



Mobile Services Review

Telstra's Initial Response to the Discussion Paper of the
Australian Competition and Consumer Commission

April 2003

Overview

Telstra welcomes this opportunity to respond to the Australian Competition and Consumer Commission's ("**Commission**") discussion paper which considers whether regulation of mobile services is appropriate under Part XIC of the Trade Practices Act 1974 ("**Act**") and, if so, the form that any such regulation should take.

This response is intended to be a preliminary one, addressing the main issue in the Commission's discussion paper, relating to the regulation of mobile terminating access services. The submission also touches on the Commission's comments relating to pass-through of reductions in mobile terminating access rates to fixed-to-mobile retail rates. Telstra may shortly comment further on other issues under discussion by the Commission, including in relation to mobile originating access, domestic roaming, international roaming and regulation of third generation mobile telephony services. Telstra also comments briefly on the Commission's pricing principles for mobiles service in this submission, but may comment in more detail on these in a further submission.

Telstra anticipates that the Commission's inquiry will publicly draw out two sets of opposing interests. On the one hand, there will be fixed network operators and resellers (e.g., AAPT, Primus and Powertel) who will be concerned about the costs of terminating calls on mobile networks and will tend to argue for lower terminating access charges. On the other hand, there will be dedicated mobile carriers (Vodafone and Hutchison) who are principally concerned about their own ability to cover network costs - reductions in mobile terminating rates may threaten their profitability. Telstra believes that these parties will be divided over mobile terminating access rates because of concerns about a wealth transfer from one group to the other. In contrast, carriers with both fixed and mobile networks (such as Telstra and Optus) have to balance these competing interests.

Having said this, Telstra does not believe that there is a case for continued regulation of mobile terminating access services and it does not believe that any of the concerns raised by the Commission could justify regulation. As the Commission would be aware, one of the major risks of regulation in a competitive market is the potential for that regulation to constrain investment, dampen incentives for technological innovation and slow market development. Since the mobiles market, as the Commission itself has previously noted, is a competitive one,¹ it does not make sense for the Commission to regulate this market.

If, however, the Commission is still concerned that mobile terminating access rates are too high and it does not want to cease regulation, then Telstra believes

¹ See, for example, ACCC Public Inquiry into Declaration of Domestic Inter-carrier Roaming under Part XIC of the Trade Practices Act 1974 - Final Report, March 1997; Pricing Methodology for the GSM Termination Service, ACCC Final Report, July 2001. In the Commission's Review of Price Control Arrangements (2001), the Commission noted that the supply of mobile services had become sufficiently competitive such that mobiles services could be removed from the existing broad price cap: p.17.

the regime could potentially be improved by a modest modification to the implementation of its pricing principles. This would be to calculate the mobile termination rate by making the relevant starting wholesale rate a uniform *industry* rate, rather than an individual carrier's wholesale charges; and to link that rate to industry retail price movements.

In its discussion paper, the Commission appears to raise two general concerns.

First, the Commission appears concerned that current mobile termination rates are set inefficiently high. For this to be correct, however, mobile operators must be pricing terminating access above the stand-alone cost of providing the service or they must be securing economic rents across their full range of mobile services. The Commission has not attempted to demonstrate either in their discussion paper. Even if the Commission were to demonstrate that economic rents are secured by mobile operators, it is far from clear that the regulation of mobile termination provides a solution. If it were found that the mobiles market was not effectively competitive, allowing economic rents to be earned, then a regulated reduction in mobile termination rates would presumably be met with an increase in the price of unregulated mobile services.

In Telstra's view, the mobiles market is competitive and hence it would be inappropriate to regulate mobile termination rates on the basis that they allow mobile operators to secure economic rents. Telstra's view on the highly competitive nature of the market accords with the views expressed by the Commission in its earlier inquiries into mobiles services. If anything, competition in the mobiles market has further intensified since these earlier findings by the Commission.

Second, if the Commission does believe that the mobiles market is effectively competitive, then its concern must be in relation to the profile of cost recovery across different mobile services. Specifically, the Commission must believe that mobile operators are recovering too high a proportion of their costs from mobile termination charges and too little from other wholesale and retail services. This is effectively a distributional issue, which the Commission's discussion paper does not address.

In Telstra's view, the distributional consequences of the current pattern of recovery across mobile services do not warrant the continued regulation of the mobile termination service. In contrast, it is Telstra's view that the current pattern of cost recovery is consistent with the objective of promoting economic efficiency.

The Commission's discussion paper expresses some concerns about the level of pass-through from mobile termination rates to fixed-to-mobile retail prices. Apart from the observation that it would appear inappropriate to consider this issue as part of the current review, rather than a retail price control review, Telstra believes that the Commission's concerns are generally unwarranted. Moreover, the solution alluded to could be potentially very harmful to investment and consumer choice in the mobiles sector and the long-term interests of end-users ("LTIE").

Fixed service providers compete in the full bundle of PSTN services including basic access, local calls, STD, IDD and fixed-to-mobile services. Given the high visibility of the retail prices of some services in the bundle and the relative demand elasticities of these services, fixed service providers may compete by choosing to flow through reductions in the cost of mobile termination to services in the PSTN bundle other than fixed-to-mobile calls. The retail price of fixed-to-mobile calls has relatively low visibility compared to a service like local calls and, as the Commission has elsewhere observed,² is relatively demand inelastic compared with services such as STD and IDD. Moreover, fixed-to-mobile calls are substitutable with a range of competing services, including mobile-to-mobile, SMS and, possibly, email. Why the Commission believes that there should be a rigid link between changes in the mobile termination rate and changes in the fixed-to-mobile retail price is unclear.

In Telstra's view, it would be detrimental to the LTIE if the Commission imposed regulation on the basis of a simplistic linkage between mobile termination rates and retail fixed-to-mobile prices, given that competition between fixed service providers is far more complex and is delivering substantial benefits to consumers.

Domestic GSM and CDMA Terminating Access Service

On reviewing section 5.1 of the Commission's discussion paper regarding the regulation of the domestic GSM and CDMA termination access service ("mobile termination service"), it is unclear to Telstra what the Commission's potential concerns are regarding the mobile termination services and accordingly the reasons why regulation may be in the LTIE.

In Telstra's view, it is impossible to provide a view on whether regulation is necessary and, if so, what form it should take without understanding exactly what the Commission views as the potential problem. It appears to Telstra that the Commission could have three potential concerns:

First, mobile operators are earning monopoly rents across their full operations and, as a result, the mobile termination rates and mobile retail prices also include a contribution to these rents, which is detrimental to the LTIE³.

Second, the Commission does not believe that mobile operators are earning monopoly rents, but is concerned about the pattern of cost recovery across mobile services chosen by the mobile operators. In other words, the Commission believes that the distributional consequences of the relatively high termination rates for fixed-to-mobile calls and the relatively low retail prices for outgoing mobile calls is not in the LTIE.

Third, the Commission is concerned about the relationship between mobile termination rates and the retail prices for fixed-to-mobile calls. Specifically, the

² See ACCC (2001), Report into the Pricing Methodology for the GSM Termination Service, p.18.

³ This was the basis on which OFTEL determined regulation of mobile termination charges in the UK was required. OFTEL conducted a study of the level of competition in the mobiles market and concluded that the mobiles market was not effectively competitive.

Commission is concerned about the extent to which any reduction in the mobile termination rate would be passed through to fixed-to-mobile retail prices.

These three possibilities are addressed below.

Commission concerns that mobile operators may be earning monopoly rents

Telstra notes that the Commission does not attempt to determine whether mobile operators are currently earning monopoly rents across their full operations and hence whether the mobile termination rate for fixed-to-mobile services includes any monopoly rents. Rather, the Commission examines the number of mobile operators, their market shares and capital expenditure, the growth rate of subscriber numbers, the trends in industry mobile revenue and retail price movements for mobile-to-mobile and fixed-to-mobile services, yet does not draw any conclusions from this in terms of the level of competition in the mobiles market, or the potential for earning monopoly rents.

While the Commission does state that it believes the price of the mobile termination service is above the efficient cost of providing the services, it does not provide any evidence substantiating this conclusion. For the price of the mobile termination service to be above efficient costs, it must exceed the stand-alone cost of providing the service, or it must allow mobile operators to secure economic profits across their full operations. As far as Telstra is aware, however, the Commission has not demonstrated that either of these situations exists.

Rather, it is Telstra's view that the Commission may simply mean that the mobile termination price is above some measure of fully allocated costs. However, as discussed below, this does not imply that the mobile termination price is set inefficiently high and does not, on its own, suggest that regulation of mobile termination charges would promote the LTIE. Telstra believes that the markets in which mobile services are provided are competitive and are becoming more so. There is scope for further market entry, including by resellers, thereby intensifying retail competition. As a result, Telstra does not believe that providers of mobile services are in a position to earn monopoly rents.

Unless the Commission is concerned that the level of competition in the mobiles market allows mobile operators to earn monopoly rents, there is no basis for regulating mobile termination services to eliminate or reduce these rents. Even if the Commission did find that mobile operators were earning monopoly rents, it is far from clear that regulating mobile termination prices addresses this problem. If the Commission really believes that the level of competition in the mobiles market is not effective, then simply reducing mobile termination prices would do little to prevent mobile operators from earning monopoly rents. If the mobiles market were not effectively competitive, then in response to a reduction in mobile termination rates, mobile operators could simply increase the price of other wholesale and retail services.

The pattern of cost recovery across mobile services

If the Commission does not believe that mobile operators earn excessive rents across their full operations, then it may still consider that regulation of mobile terminating rates is warranted to alter the pattern of cost recovery across mobile services. If mobile operators are not earning monopoly profits across their full range of services, then it must be the case that the revenue they earn does not exceed their costs. In this instance, the only possible justification for regulation is to force mobile operators to change the way they recover their costs across different services on the assumption that this is in the LTIE.

In Telstra's view, this comes down to a distributional issue, which the Commission's discussion paper does not address. In order to regulate mobile termination access to force mobile operators to recover less of their costs from mobile termination charges and more from other services (wholesale and/or retail), the Commission would need to demonstrate why potentially lower prices for fixed-to-mobile retail services and higher prices for mobile outgoing services would be a benefit to consumers.

It is Telstra's view that there are strong economic efficiency grounds for recovering more of the common costs of mobile operations from fixed-to-mobile calls than from outgoing mobile calls. As Telstra has submitted to the Commission previously, such a pattern of cost recovery is consistent with Ramsey pricing, as the demand for fixed-to-mobile services is more price inelastic than the demand for outgoing mobile services. In this regard, Telstra notes the Commission's comments in support of this position in its Report into the Pricing Methodology for the GSM Termination Service, where the Commission stated that its own market enquiries suggested that:

“... fixed-to-mobile calls may be relatively inelastic; that is, demand will not change greatly because of price movements...”⁴

OFTEL also agreed that Ramsey pricing was an economically efficient way of recovering fixed and common costs. In contrast to the Commission, however, OFTEL concluded that the mobiles market in the United Kingdom was not sufficiently competitive to motivate mobile network operators in setting termination charges above the level implied by Ramsey pricing.

In summary, Telstra does not believe that the regulation of mobile termination charges can be justified on the basis of distributional issues alone. That is, the current pattern of cost recovery across mobile services does not adversely impact the LTIE, and even if the Commission believed it did, the extent of the distributional effect, which is small and declining, does not warrant the regulation of mobile termination services. In contrast, Telstra believes the current pattern of cost recovery is efficiency-enhancing, as it minimises the distortions associated with the recovery of common costs.

⁴ p.18.

Pass-through to fixed-to-mobile retail prices

The third area where the Commission raises concerns is related to the relationship between changes in the wholesale mobile termination price and the retail prices charged to end-users for fixed-to-mobile services, what the Commission refers to as 'fixed-to-mobile pass through'.

At the outset, Telstra questions the relevance of pass-through to the continued regulation of the mobile termination service. If the Commission believes that the access regime operating under Part XIC is not the most appropriate approach to achieving the LTIE, then this is a separate issue to whether and how mobile termination should be regulated. The Commission appears to be suggesting that the regulation of mobile termination under Part XIC might not achieve the objective of the Act and hence **retail** regulation of fixed-to-mobile prices may be necessary.

As far as Telstra is aware, the Commission has never previously concerned itself with whether and to what extent changes in regulated wholesale prices have been passed through to retail prices when determining whether continued regulation is necessary and the form it should take. Telstra does not believe that it is appropriate for the Commission to consider retail price regulation as part of this review. Rather, the Commission should limit its consideration to whether continued regulation of the mobile termination service is consistent with the legislative criteria. That said, Telstra provides the following comments on the Commission's concerns regarding pass-through.

In Telstra's view, reductions in the mobile termination rates are adequately passed-through to consumers in the form of lower PSTN retail prices. It would be inconsistent with the objectives of the regulatory regime to impose a further layer of regulation on retail fixed-to-mobile prices to force the pass-through of mobile termination rate reductions.

Competitors providing fixed-to-mobile retail services compete in the provision of the full bundle of PSTN services, including basic access, local calls, STD calls, IDD calls and fixed-to-mobile calls. The current regime provides the flexibility for competitors to flow through reductions in the cost of providing this bundle of services in a manner that provides the greatest benefit to end-users.

For example, given the visibility of individual services in the bundle of fixed PSTN services, fixed service providers may choose to compete more aggressively by passing through reductions in the cost of mobile termination in the form of lower prices for services in the PSTN bundle, other than fixed-to-mobile calls. Given that the retail price of local calls is highly visible in the bundle of fixed PSTN services, and is used by service providers to attract customers through their marketing campaigns, fixed service providers may choose to use a reduction in the cost of mobile termination to reduce the price of local calls and even loss-lead on local calls, a practice widely observed in the market.

In addition, the way fixed service providers flow through reductions in the cost of mobile termination to end-users is also likely to be guided by the relative demand elasticities of PSTN services. For example, a service provider competing

in the provision of PSTN services might pass through a reduction in the level of mobile termination rates in the form of lower local, STD and/or IDD retail prices. This would be expected to benefit end-users more than a reduction in fixed-to-mobile retail prices because of the higher price elasticities of demand of the other retail services.

Viewed in another way, just because fixed service providers compete aggressively on the full bundle of PSTN services, does not mean that reductions in mobile termination rates are not being flowed through to consumers. Telstra considers it would be unfortunate for Australian consumers if the Commission regulated the retail price of fixed-to-mobile calls on the basis of a simplistic comparison between changes in mobile termination rates and the retail price for fixed-to-mobile calls, when the nature of competition between fixed service providers is far more complex and delivers large benefits to Australian consumers.

In Telstra's view, requiring a rigid link between movements in mobile termination rates and fixed-to-mobile retail prices would limit the flexibility in the way competition occurs to the detriment of end-users. Telstra believes that the current price control regime, which includes fixed-to-mobile prices in the wider basket, is the most appropriate form of regulation. It provides Telstra and hence other competitors the flexibility to price services within the full PSTN bundle in a way that delivers the highest benefit to consumers. The introduction of more specific retail price controls, such as forced pass-through of mobile termination rates to fixed-to-mobile retail prices, would limit this flexibility and hence would be inconsistent with the broadly accepted view that wider price-caps are more efficient.

Pricing Principles

Telstra wishes to make some brief comments on the Commission's pricing principles and it may provide more detailed comments in another submission. While Telstra does not believe that the Commission has produced evidence to show the need for ongoing regulation of mobile services, the Commission may be concerned that mobile terminating access rates are too high and, for that reason, it may not want to cease regulation.

If so, then Telstra believes the regime may potentially be improved by a minor modification to the implementation of its pricing principles. As the Commission is aware, under the current mobiles pricing methodology, wholesale rates are linked to variations in retail rates. The limitation of this methodology, however, is that it provides little incentive for some carriers to lower either their wholesale *or* their retail rates. First, the absence of a uniform industry rate means that mobile carriers who wish to maintain high individual wholesale charges are under no imperative to lower their wholesale prices. Second, those same carriers face no commercial incentive to lower their retail prices either. An amendment that makes the relevant starting wholesale rate an *industry* rate and which links that rate to the industry's retail price movements, would potentially address this problem.