Australian Competition & Consumer Commission

Draft MTAS Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011

November 2008

Table of contents

1 Introduction

On 30 June 2004 the Australian Competition and Consumer Commission (ACCC) declared the domestic mobile terminating access service (MTAS) for all voice services terminating on all digital mobile telecommunications networks. The declaration of the MTAS is due to expire on 30 June 2009.

Upon declaring the MTAS the ACCC released the *MTAS Pricing Principles Determination for the period 1 July 2004 to 30 June 2007* (2004 Pricing Principles). As part of the 2004 Pricing Principles the ACCC adopted an adjustment path in setting indicative prices. Subsequently the ACCC released the *MTAS Pricing Principles Determination for the period 1 July 2007 to 31 December 2008* (2007 Pricing Principles). The 2007 Pricing Principles set an indicative price of 9 cents per minute (cpm) to apply from 1 July 2007 to 31 December 2008. Table 1 below table sets out the indicative price of the MTAS between 2004 and 2008.

Table 1 – MTAS indicative price 1 July 2004 to 31 December 2008

Time period	cpm
1 July 2004 – 31 December 2004	21
1 January 2005 – 31 December 2005	18
1 January 2006 – 31 December 2006	15
1 January 2007 – 30 June 2007	12
1 July 2007 – 31 December 2008	9

1.1 Purpose

The purpose of this draft pricing principles determination is to:

- identify the issues relevant to determining appropriate pricing principles and indicative prices in respect of supplying the MTAS, and
- set out the proposed pricing principles determination and indicative price for the period after 31 December 2008.

1.2 Timetable and Inquiry process

The ACCC encourages industry participants, other stakeholders and the public more generally to consider the pricing principles for the declared services set out in this guide. The ACCC requests written submissions on the draft determination by **5pm on Friday 12 December 2008.**

The ACCC expects that it will publish an *MTAS Pricing Principles Determination for the period 1 January 2009 to 30 June 2011* (2009 Pricing Principles) including indicative prices in early 2009.

1.3 Making submissions

All submissions will be considered as public submissions and will be posted on the ACCC website. If parties wish to submit commercial-in-confidence material as part of their submission to the Commission, parties should submit both a public and commercial-in-confidence version of their submission. The public version of the submission should clearly identify the commercial-in-confidence material by replacing the confidential material with an appropriate symbol or ‘c-i-c’.

Submissions are to be sent by email, in Microsoft Word document form to:

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2 Developing pricing principles

2.1 Legislative requirement

Under Part XIC of the *Trade Practices Act 1974* (the Act), the ACCC is responsible for arbitrating access disputes concerning access to particular declared services, and for assessing access undertakings relating to access to such declared services. One of the prime issues arising under these processes is the determination of an appropriate access price. Under section 152AQA of the Act, the Commission must, by writing, determine principles relating to the price of access to a declared service.

The pricing principles determination may contain price-related terms and conditions (indicative prices) relating to access to the declared service. The ACCC must make such a determination at the same time as, or as soon as practicable after, the ACCC declares a service. The ACCC is also required to publish a draft determination, invite submissions on the draft and consider any submissions received, before it makes a final Pricing Principles Determination.

The proposed MTAS Pricing Principles Determination is expressed to operate beyond the notional expiry date of the current declaration (30 June 2009). There are two reasons for this. Firstly, the current declaration may be extended or further extended pursuant to section 152ALA of the Act. It is intended that this determination will continue to apply to such extensions (up to 31 December 2011). Secondly, notwithstanding that a declaration may expire, an arbitration under Division 8 of Part XIC of the Act may still be on foot at the date the declaration expires. It is intended that this determination will apply to the setting of prices in such an arbitration. However, if the MTAS is re-declared the Commission is obliged to make a new Pricing Principles Determination under section 152AQA(3) of the Act. The Commission will determine at that time how this determination is to be applied in relation to the period before the new Pricing Principles Determination is made. The Commission seeks to provide as much long-term certainty about its pricing intentions as the statute allows, to promote efficient investment by both access providers and access seekers.

The Commission must have regard to its pricing principles determination if it is required to arbitrate an access dispute in relation to the same declared service under Division 8 of Part XIC of the Act.[1] However, the pricing principles are not binding on the Commission, and parties to arbitrations are still able to address the Commission on the relevance and applicability of the principles having regard to the circumstances of their particular dispute. The Commission considers that, although a party may argue against the pricing principles being applied to its particular case, pricing principles may help guide commercial negotiation of access by providing greater certainty as to the Commission's views on reasonable access prices.

[1] Section 152AQA(6) of the Act.

2.2 Role of Pricing Principles

In July 1997, the ACCC published *Access Pricing Principles: Telecommunications – a Guide* (Access Pricing Principles). The purpose of the Access Pricing Principles was to advise the telecommunications industry and other interested parties about the principles that are likely to be relevant in assessing undertakings or in arbitrating access disputes. It set out the following broad principles:

- the access price should be based on the cost of providing the service
- the access price should not discriminate in a way which reduces efficient competition
- the access price should not be inflated to reduce competition in dependent markets, and
- the access price should not be predatory.

In the Access Pricing Principles, the ACCC noted that when determining a cost-based price, it would generally seek to determine the total service long-run incremental cost (TSLRIC) of providing the service. It also noted that the applicable approach would be assessed on a case-by-case basis for each service.

2.3 Legislative criteria

The object of Part XIC of the Act is to promote the long-term interests of end-users (LTIE) of carriage services, or of services provided by means of carriage services.[2] This will be achieved, in part, through establishing the rights of third parties to gain access to services that are necessary for the competitive supply of services to end-users.

An important part of the access regime is the terms and conditions of access (including the price or a method for ascertaining the price). Under Part XIC of the Act the Commission cannot make a telecommunications access code or accept an undertaking unless satisfied that the terms and conditions specified are reasonable.[3]

In determining whether terms and conditions are reasonable, regard must be had to the following matters:

- whether the terms and conditions promote the LTIE
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or carriage service provider's investment in facilities used to supply the declared service concerned
- the interests of persons who have rights to use the declared service concerned
- the direct costs of providing access to the declared service concerned
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility, and

[2] Section 152AB(1) of the Act.

[3] The Commission must also ensure that the terms and conditions in undertakings and any arbitration determination are consistent with any Ministerial pricing determination in place. See section 152CH of the Act.

- the economically efficient operation of a carriage service, a telecommunications network or a facility.[4]

This does not, by implication, limit the matters to which regard may be had.[5]

When the ACCC is making a final determination in an access dispute, the ACCC must have regard to the same matters, as well as the value to a party of extensions or enhancement of capability whose cost is borne by someone else.[6]

Accordingly, the ACCC considers that, when it is making pricing principles for a declared service, it is appropriate to have regard to the matters set out above. A more detailed discussion of these legislative criteria and their application in determining access pricing principles can be found in the ACCC's *Access Pricing Principles – Telecommunications – a guide*.[7]

3 Background to the MTAS regulation

3.1 Description of the declared service

The MTAS is a wholesale input, used by providers of calls from fixed-line and mobile networks, in order to complete calls to mobile subscribers connected to other networks. When a call is made between customers (or end-users), it will involve two essential elements – origination and termination. Origination refers to the carriage of a call from the end-user who makes, or originates, the call over the network to which this end-user is connected. Termination refers to the carriage of the call to the person receiving the call over the network on which the person receiving the call is connected. Where the person making the call and the person receiving the call are on different networks, a point of interconnection between these two networks will exist. The main network elements of providing the MTAS are illustrated in Figure 1 below.

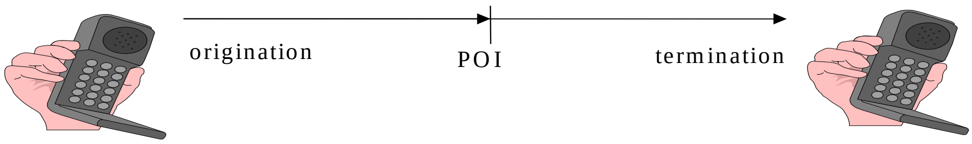

Figure 1 – Termination, origination and the POI

The MTAS is also an input for the carriage of fixed-to-mobile calls as illustrated in Figure 2.

[4] Section 152AH(1) of the Act.
[5] Section 152AH(2) of the Act.
[6] Section 152CR(1) of the Act.
[7] ACCC, *Access pricing principles – Telecommunications – a guide*, July 1997.

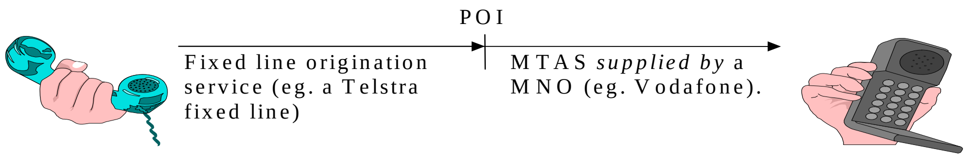

Figure 2 - Use of the MTAS to supply a FTM call

Under current commercial arrangements between network owners, the network owner that originates a call to a mobile network will, generally, purchase the MTAS from the network owner that completes (terminates) the call. The originating network owner will recover these costs, and the costs it incurs from originating the call, through the retail price it charges its directly connected end-user for providing the call. This commercial arrangement is typically referred to as the calling party pays model.

The MTAS is therefore an essential input into the provision of calls to mobile phone users where the mobile phone user is on a different network to the individual who originates the call. This is the case irrespective of whether the call terminates on a 2G or 3G mobile network.

3.2 MTAS Declaration 2004

In 2004, after holding a public inquiry under Part 25 of the *Telecommunications Act 1997* the Commission declared that it was satisfied that declaring the MTAS would promote the LTIE. In declaring the MTAS the ACCC found that declaring the MTAS would:

- promote competition in markets for listed services
- achieve any-to-any connectivity in relation to carriage services that involve communication between end-users, and
- encourage the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied.

The current declaration for the MTAS is due to expire on 30 June 2009.

3.3 MTAS Pricing Principles Determination 2004

The 2004 Pricing Principles adopted an adjustment path in setting indicative prices for the MTAS, reducing the indicative price from 21 cpm to 12 cpm over the period from July 2004 to June 2007. The specification of an adjustment path was designed to protect the legitimate business interests of access providers of the MTAS. In particular, the Commission was concerned that an immediate reduction in the price of the MTAS to 12 cpm might generate significant and potentially harmful disruption to mobile operators’ business plans.

The ACCC’s decision was informed by analyses of international cost benchmarking and Regulatory Accounting Framework (RAF) reports. In the 2004 Pricing Principles the Commission stated that any reduction in pricing below 12 cpm would be supported by the development of a bottom-up cost model.

3.4 MTAS Pricing Principles Determination 2007

The 2007 Pricing Principles further reduced the MTAS indicative price, setting a flat rate of 9 cpm for a period of 18 months. The ACCC’s decision was informed by the WIK Mobile Network Cost Model (WIK model), a bottom-up cost model developed for the ACCC. The WIK model estimated the efficient cost of supplying the MTAS (TSLRIC+) as being in the range of 6.1 cpm (31 per cent market share scenario) to 6.6 cpm (25 per cent market share scenario).

However, in setting the MTAS price at 9 cpm the ACCC took into account other constraints faced by Mobile Network Operators (MNOs) that were not considered in the WIK model. The 2007 Pricing Principles concluded a price of 9 cpm to be a *“useful indicative price that is broadly consistent with the statutory criteria and does not represent a glide path, but a considered, conservative estimate at this point in time of the cost of supply of the MTAS.”* [8]

The Commission noted that in making any future pricing determinations it would consider a range of factors such as efficiently incurred costs of MNOs with reference to actual costs.[9]

[8] ACCC, *2007 Pricing Principles*, p.44.
[9] As set out in the ACT decision *Application by Optus Mobile Pty Limited & Optus Networks Pty Limited* [2006] ACompT 8, 22 November 2006, at p.116-118.

4 MTAS pricing principles

4.1 Efficient costs

The Commission is of the view that prices should be based on the forward looking costs of an efficient operator in order to set prices that promote economic efficiency, which is the outcome that could be expected in a competitive market.[10]

In relation to the MTAS the Commission is of the view that the application of the latest technology as well as most efficient network design will reflect efficient costs. The forces of competition would not enable an operator to charge more than the costs that would be incurred by an efficient, forward looking new entrant.[11]

However, as noted by the Australian Competition Tribunal (Tribunal) in Re *Vodafone Network Pty Ltd & Vodafone Australia Limited* (Vodafone decision), in emulating the outcomes realisable in a competitive market some regard must be had to the actual processes by which operators compete and establish themselves in markets.[12] In an effectively competitive market the most efficient operator may well be able to price somewhat above its costs. It is difficult to see how any less efficient operators could survive otherwise.[13] Given a new entrant would not be able to bring the new design and technology to bear immediately in a legacy-sized network the most efficient operator would not be forced to base its prices on the costs of a network optimised for all-new design and technology.[14] The Commission also notes the Tribunal's approach to efficient costs:

> Although there is merit in the proposition that a firm in a competitive market has an incentive to be efficient and to incur costs efficiently, there is still a need for the Commission (and, on review the Tribunal), to be satisfied, having regard to the matters set out in s152AH and the objectives in s152AB of the Act, that the firm's costs are efficiently incurred. In general terms, an operator in a competitive market should have more of an opportunity to establish the efficiency of its recently incurred costs by reference to its actual costs than a monopolist or dominant operator such as Telstra in *Telstra Corporation Limited* [2004] AcompT4.[15]

In relation to the MTAS the Commission is of the view that a TSLRIC approach provides a guide as to the lower bound costs of providing the service. As noted above, costs incurred in a competitive market may be efficient, even if above the cost estimated using a pure TSLRIC approach. In the absence of actual costs, TSLRIC generally provides a reasonable lower bound estimate of the cost of the MTAS. The Commission notes that it is open to considering other approaches of pricing regulated

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[10] The Australian Competition Tribunal concurs with this view. See Re *Vodafone Network Pty Ltd & Vodafone Australia Limited* [2007] ACompT 1, 11 January 2007, para 68.
[11] Ibid., para 71 & 72.
[12] Ibid., para 73.
[13] Ibid., para 76.
[14] Ibid., para 77.
[15] *Application by Optus Mobile Pty Limited & Optus Networks Pty Limited* [2006] ACompT 8, 22 November 2006, at [116-118].

services that satisfy the legislative criteria. The ACCC has previously indicated that it will consider the appropriate pricing approach on a case-by-case basis.[16]

4.2 TSLRIC framework for pricing the MTAS

The Commission is of the view that the indicative price of supplying the MTAS should be reflected by applying cost-based pricing. However, there are many variants of cost-based pricing depending on the costs that are included, how they are allocated and how they are measured. The Commission's view in the 2004 Pricing Principles and the 2007 Pricing Principles was that in relation to the MTAS the indicative price of the MTAS should be determined based on the TSLRIC of supplying the MTAS. The Commission's view remains that TSLRIC is an appropriate framework, amongst other considerations on which to base indicative pricing of the MTAS.

TSLRIC is the incremental or additional cost the firm incurs in the long run in providing a specified volume of the service, assuming the scale of all of its other production activities remain unchanged. Alternatively, it is the cost the firm would avoid in the long run if – everything else being equal – it ceased to provide the service. As such, TSLRIC represents the costs the firm necessarily incurs in providing the service and captures the value of society's resources used in its production.

TSLRIC is interpreted by the Commission as a forward-looking measure of costs which means that the referable costs are those of the most efficient means possible and commercially available. In practice this often means basing costs on the best-in-use technology and production practices available today and valuing inputs using current prices. It includes the costs an efficient carrier would necessarily incur in providing the service, or alternatively the costs that would be avoided if the service was no longer provided in the long run.

The Commission has previously outlined why it preferred to establish access prices such as the MTAS with reference to the TSLRIC, including that:

- it encourages competition in telecommunications markets by promoting efficient entry and exit in dependent markets
- it encourages economically efficient investment in infrastructure and provides the appropriate incentives for future investment in decisions by access seekers to "build" or "buy"
- in the long run TSLRIC based pricing provides for the efficient use of existing infrastructure, promoting allocative efficiency in the use of infrastructure
- it provides incentives for access providers to minimise the costs of providing access by using the most efficient technology commercially available today and best-in-use technology compatible with the existing network design
- by allowing efficient access providers to fully recover the costs of producing the service, it promotes the legitimate business interests of the access provider, and
- it protects the interests of persons who have rights to use the declared service.

The ACCC has always been willing to accept a more pragmatic application of the TSLRIC approach.[17] The ACCC recognises that the current TSLRIC model applying to

[16] see ACCC, *Access Pricing Principles - Telecommunications, a guide,* July 1997, p. 13.

the MTAS (i.e. the WIK Mobile Network Cost Model) adopts the scorched earth approach which assumes efficiencies that may not be obtainable in a roll out under competitive conditions.

A key implication from the recognition of a pragmatic application of TSLRIC is that while estimates of costs in such models provide important information, they cannot be considered conclusive in determining an appropriate indicative price. Thus, the ACCC in this pricing principles determination is relying on various sources of information, including cost model estimates and international benchmarks. The ACCC also considers that in certain circumstances it is appropriate use regulatory accounting framework data to assist in verifying the efficient cost of supplying the MTAS.

4.3 Allocation of common costs

Non-network common costs are organisational-level costs incurred in the provision of all of a firm's services that not attributable to any particular service. Stated alternatively, they are not incremental to a particular service in the sense that they are not avoided if the firm does not produce the service. However, they are incremental in the sense that they would need to be incurred by an efficient firm if the service was provided on a stand-alone basis. An efficient multi-product firm would have the expectation of recovering, in some manner, these common costs. As a result it would be expected that the prices of the firm's services (including prices for access) incorporate some contribution to these costs.

As common costs are not directly attributable to the production of any one service, the allocation of these costs across services is somewhat arbitrary. There is a range of possible methods of allocating common costs.

In the past the Commission has acknowledged the difficulties of regulators adopting Ramsey-Boiteux pricing and has considered the Equi-Proportional Mark Up (EPMU) approach more appropriate for the allocation of common costs. EPMU allocates joint and overheads to a product in the same proportion as that product's share of total costs.

The Commission is of the view that the TSLRIC should include a portion of organisational-level common costs allocated using the EPMU approach, as represented by the TSLRIC+ approach.

4.4 WIK Cost Model

As part of developing the 2007 Pricing Principles the Commission engaged Wik Consult GmbH (Wik Consult) to provide a cost model that estimated the efficient costs of supplying the MTAS by a hypothetical MNO.

[17] ACCC, *Assessment of Telstra's Unconditioned Local Loop Service Band 2 monthly charge undertaking, Draft Decision, November 2008*, p.36

Wik Consult delivered the WIK model, a bottom-up cost model that modelled network and cost structures for a hypothetical MNO that was not constrained by technology systems and architectural decisions of the past. The WIK model adopted a scorched-earth approach to the network design component, which deployed best-in-use technology that had proven its operational feasibility and was cost-effective. The resulting optimised network structure did not necessarily reflect the structure of any operator actually operating in the market. This was particularly true as radio communications technology (a key input for a mobile network) continues to constantly evolve, resulting in increased efficiencies in providing coverage to end-users.

Wik Consult has recently supplied the ACCC with updated base data used for carrying out calculations with version 1.2 of the WIK model (2008 update). The WIK model 2008 update consists of the latest population data from the ABS based on the 2006 Census.

The effect of the update file, running similar scenarios as in the 2007 Pricing Principles, is that the WIK model 2008 update yields slightly lower estimated costs for supplying the MTAS of 6.1 cpm for the 25 per cent market share scenario and 5.8 cpm for the 31 per cent scenario.

The ACCC also ran a scenario with uplifts to the weighted average cost of capital (WACC) and minutes of use. These uplifts only marginally increased the estimated cost of supplying the MTAS. Table 4 below summarises the various efficient costs estimates of supplying the MTAS obtained using the updated and uplifted data.

Table 4 – WIK model estimates of efficient costs of supplying the MTAS

Model version	25% market share*	31% market share*
WIK 1.2	6.6 cpm	6.1 cpm
WIK 1.2 (2008 update)	6.1 cpm	5.8 cpm
WIK 1.2 (2008 update - with uplifted data**)	6.2 cpm	5.9 cpm

* market shares used in the 2007 Pricing Principles Determination

** estimates only, minutes increased 10% and WACC at 15%

At the time WIK Consult was engaged to develop the WIK model the roll out of 3G network infrastructure and services had only just commenced and the number of 3G subscribers was small. Since that time there has been an extensive roll out of 3G infrastructure by all MNOs and a corresponding increase in the use and importance of data services over mobile phones. The main developments to 3G services in the mobile sector since the 2007 Pricing Principles Determination include that:

- the number of 3G subscribers is increasing rapidly
- Telstra has completed the deployment of its extensive 3G network
- Vodafone and Optus have almost completed extensive 3G rollouts, and
- Hutchison and Telstra have agreed to share 3G infrastructure.

The ACCC considers that while it is more efficient to operate a 3G network as compared to a 2G network MNOs will concurrently operate 2G and 3G networks for some time.

It is the current view of the ACCC that the WIK model effectively provides a floor price on the cost of supplying the MTAS on a 2G network. The ACCC considers that a cost model based on a 2G network remains an appropriate tool to inform decisions, but its application as the primary tool to estimate the efficient costs of supplying the MTAS in the Australian context may become increasingly limited.

The Commission considers that TSLRIC+ (as adopted in the WIK model) is one approach that assists in determining a lower bound estimate of the efficient cost of supplying the MTAS. The Commission is of the view that other tools including international benchmarking analysis and RAF data analysis, can be used in conjunction with a cost model to estimate the efficient costs of supplying the MTAS.

4.5 International benchmarking

The ACCC is of the view that it would be appropriate to consider further benchmarking analysis of international cost models. In relation to other potentially relevant international benchmarks the ACCC notes that as of 1 July 2008 the European Regulators Group (ERG) calculated an average termination rate in 30 European countries of 15.6 cpm. Termination rates in the 30 countries range from a high of 27.1 cpm in Bulgaria to a low of 3.6 cpm in Cyprus.[18]

The average termination rate amongst the 'Big Five' European countries (France, Germany, Italy, Spain and the UK) at 1 July 2008 was 14.6 cpm. Table 5 below sets out the relevant termination rates for each of the Big Five countries.

Table 5 – Average mobile termination rates in the Big Five European countries[19]

Average mobile termination rate in AUD cpm* as at 1 Jul 08			
Country	**Peak**	**Off-Peak**	**Average**
France	12.3	12.3	12.3
Germany	14.7	14.7	14.7
Italy	19.3	19.3	19.3
Spain	15.8	9.9	12.8
UK	13.8	13.8	13.8
Average	**15.1**	**14.0**	**14.6**

* applying EUR/AUD of 0.5565, exchange rate as at 30 September 2008[20]

The ACCC notes that the European Commission (EC) is currently considering the regulatory treatment of fixed and mobile termination rates in the European Union. In a

[18] Applying EUR/AUD of 0.5565, exchange rate as at 30 September 2008. Reserve Bank of Australia (RBA), *Exchange rates since 1969*, http://www.rba.gov.au/Statistics/HistoricalExchangeRates/2008.xls, accessed 30 September 2008.
[19] ERG, *MTR update snapshot*, ERG (08) 41 MTR Snapshot.
[20] RBA, *Exchange rates since 1969*, http://www.rba.gov.au/Statistics/HistoricalExchangeRates/2008.xls, accessed 30 September 2008.

recent draft explanatory note the EC recommended national regulatory authorities should:

- regulate termination rates based on the costs of an efficient operator using a long run incremental cost (LRIC) model based on current costs
- normally adopt symmetric termination rates, and
- bring termination rates down to costs of an efficient operator as soon as possible (by December 2011). [21]

The EC's draft explanatory note has been criticised by ERG and the UK Office of Communications (Ofcom). ERG advocates a more flexible approach commenting that a bottom up LRIC model is only one of a variety of methodologies that may be used to obtain an efficient outcome. ERG also considers that benchmarking can, in certain circumstances, be a more appropriate and proportionate mode of regulation.[22] Ofcom has commented that the EC's proposal regarding cost-oriented termination charges based on LRIC fails to include a reasonable allowance for fixed and common costs.[23]

The ACCC is of the view, subject to the necessary adjustments to reflect Australian specific factors, that international cost benchmarking can be considered as one of various methodologies to assist in determining MTAS costs.

4.6 Regulatory Accounting Framework data

Currently the Regulatory Accounting Framework (RAF) record keeping rules (RKR)[24] require Telstra, Optus and Vodafone to provide half yearly reports about the relevant costs and revenues associated with the delivery of relevant regulated access and other non–regulated services.

The RAF provides a basis to test MNO's claims concerning the TSLRIC+ of supplying the MTAS and can assist in deriving a TSLRIC+ proxy for the three reporting carriers. RAF data has also been used to inform a number of the assumptions underlying the WIK model such as call revenue and call minutes.

RAF data can also be used to provide estimates of the cost of the MTAS to assist or support other costing methods. For example, the Commission used RAF data to provide corroboration and verification for the international cost benchmarking analysis establishing the 5 cpm to 12 cpm range in the *Mobile Terminating Access Service – Final Decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service* (MTAS Final Report –

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[21] EC, *Draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU*, pp. 7–8.
[22] ERG, *IRG/ERG Response to Public Consultation on Termination Rates*, September 2008, ERG (08) 31 rev1, p. 8.
[23] UK Department for Business, Enterprise & Regulatory Reform and Ofcom, *Draft European Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU*, p. 2.
[24] ACCC, *Telecommunications Industry Regulatory Accounting Framework (Record-keeping rules)*, October 2003.

2004)[25]. However, the Commission did not seek to rely on RAF data analysis to support the indicative price of 9 cpm for the 2007 Pricing Principles.[26]

Currently the MTAS is not separately reported under the RAF, but is rather reported under the external wholesale services segment. In September 2008 the Commission released the *Discussion paper on proposed changes to the regulatory accounting framework record–keeping rules* (September 2008) to require separate reporting of the declared MTAS service, as well as separate reporting of 2G and 3G activities. If implemented, these changes should be incorporated into RAF reports from the mid 2009 reporting period. It is also proposed that Hutchison be required to report under the RAF from the same period.

While this may go some way to improving the consistency and reliability of the RAF data in relation to the MTAS it is not expected to be available until late 2009. The ACCC expects the improved RAF data to help identify the cost of supplying the MTAS on different networks and by different MNOs. This will in turn increase the relevance of RAF data analysis in setting the MTAS price over time.

4.7 Waterbed effect

The waterbed effect refers to the extent to which regulated reductions in access prices such as the MTAS result in increases in retail prices such as the price of outgoing mobile calls, subscription or fixed contract and handset prices.

Some MNOs have argued that a waterbed effect is likely to operate in the markets within which mobile services are provided in Australia. For example, Optus submitted in support of its ordinary access undertaking to the ACCC in 2007 (Optus 2007 Undertaking) that retail prices would not fall following a regulated reduction in the MTAS rate, and may actually increase to compensate for lower MTAS revenues.

In the Optus 2007 Undertaking decision,[27] the Commission formed the view that:

- the behaviour attributed to the waterbed effect as a general principle may be inconsistent with profit maximisation
- the arguments for the existence of a waterbed effect in the Australian context were not sufficiently developed to enable a substantial understanding of the effects of a change in the MTAS charge on retail mobile prices.

The New Zealand Commerce Commission (NZCC) has recently acknowledged the possible existence of a waterbed effect.[28] However, the NZCC noted that to the extent that there is a waterbed effect, whereby retail mobile prices are adjusted in some way in response to regulation, it considered it likely that mobile prices will decline under regulation but at a slower rate than without. Therefore, although the waterbed effect was described in terms of mobile subscription prices increasing (and the numbers of

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[25] ACCC, *MTAS Final Report – 2004*, p.70.
[26] ACCC, *2007 Pricing Principles*, p.50.
[27] *The Optus 2007Undertaking in relation to the Domestic Mobile Terminating Access Service* Public Version, Final Decision, November 2007.
[28] New Zealand Commerce Commission, *Investigation into Regulation of Mobile Termination (2006).*

mobile subscribers decreasing), the NZCC considered it unlikely that mobile subscription prices will actually increase (or that subscriber numbers will decrease) in absolute terms.

The 2007 Pricing Principles Determination considered that a waterbed effect was not apparent in an Australian context due to lower average retail prices (including lower FTM prices) and increases in handset subsidies.[29] The Commission also noted the continued existence of two integrated operators in the Australian market as being not conducive to a waterbed effect.[30]

The ACCC considers that competition at the retail level remains strong with an increase in the availability of capped and uncapped plans and the emergence of bundled pricing packages (particularly with data services) evidence of continued competition at the retail level.

4.8 Fixed to mobile pass through

The Commission noted in the MTAS Final Report – 2004 that all MNOs, irrespective of their size, have market power when it comes to terminating calls on their network. Additionally, the Commission stated that above cost MTAS prices caused an increase in prices of an essential input for providers of fixed to mobile (FTM) calls.[31]

At that time the Commission expressed the view that above-cost MTAS rates tended to act as a barrier to providers considering entry into the FTM segment and resulted in above-cost retail prices for FTM calls.

Since 2004, the MTAS indicative price has been lowered from 21 cpm to 9 cpm, or over 57 per cent. In the MTAS Final Report – 2004 the Commission acknowledged that the market within which FTM call were provided was far from effectively competitive and leading to higher-than-cost prices for FTM calls and, consequently substantial losses in consumer welfare. The Commissions expected that *"…increased competition in the market within which FTM services are provided would create pressures on all providers of this service to pass-through reductions in the price of the MTAS to end-users."*[32]

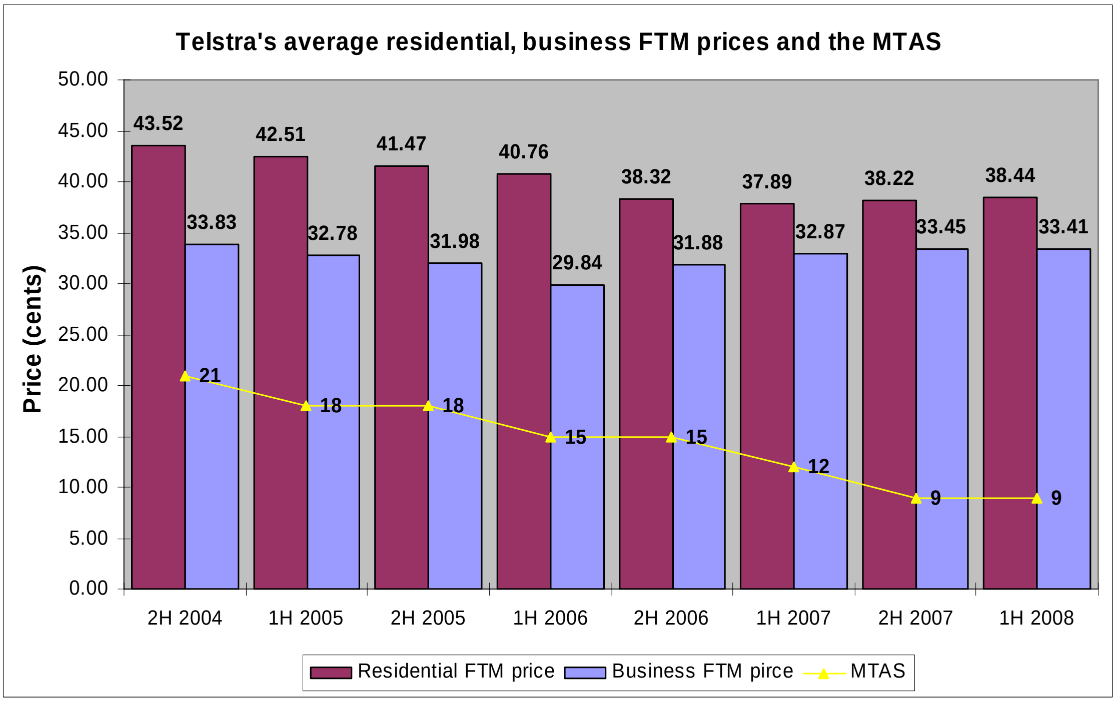
However, the ACCC is disappointed it appears there has been no significant reduction in FTM prices has emerged despite earlier expectations. For example, Telstra's average FTM residential retail price trend demonstrates that FTM pass-through appears to have weakened in recent years (see figure 3 below). Indeed, the Commission has observed an increase in Telstra's residential FTM retail prices since 2007. Telstra, as of 1 November 2008, commenced billing FTM calls in 30 second increments thereby raising the effective price paid for FTM calls significantly. This suggests that FTM pass through is not evident despite the MTAS indicative price decreasing significantly.

[29] ACCC, *2007 Pricing Principles*, p.14.
[30] Ibid., p.13.
[31] ACCC, *MTAS Final Report – 2004*, p.vii.
[32] MTAS Final Report – 2004, p. x.

The Commission noted in the 2007 Pricing Principles Determination that '…*while the reductions in FTM retail rates to date have been positive there is still opportunity for integrated operators such as Telstra and Optus to reduce retail FTM prices further particularly for residential end-users in line with reductions in the MTAS'*.[33]

While the Commission appreciates that there are other costs associated with delivering FTM services, the Commission is of the view that the degree of pass through to FTM retail prices remains lower than could be expected given the reductions in MTAS prices. The Commission notes that additional regulatory mechanisms may be necessary to ensure a greater pass through of reductions in MTAS prices to FTM retail prices. For example, price control sub caps, particularly in the less competitive segments, may be appropriate. This would, of course, be a matter to be determined by Government which has the responsibility for such changes. This may require different caps for residential and business FTM services. The Commission considers that the approach adopted in New Zealand may also be appropriate. In New Zealand any reduction in mobile termination rates by any MNO is required to be passed through to fixed customers in full under voluntary deeds made between MNOs and the New Zealand Government.[34]

Figure 3 Telstra's average FTM prices and the MTAS 2004 to 2008[35]



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[33] ACCC, *2007 Pricing Principles*, p.26.

[34] See, for example, Vodafone New Zealand Limited, *Deed of Undertaking relating to the provision of cellular mobile termination services*, 20 April 2007, clause 5.

[35] ACCC, *Imputation testing report relating to the accounting separation of Telstra*, September 2004–June 2008.

5 Proposed price related terms and conditions

The Commission proposes an indicative price of 9 cpm for the period from 1 January 2009 to 31 December 2011 as set out in the table below and Schedule 2 of the Draft MTAS Pricing Principles instrument (see attachment).

Time period	Indicative price
1 January 2009 – 31 December 2011	9 cpm

A number of methods can be used to inform the Commission of pricing for the MTAS including cost models, international cost benchmarking, consideration of developments in other markets and data captured under the RAF.

The Commission considers there remains some uncertainty surrounding the actual cost of the MTAS including:

- Given costs incurred in a competitive market may be efficient, in the absence of actual costs, TSLRIC+ as applied in the WIK model remains an appropriate approach and generally provides a reasonable lower bound estimate of the cost of the MTAS
- FTM pass through does not appear to have been as strong as expected given the significant reductions in the MTAS since 2004
- the RAF applying to MNOs is currently being reviewed and more accurate information about MNO costs is likely to be available in the future, and
- the existence of a waterbed effect in an Australian context remains unclear.

The Commission also notes that MNOs have made significant investments in infrastructure (particularly 3G technologies).

It is appropriate that the Commission at this time adopts a cautious approach in the light of the uncertainty noted above. Maintaining MTAS indicative prices at 9 cpm for a period of 3 years provides a higher level of certainty to MNOs.

Attachment 1 — Draft Pricing Principles Determination

TRADE PRACTICES ACT 1974

Section 152AQA

Pricing Principles for the Mobile Terminating Access Service

The Australian Competition and Consumer Commission (the Commission) determines, pursuant to section 152AQA of the *Trade Practices Act 1974* (the Act), that the pricing principles specified in Schedule 1 and indicative prices specified in Schedule 2 are to apply to the Mobile Terminating Access Service (MTAS) declared by the Commission under section 152AL of the Act.

This Determination commences on the day it is made.

Note: for the effect of this determination, see subsection 152AQA(6) of the Act.

Made by the Australian Competition
and Consumer Commission on
[Insert Date]

Graeme Samuel
Chairman

Schedule 1 — PRICING PRINCIPLES

The Commission’s pricing principles for the MTAS are:

- cost–based pricing principles should be adopted in determining indicative prices for the MTAS
- a total service long run incremental cost framework remains an appropriate consideration in informing the Commission of MTAS pricing, and
- other methods the Commission may take into account in determining indicative prices for the MTAS include international cost benchmarking, consideration of developments in other markets and data captured under the Regulatory Accounting Framework.

Schedule 2 — INDICATIVE PRICES

The indicative price for MTAS for the period 1 January 2009 to 31 December 2011 is:

Time period	Indicative price
1 January 2009 – 31 December 2011	9 cpm