'yes' OPTUS

Optus Submission to

Australian Competition and Consumer Commission

on

Mobile termination charge glide path

May 2004

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1. Introduction

1.1 This submission addresses Optus' concerns regarding the steepness of the glide path proposed by the ACCC in transitioning the industry to the target regulation price of 12 cents per minute.

1.2 While Optus strongly disputes the need for termination regulation, if the ACCC does decide to go down this avenue then it will need to set a more gradual glide path in order to protect consumers and mobile carriers against the associated regulatory rate shock.

2. Background

2.1 Section 152AQA of the *Trade Practices Act 1974* requires that, in the event of an access dispute, the ACCC must have regard to any determination it has made regarding the principles for pricing access to the declared service under dispute.[1]

2.2 As such, in determining its pricing principles the ACCC should consider the matters it must take into account in arbitrating an access dispute. As outlined in section 152CR of the Act, these include:

(a) whether the determination will promote the long-term interests of end-users of carriage services or of services supplied by means of carriage services;

(b) the legitimate business interest of the carrier or provider, and the carrier's or provider's investment in facilities used to supply the declared service;

(c) the interests of all persons who have rights to use the declared service;

(d) the direct costs of providing access to the declared service;

(e) the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else;

(f) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility;

(g) the economically efficient operation of a carriage service, a telecommunications network or a facility.

2.3 Optus believes the glide path proposed by the ACCC to transition the industry towards a termination charge of 12 cents per minute has not had sufficient regard to section 152CR.[2]

[1] Assuming that the existing declaration is varied, as posited in the draft decision by the ACCC. Otherwise, section 152AQA is not relevant.

[2] Whilst the ACCC has considered some of these matters in deciding to maintain the declaration, it has not outlined its reasons sufficiently in terms of how its pricing principles take into account this section.

2.4 In particular, Optus believes that the glide path is unjustifiably aggressive in that it, amongst other things:

- Harms the long term interests of mobile end users by failing to provide sufficient protection against the shock of potentially higher retail prices and less preferable pricing structures; and
- Harms the legitimate business interests of access providers by negatively affecting investment and business planning, and creating undue risk of adverse consumer demand reactions from having to set new retail prices.

3. Concerns with ACCC position

3.1 The ACCC's draft decision proposes a "closer association of prices and costs for the mobile termination service", to be achieved by a reduction in mobile termination charges to 12 cents per minute through in four instalments:

- Rates to be set at 21 cents per minute effective from 1 July 2004;
- A 3 cent reduction to 18 cents per minute effective from 1 January 2005;
- A 3 cent reduction to 15 cents per minute effective from 1 January 2006; and
- A 3 cent reduction to 12 cents per minute effective from 1 January 2007.

3.2 The ACCC's draft decision says that a gradual adjustment path to the target price is appropriate because:

> *'…any move substantially to reduce the price of mobile termination services could generate significant disruption to the pricing and business strategies of mobile network operators'*. (Page 165).

3.3 While Optus agrees with the need for a gradual adjustment path if termination regulation were to be introduced, the path proposed by the ACCC is unjustifiably aggressive. Indeed, the 'shock' of regulation would create a series of deleterious consequences if the market was given an insufficient period of time to adjust to the changes. Such consequences would include:

- The creation of inefficient subscription decisions *ex post*, whereby consumers become mobile subscribers based on erroneous expectations of future mobile usage
- Risks to market share during the transition phase resulting from carriers being required to set new price structures based on insufficient market information. Any churn arising in this manner would be the result of regulatory cost, rather than the efficiency dynamics of competition, and therefore raises significant distribution concerns.

- Threats to mobile carriers' investment decisions and business planning, thereby harming their legitimate business interests.

3.4 Optus also notes that the ACCC's proposed glide path is more aggressive than that set by the ACCC for the phase-out of the access deficit charge (ADC). This is despite that realities that:

- Reducing termination charges will cause significantly greater detriment to non-Telstra mobile carriers than removing the ADC will have on Telstra;
- The negative impacts associated with the retention of the ADC are substantially greater than those arising from the retention of termination charges above 12 cents per minute; and
- Clear proof that the access deficit does not in fact exist and that Telstra has enjoyed the benefits of ADC payments running into hundreds of millions of dollars.

4. Impact on interests of mobile consumers

4.1 The retail prices currently available to mobile subscribers are strongly driven by consumer demand preferences. Termination regulation will preclude the ability of carriers to set a structure of prices that reflect demand elasticities. This is because, as discussed in Optus' May 2004 submission, *Optus Submission to the Australia Competition and Consumer Commission on Mobile Services Review: Mobile Terminating Access Service*, in the event of termination regulation carriers will need to formulate a new set of retail prices that:

- Are less desirable in terms of consumer demand preferences to the extent that the current pricing structures (which have been shaped by aggressive competition between mobile carriers for subscribers) will no longer be available; and
- Are higher because carriers will need to offset the lost termination revenues so that they can recover the on-going costs of running the network and fulfil obligations to shareholders to deliver profit growth. Despite the ACCC's claims to the contrary, mobile carriers do not earn economic profits, and even if they did they would not be sufficient to simply absorb the magnitude of the change proposed by the ACCC.

  Optus conservatively estimates that regulating termination charges at 12 cents per minute would reduce the 'average' annual carriers' termination revenues per mobile subscriber by around $41.00. If carriers recover this fully from subscription charges, then the average price of subscription could increase by around $82.00 (assuming customer contracts last for two years). Conversely, if carriers offset these lost revenues fully through call origination charges, then the average per minute call charge could increase by over 3 cents per minute. Further price increases could follow as carriers are forced to recover their network costs across few subscribers (in response to higher subscription prices) or fewer mobile originating minutes (in response to higher call prices).

Optus recommends the ACCC refer to CRA's report "*The use of benchmarking in regulating termination rates"* which states that:

> *"there is evidence that the significant reduction in UK termination rates in July 2003 is pushing up mobile prices to marginal customers. Oftel statistics show an increase in the total cost of mobile packages for low use mobile customers between July 2003 and October 2003 of 15 per cent.*[3] *"*

These increases are significant and represent a major, unexpected price shock to mobile consumers.

In addition ACCC should also note that the Australian Competition Tribunal (ACT) recently concluded that acquirers would seek to offset any revenues lost from interchange fees in the event that it authorised bilateral contracts abolishing EFTPOS interchange fees:

> *'The evidence indicates that, understandably, acquirers will seek to recover from merchants the lost revenue of negative interchange fees.'*[4]

While this view was focused solely on the debit card industry, the economic principles used by the ACT in arriving at this stance would apply equally to the mobile market. Furthermore, the market conditions are similar across both industries. Based on this, Optus believes that the ACT would arrive at the conclusion that mobile carriers would seek to offset lost termination revenues in the event of regulation.

4.2 Consumers will certainly, therefore, be worse off under the new prices that arise following regulation.

4.3 In addition to reducing consumer welfare, Optus believes that regulation will create *ex post* inefficient subscription decisions. The average mobile user is unlikely to be aware of the issues surrounding termination regulation and therefore will not be anticipating the price changes that will arise, possibly as early as July 2004, if regulation is introduced. To the extent that subscription decisions are based upon expectations of future mobile usage charges, consumers will have made subscription decisions based on erroneous usage cost expectations. As a result, there will a number of consumers that would not have purchased mobile handsets, or entered into contracts, had they been aware of potential future price changes.

4.4 Consumers that will be most strongly impacted in this manner include:

- New mobile subscribers who will be unable to benefit from the unregulated pricing structures for a reasonable length of time; and

[3] Oftel, *Mobile Price Monitoring*, October 2003 (available at http://www.ofcom.org.uk/static/archive/oftel/publications/market_info/including.xls).

[4] Paragraph 123: http://www.austlii.edu.au/au/cases/cth/ACompT/2004/7.html

- Any consumer on a contract that extends into the period of regulated termination rate reductions.

4.5 Not only does this create inefficiencies, it also raises some serious equity issues. Regulation will be particularly unfair for customers that are unable to extract sufficient value from mobile usage to justify their expenditure on the handset, or the ongoing costs of the contract. At worst, some new subscribers may be forced to drop out of the market despite only recently becoming a mobile subscriber.

4.6 In this respect, Optus recommends that the ACCC set a more gradual glide path than that proposed in the draft decision in order to:

- Cushion consumers against the shock of less desirable mobile price structures;
- Cushion consumers against the shock of higher mobile prices that they will not have budgeted for; and
- Enable consumers to extract the value from mobile usage that they had subscribed to a network in order to reap.

5. Pricing risks

5.1 Mobile carriers compete aggressively for subscribers. Pricing is the primary avenue through which mobile carriers compete for subscribers. Because competition has precluded economic profitability, in order to recover network costs carriers have tended to compete not through the level of prices, but through the structure of prices offered.

5.2 There are significant complexities involved in setting mobile service pricing structures. In particular, pricing decisions have to take into account a wide variety of factors including:

- Consumer demand preferences;
- Competitors' pricing strategies;
- Significant risk of customer churn;
- Significant level of joint costs, rendering cost allocations extremely difficult;
- Rapidly evolving technologies; and
- Changing customer usage patterns.

5.3 Pricing is further complicated by the two-sided nature of the market and the existence of externalities in customer decisions.

5.4 Given the complexities involved in establishing the market share maximising structure of prices, carriers depend heavily upon the successes or otherwise of pricing structures that have been offered in the past, both by themselves and by competitors. For example, Optus has observed that carriers that have attempted to remove or reduce handset subsidies have generally been unsuccessful due to adverse consumer demand responses.

5.5 To the extent that prices are optimised over time as carriers develop new insights into consumer preferences, pricing is an evolutionary and iterative process.

5.6 As discussed above, regulation of termination charges as proposed by the ACCC is likely to force mobile carriers to set a new structure of mobile prices. This will cause significant disruption to carriers' established pricing strategies. In particular, the pricing structures that have taken many years and significant resources to research, develop, implement, and refine, will no longer be available to carriers. Instead, carriers will be forced to set a new structure of prices that are untested in the market, and for which consumer demand reactions will be largely unknown.

5.7 This will expose carriers to significant risk. In particular, a mobile carrier like Optus will stand to lose a large number of subscribers through unintentionally setting a structure of prices that fail to appeal to consumer demand preferences to as great an extent as those offered by its competitors. The risks of this occurring will be heightened by two specific factors.

- Firstly, the firm level elasticity of demand for mobile services is known to be high, meaning that the negative impact flowing from an error of judgement in price setting could be particularly large. A firm need not necessarily set prices that are higher than those of competitors for this to occur.

- Secondly, if a carrier did set less than optimal pricing structures, there would be a lag between the time that carriers could identify this, and subsequently alter prices to rectify the problem. This is because designing, implementing and introducing new retail price offerings to the market is a relatively long and involved process. In the meantime, carriers could lose a significant number of customers to competitors.

5.8 Given that the relative market shares of mobile carriers have not in any way been impacted by the level of termination charges, any customer churn of this nature would comprise a cost of regulation, and is illustrative of the need for an effective safeguard mechanism to manage the shock of regulation.

5.9 While a glide path is the most effective means of managing these risks, Optus believes that the ACCC's proposed glide path of two and half years is far too rapid to enable carriers sufficient time to gauge consumer demand reactions to specific pricing structures.

5.10 Optus notes that Hutchison has argued in its submission to the ACCC on the draft decision that a more rapid move to the target price should be introduced because "*carriers have had at least 12 months to reconsider their pricing and business strategies in response to the developments referred to above",* and that the reduction of termination charges to 12 cents per minute "*should not be construed as 'sudden' change*".

5.11 Given that the draft decision was introduced only in May, this argument is superfluous. As demonstrated above, the market cannot begin to adjust to regulation until it is actually introduced. In particular:

- Carriers do not yet have sufficient information to predict consumer reactions to specific price structures; and
- An important input into carriers' pricing decisions are the pricing strategies adopted by competitors. Obviously, these are not known at this stage.

5.12 Optus also holds grave concerns over an argument presented to the ACCC by AAPT, calling for a more aggressive glide path:

> *'…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. ... Therefore, it is possible that any losses in revenue resulting from the decrease in the price of the service may soon be offset by the increased revenues derived from the growth in other services.'*

5.13 The ACCC should ignore this argument. As Optus is seeking to demonstrate, a reasonable glide path is required to protect mobile carriers and consumers against the various forms of regulation shock outlined in this submission. Optus is not arguing for a glide path to protect carriers against rapid revenue losses *per se*.

5.14 Furthermore, AAPT's argument completely undermines principles governing efficient investment incentives. It is not controversial that in competitive markets, carriers should be rewarded for making good investment decisions. AAPT appears to be arguing, however, that justification exists for expropriating the returns carriers have received through their efficient, welfare enhancing investments in data, messaging and other value added services via means of a more sudden transition to the ACCC's target price.

6. Impact on investment and business planning

6.1 As discussed above, regulation will significantly disrupt the operation of the retail market and will give rise to a long period of uncertainty as carriers implement then refine new pricing structures. During this period, individual carriers run the risk of losing large numbers of customers, either to competitors, or as a result of customers dropping out of the market.

6.2 This period of uncertainty will have significant impact on Optus' investment and business planning. This is because each of the following factors will be unknown during the period it takes for the market to adjust fully to regulation:

- Future subscriber numbers;
- The structure of the long term pricing arrangements that the market will converge towards; and

- The impact of regulation on future revenues and profits.

6.3 If these factors cannot be predicted with any degree of certainty, particularly future subscriber numbers, then it may be impossible to formulate business cases that can be considered sufficiently robust for decision-making purposes.

6.4 The uncertainty accompanying this period of substantial adjustment could manifest itself in terms of:

- Delayed investment in new infrastructure, technologies, coverage expansion and services as carriers seek greater clarity as to the new 'equilibrium' position of the market;
- Reduction in scope of planned investments[5]; or at worst
- An abandonment of investment plans.

6.5 Any of these factors could, in turn, affect the future profitability of mobile carriers.

6.6 **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]**

7. Inconsistency with past glide path for removal of the Access Deficit Charge

7.1 In deciding the implement the glide path for the removal of the access deficit charge (ADC), the ACCC says in its October 2003 *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services* report:

> *'... the Commission notes the need to take account of current market conditions as well as the promotion of a stable regulatory environment and hence the desirability of avoiding sudden and abrupt changes to regulatory policies. Such changes may cause undue disruption to business and investment plans, are relevant considerations for the purposes of this provision."* (Page 19).

and

> *"... although the ADC is having distortionary effects on efficiency and competition objectives which need to be addressed in a reasonable timeframe, the immediate removal of the ADC may unduly disrupt existing business plans of access providers and seekers, including in regards to access arrangements and investment decisions.' (page 61)*

[5] Optus notes that the ACCC's draft decision erroneous dismisses the negative effect regulation has had on investment incentives by pointing to the significant level of investment that has occurred in mobile telephony since the declaration of termination services. This argument fails to recognise that it is investments at the margin that are impacted by regulation, rather than investment *per se*. Indeed, it is most likely the case that the level of investment that would have occurred in the absence of regulation exceeds the actual level of investment that has taken place.

7.2 As a consequence, the ACCC established a glide path stretching from 2003 to 2006-07, with the starting point being the average negotiated PSTN price in 2002-03. The shape of this glide path was concave in order to:

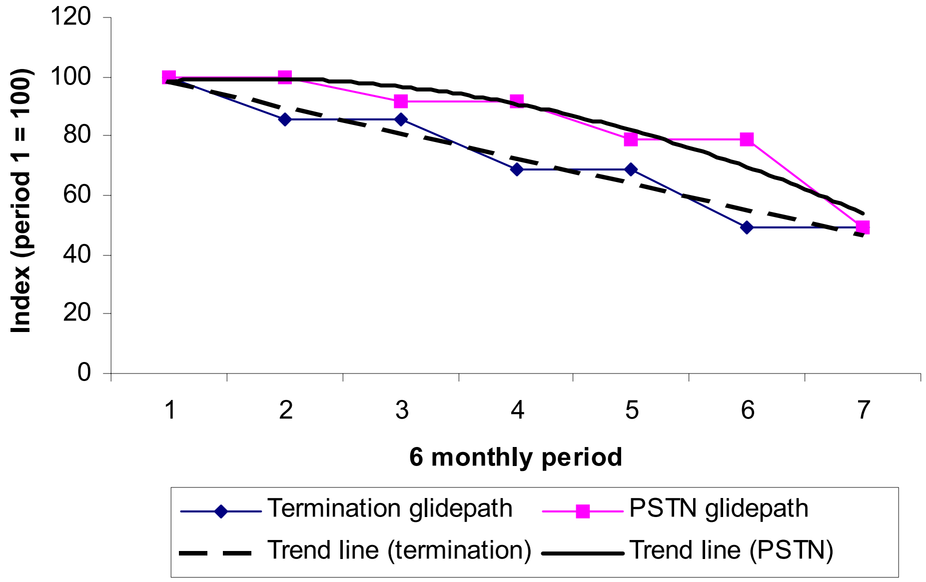
> *"best cushion the impact of the change in the regulatory approach, and will be the least distorting as it will allow the industry more time to plan for the larger decreases in the PSTN price."* (Page 64).

7.3 In contrast, the draft determination on the regulation of termination charges provides for:

- a glide path of only two and half years;
- with the starting point being the lowest negotiated price prevailing in the market rather than the average price;
- a linear (but stepped) function rather than the concave (stepped) function allowed to Telstra in the removal of the ADC.

7.4 The following diagram illustrates the shape of the proposed termination service glide path against that which was set for the phase-out of the ADC.

Comparison of glide paths for termination regulation and ADC phase-out



7.5 As this diagram illustrates, the proposed termination glide path is significantly more aggressive than that applying to PSTN prices. In particular, mobile carriers are facing a steeper series of price reductions than faced by Telstra for its PSTN access prices, with less time to prepare for the commencement of the reductions, and less time to arrive at the target regulated price.

7.6 Note further that in reality, the phase out of the ADC through the process of rebalancing has been occurring for many years. The portion of the ADC glide path discussed above reflects only the ACCC's most recent decision relating to the removal of the 'tail end' of the ADC. The *true* glide path experienced by Telstra has been significantly longer.

7.7 Optus believes that the glide path applicable termination charge reductions should be less aggressive than that applied for the ADC on the basis that the 'shock' to Telstra of the removal of the ADC is likely to be much smaller than the shock to mobile carriers from termination regulation. To demonstrate, Optus makes the following observations:

- The complete removal of the ADC had been anticipated for some time, having been strongly signalled by Government. This has provided Telstra with additional time to adjust its business and pricing plans to respond to this.

- The fixed telephony market displays strong characteristics of customer inertia which provides significant protection to Telstra's market share. This lessens the extent of churn that would occur following the introduction of pricing plans less preferable than those offered by other carriers. Telstra is therefore able to set new prices with little regard to prices offered by its competitors. In contrast to the dynamics of the mobile market, Telstra would not have to wait until regulation was introduced before it could plan its pricing responses.

- The ADC has largely been removed as part of a rebalancing exercise, with the result that Telstra has been no worse off in terms of net revenue. In many respects, Telstra is better off as the line rental charges, which are increasing, are cushioned from competitive pressures.

- In contrast, the revenue impact to non-Telstra mobile carriers of termination regulation will be significantly greater than the impact to Telstra of the removal of the ADC. To illustrate, Optus has estimated that removal of the ADC would reduce Telstra's net profit after tax by less than 7%[6], while regulation of termination charges at 12 cents per minute would reduce Optus' net profit after tax by around **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]** [7]. The non-vertically integrated carriers will most likely experience even greater profit losses than Optus.

7.8 In addition, there are compelling reasons as to why the ADC should have been removed more rapidly than termination 'rents'. In particular, the ADC had significant anticompetitive implications, providing strong justification for its swift removal[8]. Mobile termination charges, however, do not have such anticompetitive implications, either in the mobile market or in the fixed-to-mobile services market[9].

7.9 Also, it is widely accepted that the ADC creates significant distortions in the telephony market. Optus does not accept that the prevailing mobile termination rates are distortionary. Even those who took a different view, however, would find it difficult to conclude that the level of distortions created by mobile termination charge are unlikely to be anywhere near as large as those that it believes are created by the ADC.

7.10 Overall, Optus has grave concerns over the pernicious approach the ACCC has taken in establishing a glide path for mobile termination charges against previous approaches it has taken, specifically with the ADC. Optus believes that the ACCC should unquestioningly establish a more gradual glide path for mobile termination regulation to reflect the realities that:

- Reducing termination charges will cause significantly greater detriment to non-Telstra mobile carriers than removing the ADC will have on Telstra; and

- The negative impacts associated with the retention of the ADC are substantially greater than those arising from the retention of termination charges greater than 12 cents per minute.

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[6] Based on revenue loss figures for Telstra estimated by the ACCC and reported in *'Final Determination of Model Price Terms and Conditions for the PSTN, ULLS and LCS services: October 2003'*.
[7] Both of these estimates ignore the impacts of the retail price changes that would be introduced to offset at least some of the lost revenue.
[8] Refer to '*Optus submission to the Australian Competition and Consumer Commission Access Deficit for PSTN Originating and Termination Access (PSTN OTA): February 2003'*.
[9] For explanation, refer to: *Optus Submission to the Australian Competition and Consumer Commission on Mobile Services Review: Mobile Terminating Access Service*, May 2004.

7.11 To the extent that the ACCC insists on the need for a glide path, then it should be consistent with that which has applied in recent years. In the absence of regulation, mobile carriers have reduced termination rates but in a way that avoids the distortions outlined in this and other Optus submissions. By way of contrast, for PSTN, in the absence of regulation, no glide path has been offered by Telstra for PSTN OTA charges.