AAPT RESPONSE TO

AUSTRALIAN COMPETITION & CONSUMER COMMISSION

"PRICING METHODOLOGY FOR THE GSM TERMINATION SERVICE"

DRAFT REPORT

INTRODUCTION

This submission comments on the Commission's Draft Report, *Pricing methodology for the GSM termination service* (December 2000) ("**Draft Report**"). The submission is further to the submissions AAPT made in response to the Commission's Discussion Paper issued in December 1999[1] ("**Discussion Paper**") and comments made during the "economists' roundtable" held in March 2000.[2]

This submission addresses the following matters:

(a) definition of the relevant markets;

(b) observations on the state of competition in the markets;

(c) discussion of pricing principles outlined by the Commission and consideration of the long-term interests of end-users ("**LTIE**");

(d) process issues.

The submission does not address matters relevant to the application of the pricing principle in particular arbitrations, such as the backdating of determinations and the appropriate basis on which to make interim determinations.

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[1] ACCC, *Principles for determining the access prices for Domestic GSM Terminating Access and Domestic GSM Originating Access services*, December 1999.

[2] AAPT provided a submissions dated 4 February 2000 ("**AAPT's Initial Submission**") which included an economic report by Dr Nina Cornell ("**Cornell paper**") and a further submission on 27 March 2000 ("**AAPT's Supplementary Submission**").

A. MARKET DEFINITION ISSUES

AAPT agrees with many aspects of the Commission's market analysis. However, it believes that there may be a more significant separation between the retail and wholesale product markets than the Draft Report suggests.

In the section on market definition, Section 5, the Draft Report concludes that "the relevant product market in this instance is a GSM mobile call"[3] and that "[g]iven the interdependencies between the wholesale and retail elements necessary to provide a GSM mobile call, the Commission considers that they should be included in the same market."[4]

AAPT submits that this approach risks understating the important distinctions between the wholesale market for *access* services and other mobile markets relevant to the competition questions raised. The performance of the retail market and the access market will often be related, but as the Draft Report notes, there may be an inverse relationship between pricing performance in the GSM mobile call market and the access market.[5]

Purposive market definition

It is widely accepted that market definition is a tool to aid the analysis of competition questions and, where different questions are posed, it may be appropriate to define more than one market. In that sense, market definition is a purposive process. In the context of the current inquiry, the purpose of defining the relevant market is to assist answering the following questions:

(a) does the current state of competition in a market justify intervention in price setting for GSM termination and, given the characteristics of that market, what sort of pricing principles would best address any market failures in that market?

(b) what will be the effect on competition and investment in that (or another) market as a result of the answer to the first question or, in the terminology of Part XIC, will the LTIE be enhanced?

AAPT submits that different markets are relevant to the consideration of the two questions.

Wholesale markets

For the purpose of addressing the first of these questions, the relevant market is that in which the declared services are supplied. Section 4 of the Draft Report focuses on the declared service, as does the Gans/King Paper.

Starting from the service description contained in the Deeming Paper (described here as the GSM access services) a consideration of substitution possibilities suggests that there are in fact few other products in the same market. It may be an overstatement to assert that markets

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[3] Draft Report, p. 21.

[4] ibid, p. 22.

[5] ibid, p. 6.

exist for termination to particular subscribers, even though there is little opportunity for substituting between individual users. However, in AAPT's view, a separate market exists for mobile access services, and that there are also likely to be separate markets for termination and origination access services, given the different functions those services perform and the basis on which they are supplied.

In practice there is little substitutability between termination to different mobile networks (for the reasons outlined in section 4 of the Draft Report) and there is no effective demand-side substitution between the wholesale termination service and retail services. Further, the significant barriers to entry to the market[6] suggest supply-side substitution would be limited (and certainly more limited than the substitution possibilities in the retail market.)

Accordingly, the market analysis for the purpose of answering the first question posed above should focus on the access market in which the declared service is supplied. The Draft Report addresses relevant issues in section 4 but pays little attention to these factors in the discussion of alternative pricing methodologies in section 7.

Retail markets

The second group of markets relevant to the analysis are those in which the effects of the pricing principle will be felt. As the Draft Report notes, there are a number of downstream markets which may be affected by pricing decisions in the market for termination, including the market for GSM mobile calls, but also the markets for fixed-to-mobile calls and preselected services.[7] The analysis of competitive dynamics in these latter two markets is as relevant to the assessment of the LTIE as is the analysis of the effects in the retail mobile call market.

The Commission appears to conclude that fixed-to-mobile calls are part of the broader mobile services market.[8] However, market conduct indicates that in fact fixed-to-mobile calls are not part of this market in any practical sense. To AAPT's knowledge, there are no commonly-available mobile service packages which included fixed-to-mobile calls as a component of the bundle of services offered. Rather, these calls are usually included as part of the basket of pre-selected services covered by the *Telecommunications (Provision of Pre-selection for Specified Carriage Services) Determination 1998* ("**Preselection Determination**"). Consequently, AAPT considers that the competitive dynamics in this market will need to be considered separately. AAPT includes some comments on these issues in regard to the promotion of efficiency in dependant markets (pages 11-12, below).

In addressing these issues, AAPT notes the comments in section 4.4 of the Draft Report to the effect that mobile carriers are likely to be indifferent to the cost of termination between themselves. As the Commission concludes in that section, the case for regulating termination rates in respect of mobile-to-mobile calls is (by itself) relatively weak. Accordingly, it is likely that the impact of any regulated pricing in the relevant downstream market (the retail market which includes mobile-to-mobile calls) is also likely to be relatively small.

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[6] See AAPT's Supplementary Submission, p. 3.

[7] Draft Report, p. 48.

[8] ibid, p. 22.

More important is the likely impact on competition, any-to-any connectivity and investment in the downstream market for fixed-to-mobile calls. These matters have been addressed extensively during the Commission's Inquiry process. AAPT's views on the likely impact on competition in these markets is discussed in the Cornell Paper and paragraphs 6-9 of AAPT's Supplementary Submission.

Oftel's Effective Competition Review

The UK telecommunications regulator, Oftel, has recently published a consultation paper as a first step in its assessment of the state of competition in the mobiles markets.[9] The Oftel Consultation Paper does not provide definitive conclusions on the issues raised, but presents "initial findings of Oftel's review of competition".

In relation to market definition, the Oftel Consultation Paper includes an extensive discussion on different elements of the various markets and relevantly considers whether there should be a separation between retail and wholesale markets for the purpose of analysing regulatory policy. Oftel notes that it had previously considered the market as a single mobile telephony market but that the increasing complexity of mobile services justifies reconsideration.[10] Most of the factors to which Oftel refers are also relevant to the Australian market.

Annexure 2 to the Oftel Consultation Paper comments:

> *A2.47 The hypothetical monopolist test can be applied to wholesale services to see whether alternative (but not necessarily identical) services are available to resellers to which they could switch, without significant effort and expense, if a monopolist supplier tried to implement a small but significant, non-transitory price increase.*
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> *A2.48 Since there are absolute barriers to entry at the network level and there are no substitutes for the supply of airtime for mobile telephony services, it is apparent that there is a distinct wholesale market. It is clear, however, that the two markets are related. For example, a characteristic of mobile telephony is the potential for MNOs with market power in the wholesale market to constrain competition in the downstream retail market. Consideration of this issue is likely to be key in the analysis of the extent of effective competition.*[11]

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[9] Oftel, "Effective Competition Review: Mobile. *Consultation Document issued by the Director General of Telecommunications*", February 2001 (available at: http://www.oftel.gov.uk/competition/mmr0201.htm) ("**Oftel Consultation Paper**").

[10] The Oftel Consultation Paper notes:

> *In previous reviews of the mobile sector, Oftel considered a <u>single</u> market for the provision of <u>all</u> mobile telephony services to end-users. This was based on analysis at a time when, in practice, consumers purchased a bundle of mobile services from a single network operator, and the choice facing a consumer was simply the selection of alternative mobile operators. However, given the rapid pace at which the UK mobile sector has developed, Oftel considers that it is now appropriate to revisit the applicable market definitions.*

[11] Oftel Consultation Paper, Annexure 2. Figure 2 in the Oftel Consultation Paper is a diagram of Oftel's view of the relevant markets.

In the discussion on competition in the markets, Oftel indicates that the performance of different sectors within the wholesale markets is significantly different to performance of the retail markets. (The Oftel Consultation Paper does not discuss issues relevant to termination in detail, as Oftel expects to discuss these in its *Review of Price Controls on Calls to Mobiles,* due to be published shortly.) In regard to mobile-to-mobile calls, which rely on wholesale services, Oftel notes:

> *2.49 Although the mobile price index model includes off net mobile to mobile calls, the overall trend shown in Figure 7 hides a different trend for off net mobile to mobile calls, in which there is no evidence of active competition on price. As explained in detail in Annex 6, Oftel believes that the interaction between the four mobile operators when setting retail prices for off and on net mobile to mobile calls and charges for call termination on mobile networks creates a situation where the prices for off net mobile calls remain static. However, as discussed in Annex 6, Oftel's initial view is that unless there are distributional concerns it would be inappropriate to take regulatory action to address only the price of off net mobile calls while overall prices in the market for outgoing calls are falling.*

Conclusions on market definition

AAPT submits that the Commission's final report ought to be recast to reflect the significance and extent of the distinction between the relevant markets. The very different characteristics of the access and retail markets suggests to AAPT that there is likely to be significantly different assessments of the state of competition in these markets which should be considered in the Commission's final view of the markets.

B. STATE OF COMPETITION IN THE MARKETS

Following from the market definition in section 5 of the Draft Report, the Commission's assessment of competition focuses almost solely on the retail level of the mobile services market. In AAPT's submission, this analysis does not sufficiently address the market failure issues identified in the Gans/King Paper.

Although some elements of the analysis are relevant to both wholesale and retail markets (such as the barriers to entry posed by the need to acquire spectrum and establish a national network) the analysis significantly overstates the level of competition in the wholesale market. The discussion of potential substitutes such as the provision of CDMA services and the role of resellers is, almost by definition, irrelevant to a consideration of GSM termination.

Retail competition

For these reasons, AAPT does not wish to comment in detail on aspects of competition in the retail mobile call market.

To the extent that an assessment of competition in this market is relevant, it is difficult to make a sound assessment of the state of competition in the market at present, given the likely restructuring as a result of the expected sale of the Cable & Wireless Optus network. Of course, these matters will be considered by the Commission in another context and, because of that consideration, it is unlikely that a substantial lessening of competition will result. However, it may be that the *form* of competition may be different to the current model and this could substantially alter the analysis relevant to an assessment of access issues.

For example, one possible outcome would be a single entity would control the network assets of both Cable & Wireless Optus and Vodafone subject to a condition that "non-discriminatory" access would be provided to at least one other market participant. The effect of such an arrangement would be a clear concentration at the network level, tempered by undertakings intended to preserve retail competition through access and resale arrangements. Even if such an arrangement could be implemented without lessening retail competition, the concentration at the network level and the limited control "virtual network operators" would have over network costs would be likely to affect the type of retail competition that would result. Accordingly, AAPT recommends that the Commission be cautious in forming final views on the state of competition in the retail market.

AAPT submits that the Commission should conduct a similar assessment of other downstream markets dependent on the mobile termination services, particularly the market in which fixed-to-mobile services are supplied.

Wholesale competition

AAPT has previously outlined its views on the constraints on competition in the wholesale (access) market in its earlier submissions to the Commission. AAPT maintains these views which, in summary, are:

(a) the market is highly concentrated and to date has shown little evidence of price competition;

(b) there are significant barriers to entry and sunk costs, both in relation to tangible factors (eg investment in equipment and spectrum) and nontangible (eg difficulty of concluding interconnection agreements, branding); and

(c) pricing signals may be muted because of the market failures described in the Commission's consultants' report, principally consumer ignorance and "horizontal separation".

The Commission appears to agree with these conclusions in its comments on the "forbearance" approach, at least as far as supply of the termination service are concerned. In the Draft Report, it notes:

> *The Commission considers that the competitive forces which operate in relation to the GSM termination service are, and will remain in the foreseeable future, relatively weak.*[12]

Oftel Consultation Paper

As noted previously, the Oftel Consultation Paper does not make definitive conclusions. However, it comments that, although there are positive signs that the mobiles market *as a whole* is prospectively competitive, there are significant obstacles.

> *2.91 … the combination of a number of crucial factors suggests that the mobile sector still falls short of effective competition. The structure of the markets remains consistent with a finding that overall prices are set above the competitive level, despite the presence of competition. The available evidence: the market share information, the lack of well informed consumers, the initial results of the profitability analysis and the observed high static prices for some services, also supports an initial conclusion that, on balance, the mobile sector is not yet effectively competitive.*

AAPT submits that the performance of the market in Australia presents a similar picture: structurally, the market remains highly concentrated, with limited competition from new and prospective entrants; the mobile networks are extremely profitable and the prices relevant to the Commission's inquiry (principally access prices) have, in AAPT's experience, remained static during the past two years.

Importantly, though, AAPT notes that Oftel states:

> *4.6 A conclusion that the mobile sector is not effectively competitive because two or more operators are still pricing above the competitive level would not lead Oftel to conclude that high prices should be directly addressed by imposing retail price caps or cost based access obligations. It would be possible to respond to this outcome with action that directly addresses the presence of high profits, but Oftel believes that its response should be conditioned by the <u>prospect</u> of effective competition.*

Oftel further suggests that *in the UK market* there are signs of increased competition which justify a less intrusive approach to regulation than would be the case if competition were

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[12] Draft Report, p.46.

unlikely to develop. The Commission will need to make a similar assessment of the prospects for competition in the wholesale market, based on current evidence and a reasoned view of possible outcomes of any industry restructuring.

C. PRICING METHODOLOGIES

The Draft Report discusses the following possible pricing methodologies:

(a) forbearance;

(b) short run marginal cost or long run incremental cost;

(c) retail-minus; and

(d) benchmarking the change in access prices.

The Discussion Paper issued in December 1999 also discussed ECPR as an alternative pricing rule. Although the Commission did not express a final view in the paper, it outlined the "stringent set of facts" that would support application of an ECPR rule and noted that, unless final market prices were constrained (either through regulation or effective competition), ECPR may not be appropriate."[13] AAPT assumes that the Commission has concluded (and would agree with such a conclusion) that the pre-requisites for applying ECPR do not currently exist in relation to the GSM access services.

Forbearance and retail-minus not appropriate

The Draft Report quickly rejects forbearance as the appropriate methodology because the evidence available to the Commission suggests that the forces of competition are currently week and the efficient costs of providing access are lower than current access prices.[14] Accordingly, it considers that forbearance would not promote competition or encourage efficient investment and use of infrastructure. AAPT agrees with that assessment.

AAPT also questions whether a retail-minus methodology would offer any theoretical advantages that would justify the difficulties of implementing such a principle which the Commission refers to at page 49 of the Draft Report. However, in appropriate circumstances, and if applied correctly, AAPT submits that a retail-minus approach may offer significant advantages over the model proposed by the Commission. Further, this is a methodology which the Commission has decided is appropriate to determining access prices for the local carriage service. Although the regulatory context applicable to the services are very different, the Commission would be able to apply some of the expertise from pricing the LCS to the GSM access services. AAPT therefore asks that the Commission further consider the applicability of a retail-minus approach.

Access Pricing Principles

The Commission's Access Pricing Principles ("**APPs**") state that access prices should be cost based and "should not exceed the minimum costs an efficient firm will incur in the long run in providing the service."[15] The APPs also note that access prices should not discriminate in a

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[13] Discussion Paper, p. 10.

[14] Draft Report, p.46.

[15] ACCC, *Access Pricing Principles*, July 1997, p. 14.

way which reduces efficient competition. The cost-based methodology should also allow for a normal return on investment.

The Draft Report suggests two cost-based pricing methodologies: short-run marginal cost and long-run incremental costs. AAPT agrees with the Commission's conclusion that, if a cost-based rule is applied, it is appropriate to allow recovery of fixed and common costs under the rule.

The Commission states in the APPs and in the Draft Report that TSLRIC is the most appropriate pricing approach to give effect to cost-based pricing, provided certain conditions are met, namely:

> *…where the declared service is well developed, necessary for competition in dependent markets, and where the forces of competition or the threat of competition work poorly in constraining prices to efficient levels, the Commission will, in the usual case, when required to determine the access price, base such a determination on the TSLRIC of providing the service.*[16]

However, the APPs also note that it is not appropriate to pre-determine a pricing methodology, particularly where the conditions above are in doubt or where the information available to the Commission does not allow an accurate assessment of the TSLRIC to be made.[17]

In the Draft Report, the Commission refers to these pre-conditions for the application of TSLRIC pricing[18] and concludes they are not met in the case of the GSM service.

Are the declared services well developed?

The APPs explain the reason for this condition as the difficulty of assessing the "capabilities and cost structure required to produce [the access service]" and of accurately estimating the rate of return required to compensate for investment in the service.

It is arguable that the GSM access services are sufficiently well developed to allow the estimation of TSLRIC, although it is difficult to come to a concluded view on the point. The service was one of the services deemed as declared when the access regime was introduced in 1997. The technology used to deliver the service is now more than 20 years old and the first commercial application internationally was in 1991. The termination service has been supplied (at least internally) in Australia since Telstra introduced GSM technology in 1993. There is evidence that the GSM service is sufficiently well developed in the market to allow commercial entities to asses the value of spectrum used for its delivery and, more recently, to value GSM networks for the purpose of considering purchase of those assets.

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[16] APPs, p. 35.

[17] ibid.

[18] ibid, pp. 27-28.

AAPT notes that the Commission in considering the unconditioned local loop service ("**ULLS**"), stated:

> *The Commission has also previously stated that TSLRIC is particularly appropriate for services that are well developed, necessary for competition in dependent markets and where the forces of competition work poorly in constraining prices.*
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> *In the case of ULL, it is considered the service clearly meets each of these criteria. While this is a new service for access seekers, the service relates to the most basic building block in Telstra's network, the copper CAN infrastructure which has been developed and in use for generations…*[19]

Although the GSM services have not been in use "for generations" they are sufficiently well developed to avoid any of the risks referred to in the APPs in pricing access services. The GSM access services is better developed than the ULLS, which has been provided only on a (limited) commercial basis within the last year.

Do the forces of competition constrain access prices to efficient levels?

In discussing the competitive constraints, the Draft Report correctly concentrates on the declared service. However, it concludes that "the benefits of TSLRIC regulation in these circumstances are less clear cut than where there is sustained market power by one carrier." This statement overlooks the fact that, as the Commission previously notes, the peculiar characteristics of the termination market mean that market power is likely to be independent of the number of carriers supplying the service, particularly in regard to fixed-to-mobile termination.

These matters have been exhaustively dealt with throughout the inquiry and AAPT does not repeat its arguments here. However, AAPT notes that the Commission's conclusion here, and in other parts of the Draft Report that current access prices are above efficient prices and are not constrained by competition.[20]

Is the GSM termination service necessary for competition in dependent markets?

The APPs consider downstream competition in two contexts: first, they note that an appropriate pricing principle will offer protection against discrimination in downstream markets[21] and, second, they assert that TSLRIC will promote efficient entry and exit in dependent markets.

AAPT is not able to offer a definitive view as to whether the incumbent carriers discriminate in downstream markets, due to the lack of publicly available information. On one view, a

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[19] Commission, *Pricing of unconditioned local loop services and review of Telstra's proposed ULLS charges*, Draft Discussion Paper, August 2000, p.16.

[20] For example, pp. 18,46, 47, 51. Similar observations are made by Ovum in its report *Regulating Mobile Operators – The Road to Effective Competition*, Vol. 3: GSM Termination Rates, 2000, (quoted in the Draft Report), the Gans/King Paper, pp. 3-4.

[21] APPs, pp. 15-16.

claim of discrimination is consistent with the conduct of the dominant integrated carrier, Telstra, which offers retail prices for fixed-to-mobile services that differentiate between rates for termination to mobiles on its own mobile networks and on other networks.[22] If the Commission does not ultimately use TSLRIC pricing, it will need to satisfy itself by other means that the resulting access prices do not allow discrimination in downstream markets.

In regard to the promotion of efficiency in downstream markets, the Draft Report suggests that the effect may be relatively small. The principal reason given in support of this assessment is that fixed-to-mobile calls are supplied as part of a preselection basket. From this fact, the Commission concludes:

(a) competition in the downstream (pre-selection) market as a whole is likely to be vigorous, as is evidenced from significant price reductions in the other services supplied in the basket (long-distance and international calls); and

(b) new entry is unlikely to occur as a result of lower GSM access prices.

However, the observation that other calls within the same basket have been reduced in price is equally consistent with a hypothesis that service providers are cross-subsidising between services in the basket in order to maintain their competitive position in regard to the supply of the basket of preselected services. If this hypothesis is correct, the significant reductions in price for long-distance and international calls is itself evidence that the downstream market is dependent and that higher-than-efficient GSM termination prices have a distorting effect.

It is difficult to conclude exactly what the cross-product impacts are between fixed-to-mobile and other preselected calls. AAPT notes that the market in which fixed-to-mobile calls are supplied is likely to be "artificial" as a result of the Preselection Determination. In the absence of a regulated single basket, the fixed-to-mobile service would may be supplied as a stand-alone service. The correct approach for the Commission to take to assessing efficiency impacts in downstream markets is to ignore the impact of the other services in the basket and focus on the likely effect on competition in regard to the fixed-to-mobile termination service.

Conclusion on the applicability of TSLRIC methodology

AAPT submits that the declared services most likely meet the criteria for application of TSLRIC pricing described by the Commission in the APPs. Much of the Commission's treatment of these issues in the Draft Report focuses on services which are not the subject of declaration and therefore it errs in its assessment of the maturity and significance of the services and the extent to which competition is effective.

However, the appropriateness of TSLRIC cannot be determined by a mechanical application of the criteria set out in the APPs but should be assessed in the context of the particular services in question. In regard to the GSM access services, AAPT submits that TSLRIC would provide the best indicator of efficient prices but that other pricing guides may be applied to arrive at "proxy" measures of efficient prices.

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[22] Telstra's SFOA (as at 1 February 2001) includes rates for fixed-to-Telstra mobile calls of 62cpm (peak) and 37cpm (off-peak) and to non-Telstra mobiles of 73cpm (peak) and 46cpm (off-peak).

Difficulties of applying TSLRIC

In the APPs, the Commission noted that:

> *Estimating or determining the TSLRIC can be difficult and time consuming.*

Two matters which caused particular difficulty in the context of estimating a TSLRIC price for the PSTN origination and termination services – cable trench lengths and the weighted average cost of capital – may be more straightforward in the case of GSM. Of course, trench lengths are not relevant to mobile networks, however, the costing of infrastructure generally is likely to be more straightforward due to the fact that at least some of the underlying services are supplied on a commercial basis.[23] Estimation of the cost of capital could also be more easily determined due to the fact that, unlike PSTN, a stand alone mobile network is operated by Vodafone. AAPT also notes that Annexure 11 to the Oftel Consultation Paper includes an estimate of the cost of capital.

The Commission suggests that it would be difficult to determine which network should be modelled for the purpose of estimating the TSLRIC price. Given the fact that mobile penetration is now close to that of fixed services, AAPT submits that the three major networks are well developed and therefore the differences between the networks are unlikely to be significant. Therefore, the decision as to which network should be modelled could be arbitrary or could be made on the basis of which network is the subject of the greatest number of access disputes at the time the Commission commences work on the costing model.

The fact that estimating the TSLRIC is difficult is an argument that suitable "proxy" measures need to be determined to provide interim prices while the correct price is determined, not that the approach should be abandoned altogether. One possible proxy would be the lowest current access price, as by the Commission in its benchmarking proposal suggested by the Commission. However, for the reasons discussed below, this approach is not a suitable "final" pricing principle.

Proposed benchmarking approach

The Commission concludes its discussion of alternative pricing approaches with the following observation:

> *TSLRIC pricing would, therefore, appear to better meet the legislative criteria by ensuring access prices are moved to costs. In the case of the mobile services market, however, the Commission does not accept this view. It considers that, consistent with the increasingly competitive forces in the mobile services market, it is more appropriate for the Commission to take a less intrusive approach to regulation.*[24]

AAPT agrees with the Commission that the significant difference between TSLRIC and benchmarking is that the latter does not provide a mechanism by which an efficient "starting

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[23] For example, the mobile tower facilities used by Vodafone and Optus are supplied under commercial arrangements with Crown Castle Australia.

[24] Draft Report, p. 50 (repeated at p.53).

price" can be determined. The Commission's characterisation of this difference as being that the benchmarking approach is "less intrusive" is an understatement. Rather, a decision not to determine an efficient starting point would be a decision not to address a proven market failure of a kind the access regime was intended to correct. Such an approach suffers from similar same flaws to a "forbearance" approach.

Difficulties in setting a starting point

AAPT acknowledges the difficulty in setting a starting point from which "glide path" will take the price down. On page 43 of the Draft Report the Commission notes that "the current access prices for GSM termination" (as negotiated between mobile carriers and fixed line carriers) would not be an appropriate "starting point" because such a starting point would benefit the mobile carrier who had negotiated the highest access price (ie, who is able to sustain the highest access price for GSM termination given the relatively weak competitive forces). Later, the Commission suggests that an appropriate starting point would be "the lowest current access price for GSM termination (as negotiated between a mobile carrier and a fixed line carrier)".[25]

In AAPT's view, this analysis overlooks the fact that the relatively weak competitive forces in the wholesale market are likely to have affected *all* current access prices, such that the difference between the highest access price for GSM termination and the lowest will be small. From AAPT's own experience, the termination prices offered by the three incumbent networks lie within a very narrow range and are not necessarily related to likely market power. AAPT is unable to provide any comments on this point in relation to the market generally as it does not have access to relevant data. However, as one of the larger fixed line carriers, it would expect that the rates offered to it are broadly comparable, or lower than, rates available in the market generally.[26]

An alternative approach

For the reasons described earlier in this submission, AAPT considers that the correct starting price must be based on cost. The Commission's comments in the Draft Report suggest that a TSLRIC approach would address many of the market failures evident in the termination market but that there are likely to be practical difficulties associated with implementing such an approach.[27] AAPT acknowledges that these would substantially delay the resolution of arbitrations before the Commission. Accordingly, it may be appropriate to use proxy measures to assist the Commission estimate a cost-based price as an interim starting price.

AAPT has previously suggested to the Commission a methodology for determining a starting point which would better reflect the true costs of supplying the termination service. The approach suggested seeks to determine the lowest available retail proxy of the termination service. One possibility is a model which discounts a retail end-to-end service by an

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[25] ibid. p. 53.

[26] This experience is also consistent with theoretical results on mobile termination prices. See, for example, J. Laffont and J. Tirole, *Competition in Telecommunications*, (2000, MIT Press, Boston), ch.5.

[27] Draft Report p. 47.

appropriate factor to approximate the service components of termination.[28] However, an alternative is to consider currently available retail termination services supplied to large corporates. AAPT is aware that these services are provided as part of virtual private network services by at least one of the incumbent mobile networks.

The APPs note that comparison with retail prices is one of the “pricing guides” the Commission suggests would be useful in that it would reveal what internal transfer pricing levels are and whether access prices have been inflated to lessen competition in the retail markets. For the reasons outlined there, AAPT requests that the Commission seek information from the mobile networks as to their current retail prices for termination services.

Conclusions on benchmarking

AAPT considers that the proposed benchmarking approach will do little to address the market failures described in the Draft Report. Further, AAPT’s experience is that the suggested approach, by itself, will not greatly assist in progressing commercial negotiations.

However, should the Commission conclude in its final report that benchmarking is the appropriate pricing methodology, the for that approach to be useful, the starting point must be more closely aligned with an efficient price than currently available access prices. Therefore, for the reasons stated above, the Commission should at least seek information from the mobile carriers on what retail prices are currently available in order to assess whether current access prices are likely to create distortions in downstream markets.

Commission is required to consider direct costs.

AAPT notes that, regardless of the pricing rule the Commission considers to be generally appropriate, sub-section 152CR(d) requires the Commission to take into account the “direct costs of providing access to the declared service” in the context of individual arbitrations. In AAPT’s submission, it is not open to the Commission to disregard cost on the basis that it is a difficult matter to assess.[29]

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[28] AAPT notes that the Commission has considered such an approach in its comments on a retail-minus approach to pricing the termination service. AAPT does not agree with the Commission’s observation that the appropriate factor for discounting a retail end-to-end service in order to obtain an equivalent termination service should be a discount factor of greater than 50% (Draft Report, p. 42). In this regard, AAPT acknowledges that there may be increased switching costs involved in the termination end of a complete service. However, these factors would likely be more than offset by savings such as avoided retail costs. AAPT suggests that there should be a strong onus on network operators to establish that the appropriate factor to reduce the end-to-end service should be less than 50%.

[29] The Draft Report, on page 52, cross refers to its consideration of the LTIE. However, there does not appear to be consideration of how the direct costs might be determined. The Commission’s conclusion in that section, based on evidence provided to it, is that “current access prices are above efficient costs”.

D. PROCESS ISSUES

AAPT acknowledges that the process of determining the pricing principle for the GSM access services is one of the more difficult that has faced the Commission and the industry since the introduction of the access regime in 1997. AAPT understands the Commission's reluctance to pursue a "pure" TSLRIC inquiry, which would be likely to delay the resolution of disputes currently before the Commission. As addressed in other parts of this submission, the relevant GSM markets are neither clearly competitive nor totally inefficient and, more importantly, are currently restructuring.

In this context, the Commission is faced with a particularly difficult challenge to provide the industry with clear guidance as to whether or not current access prices are efficient and what pricing principles would allow for efficient prices to be determined. As currently framed, the Draft Report contains some conflicting messages on these issues, which may reduce the prospects for timely resolution of disputes, whether by commercial negotiation or arbitration.

AAPT Limited
20 February 2001