Submission by AAPT Limited
in response to the
Australian Competition & Consumer Commission’s
Draft Decision on
the Mobile Services Review:
Mobile Terminating Access Service

30 April 2004

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AAPT Limited's response to the Australian Competition & Consumers Commission's *Mobile Services Review: Mobile Terminating Access Service Draft Decision*

1. Executive Summary

AAPT welcomes the Australian Competition & Consumers Commission's (the ***Commission***) *Mobile Services Review: Mobile Terminating Access Service Draft Decision* (the ***Draft Decision***). AAPT supports the Draft Decision and the reasoning behind it.

While AAPT supports the Draft Decision, AAPT is concerned that the proposed two-and-a-half year phased-in price reduction may be too gradual. The timeframe will delay the realisation of the competition and efficiency benefits that the Commission has identified as likely to emerge from a lower cost-based price. AAPT is concerned that the Draft Decision does not make provision for accelerating the transition to a cost-based price if industry circumstances make this practicable.

In this submission, AAPT will address each of the following matters, all of which it believes merit further consideration by the Commission:

- the proposed gradual reduction in the price of the service;
- cost pass through; and
- the development by the Commission of an independent cost model.

AAPT submits that in its final decision the Commission should state that it will closely monitor the industry and will respond to changed industry circumstances by introducing price reductions earlier than currently proposed if possible. Furthermore, AAPT submits that the Commission should develop its own cost model by 2007 so that it can independently assess the appropriate cost-based price for the service and the further price reductions required to promote increases in competition and efficiency.

2. AAPT's support for the Draft Decision

AAPT supports the Draft Decision. In particular, AAPT welcomes the decision to continue the declaration of the Domestic Global System for Mobile (***GSM***) and Code Division Multiple Access (***CDMA***) mobile terminating access services and to extend the declaration to include voice services terminating on third generation mobile networks (together the ***service***). AAPT supports the Commission's conclusion that the declaration of the service is in the long-term interests of end-users (the ***LTIE***), in accordance with s152AL of the *Trade Practices Act 1974* (Cth) (the ***Act***). AAPT believes that this is particularly the case in the market for fixed-to-mobile (***FTM***) calls, and to a lesser extent, the market for mobile-to-mobile (***MTM***) calls, where access to the service represents an essential input for supplying downstream retail markets.

Further, AAPT welcomes the Commission's decision to move from the light-handed retail benchmarking approach towards a total service long-run incremental cost-based (***TSLRIC***-based) price. At present, AAPT believes that the price exceeds the cost of providing the service.

The Commission, in reaching its conclusion, outlined that without declaration and the appropriate form of price regulation of the service, the following pricing structures would emerge:[1]

- above-cost price for the mobile termination service;
- above-cost prices for downstream retail FTM services, which use mobile termination as an essential input; and
- below-cost prices for some retail mobile services, as the profits from the service are used to cross-subsidise the retail mobile market.

The Commission suggest that such prices could have an adverse impact upon:

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[1] Australian Competition and Consumer Commission, *Mobile Services Review: Mobile Terminating Access Service Draft Decision*, March 2004, p vii.

(a) **Competition**

Such a pricing arrangement would potentially allow a vertically-integrated mobile and fixed-line carrier to establish a cost advantage over fixed-line only operators in supplying FTM retail services. The Commission outlines that while the fixed-line only operators face an above-cost charge for termination of all FTM calls, the vertically-integrated carrier only pays the above-cost price on those calls that terminate on another mobile carrier's network. For all FTM calls that terminate on the vertically-integrated carrier's network, the vertically-integrated carrier is only subject to the actual cost for the service. This provides the vertically-integrated carrier with the ability to undercut the price and decrease the level of competition in the market for FTM retail services.[2]

(b) **The efficient use of, and investment in, infrastructure**

(i) The prices create allocative efficiency losses, as there is under-consumption of FTM retail services, and excess consumption of the subsidised retail mobile services. The Commission, using what it believes are plausible assumptions for the elasticity of demand for FTM calls and starting quantities, prices and costs for FTM calls, estimates that the efficiency loss in the FTM services market could be as high as $282 million per annum.[3]

(ii) The above-cost price for the service encourages under-investment in the fixed and mobile network capacity needed to provide FTM and MTM calls. The below-cost prices for some retail mobile services are likely to induce excessive investment in the infrastructure used to provide retail mobile services. For example, the Commission suggests that the subsidised price will lead to excessive handset turnover, which generates excess investment in the infrastructure that is used to produce handsets.[4]

AAPT agrees with the above concerns raised by the Commission, and supports the Commission's reasoning that declaration, combined with the appropriate cost-based price for the service, will provide the greatest benefit to end-users.

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[2] *Mobile Services Review: Draft Decision*, March 2004, pp vii-viii.
[3] *Mobile Services Review: Draft Decision*, March 2004, p 127.
[4] *Mobile Services Review: Draft Decision*, March 2004, p xiv.

The Commission's benchmark target is 12 cents per minute for the service by 1 January 2007 (expressed in 2003-2004 prices). The Commission states that, based on international benchmarking and the submissions of Australian telecommunications companies, the cost of providing the service is no higher than 12 cents, and that 12 cents is a conservative price target.[5] AAPT agrees with the Commission's assessment that this is a conservative benchmark. AAPT does not believe that there is any meaningful danger that this price will be below cost by 2007. Accordingly, AAPT supports 12 cents per minute as the maximum benchmark price for the service.

While AAPT supports the reasoning and the conclusion of the Draft Decision, it maintains a number of concerns about the future regulation of the service. These are discussed below.

3. The Gradual Reduction in the Service Price

The Draft Decision proposes a phasing in of the price reduction from 21 cents on 1 July 2004, to 12 cents on 1 January 2007 (expressed in 2003-2004 prices). As stated above, AAPT agrees with the Commission's assessment that 12 cents per minute is a conservative price target for the service. Based upon the cost estimates of the service tabled by the Commission from various countries and telecommunications companies,[6] AAPT believes that it is unlikely that this price will be greater than the efficient cost of providing the service in 2007.

3.1 Delay in achieving competition and efficiency gains

AAPT is concerned about the length of the transition period to the 12 cents per minute price. The service was deemed to be declared in 1997, and the Commission released initial pricing principles in July 2001. At that time, the Commission recognised that the then-existing price of GSM mobile termination services were likely to be well in excess of costs and that this was generating outcomes that were not in the LTIE.[7] The Commission chose to adopt a retail benchmarking pricing principle under which each carrier was required to

[5] *Mobile Services Review: Draft Decision*, March 2004, p 167.
[6] *Mobile Services Review: Draft Decision*, March 2004, pp 57-9.
[7] *Mobile Services Review: Draft Decision*, March 2004, p xvi.

decrease in the price of the service line with reductions in its average price of a bundle of retail mobile services. Unfortunately, because the retail price of the bundle of GSM mobile services has not declined significantly, the retail benchmarking approach has failed to achieve any meaningful decrease in price.

Nearly three years has already been lost in attempting to reduce the price of the GSM mobile terminating access service and to bring it down to a level near to cost. The GSM mobile terminating access service, and the service generally, are now largely mature services. An additional two-and-a-half years is a long time to wait for a regulated price that approximates cost. This is particularly the case because it delays the increased levels of competition and efficiency that the Commission has outlined are likely arise from having an appropriately set cost-based price. As outlined earlier in the FTM services market, the Commission estimated that the efficiency loss from having an above-cost price for the service could be as high as $282 million per annum.

Therefore, in total there has been a five-and-a-half year gap between the Commission's formal recognition that the price of the service exceeds cost, and the adoption of a benchmark price that the Commission acknowledges is conservative in relation to the underlying cost of providing the service.

3.2 Revenue implications as a justification to delay price reduction

AAPT understands that the Commission is concerned that moving too quickly towards a cost-based price for the service could cause significant adjustment costs (or 'rate shock') for mobile network owners,[8] and will result in an immediate fall in the price of the service. The Commission asserts that an immediate adoption of the 12 cents per minute price for the service from 1 July 2004 "would be likely to generate significant and potentially harmful disruption to the operations and planning of a number of telecommunications carriers".[9]

[8] *Mobile Services Review: Draft Decision*, March 2004, p 165.
[9] *Mobile Services Review: Draft Decision*, March 2004, p xvi.

The Commission's response to the fear of rate shock is a gradual price reduction. AAPT is concerned that the Draft Decision does not allow the Commission any flexibility to alter the proposed timetable in response to the actual developments in the industry once the price change begins to occur.

AAPT believes that it is possible that the industry will respond to the Draft Decision more rapidly than the Commission suggests. Providers and acquirers of the service may anticipate the effect of the Draft Decision when negotiating the charges for the service with one another, developing new business plans in response to the Commission's proposed changes. Although a decrease in the price for the service could lead to a loss in revenue for mobile operators, it will lead to a decrease in expenditure for the service for both fixed and mobile providers.

Assuming that the lower charges for the service are passed through to end-users (see Section 4 below), an increase in the volume and duration of FTM and MTM calls seems probable. The result of this anticipated increase in the volume and duration of calls may be increased retail revenues, which could potentially offset, or even exceed, the loss in revenue caused by a reduction in the charge for the service. Further, even with an overall decrease in revenue, the Commission notes that the service provider may still be able to make some level of profit. For example, if the mobile network operator experiences economies of scale in production, then an increase in volume due to the lower price charged for the service, will be accompanied by a lower per unit cost.[10]

Finally, although revenues from the service still form a large portion of the overall revenue for mobile network operators, its significance is expected to decline in the future. This is due to the recent growth in data, messaging and other value-added services. Using data from Telstra, the Commission notes that the growth in revenues from data, messaging and other value-added services, over the two-year period from 2000-01 to 2002-03, appears to have exceeded that from mobile termination services.[11] Therefore, it is possible that any losses in revenue resulting from the decrease in the price of the service

[10] *Mobile Services Review: Draft Decision*, March 2004, p xii.

may soon be offset by the increased revenues derived from the growth in other services.

In AAPT's view, while the price reduction may have an impact on the revenue of mobile network owners, the Commission should not simply accept that revenue streams would be so adversely affected as to necessarily justify the two-and-a-half year phase in period.

AAPT submits that given the uncertainties about the impact that the changes to the price of the service will have and how the market will respond, the Commission should state that its proposed price reduction timetable is indicative only. The Commission should state in its final decision that it will closely monitor the impact of the changes in the price for the service, and will decrease the price for the service more quickly if it is possible to do so without causing significant adjustment costs.

As the Commission notes, the telecommunications industry is dynamic in nature.[12] The impact of the changes on providers may be less than the some mobile service providers have argued they are likely to be. Also, mobile service providers may adapt their business plans and operations more rapidly than the Commission expects. Given the importance that the Commission has appeared to place on increasing competition and efficiency, the reduction in the price of the service should occur more quickly if it is practicable to do so. The more quickly the price for the service approaches a cost-based price, the better for the LTIE. The Commission should not be locked into the two-and-a-half year timetable.

4. Cost pass through

The increased level of competition and efficiency, which the Commission anticipates should emerge from a decrease in the price of the service, relies upon retail market providers passing through the cost savings they experience from the rate reduction. AAPT is concerned about whether or not the reduction in the termination price will actually be passed through to end-users of FTM calls, and to a lesser extent, MTM calls.

[11] *Mobile Services Review: Draft Decision*, March 2004, p xii.
[12] *Mobile Services Review: Draft Decision*, March 2004, p 168.

4.1 Pass through of rate reductions to end-users

AAPT believes that the Commission should clearly indicate that it will monitor retail prices closely to determine whether cost pass through is occurring. The very fact that the Commission is monitoring retail prices could deter a firm from exercising any market power it has, which subsequently increases the likelihood that the price reduction will be passed on to consumers.

Furthermore, if the Commission finds that a telecommunications company is not passing on the price reduction to consumers, it should pursue the matter. The Commission should consider whether a telecommunications company that is not passing the price reduction through to end-users has a substantial degree of power in the retail market within which FTM services are offered, or any other market. If so, the telecommunications company, in failing to pass through the price reduction, may well be taking advantage of its market power with the effect of substantially lessening competition in the market, and therefore be in breach of Part XIB of the Act.

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.

The Commission should indicate that it will monitor the pass through of price reductions to retail consumers with the intention of taking the appropriate steps under the Act where it does not occur.

4.2 Pass through in particular segments of the telecommunications market

The Commission has maintained that a decrease in the price of the service should limit the ability of vertically-integrated mobile and fixed-line carriers to raise retail market rivals costs and engage in “price-squeeze” behaviour.[13] Vertically-integrated telecommunications providers should subsequently find it more difficult to:

- price discriminate on the basis of on-net and off-net calls;
- offer FTM calls to corporate customers at prices below those charged to competitors terminating FTM calls; and
- to leverage market power from the FTM retail market to the retail mobile services market.

AAPT remains concerned that if cost pass through does not occur, it is likely that telecommunications companies will use pricing structures that distinguish between on-net calls and off-net calls. This type of price discrimination could facilitate the leveraging of market power between the FTM retail market and retail mobile services market. Similarly, there is a danger that if pass through does not occur, vertically-integrated telecommunications providers will be able to take advantage of the price reduction, and cross-subsidise corporate and government customers at the expense of other types of retail customers.

AAPT believes that in monitoring the impact of the price reduction and the extent it is passed through to retail consumers, the Commission should have a particular focus on these issues. They should also form part of the Commission’s ongoing inquiry into competition and pricing in the corporate customer segment of telecommunications markets.

4.3 Tariff filing and record keeping rules to assist cost pass through

The Commission already has the ability to obtain the information necessary to monitor the relevant markets in the manner outlined above, through the tariff filing and record keeping rules in Part XIB of the Act. AAPT believes that the Commission should take full advantage of its powers in this respect. The very fact that the Commission is known to be monitoring prices closely is likely to promote the pass through of the reduction in the price of the service to end-users.

[13] *Mobile Services Review: Draft Decision*, March 2004, p 90.

In addition, if the Commission has reason to believe that anti-competitive conduct in breach of Part XIB may be occurring, it should take the appropriate action using its powers under the Act to prevent such conduct.

5. The ACCC should develop its own Cost Model

As already outlined, AAPT welcomes the Commission's decision to move away from the light-handed retail benchmarking approach, and towards a more direct pricing principle that will generate a closer association of prices and costs for the service. AAPT supports the proposed 12 cents per minute as being a maximum benchmark price for 1 January 2007, but believes that the Commission should eventually aim to limit its reliance on the international benchmarking approach that is presently used to determine the appropriate price.

AAPT is concerned that for future purposes, if regulators place too great a reliance upon one another's international benchmarks, instead of undertaking an independent analysis, it could lead to either:

1. a static price for the service, where regulators around the world simply determine the price by looking at one another's prices. In the long-term, such a price could lie substantially above cost. This could lead to the type of cross-subsidies and inefficient use of, and investment in, infrastructure that the Commission has indicated it is eager to prevent; or

2. a price that is continuously being driven down by regulators, who each presume that the cost must lie slightly below the price estimated by the other regulator. This "ratchet effect", where regulators repeatedly undercut one another's prices, may lead to a below-cost price for the service. In the long-term this could discourage future investment, if firms are unable to earn a sufficient rate of return on their investment.

To avoid the possibility of either of the above outcomes, and to ensure the price reflects the efficient cost of providing the service, AAPT believes that the Commission should develop its own model for estimating the TSLRIC of the service. (There may be some opportunity for the ACCC to share the cost and benefits of this exercise with regulators in other jurisdictions). A model will also provide the Commission with a greater ability to assess whether or not in the future there will be any additional increases in competition and efficiency from a further price reduction.

This TSLRIC model should be developed by July 2006 so that the Commission can independently estimate the efficient cost of the providing the service before the transition period ends. This model will allow the Commission in 2007, if not earlier, to set the price for the service that will best promote competition and efficiency in the related downstream markets.

6. Conclusion

AAPT supports the Draft Decision with its continued declaration of the service and the move towards a more direct cost-based pricing regime. However, AAPT believes that the Commission needs to closely monitor the activities in the market. This monitoring should be aimed at determining whether the timetable for a move to cost-based prices can be accelerated, and for the possible existence and use of market power in delaying pass through. AAPT also believes the Commission needs to prepare itself for the regulatory requirements at the conclusion of this period by preparing a cost model.

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