Pricing Methodology for the GSM Termination Service

Telstra's Submission to the ACCC's Draft Report

2 February 2001

1 Introduction

Telstra welcomes this opportunity to respond to the Australian Competition and Consumer Commission's ('the Commission') draft report on GSM termination pricing methodology. In recognition of the lengthy investigative period preceding the Commission's draft report and the expense of all parties involved in the process, Telstra anticipates that the Commission can now move quickly to finalise its pricing principles for GSM termination.

Telstra's view remains that the mobile industry is highly competitive and set to become more so. As a result, Telstra believes that regulation of mobile termination charges is unnecessary and potentially harmful to the long-term interests of end-users.

While the Commission's view clearly differs, with the proposed pricing principles based on the assumption that mobile operators are earning monopoly rents, Telstra nevertheless welcomes the Commission's conclusion that a light-handed approach to regulating mobile termination charges is appropriate.

However, Telstra has some serious concerns regarding the Commission's proposed benchmarking approach to mobile regulation. In addition to problems associated with implementing this approach, Telstra believes that linking mobile termination rates to mobile retail price reductions may limit the flexible and innovative pricing that has characterised the mobiles market to date. In Telstra's view, the Commission's objective of reducing mobile termination rates can be achieved in a less costly manner by adopting a CPI-X approach as proposed in Telstra's various submissions to the Commission on this issue.

If the Commission continues to disagree with Telstra's proposed approach and instead adopts the benchmarking approach in its final pricing principles, then Telstra urges the Commission to address the implementation issues discussed in this submission when formulating its final pricing principles for GSM termination.

The remainder of this submission is divided into three sections. First, Telstra sets out why forbearance is its preferred approach to regulating GSM termination and urges the Commission to reconsider its views. Second, a number of problems associated with the Commission's benchmarking approach are examined including implementation issues, which Telstra believes need to be urgently addressed if the Commission is to continue with its proposed approach. Third, Telstra discusses an alternative approach that was overlooked by the Commission in its draft pricing principles paper. In particular, this section explains why a CPI-X approach can achieve the same outcomes as the Commission's proposed benchmarking approach at a lower cost to end-users.

2 Regulation of GSM termination

As a general matter, Telstra is strongly of the view that where markets are working effectively, regulatory intervention should be avoided or at least kept to a minimum. As Telstra has demonstrated in many earlier submissions to the Commission, the markets in which mobile services are provided are highly competitive, and are becoming even more so. Indeed, it is for this very reason that the Commission has proposed to withdraw mobile services from the price control regime.

For these reasons, Telstra raises the question of whether regulatory intervention in determining pricing principles for GSM access is required at all. In particular, in considering the need for specific pricing principles, the Commission should be mindful of the effect on competition and the long-term interests of end-users.

For example, an immediate reduction in termination rates, while possibly delivering short-run gains to consumers in the form of lower fixed to mobile retail prices, may discourage new mobile entry, limit investment by existing operators, increase mobile handset charges and possibly increase mobile-to-mobile and mobile-to-fixed charges.

As increasing competition is highly likely to deliver reductions in GSM termination rates – with flow ons to retail charges - in the near future, it is Telstra's view that specific pricing principles for GSM termination are unnecessary and inappropriate.

While the Commission identifies a number of factors that it suggests could result in inefficiently high termination rates, as far as Telstra is aware, this has not been demonstrated. In Telstra's view, the Commission should provide its justification for assuming that mobile termination rates and retail prices are currently set at inefficiently high levels, before implementing any regulation of mobile termination rates. Telstra believes this is particularly important given such evidence as the Productivity Commission's most recent international benchmarking report, which found that fixed to mobile charges in Australia were second lowest amongst the ten countries examined, with rates two thirds those observed in the United States and half those in the United Kingdom.[1]

If the Commission proceeds with regulation, despite Telstra's concerns, then it is critical that the Commission adopt a mechanism for determining access prices that minimises distortions, in the interests of maximising the long-term interests of end-users. The following sections indicate why Telstra believes the proposed benchmark approach is likely to introduce unnecessary distortions and sets out an alternative light-handed regulatory approach to determining GSM termination charges.

3 Benchmark approach

Telstra welcomes the Commission's attempt to move away from the administratively costly cost-modelling approach to setting access charges for the mobile termination service. However, Telstra is firmly of the view that there are a number of significant implementation difficulties as well as the potential for significant new distortions associated with the

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[1] Productivity Commission, 1999 (December), *International Benchmarking of Telecommunications Prices and Price Changes*, www.pc.gov.au, p. 24, fig 3.1(d).

ACCC's proposed benchmarking approach that have not been considered carefully in the draft report. Specifically:

- Telstra is sceptical about using the lowest industry-wide mobile termination price to set the initial mobile termination rate. Telstra submits that an industry-wide weighted average of fixed-to-mobile termination prices would be a more appropriate approach to determining the initial rate;

- It remains unclear to Telstra how the Commission proposes to construct the termination price deflator. Telstra envisages significant difficulties in the construction of a robust approach; and

- Most importantly, Telstra is very concerned about the perverse incentives that the proposed benchmark approach will introduce to the detriment of competition in the market for the supply of mobile services.

Telstra expands on each of these concerns below.

3.1 The determination of the initial GSM termination price

The first step in implementing the benchmark approach proposed by the Commission is to determine an initial termination price from which to base future adjustments. To do this the Commission proposes to take the lowest industry-wide mobile termination price.

Telstra believes that such an approach could result in an artificially low starting point and hence may be inconsistent with cost recovery. There are many reasons why carriers might offer special mobile termination rates, even below the TSLRIC of supplying those services.

For example, when two carriers negotiate prices for access to each other's networks or services, it is common for the parties to negotiate over a bundle of services, not charges for individual services such as mobile termination services. In addition, a number of factors can be taken into consideration in determining the appropriate mobile termination rate including volume discounts, contract lengths and quality requirements. As a result, Telstra believes that taking the lowest mobile termination rate across the whole industry as the starting point for all mobile termination rates is inappropriate. Instead, Telstra proposes that the initial termination price be a traffic weighted average of industry mobile termination prices.

3.2 The measurement of GSM retail prices

Subsequent to the Commission's determination of an initial mobile termination price, it is proposed that the mobile retail prices of each individual firm be assessed and, based on this assessment, the price deflator to apply to the mobile termination rate would be determined. It remains unclear to Telstra, from the Commission's draft report, how the Commission proposes to determine such a deflator. Consequently, it is difficult to provide any detailed response on this part of the proposed benchmarking approach.

Nevertheless, Telstra draws the Commission's attention to the difficulty of determining an average price in the mobile market given the vast menu of prices for many services and the many bundles of services that each carrier supplies, including subsidised handsets and additional value-added services. The Commission is likely to find it difficult and expensive to calculate an average of these mobile retail prices and to recalculate the average as these prices change.

Consequently, changes in average mobile revenue for each carrier could make a more appropriate termination price deflator. However, even in calculating average revenue figures, significant practical difficulties will be encountered. For example:

- The Commission would need to determine which metric to utilise for weighting purposes: minutes or services in operation. The former will favour carriers that have predominantly high volume users, while the latter will favour carriers with large numbers of low volume, prepaid type customers;

- The Commission would need to determine how it factors in the various additional services that come with a mobile phone service, ensuring that it is comparing like with like. Ignoring services such as Messagebank and SMS will favour carriers that provide very basic services. Newer services such as data access and WAP further complicate this process;

- More generally, the Commission will need to determine the amount of revenue to attribute to mobile services supplied as part of a bundle of services. This will prove to be an increasingly significant problem with the joint provision of fixed, mobile and Internet services occurring more often; and

- In the case of Telstra, revenues earned from mobile phones that are provided to customers as a substitute for landlines in accordance with meeting the Customer Service Guarantees and the USO (in the context of interim services) must be excluded from the price deflator calculations. It is not clear how this could be achieved. If such services are not excluded then the ability to meet these Customer Service Guarantees and USO commitments will be dependent on the effect that the commitment has on mobile termination rates.

3.3 Potential impacts on retail prices

Telstra is concerned about the perverse incentives that the benchmark approach could introduce, to the detriment of competition in the market for the supply of mobile services.

To begin with, Telstra submits that linking the initial mobile termination charge to the lowest mobile termination price may have an immediate impact on the incentives of access providers to negotiate lower mobile termination rates. Further, linking reductions in mobile termination rates to mobile retail prices could inhibit the development of innovative pricing packages such as free minutes of use during off-peak periods as such packages would flow through to lower mobile termination rates. Instead, mobile operators are likely to avoid the flow through impact by offering discounts in ways that do not impact the mobile termination rates. Such an outcome in inconsistent with the efficient use of the mobile network and with the long-term interests of end-users.

The benchmark approach will also impact on customer selection. If revenues are considered in the calculation of the termination price deflator, carriers could have an incentive to drop low-value subscribers, such as prepay subscribers, as they will have an adverse effect on the average price and, therefore, the regulated termination price. Telstra believes that such an outcome would be inconsistent with the long-term interests of end-users.

Finally, the benchmark approach could distort longer-term investment decisions. Depending upon how the initial termination rate is determined and how the price deflator is set, there is no guarantee that regulated termination rates will remain consistent with the principles of cost recovery. Moreover, decisions about bringing new services to market may be distorted by the way the revenues these services generate are included in the termination price deflator calculation.

Telstra submits that until these distortions are carefully considered the potential costs from the proposed model cannot conclusively be said to outweigh the costs of the alleged inefficiently high termination charges.

4 An alternative approach

Given the implementation difficulties and incentives problems that beset the benchmark approach, Telstra proposes that the Commission instead consider a CPI-X approach to pricing GSM termination services. Telstra submits that a CPI-X mechanism involves more manageable implementation than the Commission's proposed benchmark approach and provides efficient incentives that are consistent with maximising the long-term interests of end-users.

- Telstra submits that the CPI-X mechanism is likely to be more easily implemented than the benchmark approach. The Commission need only consider the consumer price index, published at regular intervals by the Australian Bureau of Statistics, and an appropriate X value reflecting forecast reductions in the unit cost of providing mobile termination services.

The CPI-X approach also differs from the Benchmark approach in terms of the incentives faced by carriers. The CPI-X approach would provide mobile carriers with the incentive to reduce costs and would avoid the potential for the harmful distortions that would result by linking mobile termination rates to mobile retail prices.

5 Conclusion

In conclusion Telstra does not share the Commission's view that regulation of mobile termination rates is necessary and in the long-term interests of end-users. Telstra has made these opinions obvious to the Commission but to little affect. Therefore, if the Commission is intent on regulating mobile termination rates then Telstra submits that it is critical that the Commission adopts a mechanism for determining access prices that minimises distortions in the interests of maximising the long-term interests of end-users.

While Telstra welcomes the Commission's recognition that a light-handed approach is appropriate to regulating mobile termination rates, Telstra believes there are a number of significant implementation issues and possible distortions that could seriously undermine proposed benchmarking approach.