Non-confidential Submission on the draft decision of the ACCC on the declaration of the mobile terminating access service

30 April 2004

1. Overview

1.1 Summary of submission

Virgin Mobile (Australia) Pty Ltd (**Virgin Mobile**) appreciates the opportunity to make submissions on the Commission's draft decision to vary its existing declaration of the mobile terminating access service, dated March 2004.

Virgin Mobile understands that the Commission has decided that the declaration of the varied mobile termination service and the application of the Commission's pricing principles as varied in the draft decision would be in the long term interests of end users (**LTIE**) of carriage services, specifically by enhancing competition for fixed to mobile services.

However, the draft decision will not necessarily achieve this outcome and has implications for competition in the wider telecommunications industry. Specifically the proposal to move away from retail benchmarking prices to the introduction of a target price, in Virgin Mobile's submission, is likely to lead to a reduction in competition rather than an increase in competition in the medium to longer term. This is because it fails to consider the impact of the draft decision on niche providers of retail mobile services such as Virgin Mobile.

At the very least, the proposal to amend the pricing principles is likely to have a significant and disproportionate impact on the commercial viability of Virgin Mobile. This is because of its particular position in the relevant markets and vulnerability as a relatively new entrant in those markets and so would, as a result, inhibit its ability to constrain the behaviour of its competitors. [Confidential].

Neither of these outcomes would be in the long term interests of end users of retail mobile services.

Virgin Mobile does not believe that the draft decision is in the LTIE and is concerned that it does not analyse in any detail the actual cost of providing the mobile terminating access services. Virgin Mobile is concerned that the Commission's process of consultation and review of relevant considerations is being truncated to the point where due consideration is not being given to the potential very serious impacts of the draft decision. These may go to the survival of vigorous and effective competitors which have demonstrably resulted in benefits to end users of retail mobile services.

Virgin Mobile's submission focuses on the impact the amended pricing principles will have on Virgin Mobile and competition for retail mobile services.

Virgin Mobile would appreciate an opportunity to discuss this issue and the proposals outlined in this submission with the Commission before it makes its final decision to ensure that the Commission's decision takes into account all relevant matters in making its final decision.

1.2 Confidentiality

Virgin Mobile provided a confidential submission to the Commission on 30 April 2004. This is the non-confidential version of that submission.

1.3 Structure of submission

Section 2 provides an outline of Virgin Mobile’s unique position in the market involving the supply of retail mobile services.

Section 3 outlines the effect the draft decision would have on Virgin Mobile.

Section 4 outlines the effect of the draft decision on competition in relevant markets.

Section 5 proposes two alternative ways of addressing the issues raised by the draft decision.

Section 6 contains Virgin Mobile's concluding submissions.

2. Virgin Mobile

2.1 MVNO

Virgin Mobile provides retail mobile services as a mobile virtual network operator (**MVNO**) using the Optus mobile network. There are several features of the MVNO structure that distinguish Virgin Mobile’s business model from that of a traditional telecommunications reseller, and which are relevant to the Commission’s consideration of the impact of the draft decision on Virgin Mobile. This Virgin Mobile MVNO model:

- is a hybrid between the full service carrier and reseller models. While Virgin Mobile does not own the network on which it operates, it does own fundamental network elements such as short message service centres and rating engines to which licence fees and maintenance costs attach. Virgin Mobile therefore has larger capital requirements than do traditional telecommunications resellers;
- enables Virgin Mobile to operate with a lower infrastructure cost than do full service carriers, which in turn allows it to operate on smaller margins and provides a significant competitive constraint on full service carriers;
- relies on reductions in mobile termination rates being passed through from the carrier to Virgin Mobile, unlike the approach taken in a reseller arrangement. The Virgin Mobile MVNO model therefore relies on pricing from the carrier remaining competitive. [Confidential]
- enables Virgin Mobile to deliver unique offers, not just rebill Optus offers.

Using this structure Virgin Mobile has been able to offer a retail mobile service under the Virgin Mobile brand in competition with Optus and other retail mobile service providers.

2.2 Characteristics of Virgin Mobile's customers

Virgin Mobile offers a range of retail mobile services, including pre-paid and post-paid mobile carriage services and a number of mobile value added services. It does not offer any fixed line, broadband or internet services.

Virgin Mobile has positioned itself as a niche provider of retail mobile services, offering a range of services without complicated terms and conditions and at competitive prices. Those services have attracted young people and price conscious consumers.

In Virgin Mobile's experience, these types of customers tend to use pre-paid services and are high users of SMS. This is reflected by the fact that over [confidential]% of Virgin Mobile’s revenue is derived from its pre-paid customers and [confidential] to [confidential]% of the revenue Virgin Mobile receives from its customers is generated from SMS services. **Attachment 1** [confidential].

One reason such a high proportion of services used by Virgin Mobile customers are SMS services may be because in many cases it is cheaper to send an SMS than make a telephone call. Virgin Mobile believes that there is also a tendency among young people and other price conscious customers to use SMS for the purpose of asking the recipient to call the originator of the SMS. Virgin Mobile’s research demonstrates that it has a higher penetration and average use of SMS than the industry average, and has [confidential] higher proportion of incoming voice minutes than outgoing voice minutes. As a result, Virgin Mobile customers are net receivers of telephone calls. For each minute of outgoing voice usage by customers, Virgin Mobile receives [confidential] minutes of mobile terminating voice traffic.

These factors account for over [confidential] of the revenue generated by Virgin Mobile in the last financial year being generated from mobile terminating access charges.

3. Effect of the draft decision on Virgin Mobile

3.1 Virgin Mobile is a vigorous and effective competitor

It is well recognised in the industry that Virgin Mobile, although a relatively new entrant, has been a vigorous and effective competitor in the supply of retail mobile services through offering innovative products that have contributed greatly to the take up of mobile services in its market segments and the reduction in retail mobile prices. Its success has resulted in part from its positioning as a niche provider of retail mobile services to young people and/or price conscious consumers.

By offering innovative products at competitive prices, Virgin Mobile has made a significant contribution to competition for retail mobile services. In addition to Virgin Mobile customers benefiting from receiving lower prices for retail mobile services, consumers more generally have benefited from Virgin Mobile's product offerings as its products and prices have caused its competitors to reduce their prices.

For example, Virgin Mobile has noted a correlation between the introduction in 2003 of 5c Virgin to Virgin text messaging and the subsequent promotion by “3” of 15c text and the introduction by Telstra of a “50 free SMS” offer.

3.2 Effect of the draft decision on Virgin Mobile

Virgin Mobile is a relatively new entrant and is working towards becoming a sustainable competitive provider of retail mobile services. The implementation of the draft decision will have a serious and disproportionate impact on Virgin Mobile for the following reasons:-

(a) The proposal in the draft decision to amend the Commission's pricing principles so that the price of mobile terminating services is reduced to a target of 12 cents per minute over the period from 1 July 2004 to 1 January 2007 will have a dramatic impact on Virgin Mobile's revenue. [Confidential].

(b) As Virgin Mobile is a mobile only provider, not a fixed and mobile network operator, it has no ability to balance the charges for incoming and outgoing calls, and receives no corresponding benefit in the reduction of input costs for fixed to mobile calls. [Confidential] the effect of the draft decision will be felt most acutely by Virgin Mobile and as a result it will require an appropriate amount of time to adjust its business plans to counteract this impact and remain viable.

(c) Virgin Mobile has been able to compete in such a vigorous and effective way primarily because of the structure of the services it offers and the prices for those services. The draft decision will have a significant and disproportionate impact on Virgin Mobile precisely because it has the effect of penalising operators such as Virgin Mobile who offer only mobile services and its customers are net recipients of calls.

3.3 Possible alternative sources of revenue

Virgin Mobile has anticipated ongoing reductions in mobile terminating revenue and recognises that over time it will have to supplement revenue from mobile terminating access charges with other sources of revenue. However, its current business plans do not account for the dramatic impact the proposals in the draft decision will have on Virgin Mobile's revenue. This is of particular concern presently as Virgin Mobile is a new entrant which only achieved a positive EBITDA in the third quarter of 2003 and is competing in a market where the incumbent retains substantial market power.

The Commission has identified some alternative sources of revenue to replace the loss of a proportion of mobile termination revenue and Virgin Mobile has considered whether there are any alternative sources of revenue it could generate over the short term to offset the impact of the proposals in the Commission's draft decision.

There is no alternative revenue source which will enable Virgin Mobile to offset the dramatic and significant impact on Virgin Mobile of the draft decision over the short term. In particular:-

- The Commission’s suggestion of increasing the cost of retail mobile calls originating from the Virgin Mobile network is not a viable alternative for Virgin Mobile without losing customers. This is particularly so as Virgin Mobile has built its brand around being the consumer champion and so its customers are less likely to accept an increase from Virgin Mobile than from other carriers. As noted by the Commission, retail prices of mobile calls do not appear to have increased in the UK.

- Virgin Mobile does not operate a fixed network and so cannot increase the cost of originating fixed to mobile calls or offset reductions in the wholesale mobile terminating revenue stream with margin increases in fixed to mobile calls. In any event, this would be inconsistent with the Commission's expectation that the cost of fixed to mobile services will decrease as a result of the implementation of the proposals in the draft decision.

- The Commission has noted opportunities for mobile providers to achieve revenue growth through other sources such as data and international roaming. Virgin Mobile’s revenue from sources other than voice usage are[confidential] – less than [confidential] % each for international roaming and data services (see Attachment 1);

- International roaming is unlikely to be a source of significant revenue growth for Virgin Mobile. A large proportion of Virgin Mobile's customer base consists of prepaid customers, and these are not permitted to roam internationally. In addition, young consumers and price conscious customers tend to be less likely to travel overseas on a regular basis and to use their mobile phone when they do so.

- Virgin Mobile acknowledges that over the longer term, new data services will provide alternative sources of revenue growth. Virgin Mobile launched its MMS service in December 2003. Further time is needed to develop this as an alternative source of revenue. Although Virgin Mobile is actively promoting MMS services, it does not share the Australian Communications Authority's optimism about the take-up of MMS and the number of MMS capable handsets is low in Virgin Mobile's existing customer base.

- Handsets with new functionality are generally higher priced. Prepaid customers (who represent a high proportion of Virgin Mobile's customers) historically look for low priced entry into the market. Until new functionality becomes widely available on lower priced handsets, many prepaid customers are precluded from participating in the use of services such as handset originated MMS.

- [Confidential]

As a result, the implementation of the draft decision will seriously damage Virgin Mobile's ability to develop into a sustainable competitive provider of retail mobile services. This may mean that Virgin Mobile will be unlikely to continue to exert an effective competitive constraint on the prices and quality of retail mobile services. [Confidential]

4. Effect of the draft decision on the LTIE of mobile services

4.1 Effect of the draft decision on competition

In determining whether the declaration of the mobile terminating access service and pricing principles that apply to that service is in the LTIE of carriage services, the Commission must consider a number of factors including whether the declaration will promote competition in markets for relevant services, which include retail mobile services.

Virgin Mobile submits that the proposed amendment to the pricing principles is not in the LTIE as it will not necessarily promote competition for any listed services, particularly fixed to mobile services and is likely to lead to a lessening of competition in retail mobile services.

The Commission in its draft decision states that it expects that the decision will increase competition in the market for fixed to mobile services and that this increase in competition would:

> *"create pressures on all providers of this service to pass-through reductions in the price of the mobile termination service to end-users"*.

There is no guarantee that these pressures will be created and the decision has implications for the mobile industry more generally, in particular the supply of retail mobile services.

4.2 Competition in retail mobile services

Virgin Mobile believes that competition for retail mobile services is increasing. New products are being offered and prices have decreased substantially since deregulation in 1997. Competition at the retail level has been driven by a number of factors, including the increase in the range of products and the vigorous competition from niche operators such as Virgin

Mobile.

This view is supported by the Productivity Commission in its *Telecommunications Competition Regulation,* Inquiry Report No. 16, 21 September 2001:

> *"The mobile services market appears to exhibit characteristics of an effectively competitive market as evidenced by the following key structural and performance indicators:*
>
> - ...
> - *At the retail level, ... there appears to be significant competition between network operators and the resellers as evidenced by the increased range and features of product offerings and trend towards lower retail prices for mobile calls" (page 132).*

The Commission itself acknowledges that there are over 700 mobile telephone plans available to end users. A benefit from the current way in which the service is regulated (including the current pricing principles) is that the current regulations have encouraged the uptake and usage of mobile services through low initial charges and call rates, including low handset costs to end users. This may provide longer term benefits by creating dynamic efficiencies in the mobile market.

The Commission does not appear to have analysed comprehensively how the draft decision (if implemented) will impact competition for retail mobile services and particularly its potential effect on the participants, such as Virgin Mobile, which provide a strong impetus for competition and which in turn ultimately benefits end users.

Virgin Mobile submits that the implementation of the draft decision will inhibit the development of competition for retail mobile services for the following reasons:

(a) The beneficiaries of the draft decision will be the vertically integrated fixed and mobile network operators and the fixed network operators that do not have mobile networks or MVNOs. Operators such as Virgin Mobile who do not have a fixed network and so not only will not receive any benefit from the decision but also do not have the incentive or ability to raise the costs of rival providers of fixed to mobile service, stand to be adversely affected most by the draft decision.

(b) The implementation of the draft decision will seriously impact the ability of Virgin Mobile to continue to offer competitive prices for retail mobile services as its revenue from mobile terminating access services will decrease dramatically over a relatively short time frame.

(c) As a result, Virgin Mobile will be in a position where it is not able to exert the same competitive constraint on other operators as it has done so since it commenced operations.

Virgin Mobile submits that implementation of the draft decision is likely to have a chilling effect on the current vigorous competition in the market for the supply of retail mobile services. This detrimental effect on competition will ultimately not be in the LTIE as niche providers such as Virgin Mobile find it more difficult to compete and [confidential]. In the medium to long term, therefore, competition is not likely to be increased by the implementation of the draft decision and for this reason the draft decision is not in the LTIE.

5. Pricing issues

5.1 12c target is inadequately substantiated

Virgin Mobile does not agree with the approach proposed by the Commission to reducing mobile terminating access charges and is concerned that the Commission has not provided evidence that 12 cents per minute reflects the cost of providing the service. Virgin Mobile submits that the Commission should explain comprehensively how it arrived at the 12 cents per minute target.

5.2 Alternative possible pricing approaches

Virgin Mobile submits that, if the draft decision is to be implemented, it should be implemented in a way which minimises the adverse impact of the draft decision on competition. Virgin Mobile proposes that the Commission adopt pricing principles which:

(a) reflect the cost of providing the service; and

(b) do not cause the significant and disproportionate impact on the viability of niche retail mobile providers such as Virgin Mobile.

These objectives could be achieved by adopting either one of the following proposals:

- The Commission could adopt a CPI-X% pricing methodology. This methodology may more appropriately reflect the cost of providing the mobile terminating access service. Further work would have to be done to determine what "X" should be. This proposal would allow the prices to be smoothly reduced in accordance with the cost of providing the service, and would have the dual advantages of:
    - not presupposing a target price (or at least allowing the Commission the opportunity to conduct further investigation to accurately determine and substantiate the appropriate target price); and
    - ensuring a steady decline in the real price of wholesale mobile terminating rates.
- Should the Commission be able to provide adequate justification for nominating 12 cents as its preferred target, another alternative may be to alter the trajectory of the reduction path. This would minimise the 'revenue shock' during the earlier years of the implementation period while maintaining the amount of the target and retaining the final date by which it is to be implemented. This would enable the Commission to achieve its stated 12 cents per minute target over the same period of time but uses smaller initial - and gradually larger - incremental reductions over the period. This would be likely to cause less damage to Virgin Mobile during the implementation period.

Under this proposal, the reductions would take place in accordance with the following timetable:-

Time	Amount
1 July 2004	21.0 cents
1 January 2005	20.0 cents
1 July 2005	19.0 cents
1 January 2006	18.0 cents
1 July 2006	16.0 cents
1 January 2007	12.0 cents

Although this proposal is not ideal, it would at least allow Virgin Mobile to develop alternative sources of revenue without having to deal with such a dramatic reduction in revenue each year.

5.3 Comment on the Hutchison proposal

Virgin Mobile notes that on page 170 of the Draft Decision that the Commission has invited comments from interested parties as to the suitability of a mechanism proposed by Hutchison whereby reductions in mobile termination prices would be linked to prices charged in the retail market for fixed to mobile services.

Virgin Mobile would not support the use of this type of mechanism for the following reasons:-

- It would be operationally awkward to introduce, measure and manage.
- It provides no discernible benefit to a mobile only operator in that it implies an ongoing higher rate of termination for a mobile only operator than a fixed to mobile operator.
- Virgin Mobile believes a more effective means of bringing about a reduction in retail fixed to mobile prices would be to introduce a sub-basket of calls into the existing Telstra price control regime.

6. Concluding submissions

Virgin Mobile submits that the implementation of the draft decision will not be in the LTIE and Virgin Mobile believes that the Commission has not taken into account all relevant matters in making the draft decision.

Specifically, the proposal to move away from retail benchmarking prices to the introduction of a target price is, in Virgin Mobile's submission:

(a) unlikely to put pressure on providers of fixed to mobile services to pass-through reductions in the price of mobile telecommunications services to end users;

(b) likely to have a significant and disproportionate impact on the commercial viability of Virgin Mobile because of its particular position in the relevant markets and vulnerability as a relatively new entrant that is a net recipient of mobile calls, which will adversely affect its position in the market as a vigorous and effective competitor; and

(c) likely to lead to a reduction in competition in the market for retail mobile services as a result of the impact on the commercial viability of Virgin Mobile and loss of the constraint it currently exerts on competitors in this market.

These matters are relevant matters which should be taken into account by the Commission in making its final decision on declaration of the mobile terminating access service and the pricing principles to apply to that service.

Attachment 1 - [confidential]