'yes' OPTUS

Optus Submission to

Australian Competition and Consumer Commission

on

Mobile Services Review: Mobile Terminating Access Service

May 2004

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1. Introduction

1.1 This submission addresses one of the fundamental components of the ACCC's draft decision on the future regulation of mobile termination; namely, the impact that such regulation is likely to have on competition in both the mobile and fixed-to-mobile services market.

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 draft pricing principle determined by the ACCC – anecdotally known as an adjustment path towards a closer association of prices and costs for the mobile termination service – 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 This submission considers whether the draft pricing principle is in the long-term interests of end-users of carriage services, specifically, in accordance with section 152AB, whether it *promotes competition* in carriage services.[3]

2.5 The ACCC suggests that "*competition is a process of rivalry*" but in "*many cases, it will be more instructive to examine the extent to which declaration promotes competition from the perspective of end-users*" (page 94). It is, however, important to distinguish between promoting competition and promoting efficiency.[4]

2.6 The creation of an environment for improving competition was integral to *Duke Eastern Gas Pipeline*, where the Competition Tribunal held that:

> *…criterion (a) [the promotion of competition] is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the notion of promotion of competition involved a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial. We agree.*[5]

2.7 Optus believes that competition is indeed a process of rivalry and that promoting competition involves action that improves the conditions of competition to facilitate entry, increases competitive neutrality or removes conditions allowing for tacit collusion.

2.8 The ACCC needs to distinguish its arguments carefully between the arguments for declaration and arguments for its pricing principle, and the impact on competition (rather than impact on efficiency) of the proposed pricing principle.

3. Concerns with the ACCC draft determination

3.1 The ACCC itself concludes that the declaration, coupled with "a closer association of prices with costs for mobile termination services", is:

> *… unlikely to generate greater competition in the markets within which mobile termination services are provided" (page 98)*

and only

> *has the* ***potential to help*** *promote competition in retail mobile services (page 102).*

3.2 In the *Sydney Airports* case, the Competition Tribunal specifically rejected an argument that competition needs to be quantified. It was argued that the notion of "promoting" competition was stronger than "encouraging" competition, and that the test required a measurable advancement of competition was required. The Tribunal disagreed with this analysis:

[3] Further submissions will consider the impact of the ACCC pricing principles on other matters the ACCC must have regard to in 152CR.
[4] Competition is perhaps one means to achieving greater efficiency.
[5] *Duke Eastern Gas Pipeline Pty Ltd* [2001] A CompT 2 (4 May 2001) at 75.

> *The Tribunal does not consider that the notion of 'promoting' competition…requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased.*[6]

3.3 However, it was also argued that the Tribunal needed to have a "degree of confidence" which was greater than a "mere likelihood" that competition would be promoted. Optus believes that the ACCC has failed to demonstrate (beyond conjecture) any degree of confidence that competition will be enhanced in any market as a result of its pricing principle.

3.4 In fact, whilst its pricing principle seeks to remove economic profits from mobile termination, it seems to accept that:

> *Without the economic profits from providing termination services, a new entrant will be constrained in its ability to subsidise subscription and therefore will be unable to compete effectively in the mobile services market.* (page 107)

3.5 This would imply that the ACCC accepts that its pricing principle in effect raises barriers to entry in the mobile services market. That is, far from promoting competition, it will lead to a lessening of competition.

3.6 The ACCC indicates that it believes its declaration (and pricing mobile termination at some measure of cost) will promote competition in fixed-to-mobile services. It believes:

> *…the main source of ineffectiveness of competition in the market within which FTM services are provided stems from the price of mobile termination services being well in excess of cost.* (page 100)

3.7 The ACCC appear to be confusing the promotion of competition and the promotion of efficiency. Pricing an input closer to a measure of cost may have some perceived efficiency benefits in one market, but this is not *promotion of competition*. More puzzling, however, is the ACCC claim that:

> *… it is possible that reductions in the price of the mobile termination service could lead to even greater absolute reductions in the price of FTM* (page 103)

3.8 There is no basis provided for this conjecture, particularly when the "Commission would expect only partial 'pass-through' of lower mobile termination rates to lower FTM service prices" (page 102), which would indicate a low *degree of confidence* that competition will be promoted.

3.9 The ACCC's principal basis for claiming that it proposed pricing principle would promote competition in a related market is the:

> *… removal of the cost advantage vertically-integrated carriers have over fixed-line only operators due to the pricing of mobile termination services above cost on their networks* (page 104).

3.10 Once again, however this is simply conjecture, without evidence. As demonstrated below, all the economic literature (and even the ACCC

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6 *Sydney International Airport* [2000] ACompT 1 (1 March 2003) at 106

elsewhere in its decision (see page vii)) observe that the supposed economic profits from above cost pricing of termination charges are likely to be dissipated via competition for mobile subscribers. Hence, even if it could be shown that integrated carriers did obtain economic profits from the mobile termination service, this does not in itself provide sufficient evidence of a cost advantage in the fixed-to-mobile market.

4. Impact of proposed pricing principle on the fixed-to-mobile market

4.1 The ACCC believes regulation of mobile termination at a proxy of cost will promote competition in the fixed-to-mobile services market. This is premised on the ACCC's belief that, at present:

- Integrated fixed and mobile operators have a cost advantage, which translates into a "competitive advantage" in the fixed-to-mobile services market as a result of termination charges being priced above cost.
- Competition in the fixed–to-mobile services market is inhibited by "the potential for anti-competitive conduct" and in particular creates incentives for integrated carriers to price squeeze fixed-only competitors in that market.
- There is less than "effective competition" in the fixed-to-mobile market reducing pressure for 'pass though'.

4.2 The ACCC believes that regulating termination charges at a level that it claims to be closer to cost will promote competition by reducing the competitive advantage that it claims integrated carriers have in the fixed-to-mobile services market. According to the ACCC, this will in turn lead to incentives for operators to pass-through the reductions in termination charges to consumers. Ultimately it is expected by the ACCC that cheaper fixed-to-mobile calls will result.

4.3 However, Optus believes that the ACCC's logic, summarised above, is fundamentally flawed. Optus does not believe that regulation will achieve the outcomes sought by the ACCC. In particular, Optus notes the following:

- Integrated mobile carriers do not hold any cost advantages in the fixed-to-mobile market, as all termination revenues (including from on-net calls) are required to enable mobile operators to achieve a reasonable return on their capital.
- Telstra's continued dominance of the local loop is the source of ineffective competition in the fixed-to-mobile services market; not above-cost mobile termination charges. Accordingly, any regulatory attempts to promote competition should target barriers to entry in the fixed-to-mobile market, as this is where the true source of the market failure exists.
- Further, the ACCC's decision only serves to enhance Telstra's dominant position in the fixed-to-mobile market, thereby harming competition in this market. Telstra is in a position to receive windfall

profits from the ACCC’s decision – industry analysts estimate that this windfall to Telstra will be in the order of $50 million (with partial fixed-to-mobile pass-through) to $140 million (if no pass-through) over the next 3 years.[7]

- The fixed-to-mobile services market is not subject to a price squeeze, as evidenced by, among other things, imputation tests that reveal the existence of high margins for non-integrated service providers.
- Lowering termination rates will not change the field of rivalry in fixed-to-mobile services.

4.4 The implication of these factors is that the ACCC’s proposed regulatory intervention will be completely ineffective in addressing the perceived lack of competition in the fixed-to-mobile services market. Given that the objective of the draft pricing principle is to promote competition, the ACCC runs the risk of imposing significant regulatory costs on the industry, and imposing a pricing principle that is not in the long-term interests of end-users of carriage services (including fixed-to-mobile users). Further, the ACCC’s proposed decision only serves to enhance Telstra’s dominance in the fixed-to-mobile market.

Vertical integrated carriers do not hold a competitive advantage

4.5 The ACCC’s draft decision implies that integrated mobile carriers face cost advantages in the fixed-to-mobile market:

> *…setting above-cost prices for mobile termination services allows vertically-integrated fixed and mobile network operators to raise the cost of rival FTM service providers that only operate fixed line networks in a way vertically-integrated operators are not subjected to. That is, fixed-line only operators… must pay above-cost prices to terminate all FTM calls. Vertically-integrated carriers… will only need to pay above-cost prices for calls that terminate on other mobile carriers’ networks.*

4.6 The ACCC argues that integrated mobile carriers (i.e. Telstra and Optus) have an advantage in competing in the fixed-to-mobile market. The argument is that a reseller (such as Primus or AAPT) faces a 'hard floor' in setting a retail fixed to mobile price, namely the mobile termination price that it must pay mobile operators to terminate the call. Integrated carriers do not face this 'hard floor' because they are paying the mobile termination price to themselves, and are thus free to reduce the price below the market price of mobile termination.

4.7 The ACCC's argument is flawed for several reasons.

4.8 Firstly, when Optus sells fixed-to-mobile services in the marketplace, only around one third of the calls it sells will terminate to its own network. Two thirds of the time, we face exactly the same 'hard floor' as is faced by resellers such as AAPT or Primus.

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[7] Citigroup Smith Barney, Telstra Corporation Ltd*: “Lower mobile termination prima facie positive for TLS*”, 29 March 2004

4.9 Secondly, this argument assumes that integrated carriers such as Optus can price termination below the market price and suffer no detriment. That assumption is not correct. Optus sets mobile termination prices in the market to recover the costs of operating a mobile network and earn a return on capital. That cost must be recovered across all calls which terminate onto the Optus network - regardless of whether they originate on the Optus fixed network, the Optus mobile network, another fixed network, or another mobile network. Hence, when Optus sells a retail fixed-to-mobile call, we must build into the cost of that call the same element to cover the cost of mobile termination as we build into the mobile termination charge we charge another operator to terminate calls onto Optus' network.

4.10 If you believed that mobile carriers were setting termination charges above cost, then we would expect integrated carriers to be earning economic profits from their mobile networks. However, there is no evidence that this is occurring (as discussed in further detail in Section 5 of this submission). Indeed, with this view of the world, internally pricing termination below some measure of cost would cause real economic detriment to Optus, in the same way as the reseller would suffer real economic detriment by reducing its margin on fixed-to-mobile calls below cost recovery levels.

4.11 Thirdly, the ACCC seems to reason by analogy from the situation which prevails in the fixed line market. The analogy is invalid, however, because in the fixed line market Telstra is a near-monopolist and enjoys market power at the wholesale level and the retail level. Hence, when Telstra uses its market power in the fixed line market to charge above cost wholesale prices for, say, wholesale DSL, it is able to earn and retain economic rents from doing so. In the mobile market, the fundamental point is that Optus does not enjoy a monopoly. We are constrained in the termination price that we charge, in that if it rises too high above market levels, our competitors will introduce differential charging to terminate calls to the Optus network. We are also constrained by the capacity of our competitors to win customers away from us, and hence to the extent that mobile termination charges are above cost we are forced to use the proceeds to fund lower prices in the retail mobile marketplace. Indeed, competitive pressure requires us to do this as all operators we compete with also have a termination revenue stream which they similarly use to fund such retail pricing.

4.12 It is therefore inaccurate to think that vertically integrated mobile players' mobile termination revenue provides them with a competitive advantage in the fixed-to-mobile market.

4.13 As observed by the ACCC in its draft determination, and by Armstrong (2002), Wright (1999) and Wright (2002), higher termination charges increase the price of fixed-to-mobile calls but reduce prices for mobile subscribers.[8] For example:

> *Provided an increase in termination charges increases the profit from termination, it will result in greater competition for cellular customers.*

[8] The efficiency consequences of this outcome are not considered here (but will be expanded upon in later submissions) beyond noting that whilst the ACCC's model has been calibrated to conclude negative welfare consequences, Optus believes this is the result of inappropriate assumptions and a misunderstanding of mobile network costing.

Firms lower rentals in an attempt to capture greater market share and thus a greater share of the lucrative termination revenue. (Wright, 1999)

… due to competition to capture this lucrative termination revenue, cellular firms may well have competed away much of the higher termination revenue under dispute. (Wright, 2002)

4.14 Similarly the ACCC, perhaps drawing on Armstrong (2002), notes that:

… depending on the level of competition they face when attracting subscribers to their network, seek to attract more subscribers to their networks by subsidising the prices they offer potential mobile subscribers for retail mobile services. This suggests mobile operators may have an incentive to transfer part of the economic profits from pricing mobile termination services above cost to retail mobile subscribers in the form of subsidised prices for retail mobile services (e.g. handset subsidies, free access plans etc.). The greater is the level of competition for retail mobile services, the greater will be the incentive to transfer economic profits earned from mobile termination services to retail mobile subscribers. The Commission believes, therefore, that mobile operators may determine a cross-subsidised structure of prices with higher-than-cost prices for mobile termination services and below-cost prices for some retail mobile services. (ACCC, page vii)

4.15 Armstrong (2002) shows that with competition in mobile services, any rents will be completely competed away. Perhaps the ACCC would claim that rents would not be 'completely' competed away because of "less than effective competition" in mobile services. However, this would be an illogical retort because if mobile operators had the capacity to price above total cost then preventing them from doing so on one service would not inhibit their ability to raise prices elsewhere.[9] Once again, competition would not be promoted by the decision to regulate one service at cost.[10]

4.16 Critically then, the competition to capture the subscribers and the termination revenue will mean that mobile operators will invariably compete away the termination revenue, giving them no competitive advantage in fixed-to-mobile services. Any integrated carrier that sought to establish such an advantage could only do so at the expense of diminishing its ability to compete in the mobile market.

No incentives for double marginalisation

4.17 The ACCC has indicated that it believes that the current structure of termination charges is leading to double marginalisation:

In combination, the ability to charge above-cost prices for mobile termination services would appear to be manifesting

[9] We note that the ACCC has provided no evidence that mobile operators are earning economic profits. At best the ACCC has demonstrated that one or two may be recording accounting profits, which offers little valuable insight.

[10] Regulating mobile termination at some measure of cost will therefore only change the mix of prices with no impact on competition in mobile services.

itself in the form of two mark-ups above cost. Firstly, the price of mobile termination is set above its underlying cost of production. In turn, this helps – via the vertically-integrated nature of some FTM providers – maintain market power in the FTM market and ensures there is a second mark-up of prices above costs in this market.

4.18 In reality, it is highly unlikely that double marginalisation exists in the fixed-to-mobile market. There are no incentives for double marginalisation when vertically integrated firms operate in the market. This is because attempts to extract monopoly rents on fixed-to-mobile prices will reduce overall profits, due to decrease in volumes. Essentially, downstream fixed-to-mobile operators impose an unwanted externality on mobile operators by adding the second mark-up (Tirole, 1999). This suggests that vertical integration actually solves the problem of double marginalisation.

4.19 Notwithstanding this, non-linear access pricing would better solve the problem of double marginalisation if the ACCC believed it to exist. Most importantly, it would solve it in a significantly less distorting manner than the proposed regulation of termination charges.

No price squeeze in the fixed-to-mobile market

4.20 The ACCC's draft decision seeks to justify termination regulation on the basis that the current structure of termination charges give rise to anti-competitive price squeezing behaviour:

> *… the Commission considers that existing market structures provide vertically-integrated fixed and mobile network operators with considerable scope and incentive to use their control over access to the mobile termination service to engage in anti-competitive price-squeeze behaviour.* (page 90)

4.21 Optus believes the ACCC's claims in this regard to be incorrect for the following reasons:

- Incentives for vertically-integrated carriers to price squeeze competitors in the fixed-to-mobile market are not present in the fixed-to-mobile market.
- Imputation test results strongly indicate that the market is not being subject to a price squeeze.

Price squeezing not a rational strategy

4.22 Even if vertically-integrated carriers did face a cost advantage in the market, incentives would not exist for the carriers to engage in price squeezing behaviour in the fixed-to-mobile market.

4.23 The ACCC, in its draft decision, points to a recent report by NERA that claims that there are three necessary conditions for an anti-competitive price squeeze to be a rational and viable strategy for an integrated firm. They are:

(a) The two markets must be vertically-related and the upstream product must be a necessary input into producing the downstream product.

(b) At least one firm must be vertically-integrated and possess substantial market power in both the upstream and downstream markets.

(c) The downstream market must be open to competition from rival, non-vertically integrated firms.[11]

4.24 The ACCC has incorrectly interpreted the required market conditions as forming the basis of a rational profit maximising strategy. In reality, however, this linkage is not present in the context of the fixed-to-mobile market.

4.25 A firm may engage in price squeezing if doing so will allow it to increase profits in the long term. Otherwise, the firm could retain the margin and increase current profits.[12]

4.26 In *Boral,* Heerey J stated:

> *To recapitulate, selling below cost plus recoupment by supra-competitive pricing equals predatory pricing. Absent the second element, or at least the hope or expectation thereof, there is no more than ruthless competitive conduct, something which the TPA does not forbid, but rather promotes.*[13]

4.27 If there are low barriers to entry in the fixed-to-mobile market then any future rents achievable as a result of price squeezing are likely to be competed away again, as stated by NERA for the ACCC:

> *Unless there are high barriers to entry in the market, then any future price increases would encourage entry by new rival, negating any benefits from the anticompetitive conduct. Under these conditions, the firm would be unlikely to recoup its sacrificed profits by charging higher prices after rivals had exited.*

4.28 The ACCC say in its draft decision that there are not high barriers to entry in the fixed-to-mobile services market:

> *…due to the current declarations of these essential input services, the Commission believes that these barriers to entry are substantially mitigated. This view appears to be supported by the large number of carriers currently providing FTM services.* (page 85)

4.29 While it is certainly possible to for dominant firms to use these strategies to engage in anti-competitive foreclosure of competitors in adjacent markets, the

[11] NERA, *Imputation Tests for Bundled Services: A report for the Australian Competition and Consumer Commission,* January 2003.

[12] Economics tells us that there is "only one monopoly profit" in the vertical channel, which can be extracted by charging a monopoly price for the input. An upstream monopolist cannot generate higher profits by leveraging its market power downstream, because there are no additional profits that can be extracted, except at the "cost" of sacrificing upstream profits. If there is one at all, there is only one monopoly profit, and it will be rationally extracted upstream.

[13] ACCC v Boral Ltd [1999] FCA 1318, at [173].

ACCC needs to demonstrate that it is a rational and profitable strategy for them.

4.30 Optus believes the ACCC has failed to demonstrate any price squeeze and certainly none that would generate a substantial lessening of competition. By corollary, the ACCC has failed to demonstrate how Part XIC intervention (via its pricing principle) would promote competition.

4.31 Interestingly, Wright (2002) goes further to note concerns that high termination charges raise the prospect of inappropriate anti-competitive conduct claims against mobile carriers, because:

> *… due to competition to capture this lucrative termination revenue, cellular firms may well have competed away much of the higher termination revenue under dispute. Where upstream firms dissipate most of the termination revenue (to their customers), but retain the litigation risk for damages associated with collecting the revenue, then the upstream firms appear to have a strong incentive to act collectively to avoid inflated termination charges. (Wright, 2002)*

Imputation test results clearly dispel claims of price squeezing

4.32 Under the terms of the Ministerial Direction and the Record Keeping Rules issued by the ACCC, Telstra is required to provide the ACCC with quarterly imputation tests for a variety of services, including fixed-to-mobile telephony. These tests are subject to external auditing as well as ACCC scrutiny.

4.33 The imputation test results clearly reveal that Telstra's fixed-only competitors are not being subject to a price squeeze.

4.34 The following table outlines the imputed margins applicable to business and residential fixed-to-mobile calling services for the periods July to September 2003 and October to December 2003 respectively.

	Imputed margin (Jul-Sep 03)	**Imputed margin (Oct-Dec 03)**
Business	21%	19%
Residential	36%	36%

Source: '*Imputation and non-price terms and conditions reports relating to accounting separation of Telstra for the December quarter 2003*' ACCC, April 2004.

4.35 This results show that substantial margins exist in this market for non-integrated service providers. Claims by some market participants to the contrary are therefore incorrect. Indeed, while corporate market yields are sometimes lower than termination charges, there can be many reasons for this pricing structure. This is quite certainly due to aggressive competition and efficient price discrimination, rather than anti-competitive price squeezing.

4.36 If the ACCC cannot articulate a perceived problem through Part XIB, which is specifically designed to address behaviour such as price squeezes, then it is

unclear how its proposed Part XIC action will assist in solving the perceived problem.

Termination charges are not the source of ineffective competition

4.37 The ACCC's decision to regulate termination charges arises from its belief that the prevailing termination charges are the source of market failure in fixed-to-mobile services:

> *The Commission believes that the main source of ineffectiveness of competition in the market within which FTM services are provided stems from the price of mobile termination services being well in excess of cost.*

4.38 The ACCC's draft decision presents a range of evidence that it believes points to the existence of ineffective competition in the fixed-to-mobile market arising from termination charges being too high. This evidence is as follows:

- The price of a fixed-to-mobile call appears to be in excess of cost.
- The rate at which the price of fixed-to-mobile calls has declined over recent years has been slower than that of other fixed-line PSTN services.
- The rate of decrease of fixed-to-mobile calls has slowed in recent years.

4.39 Optus believes that there are at least two problems with the ACCC's approach. Firstly, it is inappropriate to use price comparisons between fixed-to-mobile, long distance and international calls as a basis for concluding that competition in the fixed-to-mobile market is less pervasive than that for long distance and international calling.

4.40 Secondly, the ACCC has failed to evidence the causal effect between termination charges and the pricing conduct outlined above. Optus believes that if prices in the fixed-to-mobile market are not at competitive levels, this is because Telstra has unique structural advantages. Regulation to increase competition in the fixed-to-mobile services market should target these problems rather than termination charges.

Price reduction comparisons between call types

4.41 As discussed above, the ACCC has espoused concerns over the fact that fixed-to-mobile call prices have declined at a slower rate than those of other fixed-line call types. This concern is ill founded.

4.42 It may be logical for fixed-to-mobile call prices to fall at a lower rate than other fixed-line services. This is because, as a result of the pre-selection determination, fixed-to-mobile, long distance and international calls are taken as a bundle by consumers. Therefore, price competition between service providers for customers will be targeted at the bundle of calls, rather than call prices of individual call types.

4.43 Presented in the table below are demand elasticity estimates for the various call types. As shown, fixed-to-mobile calls are the most inelastic of call types within the preselection bundle.

Service category	Elasticity estimate
STD	0.55
Fixed-to-mobile	0.08
IDD	1.00

Source: Access Economics '*Review of the Price Controls on Telstra – prepared for the Department of Communications and the Arts*', August 1998.

4.44 Consequently, the competitive benefits that accrue to service provider as a result of reducing prices will be most pronounced for the more elastic services. It is therefore consistent with economic theory for service providers to reduce fixed-to-mobile call prices at a less rapid rate than other call types. Pricing decisions in this regard are entirely exogenous to the level of termination charges.[14]

4.45 Similarly, when pricing a bundle of services in a market that is not perfectly competitive, economic efficiency is promoted when the highest margins are targeted to the more inelastic services. Optus believes that this argument addresses the ACCC's concern about the yield of fixed-to-mobile calls being higher than that of long distance calls.

Competition is ineffective as a result of Telstra's structural advantages

4.46 Any lack of effective competition in the fixed-to-mobile services market can be attributed to the unique structural advantages enjoyed by Telstra in the fixed-line market, which include historic incumbency, ubiquity, control over key natural monopoly infrastructure, and partial government ownership.

4.47 These structural characteristics provide Telstra with a variety of downstream benefits that have the impact of muting price and non-price competitive influences in the market. Examples of such downstream benefits include:

- Strong economies of scale and scope.
- High market share, afforded protection by consumer inertia. The general implication of this is that the market share of the incumbent will be eroded only slowly and perhaps never completely to a level consistent with relative competitive price/quality offerings.
- Established brand recognition and first mover advantage.

4.48 These benefits explain why the preselection determination may have not been effective in eroding Telstra's market share to a level that is consistent with relative competitive price and quality offerings.

[14] For an expansive discussion of incentive regulation and its ability to enhance welfare, we refer the ACCC to Laffont and Tirole (2001).

4.49 In addition, the current policy regulations applying to local call resale arrangements limit the ability of non-Telstra carriers to compete in the pre-selectable bundle of services. The increase in line rental prices and increase in local call resale prices combined with the retail price caps lead to margin erosion that is greater than that faced by Telstra.

4.50 Optus has presented a range of policy options to Government that seek to address some of these underlying problems arising from Telstra's market dominance. These include:

- More effective regulation of access prices for the monopoly local loop services, including: PSTN, local call resale, and ULLS.
- Relief to Telstra's competitors of the obligations that are imposed on the incumbent, such as USO funding.
- Placing time restrictions on Telstra's ability to 'win-back' customers from its competitors.
- Consideration of the likely impacts of structural separation of Telstra.

4.51 Implementation of these policy options will, in Optus' view, be far more effective than mobile termination regulation in promoting competition in the fixed-to-mobile services market.

Pricing principle will not make fixed-to-mobile competition more effective

4.52 As discussed above, regulation of termination charges will not promote competition in the market for fixed-to-mobile services. Regulation will reduce the costs of producing fixed-to-mobile calls for non-integrated providers. This, however, will not enhance competition in the way that the ACCC believes it will, particularly because there is no competition imbalance to correct. Cost reductions should therefore not be interpreted as leading to improvements in competition.

4.53 The only possible mechanism through which the proposed regulation would promote competition is if the cost reductions were passed onto end-users which in turn stimulated sufficient demand to encourage new market entry and the introduction of new competitive pressures into the market.

4.54 In reality, this outcome is unlikely to occur for two reasons:

- Demand for fixed-to-mobile calls is inelastic so the demand responses won't be sufficient to drive new entry; and even if it was
- There is already significant entry in the market, as the ACCC acknowledges (page 86).

4.55 In any case, Optus notes that if termination charges were to be regulated at some measure of cost, the size of handset subsidies offered in the market would most likely fall. This would have the effect of reducing demand for subscription, thereby reducing the size of the addressable market for fixed-to-mobile calls so reducing call volumes.

4.56 The ACCC has not presented any evidence to support its presumption that regulation will alter the dynamics and/ or effectiveness of competition in the fixed-to-mobile services market. Optus believes that mobile termination regulation will not achieve the outcomes sought by the ACCC. In particular, even in the event of full retail pass-through of termination reductions, the level of competition within the fixed-to-mobile services market would remain unchanged.

4.57 Optus does not believe that the extent of pass-through is a reliable indicator of the effectiveness of competition in a market, or that the level of competition provides evidence of the degree of pass-through that will occur. Beard (1999) warns that:

> *…caution should be applied in asserting that the presence of flow-through implies competition, or in claiming that the absence of flow-through (in some senses) implies a lack thereof.*

4.58 Regardless of the degree of competition in the fixed-to-mobile market, full 'pass-through' is unlikely to occur because the retail price control arrangements incentivise Telstra to pass on cost saving in the prices for the more elastic services, such as long distance.

4.59 Even if full fixed-to-mobile retail pass-through were to be achieved, it will not change the competitive landscape (field of rivalry) and may not even result in a change in profits. For example, if as a result of an input price change, each firm individually adjusts its prices in a way that maintains the same level of individual firm profit, industry prices will adjust so that, on balance, industry profits are also unchanged.

5. Impact of proposed pricing principle on the mobile market

5.1 The ACCC's draft pricing principle does not adequately consider the likely impact that regulating termination charges would have on the retail mobile market. It indicates that it expects the impact will be limited:

> *… a closer alignment of mobile termination charges with underlying cost would therefore be likely to result in limited impact on the level of competition in the market within which retail mobile services are provide.* (page 104)

5.2 Optus believes that this is misleading, and that in fact the impact will be detrimental in nature and will impose substantial regulatory costs on the market. In particular, Optus believes regulating mobile termination at a proxy for cost will give rise to new pricing structures that are less desirable than those currently offered. This will in turn:

- Reduce competition between carriers in the mobile market by increasing barriers to market entry and reducing the scope for carriers to use pricing as a form of product differentiation.
- Have a detrimental impact on competitive investment such as 3G.

5.3 The net result is that the impact on competition in the mobile services market of the proposed pricing principle is in fact negative, which is inconsistent with section 152CR and the LTIE.

5.4 These outcomes arise because regulating termination charges below current access prices will inevitably put upward pressure on the price of retail mobile services. This is recognised by all the academic literature, including Gans and King in their submission for CoRe Research. The draft decision also appears to indicate that this is recognised by the ACCC (page 103).

5.5 This means that there will be a fall in demand for those services that experience increased prices, and the aggregate demand for all jointly produced mobile network services will by definition fall. This will reduce competition for subscribers because their individual value to the network will be reduced.

Less desirable pricing structures

5.6 In establishing the structure and level of prices that will maximise return on capital investments, carriers have to take into account a variety of factors, including:

- Consumer preferences regarding pricing structures.
- Anticipated consumer demand to pricing levels.
- Competitors' price offerings.
- Likely responses by competitors to price changes.

5.7 In addition to the considerations outlined above, prices must be capable of providing shareholders with a reasonable return on capital invested.

5.8 In the event that mobile termination charges are regulated, in order to fulfil obligations to shareholders and to ensure recovery of the on-going costs of running the network, mobile carriers will seek to offset the lost termination revenues. This will require carriers to formulate a different structure of prices to enable the recovery of termination revenue losses.

5.9 Given the iterative process of competition, Optus does not yet have a clear pricing strategy for responding to the proposed regulation. Optus' actual response will, to some extent, depend on competitors' pricing responses. Nevertheless, all carriers will have to recoup any reductions in mobile termination revenue. There are a variety of options available to help offset termination revenue losses, including:

- Increasing call origination prices.
- Increasing handset prices.
- Increasing call flagfall rates.
- Reducing the number of 'free' calls included in call plans.

5.10 Such responses have been observed in the UK following the Competition Commission's decision to reduce mobile termination rates, as outlined in a

letter from Optus sent to the ACCC in November 2003, entitled '*Impacts of mobile termination regulation: the UK experience*'. (It is odd that the ACCC asserts in footnote 238 of the draft report that the UK mobile operators have not increased prices following the regulator's decision there, when in fact they have and Optus provided evidence to the ACCC of that fact).

Increased barriers to entry

5.11 Regulation that increases the price of retail mobile services will reduce consumer demand for mobile services. To the extent that sunk costs and economies of scale exist, this will reduce industry profitability. This will in turn reduce the financial feasibility of mobile investments, and hence raise barriers to market entry and expansion.

5.12 The ACCC has itself identified a key increased barrier to entry as a result of its pricing principle when it notes that:

> *Without the economic profits from providing termination services, a new entrant will be constrained in its ability to subsidise subscription and therefore will be unable to compete effectively in the mobile services market* (page 107 - 108).

5.13 Whilst Optus would not agree that there necessarily exists any economic profit or cross-subsidy, even according to the ACCC the new entrant is deterred by the pricing principle because it cannot implement a competitive market entry strategy.[15]

5.14 The outcomes from the introduction of the draft pricing principle may have the effect of muting the competitive pressures prevailing within the industry in at least two different ways:

(a) The reduced threat of market entry will lower the level of competitive pressures that are imposed on carriers by the threat of entry.

(b) The reduced level of actual entry in the future will preclude the emergence of additional competitive influences on carriers. Moreover, consumer choice with respect to mobile networks will be diminished.

5.15 Similarly, by reducing the profitability of carriers, regulating termination may have the effect of encouraging market exit. Such an outcome will harm the long-term interests of end users.

5.16 The ACCC's draft decision outlines its concern that high barriers to entry are hindering competition in the mobile market. Optus does not agree that there are presently high barriers to entry. We do, however, agree with the ACCC that high barriers to entry are undesirable. This is an argument against the ACCC's proposed regulation of termination, which is likely to increase barriers to entry.

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[15] Notwithstanding the arguments of Hutchison, smaller players are likely to suffer most from this regulation. Those operators seeking to expand market share at this point in their lifecycle will be restricted from attaining the cost structures developed by more established players (which have to some extent been achieved through aggressive competition for subscribers) funded by demand for fixed to mobile termination services.

Reduced scope for competitive differentiation

5.17 Mobile carriers use pricing as a means of differentiating their mobile services from those of competitors. For example, within the market carriers have positioned themselves in different ways, with some carriers targeting handset subsidies and others lower call prices - some analysts estimate that there are currently over 700 different pricing packages in the market.[16] Such differentiation is an important feature of competition in the mobile market.

5.18 By restricting pricing flexibility, however, regulation will reduce the scope of carriers to compete through product differentiation.

5.19 As an example, a new or existing carrier may propose a new package with a unique mix of call origination charges and termination charges which is attractive to certain customers. Without regulation, this is an available strategy and, depending on its popularity with customers, could be a successful entry or expansion strategy.[17] However, with the ACCC's proposed pricing principle, such a strategy would be prohibited if the termination charges deviated from the 'target price'. As a result, competition would be lessened.[18]

Reduced churn

5.20 The value of a subscriber to the mobile network is what drives vigorous competition in the mobile services market. If that value is reduced because the available mix of prices is constrained by regulation, then competition will be lessened; not promoted.

5.21 Vigorous competition for subscribers (most commonly via cheap handsets) by many mobile carriers promote customer churn between networks. Customer churn is pro-competitive in that it offers the following benefits:

- Barriers to market entry are lowered. This is because churn between networks offers a means for market entrants to achieve sufficient subscriber numbers to obtain a return on capital invested.
- It promotes increased rivalry between carriers, which provides clear benefits to consumers. Rivalry is enhanced because churn enables carriers to compete not only for new mobile subscribers, but also for consumers that subscribe to other networks.
- It encourages carriers to improve service delivery to existing customers, as the threat of customer churn forces carriers to 'work harder' to retain subscribers and increase cost efficiency.

5.22 By reducing the desire for carriers to compete for customers, and by reducing the ability of carriers to offer pricing structures which drive churn (such as

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[16] IBISworld, *Report J7122 - Mobile Telecommunications Carriers in Australia,* page 7

[17] An objection to the argument that this would be an effective strategy could be that fixed operators uniformly price fixed to mobile services (Wright 2002) or are unaware of the mobile network they are calling (Gans and King 2000) – hence consumers would not be able to form preferences. However, if uniform pricing is the impediment to effective competition then it should be addressed in preference to regulating mobile termination rates.

[18] We also note that consumer welfare would be harmed by such an outcome.

cheap handsets), the ACCC's draft decision to reduce termination charges from their competitive levels will likely reduce the level of customer churn between networks. This will essentially result in a lessening of competition within the market.

No super-normal profits to offset

5.23 The ACCC's draft decision is circumspect as to whether carriers would attempt to offset termination revenue losses in the event of regulation. The ACCC appear to argue that the resulting outcome would be positive for consumers in that monopoly profits would be transferred from mobile carriers to fixed-to-mobile consumers, with no offsetting price increases for mobile customers.

5.24 This argument assumes, incorrectly, that there are super-normal profits in the mobile industry. There are not. Profits lost on termination revenues will need to be recouped elsewhere to enable investors to achieve a reasonable return on capital invested.[19]

5.25 Optus contends that ACCC has failed to provide any compelling evidence that the industry is earning supernormal profits. Instead, it has relied upon a range of accounting profitability information to evidence its claims regarding economic profitability.

5.26 Optus believes that the ACCC's profitability analysis was far from robust and consequently provides no evidence of super-normal profitability. In particular, Optus makes the following brief observations:

(a) The ACCC's analysis has placed considerable emphasis on Telstra and Optus' profitability, with no reference to the significant disparities that exist between their respective financial performances. Indeed, the ACCC's conclusion that the industry is highly profitable was drawn largely from '*the estimated high ROCE for Telstra and Optus'* (page 82).

Optus believes that it is entirely inappropriate for the ACCC to describe Telstra and Optus' profitability in the same light. This is because Telstra's mobile business is significantly more profitable than Optus' mobile business. To highlight, JP Morgan's 2001 return on capital analysis[20], as quoted on page 81 of the ACCC's report, estimates Telstra's ROCE to be 46%, with Optus' being in the 'high-teens'. Clearly, there is significant disparity between these figures.

(b) *EBITDA is not a good indicator of mobile industry profitability, given the capital-intensive nature of the industry.* The ACCC's draft decision claims that the positive EBITDA figures achieved by all

[19] Within a competitive market, prices can increase so long as the cost increases, or revenue reductions, are incurred by all market participants (as would be the case with termination regulation). Competition would only prevent prices from increasing if prices were above-cost prior to regulation. It is not feasible over the long-run for firms to price below marginal cost.
[20] JP Morgan, *Australian Mobile Industry Return on Capital Analysis*, 2001, p. 4.

mobile carriers[21] to be indicative of a highly profitable industry. Optus, however, believes that EBITDA holds very limited capacity to reveal the profitability of the mobile industry. This is because depreciation expenses are a significant part of the cost structure, reflecting the substantial level of capital resources tied up in carriers' networks and infrastructure. In particular, depreciation of capital is the second largest component of total expenses in the mobile industry[22]. Depreciation expenses therefore form a very important component of the business case for mobile market entry.

In addition, investors' require both a return of capital (depreciation) and a return on capital (a WACC to reflect the opportunity cost of capital). Neither of these is allowed for in EBITDA.

(c) *Accounting profit does not reveal the existence of monopoly profits.* The ACCC's analysis points to various accounting profitability indicators as evidence that the mobile industry is making supernormal profits.

In reality, the linkage between accounting and economic profitability is not particularly strong. By implication, accounting profitability does not confirm the existence of economic profitability. Indeed, economic theory comfortably accommodates the existence of high profitability within competitive markets absent of any market power problems[23].

Optus' accounting profitability can be attributed to the cost advantages they have achieved as a result of scope and scale. Sound regulatory pricing principles allow for market participants to retain accounting profits achieved through cost advantages. Indeed, such pricing principles promote incentives for efficient cost minimisation.

In any case, the accounting profitability figures of Optus are not directly comparable with those of most other carriers. In particular, Optus' corporate overhead costs are allocated across a much wider range of services than that of the mobile-only carriers.

Further, accounting profits do not allow carriers a return on intangibles, which may be significant in the retail space.

Finally, the ACCC's analysis only presents a snapshot of profitability. The accounting profits are likely to offset significant accounting losses from the earlier years of the investment. Taken over its economic life, the accounting profits on the mobile investment will be much lower than the selective snapshot presented by the ACCC.

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[21] Excluding Hutchison's 3G network

[22] IBISworld, *Report J7122 - Mobile Telecommunications Carriers in Australia,* page 17

[23] The soft drink industry provides a useful example of a competitive market with highly profitable market participants. It is not disputed that the soft drink industry is highly competitive: the industry is characterised by a large number of players, and barriers to market entry are relatively low. Notwithstanding this, the industry remains highly concentrated with market share being dominated by Coca-Cola and PepsiCo, both of which are extremely profitable. However, it would clearly be inappropriate to regulate these firms (or the industry) on the basis of their high level of profitability.

(d) *Mobile industry returns need to be high to reflect riskiness of mobile-related investments*. Mobile industry investment is subject to a high level of risk.

Risks specific to the mobile industry include:

- Risk of technological obsolescence.
- Continuing threat of new market entry and eroded market share.
- Vulnerability of mobile telephony traffic volumes to fluctuations based on business cycles.

It is well recognised that average returns from risky investments need to be higher than risk-free returns to compensate investors for taking on the risk.

Optus believes that the evidence quoted in the ACCC's draft decision implying that only two carriers are earning a reasonable accounting return on capital (as measured by ROCE), suggests that the industry is not particularly profitable, particularly when considered in terms of the riskiness of mobile-related investments.

5.27 Overall, Optus believes that the ACCC's assessment of industry profitability is far from adequate, and ignores even basic accounting theory. The evidence does not support the claims that the industry is highly profitable. Any accounting profits that are obtained by Optus are more likely attributed to cost advantages derived from scope economies, which were likely built up when accounting losses were made.

Impact on entry into innovative services

5.28 The competitiveness of the mobile industry is highly reliant on investment in capacity, coverage and new technologies. The importance of this continued investment cannot be overstated.

> *Since 1997, capital expenditure on new networks has exceeded $8 billion. These investments underpin expansions to mobile network coverage that make mobile services available to more people in more places as well as supporting the development of innovative services.*
>
> *In 2003, the mobile industry will invest an expected $1.4 billion in capital to support new networks, network expansions and upgrades to existing networks. This is in addition to regular operating expenditures.*[24]

5.29 Competition is clearly promoted by new investment, but is lessened where entry and expansion is deterred.

5.30 The mobile industry is characterised by virtuous circle of continued investment and penetration that is in the mutual interests of both carriers and

[24] The Allen Consulting Group, *Australian Mobile Telecommunications Industry: Economic Significance: research commissioned by AMTA*, September 2003, page 3

end-users. The former pursue scale to drive efficient use of the infrastructure and reduce costs to serve; the latter benefit from reduced costs and the external benefits of higher mobile penetration and service development, differentiation and choice.

5.31 The proposed pricing principles are a threat to this virtuous circle because they act to reduce the incentive to pursue valuable subscribers. Specifically, Optus believes that the proposed pricing principle will lessen competition by reducing the value of marginal subscribers, particularly those interested in:

- New networks (such as 3G and other technologies); and
- New services on existing networks.

5.32 The pricing principle is likely to impact on prototype investment in new technologies such as 3G. These are the riskier investments that may need to be reconsidered under the proposed pricing principle. With respect to 3G it is expected that it would cost an Australian operator around US$1billion to roll out a 3G network, in consideration of the size of the country as well as the density of the population.[25] Whilst the pricing principle may not completely deter such an investment it may impact on the scale and size of such a rollout. A similarly heavy-handed approach to regulation in the UK caused O2's 3G network launch to be delayed.

5.33 In addition, handsets are a key component of new technology developments and handset charges are largely driven to support these new services, with associated incremental revenue streams. For example, in recent times new handsets have been released to provide SMS, data, and MMS capability. Further, these handsets cannot be rolled out without customer demand and the ability to achieve a return on the investment. The ACCC itself has acknowledged the importance of handsets in its own draft decision when it states that:

> "*Whilst SMS has been a 'stunning success' for all mobile operators, other mobile data services, such as Wireless Application Protocol (WAP) have received muted consumer response. In 2001, less that 5 per cent of mobile users were using WAP applications. Analysts of these applications have suggested that major inhibitors to the wide-spread consumer* ***take-up may have been the limited content and applications, and the high costs of compatible handsets***."

5.34 If mobile operators cannot recover their economic costs then there is likely to be reduced investment and in the worst case, market exit. Those firms that remain in the market will have less incentive to invest in developing any further expansion in infrastructure and because wholesale termination rates will be set exogenously at below efficient levels, resale (via say an Virtual Mobil Network Operator arrangement) will look to be a more profitable option to supply mobile telephony.

[25] BIS Shrapnel Technology Applications Group, *Telecommunication Infrastructures in Australia 2001: A Research Report prepared for ACCC*, page 117

5.35 Such an adverse investment impact on infrastructure investment will almost inevitably lessen competition. It would be a perverse outcome for a regulator to pursue a policy that diminishes competition.