Optus submission

to the Australian Competition and Consumer Commission

Implementation of GSM pricing principles

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Introduction

This paper is written in response to the Australian Competition and Consumer Commission's, (the Commission) letter in relation to the implementation of the GSM pricing principles.

In previous submissions, Optus has expressed concern with the Commission's pricing principles. In particular, Optus has argued that:

- The mobiles industry is not subject to the market failure identified by the Commission. Optus does not agree with the Commission's view that there is consumer ignorance, and does not believe mobile termination is a separate service with bottleneck characteristics. The empirical evidence supports the view that mobile termination is subject to competitive constraints, due to the existence of competitive substitutes, amongst other things;

- The pricing principles proposed by the Commission are likely to inefficiently distort pricing and investment decisions in the mobile industry; and

- If the Commission were to forbear from regulating the mobiles industry, consumer welfare would be higher than would be the case if the Commission implements its pricing principles.

Having said this, Optus is keen to provide comment on the implementation of the Commission's pricing principles. Optus' overall response to the Commission's proposed implementation is as follows:

- The Commission should not implement its pricing principles in a way that threatens the primacy of commercial negotiations in setting GSM termination rates.

- Optus is concerned that in its letter, the Commission seems keen to both collect and publish pricing information. This would diminish any incentive for resellers to strike commercial deals on GSM termination. Optus does not believe that the Commission should collect data outside the context of an arbitration, and certainly does not support the publication of data on a regular basis. Collection and publication of data would have the result that operators would launch arbitrations every six months without even bothering to commercially negotiate.

- Optus does not support the yield methodology proposed by the Commission, as it is significantly flawed:

- A yield approach treats peak minutes of traffic in the same way as off peak minutes, diminishing the incentive of operators to price in a way that encourages the efficient use of their network;

- A yield approach penalises 'on net' [1] pricing, as the yield approach shows an increase in usage due to the provision of free on net minutes as a price fall, when it is actually designed more as a means to efficiently utilise existing network capacity; and

- A yield approach will dull the incentive to offer capped rates on mobile networks, as again, these rates are typically used in off-peak times, and can be expected to encourage increased usage of the network.

While Optus accepts that the CRU methodology also has problems associated with it, Optus believes it more accurately measures pricing behaviour over time. More importantly, Optus believes the CRU approach enables operators to maintain a degree of pricing flexibility that a yield approach does not.

Maintaining retail pricing flexibility, and the incentives to innovate at the retail level is very important. The Commission must ensure its implementation of the pricing principles does not distort pricing decisions. The pricing principles are designed to reflect changes in retail prices, and should not actually drive those pricing changes.

[1] Where calls stay entirely on the one mobile network operators often offer differential pricing.

1. Date of the initial starting point

1.1 The Commission suggests that the starting point for the implementation of the pricing principles should be the lowest current access price, and puts forward 1 July 2001 as a preferred date.

1.2 Optus' position on the appropriate starting date is as follows:

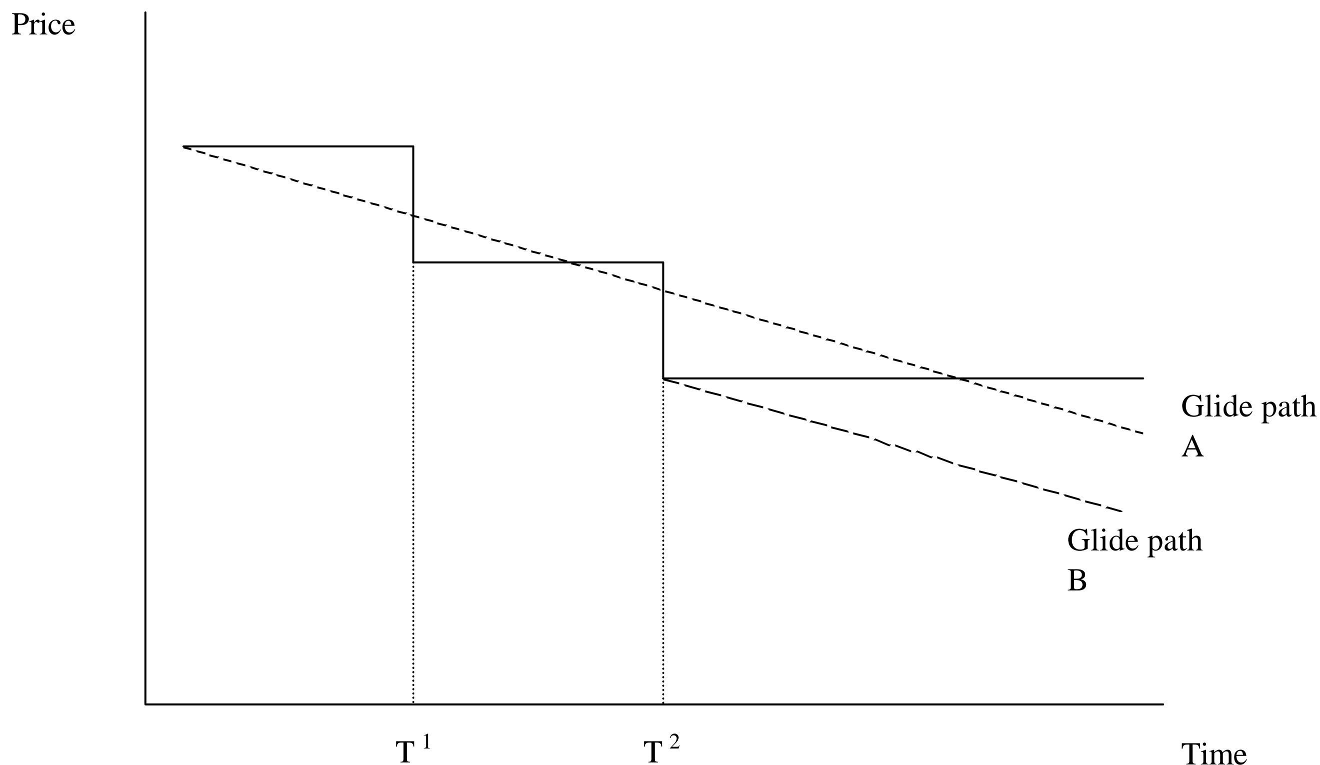
(a) The start date should be the day before the two six monthly pricing periods for comparison; and

(b) Setting a start date at the end of the period for comparison "double dips", and penalises operators for commercially negotiating.

1.3 Optus believes the starting date is arbitrary at best, and believes it is important to get the principles correct rather than focussing exclusively on a date. In setting the starting price, it is important that the Commission does not overly distort the incentives to commercially negotiate. It is also important that the Commission's glide path replicates, to the fullest extent possible, the commercially negotiated path. Optus does not believe that mobile carriers should be penalised for continuing to commercially negotiate and lower mobile termination rates.

1.4 Figure 1 illustrates the typical negotiated path for mobile termination rates. The price for mobile termination follows a step function over time, being stable for perhaps a year, before a significant reduction is negotiated for another year. Importantly though, the average price over time falls more gradually. The average price follows the Glide Path A, as set out in Figure 1. For the Commission to implement this glide path, it must ensure that the starting price is not a newly negotiated rate, which would be at the bottom of the step function. If the Commission set the starting rate at the bottom of the step function, it has imposed a new glide path on operators, shown below as Glide Path B.

Figure 1: Negotiated termination rates and glide paths



1.5 Optus supports setting a starting price to be the date just before the six month period for pricing comparison. Setting the start date this way ensures that operators are not penalised for commercially negotiating mobile termination rates, and ensures that any arbitrated rates do not "double dip".

1.6 To illustrate the timeline, an example is set out in Table 1:

Table 1: Illustration of the appropriate timing for GSM pricing principles

	Date	Price (index)
Starting point	30 June 2000	24.5
Pricing period 1	1 July 2000 – 31 December 2000	100
Pricing period 2	1 January 2001 – 30 June 2001	99
Price reduction (six monthly)		1 per cent
Arbitrated price	Available to access seekers from 1 July 2001	24.3

1.7 In the example outlined in Table 1, if the Commission took the starting date as 1 July 2001, it risks subjugating the role of commercial negotiation. To understand this point, given that operators can observe the price reductions in the retail market, they have the incentive under the Table 1 illustration to commercially negotiate a reduction in termination rates to 24.3 during the period. However, if operators know that the starting date is set at the end of the period, they have no incentive to negotiate at all, as the 1 per cent reduction would be from a starting price of 24.3 cents per minute rather than 24.5 cents per minute.

1.8 Going back to the glide path figure, putting the start date at the end of the pricing period rather than the beginning puts carriers on a lower glide path for no good reason.

1.9 The Commission should always set the start date at the beginning of the period of pricing comparison. It should not select a start date towards the end of the pricing period and give access seekers some sort of retrospective price reduction from this price. This would mean rates would only ever be arbitrated rates, as there would be no incentive for operators to commercially negotiate. For example, assume in the Table 1 illustration that Optus struck a deal with a reseller at 24.3 cents per minute on 1 July 2001. Now assume that the reseller launches an arbitration on 2 July 2001. If the parties knew that the Commission would automatically give the reseller the 1 per cent reduction from 24.3 cents per minute (rather than 24.5 cents per minute), the deal would never be struck in the first place.

1.10 For this reason, Optus does not agree that under a period-on-period approach, the starting price should be the most recently agreed price. Rather, the price

should be the price that prevailed just before the pricing period that is being used to determine the price reduction.

1.11 Additionally, Optus does not agree with the Commission's view that the price used as a starting point should be the lowest price across the market. Such an approach sets regulator-imposed uniformity across the market, rather than allowing parties to negotiate rates between themselves in response to their specific circumstances. We believe that the better approach is that the applicable price should be the price that prevailed between the access seeker and access provider, rather than a lowest price across the market. This will mean that different carriers have different glide paths with different access seekers.

2. Time period for assessing retail price movements

2.1 Optus would prefer an annual basis for pricing comparisons, rather than the six-monthly basis the Commission proposes. Given that the Commission would likely only ever set mobile termination prices annually, Optus sees no reason that it must bear the administrative cost of gathering the necessary data more regularly than is needed.

2.2 The Commission has raised the issue that mobile carriers such as Optus which does not report on the Australian traditional financial year basis may face difficulties on producing pricing information from a 1 July to 30 June timeframe.

2.3 Optus would support an annual pricing period based around the Optus financial reporting period, which starts on 1 April and finishes on 31 March.

2.4 It would be difficult for Optus to produce audited pricing information for periods outside our financial year, so a uniform July – June reporting period would not be ideal. The advantage of this approach for carriers with non-standard financial years is that the Commission could rely on audited financial information.

2.5 Optus sees no reason why different reporting periods for the different mobile operators could not be adopted, particularly since Optus does not think pricing performance should be reported by the Commission.

3. How to determine the average price per minute and retail price movements

3.1 The Commission has expressed a preference for using a yield methodology in both its final pricing principles paper and in the implementation letter. Under a yield approach, the Commission would gather the total outgoing mobile revenue and divide that revenue by the total number of minutes (including free minutes) to get an average price per minute. The Commission cites ease of implementation as the main reason it favours a yield approach.

Optus does not support the yield approach

3.2 While Optus can see that a yield approach may be easier to implement than other approaches, Optus believes it is important that the approach used is the approach that least distorts pricing behaviour at the retail level. Unfortunately, Optus believes that the yield approach is likely to distort pricing behaviour. As such, Optus would prefer the Commission implemented its pricing principles using the CRU approach.

3.3 Optus does not support the yield methodology proposed by the Commission, as it is significantly flawed:

(a) A yield approach treats peak minutes of traffic in the same way as off peak minutes, diminishing the incentive of operators to price in a way that encourages the efficient use of their network;

(b) A yield approach penalises on net pricing, as the yield approach shows an increase in usage due to the provision of free on net minutes as a price fall, when it is actually designed more as a means to efficiently utilise existing network capacity; and

(c) A yield approach will dull the incentive to offer capped rates on mobile networks, as again, these rates are typically used in off-peak times, and can be expected to encourage increased usage of the network.

3.4 Given that Optus does not support the yield approach, our comments on its implementation are necessarily brief. If the Commission were minded to use the yield approach despite our concerns, Optus would make a further submission to the Commission at that point.

The yield approach does not treat off peak minutes appropriately

3.5 One of the reasons Optus does not support the use of a yield approach is that it does not treat off-peak minutes of use appropriately. Application of the yield approach as foreshadowed by the Commission would have the effect of reducing operators' incentives to efficiently operate their networks, to the detriment of consumers.

3.6 Given that networks must be dimensioned to handle the peak load of traffic, it is a common feature of the mobile industry to find that the network has excess capacity in off peak times. It is economically efficient to use up this excess capacity to the extent possible through retail tariffs that differentiate between peak and off peak times. This pricing can be observed in the mobiles market for both weeknights and weekends. The effect of lower off peak prices is to stimulate the usage of the network in off peak times.

3.7 However, under a yield approach, this network usage stimulation would be effectively penalised, as it would be counted as a price reduction. The result would be that operators would tend not to offer aggressively low off-peak rates, as they may drag down the price of mobile termination further than is warranted.

3.8 The yield approach is flawed in that it treats a peak minute of usage the same as an off peak minute of usage, even though the marginal cost of a peak minute of usage is much higher than an off peak minute of usage. That is, if the minutes of use is a proxy for the quantum of the supply of mobile services, there should be quite a large discount for off peak minutes. From an operators' perspective, supplying a peak minute of use is much more costly and difficult than supplying an off peak minute.

3.9 Because the yield approach is such a blunt way of attempting to measure price reductions, it does not actually capture reductions in the average price from a consumer surplus perspective. This arises largely because the yield approach reduces the incentive of operators to capture socially beneficial use of their network. For example, given that in off peak times the marginal cost of using a mobile network is low, it is efficient to stimulate usage. However, if operators are effectively penalised for this usage stimulation through the yield approach, there would likely be a shift to more uniform pricing that would not be able to capture consumer surplus to nearly the same extent.

3.10 The yield approach risks a reduction in both allocative and technical efficiency. To understand this point, an illustration is useful:

3.11 Assume that an operator prices all calls as though they were peak time calls.

$$\text{Demand}^{\text{peak}} = 100 - P$$

$$\text{Demand}^{\text{off peak}} = 40 - P$$

Total network capacity = 120 units

Price of a minute of use = 40

$$\text{Demand}^{\text{peak}} = 60 \text{ units}$$

$$\text{Demand}^{\text{off peak}} = 0 \text{ units}$$

3.12 Now assume that the operator identifies that its network is being efficiently utilised in peak times, but has excess capacity in off peak times. The operator introduces off peak pricing at zero.

$$\text{Demand}^{\text{off peak}} = 40$$

3.13 Now, under a yield approach, this stimulation of off peak demand would be counted as a price reduction. The revenue earnt has not increased at all, but the minutes of use have increased.

3.14 Under a yield approach, the Period 1 average price would be 40 (all minutes are charges at the peak rate of 40). However, the Period 2 average price would fall to 24 (60 units priced at 40, and another 40 units priced at zero). This means termination rates would be forced down by 40 per cent.

3.15 The problem with the yield approach is particularly acute when the second round effects are considered. Under the yield approach, the increase in use in off peak times flows through to lower termination rates that apply in both peak and off peak times. This has two undesirable effects:

(a) Allocative efficiency is reduced — the demand for peak termination increases, as its price has fallen by 40 per cent. However, peak termination has a lower marginal valuation than peak origination, which is still priced at 40. Since capacity is assumed to be constant, this means that low value peak termination minutes begin to displace high value peak origination minutes; and

(b) Technical efficiency is reduced — if the operator responds to the newly inefficient pricing structure through increasing capacity, the technical efficiency of the network has been inefficiently reduced.

3.16 The other option for operators besides increasing capacity is to withdraw the social tariffing they offered, which again results in a reduction in consumer welfare, as demand for off peak minutes falls back to zero.

The yield approach penalises on net pricing

3.17 Optus understands from the Commission's implementation letter that under a yield approach, on net pricing offers such as yes time would be included. That is, despite the fact that no revenue is earned between 8–12pm on the Optus network, the minutes of use in this time period would count towards the total minutes of use to calculate the average price.

3.18 Optus has previously argued that the Commission should not include 'on net' pricing in its weighted average retail basket. Optus believes that the increased aggressiveness of on net pricing is a vitally important benefit to consumers, and contributes to a dynamically competitive telecommunications industry. In particular, on net pricing enables mobile operators to harness the closed user group nature of callers, and compete with the fixed network incumbent, Telstra.

3.19 The Commission would be aware that Optus was the leader in developing on net pricing, or social tariffing, as it is often called. On net pricing was developed to build subscriber numbers, and clearly enables consumers to switch their calling from the fixed to the mobile network.

3.20 On net pricing competes directly with fixed to fixed calling. If the Commission includes on net calls in its weighted average basket it will create incentives for such free/cheap calling deals to be deployed less vigorously, or even to be removed. This will substantially lessen competition and competitive constraints of fixed to fixed calling.

3.21 However, if a yield approach had existed before Optus introduced on net pricing, it is very doubtful that it would have developed in the way it has to this point. If an increase in the usage of 'yes' time had led to a reduction in the mobile termination revenue stream, Optus would have been unlikely to offer the service in the way it has.

3.22 On net calls should not be included in the yield calculation because they are not actually a voice call in the traditional sense. Due to any-to-any connectivity, when a subscriber makes a normal call, he or she can call anyone on any network, and is charged on that basis. The utility of making that call incorporates an option value that the consumer can call anyone in the country, for example. However, on net calls are quite different in their nature. Subscribers wishing to make on net calls face eligibility conditions that restrict a more wider deployment of the free calling option:

(a) In most cases, they must know the identity of the person they wish to call, and they must know that the person subscribes to the same network. Clearly, some subscribers may inadvertently benefit from on net pricing, but in most cases, on net calls are made with the knowledge that they are an on net call; and

(b) Subscribers can, in general, only take advantage of on net call offers at certain times of the day.

3.23 For these reasons, we would not expect that on net calls would necessarily be priced at the same rate as off net calls. Neither would we expect that the usage patterns of on net calls, and the prices of on net calls provide a true indicator of the competitiveness of the broader retail market.

3.24 As Optus has previously argued, if the Commission were to include on net calls, it would:

(a) adversely impact new entrants worse than other players;

(b) substantially lessen competition between MTM and fixed to fixed calling;

(c) reduce growth in mobile penetration;

(d) undermine investment incentives;

(e) prevent continued innovative pricing;

(f) lead to less efficient ulitisation of the network; and

(g) reduce consumer welfare.

The yield approach reduces the incentive to offer capped rates

3.25 Competition in the mobiles industry has seen the introduction of capped rate mobile calls, usually on the weekend or in off peak times. Capped rate calls can be expected to stimulate usage in a similar way to free calls or included minutes, and are used by operators to compete against the fixed line. As such, capped rate calls are an efficient pricing option, and add to consumer welfare.

3.26 However, because they stimulate usage, capped rate calls are penalised by the yield approach, and are unlikely to be offered if the Commission were to implement the yield approach.

The CRU approach is less distortionary than the yield methodology

3.27 Optus has a preference for the CRU approach, largely because we believe the CRU approach would distort retail-pricing decisions to a lesser extent than the yield approach.

3.28 The CRU approach involves constructing representative bundles of mobile usage to determine average prices. A mobile carrier index is formed from these baskets and could be compared over time to determine the retail price movements.

3.29 Optus believes that the use of representative bundles of use helps to preserve operator's incentives to innovate in their pricing approaches and to utilise their networks efficiently. This is because within a particular pricing plan, the minutes an Optus customer actually uses does not form part of the calculation. Rather, usage is defined through the representative basket.

3.30 For this reason, operator's decisions on whether to offer cheaper calls in off peak times or free calls for on net calls are less affected by the pricing principles than would be the case under the yield approach. This is not to say that operators are completely unaffected by the CRU approach, but the quantum of the distortion to retail pricing decisions is likely to be less than under a yield approach.

Services for inclusion in measuring retail price movements

3.31 The Commission has suggested that the following retail revenues should be counted under a yield approach:

(a) Outgoing calls;

(b) Subscription (access) fees;

(c) Sales of handsets;

(d) Initial connection charges;

(e) Data services (eg. SMS); and

(f) Value added services (eg. Voicemail).

3.32 As argued above, Optus does not support the application of the yield approach, so is not minded to comment extensively on which services should be included. Having said this, Optus believes that the Commission has included all of the relevant revenue streams, with one important exception. The Commission has omitted incoming revenues, with the explanation that incoming revenues are wholesale revenues.

3.33 While the price of incoming revenue is set at the wholesale level, Optus believes that if a yield approach were implemented, incoming revenues should be included as they form an integral part of the total mobile service offering.

3.34 Under the CRU approach, Optus would support the inclusion of the services suggested by the Commission as part of the representative bundles of usage.

Provision of revenue information

3.35 The provision of revenue information is only relevant if the Commission were to proceed with the yield approach, which Optus does not support.

3.36 However, if the Commission were minded to implement a yield approach, Optus does not see any problems with the provision of revenue information as outlined by the Commission with the following caveats:

(a) The revenue information should only be provided within the context of arbitrations, not every six months;

(b) The revenue information should be audited, which means that the six monthly time periods must be set according to the financial years of the respective operators; and

(c) The revenue information would be provided on a commercial in confidence basis, and should not be reported by the Commission.

3.37 The provision of minutes of use would be on the same basis as the provision of the revenue information. Minutes of use would be provided on a commercial in confidence basis, as would the number of SMS messages sent.

Adjusting for quality

3.38 Optus has previously argued that if the Commission does not correctly implement its methodology, changes in the quality of the product supplied may be mistaken for changes in real prices of outputs. That is, as newer low ARPU customers enter the market with low quality handsets, the yield approach could show a reduction in price when really only the quality of the service has fallen.

3.39 We argued that the Commission needs to develop a mobile subscription quality index to enable the proper implementation of its methodology, and the separation of price and quality changes to mobile users.

3.40 We believe that the CRU approach may partly address concerns about quality changes over time, but think that if the Commission decides to implement a yield approach, it may need to consult with industry through a forum such as the Australian Communications Industry Forum (ACIF).

3.41 A related point is the question of how to handle the increase in mobile plans that do not include a handset. Over the last few years, operators have competed vigorously for subscribers through offering handsets at zero upfront cost, recouping the handset subsidy through a combination of access and airtime charges. However, as the mobile market matures, many subscribers are willing to continue subscribing to a mobile network with their own handsets from previous mobile plans. This means that operators have started to offer plans that do not have a built in recoupment of a handset in the pricing structure. These new plans, under the Commission's proposed approach, would be counted as a reduction in price, when clearly they are simply a different service.

3.42 If the Commission lumps in mobile plans that include a handset with plans that do not, it will over-state price reductions over time, as the mobile market matures. The Commission must decide whether it will exclude SIM only plans or make an adjustment to its data to reflect its impact.

3.43 Optus notes that taking SIM only plans into account would be much easier under the CRU approach than under the yield approach — another reason for supporting the CRU approach.

4. Collection of information and disclosure in aggregated form

4.1 In its letter, the Commission raises the question of how it should collect information and how that information should be disclosed. In particular, the Commission suggests that the most appropriate manner in which to collect the information is via voluntary provision or a record-keeping rule.

4.2 Under voluntary provision of information, the Commission envisages entering into agreements with operators that would specify the information to be provided and the timeframes for the provision of that information. The Commission also envisages that these agreements would include confidentiality arrangements that may allow the disclosure of information in an aggregated form. Optus assumes the Commission would like information provided once every six months, and would disclose the information to the market each six months — "this will likely involve publishing details as to the six monthly retail price movements of each mobile carrier". [2]

4.3 Optus is concerned that in its letter, the Commission seems keen to both collect and publish pricing information. This would diminish any incentive for resellers to strike commercial deals on GSM termination. If the Commission published six monthly pricing data, resellers would simply wait until results were published before launching an arbitration. Resellers would have no incentive to strike deals over a term longer than six months. Publication of pricing results is likely to increase the number of disputes, and subjugates the primacy of commercial negotiation.

4.4 Optus is concerned that implicit in the Commission's implementation letter is the belief that its regulated mobile termination rates will always be lower than mobile operators are able to commercially negotiate. As Optus has argued extensively over the past few years, commercial negotiations have produced impressive reductions in termination rates, and are likely to continue to do so, contrary to the Commission's contentions of market power. If the Commission completely subjugates the primacy of commercial negotiation, Optus believes it may well slow the rate of reduction in termination rates, an outcome Optus assumes the Commission does not wish to encourage.

4.5 Optus does not believe that the Commission should collect data outside the context of an arbitration, and certainly does not support the publication of data on a regular basis. Collection and publication of data would have the result that operators would launch arbitrations every six months. It could also discourage retail price competition, to the detriment of consumers.

4.6 While Optus accepts that it will need to collect the information needed by the Commission to calculate its price movements, it sees no reason to provide the

[2] ACCC letter, 15 August 2001, p. 12

Commission with this information outside the context of an arbitration. Optus has been able to strike attractive commercial deals with all carrier that terminate calls on our mobile network, and would ideally wish to continue to strike commercial deals. Given this commercial approach, Optus does not see any reason why the Commission would need to collect data, unless an access seeker actually launched arbitration against Optus.