure they are able to earn an adequate return for their capital providers.

In recent statements to the press though, Vodafone has made quite opposite claims. For example, in 'Vodafone Lays it on the Landline' by Matthew Charles, *Herald Sun*, 3 May 2004, Vodafone's new Victorian boss Edward Goff made several remarks about Vodafone being in a strong position relative to Telstra and Optus, precisely because it was only a mobile network operator. A number of statements in the article to this effect are outlined below:

> Mr Goff has no about Optus and Telstra will be the big losers. Incredibly, he even harbours doubts they can survive. "We don't believe any business that is selling both mobiles and landlines can survive", Mr Goff says.
>
> Despite the massive cash flows generated, Vodafone insists Telstra and Optus' fixed line networks are obsolete.

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[15] 'Upwardly Mobile' by Lucinda Schmidt, *Business Review Weekly*, 20 May 2004.
[16] R. Posner, "The Social Costs of Monopoly and Regulation", *Journal of Political Economy* 83, pp 807-28, 1975.

> "If you look at Telstra they have huge market share in mobiles but also in landline so the only way they can grow is to cannibalise themselves" Mr Goff said.

Vodafone also seems to believe that it will increase the use of mobiles, because of the recent increases in the monthly line rentals by Telstra. For example, Vodafone Australia Chief Executive Grahame Maher states that he believes the increase in the line rental will provide a "huge opportunity for mobile phone companies to erode the fixed line market".[17] In highlighting the potential for further growth, Maher cites data showing that presently in Australia the mobile to fixed-line split is only approximately 20/80, whilst in the US this ratio is around 50/50 and in Portugal 70/30.

3.3 The Effect of Regulated Pricing on Mobile Penetration Rates

The supplementary submission by CRA on behalf of Optus argues that the Commission should be aware of the potential for regulation of the service to decrease mobile penetration rates.[18] CRA maintain that in the UK, following the reduction in termination charges there was a decrease in penetration rates. CRA states at page 15 that the Office of Telecommunications (Oftel) statistics showed "overall mobile penetration falling between May and August 2003 from 75 to 73 per cent."

This claim made by the CRA that penetration rates have fallen in the UK is however incorrect and does not accurately capture the data or findings of Oftel.[19] In examining overall mobile penetration rates Oftel actually provides two sets of statistics — the household penetration rate and the proportion of people that personally own or use a mobile. The data illustrates that:[20]

- household penetration has remained stable at 85 per cent following an increase in the November 2002 to May 2003 period; and

[17] 'Telstra Rivals Lash Out at Line Rental Increases', *Communications Day*, 3 May 2004.
[18] Charles River Associates, *The Use of Benchmarking in Regulating Mobile Termination Rates*, 28 May 2004, page 14-15
[19] Oftel, *Consumer's use of mobile telephony Q14 August 2003*, 27 October 2003.
[20] *Consumer's use of mobile telephony*, 27 October 2003, Page 6.

- while there was an apparent fall in the proportion of users who personally owned or used a mobile from around 75 per cent to 73 per cent, this decrease was “within the survey’s error margins”, leading the regulator to conclude that the proportion had also “remained stable for 9 months.”

4. Conclusion

This current review of mobile services has been underway since March 2003. Nothing in the initial and supplementary submissions in response to the Draft Decision detracts from the reasoning of the Commission. The Commission must not prevaricate any further on this matter. There are only two decisions before it and they are, whether the service should remain declared and the appropriate pricing principle. The Commission’s glide path will operate as effective guidance for industry. If in the extreme the glide path would result in termination prices below cost, the Commission can be assured that the MNOs will provide detailed cost models to demonstrate this outcome. In the absence of any such models being provided, the Commission can proceed with confidence in the application of the glide path.