SUBMISSION TO THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

Supplementary submission to ACCC Draft Decision

Mobile termination access service

1 June 2004

1 Introduction

This submission represents Vodafone's supplementary submission to the Australian Competition and Consumer Commission's (Commission) Draft Decision on the mobile terminating access service. This submission is therefore in addition to Vodafone's preliminary submission to the Commission of 30 April 2004 and also letters that Vodafone has sent to the Commission on 1 April, 16 April and 28 April 2004.

In its preliminary submission, Vodafone flagged to the Commission, that due to the short timeframe available for response and also the complexities of the Draft Decision, it intended to provide further information to the Commission on various matters. Even though Vodafone is submitting this submission one month after the deadline for imposed by the Commission, Vodafone's view remains that the short timeframes available to respond has affected our ability to fully consider the issues raised.

This submission provides further information on:

- Market Definition
- An analysis of the competitiveness of the outbound mobiles market
- An analysis of the likely impact of the Draft Decision on competition in the mobiles market and also the market in which F2M calls are provided
- International benchmarking of mobile termination rates
- Service description
- Pricing principle and 'pass through'

Since the release of the Draft Decision, the Commission has released further information in relation to the basis of its 'target price range'. These related to:

- The methodology used to calculate a cost proxy using data from Telstra's Regulatory Accounting Framework (RAF); and also

- A model referred to in the Draft Decision as that done by an Australian carrier and submitted on a commercial in confidence basis to the Commission.[1] This model has been provided to Vodafone.

Vodafone therefore also comments on these two matters in this supplementary submission.

2 Service Description

The Commission has decided in its Draft Decision that both F2M termination and mobile to mobile termination should be included in the service description and therefore included within the declaration. As Vodafone stated in its preliminary submission, Vodafone does not believe that the declaration should cover mobile to mobile termination.

The Commission's reasoning to include mobile to mobile termination essentially comes down to two points:

- That the service of F2M termination is "largely the same" as M2M termination;[2] and
- That declaration of the mobile termination service will promote the objective of any-to-any connectivity as it "protects new entrants and small operators from being refused access to the mobile termination services of other operators.[3]

The Commission appears to be less concerned with the potential competitive impacts of not declaring or publishing a pricing principle for the mobile to mobile termination service.

Vodafone does not believe declaration of mobile to mobile termination is justified for the following reasons:

- The fact that the service is "largely the same" is no justification to regulate it. Regulation should only be implemented where it is justified and where it is addressing a market failure. While Vodafone does not believe that declaration of mobile termination is necessary at all, Vodafone believes there

[1] ACCC, Draft Decision, page 59.
[2] ACCC, Draft Decision, page 24.
[3] ACCC, Draft Decision, page 108.

is significantly less justification for regulating mobile to mobile termination service compared to fixed to mobile termination;

- The declaration of mobile to mobile termination will not promote competition in the mobile services market, as it is likely that traffic between carriers is likely to be symmetric. This therefore means that the level of mobile to mobile termination prices cannot affect competition in the market;
- Vodafone does not believe regulation is necessary on the basis of promoting any-to-any connectivity. Given the transiting arrangements that already exist and the number of players in the market, Vodafone considers it is highly unlikely that a new entrant would be refused access by all carriers. Once a new entrant has negotiated an access agreement with one carrier, transiting arrangements mean that they have access to all carriers. Vodafone also understands that transiting arrangements would mean that the new entrant would gain access on terms and conditions that were not materially different from those that would prevail if the new entrant interconnected directly with all established carriers. Indeed, not all carriers interconnect with each other today and there is no evidence that the any-to-any connectivity objective has been compromised;
- Further, even if you accept the Commission's arguments that existing carriers would have a low incentive to interconnect with a new entrant, there would be no reason for an existing carrier to refuse to interconnect with a new entrant once the new entrant has negotiated an arrangement with one established carrier; and
- Vodafone is not aware of any access disputes between existing and new entrants in relation to mobile to mobile termination. If there have not been any disputes, Vodafone does not accept the Commission's argument that an established carrier would have an incentive to refuse to interconnect with a new entrant.

3 Market definition and competition

On 24 April 2004, Vodafone provided to the Commission a paper prepared by Frontier Economics titled "*Analysis of Markets and Competition in the ACCC Mobile Services Review Draft Decision*." This paper, prepared on behalf of Vodafone,

provides further substantive material supporting its view that the Commission has defined the market too narrowly and it should have defined the market as a broader mobiles services market. The paper also provides further justification that there is likely to be a negative impact on competitive pressures in the mobiles market.

4 Efficient use of infrastructure

A further paper has been prepared by Frontier Economics, on behalf of Vodafone, on the issue of efficient use of infrastructure with particular attention to the issues of Ramsey pricing and externalities. That paper is attached to this submission.

5 Pricing principle

As Vodafone has expressed to the Commission in previous correspondence, Vodafone has serious concerns with the Commission's so called pricing principle articulated in the Draft Decision. The comments which follow in this section are in addition to those concerns and are not taken to constitute, in any way, an admission by Vodafone that the Commission has the power to formulate a pricing principle in a way that it purports to do so in the Draft Decision.

Vodafone believes that the pricing principle requires significantly more consideration than has been given by the Commission to date. The pricing principle in the Draft Decision is extremely vague and unclear. Vodafone also believes that there are number of significant problems with the Commission's analysis underpinning it's so called 'target price' of 12 cents per minute. These were outlined in our preliminary submission and are also further outlined in this submission. The benchmarking study by Frontier Economics (also attached to this submission) clearly demonstrates that Australian mobile termination prices currently compare favourably to international prices.

Given the shortcomings associated with the Commission's pricing principle and its target price, Vodafone urges the Commission to consider not publishing a pricing principle and release a Final Decision only in respect of whether the mobile termination service should be re-declared or varied. Vodafone notes that the Commission does have some flexibility under the legislation in this regard and we note it has chosen to use this flexibility for the Transmission Capacity Service Final Decision. Vodafone believes this approach has significant merit and will provide the

necessary time for the Commission to consider the appropriate pricing principle in greater detail.

Nonetheless, if the Commission is committed to publishing a pricing principle for the mobile termination service on or shortly before 1 July 2004, Vodafone considers that a number of changes should be made.

Firstly, Vodafone believes that the issue of ‘pass through’ must be addressed explicitly in the pricing principle. Vodafone is concerned that the Commission chose not to address the issue of ‘pass through’ in its Draft Decision. Vodafone considers this untenable given the data and information provided to the Commission, including by a number of fixed carriers suggesting a low level of pass through and also that F2M prices for residential customers may have increased since 2001.[4] Vodafone also notes that Telstra announced at the end of April it had increased F2M retail prices. This further highlights to Vodafone the necessity to address the issue of pass through explicitly in the pricing principle.

Vodafone has outlined in its preliminary submission that we doubt the strong link that the Commission believes exists between regulating mobile termination prices and promoting competition in the market in which F2M calls are provided. Vodafone does not believe that this will promote competition in the fixed market, and is not the “key” reason why competitive pressures in the market in which F2M calls are provided has not intensified. We therefore do not accept the Commission’s argument that ‘pass through’ will be addressed through its proposed declaration and pricing principles to apply to the mobile termination service.

In terms of the specific pass through proposal by Hutchison, Vodafone supports the proposal in principle, however it does not believe it is neither appropriate nor workable for the Commission to stipulate a range of prices for the mobile termination service and a corresponding retail price for F2M calls.

Rather, Vodafone believes that the Commission should include in any pricing principle a requirement that an access seeker should only be able to receive a lower termination price if they are able to demonstrate that all reductions from the previous periods have been passed through. To aid negotiations, Vodafone believes that the

[4] Moreover, AAPT indicated in the ACCC Mobile Services Forum of 11 September 2003 that F2M prices for residential customers had increased in real terms over the period 2001 to 2003.

Commission should establish a monitoring programme commencing 1 July 2004. The monitoring programme would be similar to that introduced under the current pricing principle and the retail benchmarking approach. Such a monitoring programme was proposed in the Commission's Final Report on the Pricing Methodology for the GSM termination service in 2001.[5] However, Vodafone understands that no such monitoring program has been implemented by the Commission. Had the Commission undertaken that work, Vodafone believes that the Commission would be in a better position to make informed decisions about the regulation of the mobile terminating access service.

The monitoring program should involve all providers of F2M calls to provide to the Commission on a six monthly basis total revenues and minutes for F2M calls disaggregated by customer type (residential, small business and corporate). Providers of the mobile termination service would continue to provide total mobile termination revenues and minutes for the same period. The Commission would publish a six monthly monitoring report looking at the percentage change in both the average F2M price (and also disaggregated by customer type) by carrier and also the percentage change in the mobile termination price over the period.

Secondly, given the number of significant problems with the Commission's proposed target price of 12 cents per minute in the Draft Decision that Vodafone has outlined in its preliminary submission and also in this submission, Vodafone believes that an alternative approach should be adopted. Vodafone does not believe that sufficient analysis has been conducted by the Commission or other parties to the review to ensure the underlying costs of terminating voice calls on mobile networks in Australia are properly understood.

Further, there has only been limited analysis regarding the implementation of Ramsey pricing and the quantification of the relevant externalities to apply to the mobile termination service. While Vodafone has not conducted such an analysis at this point, Vodafone considers that any such analysis would be likely to show substantially higher prices than the Commission's target price of 12 cents per minute can be justified. This is of significant concern to Vodafone. However, these are complex matters and require greater time for consideration.

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[5] ACCC, Pricing Methodology for the GSM termination service: Final Report, July 2001. page 6.

Vodafone's alternative approach involves the imposition of an interim price cap, in the form of CPI-X, to apply to the mobile termination service. This would be in place for a maximum of two years commencing on 1 January 2005 and ending 1 January 2007 – therefore involving three step change reductions in mobile termination prices. Vodafone believes the X factor should be set conservatively at 5 per cent per annum. This would have the effect of ensuring a downward pressure on prices during the period while acknowledging the significant uncertainty surrounding the appropriate price of mobile the termination service in Australia (including the appropriate mark ups using Ramsey adjustments and quantification of relevant externalities).

Thirdly, Vodafone believes that that the pricing principle should only apply to 2G mobile networks. As Vodafone outlined in its preliminary submission, the costs of terminating voice calls on 3G networks are not properly understood globally let alone in Australia. Also, the Commission has had no regard to 3G cost data or modelling to arrive at its target price of 12 cents per minute. There is also likely to be little if any discernible benefit to be realised from any regulation as 3G networks have yet to be deployed in any scale and the terminating traffic volumes are negligible. Given this, Vodafone strongly believes that any pricing principle should only apply to 2G networks.

And finally, if the Commission is minded to continue with a similar approach to that proposed in the Draft Decision (which we strongly object to), Vodafone believes that the Commission should include a longer glide path than that proposed in the Draft Decision. Vodafone believes that there is significant merit to extending the glide path to 5 years, to coincide with the length of the declaration for the mobile termination service. Vodafone believes that this approach would provide a better balance between the legitimate commercial interests of Vodafone and other providers of the mobile termination service and also that of access seekers. It is also more closely aligns with the approach that is taken by European regulators.

The glide path that the Commission is proposing, in real terms, is very steep and involves implied X or adjustment factors of around 16 to 22 percent per annum (assuming the Commission's target price of 12 cents per minute to take effect from 1 January 2007). This will have a substantial impact on Vodafone's business, particularly given that the Commission is not proposing to address the issue of 'pass through'. Vodafone therefore believes that the glide path should be extended to coincide with the timeframe of the declaration.

6 International cost benchmarking

In relation to the international benchmarking study, we have attached a further report by Frontier Economics. This report uses data primarily from two sources: Cullen International and also the International Regulator's Group (IRG). This report clearly demonstrates that mobile terminating prices in Australia compare very favourably to most European countries.

Vodafone notes that the Frontier report is a 'point in time' or snapshot of the current mobile termination prices and that some of these countries may be in the process of gliding down towards lower figures. Vodafone also notes that Australian mobile termination prices have and would continue to decline over time in the absence of regulation. We understand that the prices in the report are not necessarily based on a detailed costing analysis of the providing the service. However, a bottom up LRIC+ model has been used in the United Kingdom and many of the countries cited perform costing analyses (eg. fully allocated costing methodologies) or have regard to cost information in arriving at an appropriate mobile termination price. Vodafone also understands that the respective regulatory authorities in Greece and Sweden are currently developing LRIC+ models and the results of these costing studies are due to be publicly released sometime in June and July 2004 respectively.

Importantly, Vodafone also notes that the Frontier report does not seek to adjust mobile termination prices to account for differences that may exist in these countries compared to the Australian situation. These differences may relate to population density, coverage, geographical differences, input costs, quality of service and the technologies employed.

However, due to the short timeframes available for response to the Draft Decision, there has not been sufficient time to consider what adjustments to international benchmarks should be made to account for differences in Australia. Nonetheless, Vodafone believes that it is highly likely that Australia would sit at the top end of termination costs elsewhere predominately due to its low population density relative to other countries. This would also be consistent with the Commission's 'conservative' approach of establishing its proposed target price for the mobile termination service in the Draft Decision.

7 Gibson Quai/Primus model

The Commission provided to Vodafone a paper copy of the model developed by Gibson Quai for Primus (in Excel spreadsheet form) on 5 May 2004 and subsequently forwarded on 12 May 2004 an electronic copy of the model and extracts of a letter from Gibson Quai to Primus outlining the methodology and assumptions of the model.

The model was provided to Vodafone with two caveats:

- The model was developed five years ago and therefore any critique of it must be considered in that context; and
- It is a high level and basic cost model. Therefore, it is not a substitute for a detailed costing analysis which would involve substantially greater effort than that which Primus commissioned.

Vodafone requested PricewaterhouseCoopers to undertake a short review of the model and also the methodology. This advice is attached. This review demonstrates that this model is not suitable for the Commission to use in any capacity to inform its target price range for the mobile termination service.

Further, while Vodafone acknowledges the caveats that have been applied to the disclosure of the model, Vodafone believes that these caveats are significant and are the main reasons why this model should not be considered at all. This model should not have been given any legitimacy by being referred to in the Commission's Draft Decision. This is an extremely high level model that was developed five years ago. Given the significance of this matter, Vodafone does not believe it is appropriate for the Commission to use this model.

Further significant concerns of Vodafone include the following:

- Many of the assumptions are not verified or sourced;
- The basis of weighted average cost of capital (WACC) of 9 percent is unclear but it appears to be based on a WACC for a fixed line business. While Vodafone has not estimated an appropriate WACC for use in this model, this is considered very low for a business competing in the Australian mobiles market which is a significantly riskier proposition than fixed line investments;

- It does not set to quantify the level (and allocate a portion to the termination service) of fixed and common costs that are incurred by mobile carriers. This would be inconsistent with many regulators' views that carriers should be able to recover a portion of the fixed and common costs they incur in termination prices; and

- It is unclear whether any allocation of organisational and corporate overhead costs has been provided for in the model. The assumption that operational expenditure will be assumed to be 20 percent of capital is not substantiated or explained in any way. Vodafone considers this would be insufficient to recover an appropriate allocation of operational and maintenance costs associated with the network and also organisational and corporate overheads.

For these reasons, and also those outlined in the review undertaken by PwC, Vodafone is very concerned that the Commission is using this model in any capacity to inform its target price. Given the importance to Vodafone and other carriers of the mobile terminating revenue to their businesses, Vodafone does not believe this model should be relied upon or used in any way by the Commission. Vodafone considers that had the Commission performed a critique of the model - itself or had a review performed by an external party - it would have realised that this model is not sufficiently robust to be used for informing it regarding the costs of provision of the mobile termination service.

8 Regulatory Accounting Framework (RAF) data

The Commission outlined in a letter to Vodafone of 13 May 2004 details of the methodology it has used to estimate the cost of the termination service using data from Telstra's Regulatory Accounting Framework (RAF) accounts. A meeting also occurred on 14 May 2004 between representatives of the Commission and Vodafone to further discuss the methodology. On 20 May 2004, the Commission also provided Vodafone a confidential copy of Chapter Seven of Telstra's Regulatory Accounting Procedures Manual ('the RAPM').

Vodafone however does not have access to Telstra's RAF data and therefore does not know the cost proxy number calculated by the Commission and therefore where the cost number sits within the Commission's price range for the mobile termination service. Nonetheless, Vodafone does have a number of concerns regarding the use

of Telstra's RAF data to calculate a cost proxy to apply to Vodafone's mobile termination service:

- This type of modelling is based on a top down analysis. It therefore has inherent within it a number of shortcomings associated with this type of modelling. In particular, given that top down modelling is based on accounting statements, depreciation is based on accounting principles and not economic principles. Economic depreciation aims to reflect the declining market value of an asset over time;

- Vodafone understands that OFTEL sought to adjust the top down modelling numbers to account for the differences between accounting and economic depreciation. From our understanding of the Commission's analysis, no such adjustment has been undertaken by the Commission. Failure to do so may mean that the Commission's 'target price' does not adequately compensate Vodafone for its true underlying economic cost of providing the mobile termination service;

- Top down modelling of this kind, unlike bottom up TSLRIC modelling, does not seek to understand the level of fixed and common costs associated with mobile networks. It is therefore likely, with the adoption of Ramsey pricing, a greater proportion of fixed and common costs will be allocated to mobile termination given that is relatively inelastic compared to other mobile services;

- The Commission's analysis is based on Telstra's RAF data which is not appropriate for a mobiles only business like Vodafone. Telstra enjoys greater economics of scale and scope than Vodafone. For example, mobile network costs, information technology costs, organisational costs, billing costs and customer care and support costs. The Commission's target price for the mobile termination service must reflect that of a mobiles only business. Vodafone understands that the Commission has not adjusted Telstra's RAF data to ensure the resulting cost proxy reflects that of a stand alone mobiles business;

- The cost of capital used in the calculation is that estimated by Telstra. It is widely accepted that the cost of capital of a mobiles only business would be greater than that of business like Telstra. Once again, Vodafone understands

that the Commission has not adjusted Telstra’s RAF data to reflect a cost of capital more reflective of a mobiles only business.

9 Vodafone financial data

[section 9 is commercial in confidence]