VODAFONE SUBMISSION TO THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

Pricing Methodology for the GSM Termination Service
Draft Report

FEBRUARY 8, 2001

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1. Executive Summary

1. Vodafone welcomes the opportunity to provide feedback on the ACCC's draft report on GSM terminating access.

2. Vodafone considers it was an error to declare the service when the access regime was first introduced. We consider that the service would not have been declared if it had been subject to the standard Long Term Interests of End-Users (LTIE) test. The mobile market is intensely competitive. Introducing further, specific regulatory oversight will dull incentives to innovate and invest and distort prices in other areas of the mobile market (as well as related markets).

3. Notwithstanding our broad view against regulation of the GSM termination service, we consider that the ACCC is correct in basing the proposed regulation on a benchmarking approach. Compared to other potential regulatory intervention, we consider that this approach will result in the least harm to the market.

4. The draft report is the first time that industry has had the opportunity to review the proposed approach. We consider that it suffers from a number of significant problems. It is likely to distort pricing decisions in the retail market while providing opportunities for integrated carriers to game the price index. Commercial incentives will be dulled across the industry. There is also no guarantee that lower regulated termination rates will flow through to retail rates, which presumably is the ACCC's goal.

5. These deficiencies add up to a serious risk to future investment in the industry right at the time when major investment is required for third generation networks. This proposed regulation is also occurring at a time when it is increasingly difficult to attract investment funds in the telecommunications industry. Hence, the risks of regulatory intervention far outweigh any perceived benefits and we strongly caution against proceeding with the proposed application of the benchmarking approach.

6. Instead, Vodafone believes that the ACCC's objectives can be achieved through a modified approach that reduces the potential for harmful market impacts. This approach has the following essential elements:

   - adopting a benchmarking pricing principle that allows the ACCC to apply an arbitrated termination rate. This rate would be set having regard to the carriers own termination rates (within a range between the carriers lowest rate and its weighted average rate) and any other relevant market factors (such at the level of the lowest rate in the market generally and price trends in the retail market);

- allowing existing competitive disciplines (such as mobile to mobile interconnection negotiations, transit arrangements and substitutes) to exert competitive pressure on fixed-to-mobile termination rates;
- monitoring ‘pass through’ of lower termination rates to lower fixed-to-mobile retail rates; and
- if ‘pass through’ is not occurring, consider further intervention to ensure end users reap the benefits of lower mobile access rates.

2. Introduction

2.1 There has been significant debate between the ACCC and industry on the type of regulatory approach to apply to GSM termination (eg. Cost based, retail minus or benchmarking). Vodafone has prepared a number of submissions dealing with this issue and has commissioned a number of consultants to provide additional analysis. The views expressed in our earlier submissions remain relevant.

2.2 However, the draft report presents the first opportunity for industry to examine the details of the benchmarking approach proposed by the ACCC.

2.3 Our strong view remains that regulation of GSM termination rates is unnecessary. Regulatory forbearance is preferable to active intervention. However, Vodafone appreciates that the ACCC has a statutory obligation to resolve outstanding and future arbitrations. In light of this, if the ACCC considers that forbearance is not an option then we consider a benchmarking approach is the most appropriate form of regulatory intervention in the mobile market. We generally support the Commissions view that:

- the type of regulation to be applied in the mobile market should be 'light handed';[1]

- the competitive environment for mobiles is different enough from the fixed market to warrant a different regulatory approach;

- a benchmarking approach is superior to a cost based approach for the regulation of GSM termination rates;[2] and

- the relevant market for analysis is one in which the mobile call is supplied and that this includes mobile origination and termination services supplied by GSM and CDMA networks, mobile access services and outgoing call services.[3] Although Vodafone would add that there is an increasing range of substitutes for a mobile call (notably text messaging).

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[1] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 50.
[2] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 50.
[3] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 25.

2.4 We interpret the ACCC's view on GSM termination as follows:

- the essential problem in the market is that the prices for fixed-to-mobile calls may be inefficiently high;
- The reason for this is that GSM termination rates appear to be above cost;
- mobile carriers can charge high termination rates because of a market failure in this element of the market. The market failure is caused by consumer ignorance by end-users making fixed-to-mobile calls and through market control over access to the mobile customer; and
- the Commission's proposed solution is to regulate GSM termination rates to make them equal to the lowest GSM termination rate in the current market place. Future termination charges will be formally linked to price trends in each carriers retail prices.

2.5 We dispute the ACCC's findings. Our view (outlined in more detail in the remainder of this submission) is that:

- the regulatory intervention proposed penalises entrants that have invested heavily in the development of infrastructure and services and will ultimately discourage future investment at a time when investment funding is already much more difficult for telecommunications companies than it has been in the past;
- the proposed approach is a pricing rule rather than a pricing principle. It does not appear to give the ACCC any flexibility in the application of the proposal in arbitrating disputes. In addition, it promotes regulatory intervention over commercially agreed outcomes. In particular:
    - ➢ there are a number of risks in the proposed 'starting point' including the likely adverse impact on carriers that do not have the benefit of having both a mobile and fixed business. In addition, because the ACCC is not aware of all the rates in the market place, there is a risk that there is an 'outlier' which would distort the 'starting point';
    - ➢ the proposed 'glide path' is likely to distort retail pricing (because of structural differences in retail and wholesale prices) and provide opportunities for some carriers to 'game' the setting of the price index (particularly those that are able to take advantage of economies of scope);

- the pricing rule proposed by the ACCC is contrary to the long term interests of end users (LTIE);

- the ACCC has overestimated the impact on GSM termination rates of consumer ignorance and a mobile carriers control over access; and

- the ACCC has underestimated the impact of a range of factors that provide competitive disciplines on mobile operators when negotiating GSM termination rates.

2.6 We suggest that, in the event that the ACCC decides to pursue an active regulatory approach (instead of regulatory forbearance), a modified approach should be adopted to reduce the likelihood of harmful market impacts. Vodafone's recommended approach promotes commercial negotiation and competitive market outcomes and would avoid undue regulatory intervention by reducing incentives on access seekers to automatically seek arbitrated outcomes. The key features of Vodafone's approach are:

- adopt a benchmarking pricing principle that allows the ACCC to apply an arbitrated termination rate. This rate would be set having regard to the carriers own termination rates (within a range between the carriers lowest rate and its weighted average rate) and any other relevant market factors (such as lowest rate and retail price trends). The length of the proposed wholesale contract would also be an important factor to consider when deciding on the arbitrated rate as well as other factors such as the form and scope of the commercial contract being considered;

- allow existing competitive disciplines (such as mobile to mobile interconnection negotiations, transit arrangements and the impact of substitutes) to exert competitive pressure on fixed-to-mobile termination rates;

- monitor 'pass through' of lower termination rates to lower fixed-to-mobile retail rates; and

- if 'pass through' is not occurring, consider further intervention to ensure end-users reap the benefits of lower mobile access rates.

3. Submission Structure

3.1 This submission is structured as follows:

- Section 4 reviews and provides a critical analysis of the draft report's conclusions with respect to market definition;
- Section 5 reviews and provides a critical analysis of the draft report's conclusions regarding consumer ignorance and mobile carrier's control over access;
- Section 6 reviews the extent of competition in the mobile market and provides Vodafone's views on whether GSM termination rates are set inefficiently high;
- Section 7 analyses the link between termination rates and fixed-to-mobile retail rates and argues that there is a lack of 'pass through' of lower termination rates to lower retail rates. It concludes that the cause of any perceived problems in the fixed-to-mobile market are likely to exist at the retail level rather than the wholesale level;
- Section 8 reviews the ACCC's proposed benchmarking approach and argues that it suffers from a number of significant problems;
- Section 9 provides Vodafone's modified approach which will allow the objectives of the ACCC to be met while reducing the potential for harm in the market;
- Section 10 provides feedback on the ACCC's proposed monitoring programme;
- Section 11 outlines the broad conclusions of the submission; and
- Appendix A provides comment on the ACCC's view on the GSM origination service.

4. Market Definition

4.1 Promoting the Long Term Interests of End Users (LTIE) is the main objective of Part XIC of the Act. The LTIE objectives refer explicitly to the 'markets' for services. The Draft Report refers to the 'mobile services market' but then goes on to consider the 'termination element of the mobile services market'. Vodafone does not consider that GSM wholesale termination is a separate market from the mobile services market. Hence, it is not appropriate to base analysis on the impact of the LTIE on only one element of the mobile services market. Rather the analysis should be focused on the market as a whole.

4.2 In our view, the appropriate market to consider is the market for mobile telecommunications services, which includes both making and receiving calls involving a mobile element and other types of non-voice mobile communications (such as text messaging). A critical feature of mobile telecommunications services is that they are jointly produced and jointly consumed elements of the mobile service, with the common costs of production allocated among different price elements.

4.3 The LTIE test cannot be ascertained by examining the individual elements of the service. It is necessary to consider the affect of any regulation on the markets in which end-users participate.

4.4 The LTIE test means that the burden of proof for regulatory intervention squarely sits with the ACCC. There should be adequate evidence produced of a problem that is negatively impacting on the LTIE and that the proposed solution produces net-benefits. Vodafone does not consider that the draft report has provided any such evidence.

4.5 Although the Commission states that 'indications are that the termination element of the mobile services market remains significantly above cost[4]', no evidence is put forward to support this assertion. A recent study comparing mobile termination charges in various international jurisdictions would place Australian mobile termination charges at the lower end of the spectrum.[5] This study was restricted to 15 countries which have competitive mobile markets and/or rates determined based on costs.

4.6 Vodafone considers that the solution proposed is an inferior regulatory intervention which is not likely to result in net-benefits to consumers. In particular, there is no guarantee that the solution will result in lower fixed-to-mobile retail prices – indeed it is likely to result in a transfer of wealth from mobile operators to fixed-to-mobile retailers. Specifically, the proposed solution is likely to have a much harsher impact on smaller players and carriers that do not offer both fixed and mobile services.

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[4] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 6.
[5] OSIPTEL (2000), Report on the International Comparison of Interconnection Charges for Call Termination in the Mobile Network

5. The impact of control over access and consumer ignorance in practice

5.1 As we have argued in earlier submissions to the ACCC we do not consider that mobile carriers can effectively exploit any market power over access to the mobile customer. In addition, we do not consider that consumer ignorance has a material impact on the setting of GSM termination charges.

Control over access

5.2 The draft report argues that mobile operators exert market power over the wholesale rates they charge other operators on the basis that each termination is unique. However, taking this argument to its logical conclusion would suggest that every carrier has market power for every termination on every telecommunications network. The 'uniqueness' of termination cannot be a sufficient reason for intervention as it implies that every operator, irrespective of market position or market conditions, should be regulated. The real issue is whether mobile carriers can abuse their perceived market power in termination.

5.3 Any abuse of call termination can only last as long as the subscriber remains a customer of the network in question and alternative communication methods are not available. The current typical market levels of customer churn (estimated to be around 25-30 per cent) and the high level of contract reconnection show the ease with which people exercise their right to choice. 'Abuse' your market power over termination and customers will churn to other networks.

5.4 Consumers are faced with an abundance of choice when seeking to make contact with others. These include fixed calls, mobile calls, short messaging services (SMS), fax, WAP and e-mail to the mobile.

5.5 With most households owning a fixed line and mobile penetration exceeding 50 per cent, competition for the origination and termination of calls exists across networks, platforms and technologies. There are real call-by-call economic decisions available to callers, both in the choice of the origination and termination medium. One can make fixed-to-fixed, fixed-to-mobile and mobile-to-mobile calls. The reasons to choose one over the other are many, but price arbitrage is patently available and used.

5.6 In addition, text messages are increasingly being used as a substitute for voice (or to trigger call back). 12 billion text messages were made across the world in October 2000 and this is increasing at a rapid rate.[6] The existence of web-based text messaging (which are in some case offered free of charge) increases the viability of text messaging as a substitute for voice calls.

5.7 While text messaging cannot fully replace some phone conversations, it does represent a valid communication substitute for some price sensitive customers. There is anecdotal evidence of increasing sophistication of price-sensitive users, sending text messages at peak tariff times, and placing phone calls at off peak times. Budget constrained customers tend to revert to text messages as they reach the end of their prepay credit. Typically, usage is much higher in the pre-paid market than in the contract market. The extent to which this exerts competitive pressure is hard to quantify but it is clear that there is the potential for arbitrage.

5.8 The range of alternatives available and used to call an individual removes any 'market power of mobile carriers on call termination'. Abusing the 'unique' termination path will induce either churn or price arbitrage.

5.9 Also, on the supply side, a range of factors restrict the ability of mobile carriers to 'abuse' any perceived market power over termination. These include the existence of transit arrangements and the countervailing power each carrier brings to the negotiating table.

5.10 Access seekers have the ability to use transit networks if they consider that an individuals carrier's termination rate is too high. The Commission discounts the impact of transit networks. In particular it states that:

> … the price of transitting calls is the same, or more, than the access price for GSM termination. This does not suggest that transit arrangements mitigate control over access to GSM termination.[7]

5.11 However, Vodafone considers that it is the potential for transit networks to create competitive pressure that is important – not whether they are actually used for this purpose. Indeed, Vodafone considers that the absence of evidence that transit networks are used in this way is evidence that no problem currently exists. The experience of Vodafone in New Zealand, where it has actively used transit networks to force lower termination prices on Telecom NZ, is a real world example where transit networks have influenced termination rates.

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[6] Source: GSM Association website: www.gsmworld.com

[7] ACCC (2000), *Pricing Methodology for the GSM Termination Service,* p. 14.

5.12 The ACCC also discounts the influence of countervailing negotiating powers among operators. However, is in every carrier's interest to use the range of countervailing powers at their disposal to extract the best commercial price from the negotiation. Fixed-to-mobile termination rates are rarely set in isolation from other interconnection charges (such as mobile-to-mobile and mobile to fixed).

Consumer ignorance

5.13 As discussed above, the increasing range of substitutes translates to strong pressures in the fixed-to-mobile retail market. These trends strongly suggest using a forbearance approach in mobile markets.

5.14 However, the ACCC assume that mobile carriers are somewhat insulated from the demand effects of higher termination charges by the 'customer ignorance' of end users. In particular, end users do not have perfect information on the mobile network they are calling, and hence tend to be ignorant of the prices that they will be charged for the call. Due to this ignorance, it is argued that mobile carriers can increase termination charges without influencing the demand patterns of end-users. It is argued that these users can do no better than base their decisions on estimates of the average access price for GSM termination.

5.15 While some degree of end-user ignorance may exist, Vodafone considers that this ignorance does not have any material impact on the setting of termination rates. The main reasons for our view, as set out in earlier submissions, are:

- the existence of closed user groups;
- the emergence of callback (either through voice or text messaging); and
- the disproportionate impact that informed consumers have on prices at the margin

5.16 In addition, we consider that as mobile penetration increases fixed-to-mobile calls will become more price elastic. As these types of calls increasingly comprise a greater proportion of the telecommunications budget, consumers and businesses will have stronger incentives to press for lower retail prices from fixed to mobile operators. Also, greater mobile penetration will increase the availability of substitutes for making a fixed-to-mobile call, putting further pressure on retail prices.

6. Competition in the mobile services market – Are GSM termination rates too high?

6.1 The ACCC generally accepts that effective competition exists at the retail level of the mobile market. We agree. In fact, we consider that the very fact that there is effective competition at the retail level translates to an effective competitive discipline on all revenue streams of mobile operators (including revenue gained through GSM termination).

6.2 Given that Vodafone operates as a mobile only operator, our operating environment is intensely competitive. We do not have the potential opportunity to use revenues gained in less competitive markets to subsidise our mobile operations. Hence, the regulation of one aspect of our revenue streams is likely to impact on the others. In particular, we consider that the regulation of GSM termination will lead to pricing distortions in other parts of our business, including the need to raise access or usage charges to consumers.

6.3 In arguing that there are high termination rates, the ACCC appears to consider that monopoly profits are being earned in the mobile market (although no evidence is produced). It is only in the last few years that mobile operators have begun to produce positive returns on their investments. For Vodafone, who entered the market in 1993, it took 6 years before a positive return was achieved. And significant further investment is still needed to be able to compete in the mobile market – including investment in third generation spectrum and networks. New mobile players are still waiting for positive returns on their sizeable investments.

6.4 Regulatory intervention, which risks producing a dislocation of terminating access charges, will send strongly negative signals to investment financiers and limit the ability to invest in new services and infrastructure.

6.5 Another important limb of the ACCC's argument on the level of termination rates is a comparison of current rates with an estimate of costs of GSM termination. Vodafone disagrees with this simplistic approach to pricing in the mobile market. A view that each individual aspect of a mobile carriers business should be equal to its respective cost is not consistent with the reality of how mobile markets operate in a dynamic environment.

6.6 In particular, the proper framework for analysis should be whether the end-user market is effectively competitive. Effective competition is the best way of ensuring that mobile carriers cannot earn excessive profits by exploiting any theoretical market power.

6.7 With this broader view in mind, it is clear that while some products areas may be set above cost, some other product areas may be set below cost. For instance, the price for Optus 'yes' time is obviously set below cost, as are handsets generally (particularly for prepaid customers, who are not tied to customer contracts). The examination of whether prices are set above cost must take into account the range of products and services offered by the mobile carrier. In other words, if the retail market is effectively competitive, the work of the regulator should be largely left to ensuring that market participants do not act anti-competitively. Moves to impose regulation on a particular part of the product/service bundle considered 'above cost' creates the potential for distortions on other aspects of the carrier's service bundle.

6.8 In a similar vein, Vodafone (and others) have argued that Ramsey pricing would suggest that prices should differ according to the elasticity of demand for each product. In particular, if the demand for calls for the fixed to the mobile network is relatively inelastic while demand for calls from a mobile network to other networks is relatively price elastic, then terminating traffic ought to carry a higher share of the common element of traffic sensitive mobile costs. This suggests that an efficient pricing outcome is one where GSM terminating rates exceed the average incremental cost of a mobile call terminating on a network.

6.9 These considerations, alongside the range of competitive checks in the market place as described above (such as callback, closed user groups and the existence of transit networks), suggest a regulatory forbearance approach to the mobile market (and particularly GSM termination rates).

7. The problem appears to exist in the fixed-to-mobile retail market

7.1 Presumably a key anticipated consumer benefit resulting from any regulatory intervention would be a reduction in the price of mobile terminating access charges, which in turn would lead to a reduction in the retail price of fixed-to-mobile calls. However, the available evidence suggests that this will not be the case. Indeed, it can be expected that a reduction in the price of terminating rates will simply effect a transfer of value from access providers to access seekers.

7.2 Since December 1997 Vodafone's GSM termination rate to Telstra has fallen by nearly … [commercial in confidence]. However, notwithstanding increased cost efficiencies and reductions in GSM terminating rates, Telstra's retail 'rack rate' for a two minute fixed-to-mobile call has actually increased over the same period. [8]

7.3 The cost of a two minute fixed-to-mobile call in December 1997 was 100 cents (peak) and 50 cents (off-peak).[9] This compares with a January 2001 rate of 108 cents (peak) and 77 cents (off-peak).[10][11] Hence, since December 1997, fixed-to-mobile retail prices have increased by 8 per cent for peak calls and 35 per cent for off-peak calls for an average two minute call.[12][13]

7.4 It is not only Telstra that has declined to pass on significant savings in GSM terminating rates. A reduction in GSM terminating access prices paid by … [commercial in confidence] … has yet to be translated into a reduction in their retail fixed to mobile retail rates.

7.5 It was expected that the introduction of carrier pre-selection for fixed-to-mobile calls (which became effective in July 1999) would foster competitive disciplines in this area of the market over time. However, this appears to have been slower than originally expected.

7.6 As outlined in earlier submissions, one reason for the apparent lack of competition in the fixed to mobile retail market could be the lack of multi-basket preselection options for consumers.

7.7 Preselected service providers do not compete directly for the fixed-to-mobile traffic but are allocated this traffic based on the customer's long distance preselection choice. Consumers are unable to choose fixed-to-mobile preselection as a stand-alone service. Hence, pre-selection service providers "inherit" their fixed-to-mobile market share and therefore have less incentive to compete for this revenue. Rather, the competition appears to occur in the relatively higher revenues areas such as long distance traffic.

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[8] Vodafone's data indicates that the average length of a call for callers from a fixed line is around two minutes.

[9] In December 1997, retail prices were charged in 37-second units (peak) and in 71-second units (off-peak). This explains the difference between the per-minute rate and the rate quoted for a two-minute call.

[10] In December 1997, Telstra charged the equivalent of 40.5 cents per minute (peak) and almost 22 cents per minute (off peak) for a fixed-to-mobile call to a Vodafone mobile. In January 2001, the equivalent prices are 44 cents (peak), 27.5 cents (off-peak) with a 22 cent flagfall for each call.

[11] January 2001 retail prices sourced from public information (Telstra customer services).

[12] We do not have any information on the any discounts that Telstra may offer to its residential or business customers for fixed to mobile calls.

[13] This compares very favourably with the Commissions analysis of GSM retail price movements over a similar period, page 34. In fact the Commission's proposed glide path would have slowed the reduction in GSM terminating rates over the period analysed.

7.8 As mobile penetration rates increase, more and more consumers will be looking for ways to reduce fixed-to-mobile call costs through pre-selection. Also, there will be increasingly greater opportunities for consumers to use mobile-to-mobile calls and text messaging as an alternative to using the fixed line service. Given that mobile-to-mobile calls are often cheaper than fixed-to-mobile services, this will increase competitive pressures to reduce fixed-to-mobile retail prices.

8. The Commission's proposed regulatory approach: Benchmarking, the 'starting point' and the 'glide path'

8.1 While Vodafone remains opposed to the regulation of GSM termination (for reasons given above and in earlier submissions) we consider that if regulation is to be applied to GSM termination then a benchmarking approach is superior to other forms of pricing regulation (such as cost based TSLRIC).

8.2 However, Vodafone has a number of concerns about the form of benchmarking proposed by the Commission. Our main concerns:

- The practical impact of the approach appears to be the implementation of a pricing rule on all mobile carriers rather a pricing principle to aid the Commission in resolving access disputes. A pricing rule suggests a 'one size fits all' approach, which is not appropriate in such a dynamic market. A pricing rule also removes incentives on parties to agree on commercial terms and represents a highly interventionist approach to pricing in a relatively competitive market;

- It is not correct to assume that all GSM terminating access services are the same. They vary in quality, but more importantly in size and extent. For instance, One.Tel does not supply a national GSM terminating access service on its own network. Furthermore, each access provider may supply different GSM terminating access services to different access seekers, depending on their requirements. The most common difference is in the number and location of the points of interconnect.

- The revenue impacts of lower (regulated) GSM termination rates will be felt relatively more by less integrated carriers. Integrated carriers may be relatively ambivalent towards the proposal as what they lose in GSM termination revenue they gain through higher fixed-to-mobile retail margins. The outcome of this will be to distort competition in the market place.

- Moving all rates to the lowest in the market penalises any access seeker who has successfully negotiated commercial agreements. Moving forward, it will reduce incentives on access seekers to agree to longer-term wholesale contracts which will increase transaction costs in the industry for all players (including the ACCC);

8.3 More detailed comments on the proposal is outlined below.

A pricing rule versus a pricing principle

8.4 Vodafone seeks clarification on the practical impact of both the 'starting point' and the 'glide path'. It appears from the draft report that the ACCC's approach will act as a pricing rule on all mobile carriers rather than a pricing principle to aid in arbitration disputes. For instance, the ACCC states:

> Under … [the ACCC's] … proposed approach changes in each carriers' access prices would be benchmarked against the percentage change of its weighted average retail prices for the overall mobile package (access and outgoing calls). The initial 'starting point' for the 'glide path', created by this pricing rule, would be the lowest current access price for GSM termination.[14]

8.5 Vodafone considers that the practical impact of this pricing rule will be to force all carriers to reduce their terminating rates down to the lowest currently commercially agreed rate, irrespective of whether there are any current arbitrations related to particular carriers. Vodafone considers this a highly interventionist approach to the initial starting point for the pricing of GSM termination. The Commission also proposes that from then on, GSM termination rates would be tied to each carriers retail prices for access and outgoing calls. Hence GSM termination rates would be forced to follow changes in the weighted average of these retail rates. We consider that benchmarking GSM termination rates to the weighted average of each carriers retail rates could result in some perverse outcomes in the currently highly competitive retail market (discussed in more detail below).

8.6 The current incentives to pursue commercial outcomes should be preserved. A pricing rule reduces the potential for commercial arbitrage in negotiations, as parties will know in advance the value of a key 'price'.

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[14] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 7.

This will reduce the opportunities for negotiating parties to construct innovative commercial contracts.

The 'starting point' for the glide path

8.7 The Commission proposes that the starting point for the benchmarking approach should be the lowest current GSM termination rate in the market. Vodafone considers that there are a number of problems with this approach.

8.8 The practical impact of this approach appears to be that all carriers will be required to reduce their GSM termination rates to the lowest current GSM termination rate in the market place. Although it is unclear if this is the intention of the draft report, Vodafone assumes that current commercially agreed prices would not be affected by this regulation.

8.9 GSM termination rates charged by each carrier are a closely kept commercial secret. It is uncertain what is the lowest market rate. We understand that the Commission has a range of information about GSM termination rates. However, the Commission may not have information on the complete set of prices in the market. For instance, a number of new agreements have been entered into since the ACCC last collected information from carriers. As there is potential for the rates to differ according to each commercial negotiation, an outlier may exist in the market place. In any competitive market it is not unusual for one party to a negotiation to agree to price below its long term sustainable price for a limited period of time in return for a corresponding benefit from the other party.

8.10 There may be incentives for some new carriers to offer quite low termination rates in order to generate traffic in the start up phase of their business. Some companies may have sound commercial reasons to set very low termination rates. However, these company specific incentives should not be used to force all prices for all carriers down to this low rate.

8.11 It is not correct to assume that all GSM terminating services are the same. They vary in quality and extent (see discussion in section 8.2).

8.12 A key outcome of using this as a starting point would be that the value of a key revenue stream in a mobile carriers business would be determined by factors beyond each mobile carrier's control (except for the carrier with the lowest rate) and therefore would not be reflective of other valid commercial concerns (such as the scale of operations).

8.13 The existence of economies of scale and scope mean that differences in GSM termination rates can legitimately arise due to different services, marketing approaches and cost structures among carriers. Forcing all carriers to reduce their GSM termination rates to the lowest in the market will penalise smaller carriers more than larger or more integrated carriers.

8.14 Setting the start point at the lowest GSM terminating rate presents a gaming opportunity for some carriers. Any changes in rates set since the issue of the draft report could be evidence of such gaming.

Problems of using a 'glide path'

Tying wholesale prices to retail prices

8.15 The ACCC proposes that reductions in the weighted average of each carriers' retail price should be mirrored in its wholesale termination rate. Vodafone considers that there are dangers creating this regulatory linkage. Wholesale termination and retail services are separate products with significantly different characteristics.

8.16 Terminating access is a commodity supply negotiated for relatively long periods due to the dynamics involved.

8.17 On the other hand, retail services are highly diversified and can include a range of products and features such as voice mail, text messaging, mobile data, fax services and so forth that allow significant economies of scope and resulting price reductions. They also involve significantly more back office functions such as call centres and customer billing which benefit from scale economies to a far greater extent than the termination service. As a result, efficiencies at the different levels will manifest themselves differently, and the most efficient price paths may have significant differences.

8.18 The Draft Report claims that:

> The Commission has considered whether benchmarking the change in access prices would create a disincentive for mobile carriers to slow retail prices reductions for the overall mobile package, as to do so ensures that access prices for GSM termination do not fall. The Commission notes that such a disincentive may exist; however, it considers that the increasingly competitive mobile services market, and in particular the retail element of the market, should ensure downward retail price movements continue.

8.19 This analysis appears to misunderstand the complex interaction between the termination charge and the other elements of the mobile telephony service. Linking the wholesale price (which may be relatively inelastic) to the retail price (which may be relatively elastic) may reduce the incentives to reduce retail prices because of the inevitable flow-on effects to wholesale prices.

8.20 The Draft Report refers to some of these concerns in rejecting the retail-minus approach, but apparently fails to recognise that exactly the same concerns arise in relation to its preferred benchmarking approach.

8.21 We understand that the ACCC intends to include retail prices and price substitutes in its calculation of the weighted price index. In practice this will involve some complex subjective judgements about the value of some price substitutes. There is also likely to be a high degree of complexity involved in correctly identifying the proper basket of price and price substitutes to include in each carriers index.

8.22 For example, the ACCC will need to make decisions on how to take account of temporary price reductions (such as Christmas sales and price specials driven by the introduction of mobile number portability)[15]. Given the dynamic and competitive nature of the retail mobile market, operators are constantly searching for new and innovative pricing approaches. For example, we understand that CWO offer a free scooter with every mobile phone sold. In Vodafone’s case, we offer our customers free access to the ‘My Vodafone’ internet portal. It is unclear how these types of services should be treated in the weighted price index proposed by the Commission.

8.23 A broader issue concerns those carriers that offer services across a range of markets. Both Telstra and CWO offer discounts to customers that sign up for a number of products (such as mobiles, fixed line, internet and pay

[15] See paragraph 8.26.

TV). Customers generally receive discounts off the total bill for these bundled products. Depending on the way the price index is constructed, it may be beneficial for integrated carriers to offer customers price discounts in product markets that are not included in the mobile price index. This will allow them to keep prices within the regulated basket unchanged but still be able to stimulate demand for their retail product. This provides integrated carriers with a potential powerful competitive advantage over 'mobile only' carriers.

8.24 These limited examples give an idea of the opportunities that will be available for carriers to 'game' the value of the price index.

8.25 Mobile number portability (MNP) (to be introduced in September 2001) creates additional complexity in constructing a glide path. We consider that there will be strong incentives for some carriers to offer low price options in an effort to entice consumers to switch to their network in the initial period following the introduction of number portability. Other carriers will be forced to react to any price reductions in the market place. These potential 'price wars', attractive to customers but transient in nature, are to be expected in such a competitive market. However, the added complexity is that these price reductions would automatically feed into wholesale rates, leading to perverse pricing outcomes.

8.26 It is unclear from the draft report how the values inherent in any 'glide path' will be reviewed. Given the dynamic nature of the market place, retail prices tend to move quickly. It will be inefficient and cumbersome (for both carriers and the ACCC) for terminating rates to be constantly reviewed every time the carriers retail price basket changes or at the time of every arbitration.

Competitive impacts

8.27 As discussed above, there will be differential revenue impacts between integrated and 'mobile only' carriers. For example, Vodafone estimates that Telstra still controls the majority of retail fixed line originations for fixed-to-mobile calls and around 50 per cent of all mobile terminations. For the large number of fixed-to-mobile calls that are wholly within the Telstra network, its margin will be unaffected by any move to reduce GSM termination rates. In addition, it is likely that Telstra will benefit from lower termination rates for those calls that are pre-selected to Telstra and that terminate on other networks. GSM termination rates are a matter about which Telstra can be ambivalent. What it loses on mobile terminations, it gains on fixed-to-mobile calls. Thus, while Telstra will continue to derive significant margins for fixed-to-mobile calls (and particularly for Telstra-to-

Telstra fixed-to-mobile calls), other mobile operators will be impacted significantly, affecting the overall and longer term competitiveness of the mobile market and incentives for mobile entry.

8.28 This asymmetric effect is particularly harsh for mobile carriers that are not horizontally integrated and who, therefore, must recover their network investment and other costs from either retail mobile services or wholesale mobile termination services. If the revenue from wholesale termination services decreases, this will inevitably and significantly increase the pressure on those carriers to recover their costs from retail mobile services. This will limit their price competitiveness in that market and, therefore, the investment necessary to enable delivery of innovative services.

8.29 These carriers are required to compete with larger vertically and horizontally integrated carriers but do not have the same economy of scale benefits or the ability to bundle together a variety of services or cross-subsidise between services. Accordingly, they are even more dependent on their ability to introduce mobile-specific price and quality benefits. Clearly, if they are unable to do so, this will impact their growth and profitability.

8.30 CDMA is not included in the regulated approach meaning that CDMA operators will be at a competitive advantage to GSM operators. They will not need to consider the impact on their CDMA terminating rates when contemplating retail price structures. While we would not support CDMA being included in this regime – as the same arguments against the regulation of GSM termination apply for CDMA – we would note the artificial competitive advantages that would accrue to CDMA operators under the Commission's proposal.

Investment and Innovation impacts

8.31 The timing of the draft report has the potential to influence the incentives facing bidders in the upcoming auction of 2Ghz spectrum. In particular, the threat of regulation and the uncertainty surrounding how it will be applied increases the risk that must be factored into any potential investment in third generation networks. The Commission should not underestimate the potential for regulatory error. It will impact on the value of the business case for third generation spectrum bidders.

8.32 The threat of regulatory intervention is occurring just at a time when substantial new investment will be required to bid for spectrum and build third generation networks. It is also occurring at a time when it is becoming much harder to secure funds for investment in telecommunications. Uncertainty over the practical impact of the ACCC's approach adds to the adverse impacts of regulatory intervention in the mobile market (as discussed in earlier sections of this submission).

8.33 The prospect of regulatory error is exacerbated by the fact that the Commission proposes to set a start point at a fixed, but unknown rate, which does not reflect the current commercial agreed rates of any but one of the carriers. Further, it proposes formulated, but unquantifiable rates looking forward.

8.34 In addition, the focus on 'per minute' fixed-to-mobile charges ignores the developing range of innovative communication services that are being and will continue to be introduced into the market place over the next few years. 'Always on' features such as GPRS signal a shift away from time based charging to volume based charging. The issues of fixed-to-mobile termination charges may become irrelevant as these services are progressively introduced. However, regulating GSM termination may hamper the development of these services and slow their introduction. In particular, regulating one area of the mobile market will create pricing and other distortions that have the potential to have adverse impacts on the introduction of new technology (because of the risk that new technology will also be subject to — or impacted by — regulatory oversight).

9. A modified approach

9.1 As discussed above, Vodafone does not consider that a problem exists in the area of GSM termination and favours regulatory forbearance over any active regulatory intervention. However, we are cognisant of the ACCC's obligation to determine outstanding and future arbitrations and wish to provide alternatives which allow the ACCC to fulfil its obligations. This section provides a practical suggestion on how the proposed approach can be modified to meet the needs of the ACCC and reduce the risks that we have highlighted above.

9.2 Our modified approach consists of the following elements:

1. Adopt a benchmarking pricing principle that allows the ACCC to apply an arbitrated termination rate. This rate would be set having regard to the carriers own termination rates (within a range between the carriers lowest rate and its weighted average rate) and any other relevant market factors (such as the level of the lowest rate and retail price trends). The length of the proposed wholesale contract would be an important factor that the ACCC would take into account in deciding on the arbitrated rate, along with other factors such as the type and scope of the commercial contract proposed;

2. Allow existing competitive disciplines (such as mobile to mobile[16], interconnection negotiations, transit arrangements and the impact of substitutes) to exert competitive pressure on fixed-to-mobile termination rates;

3. Monitor 'pass through' of lower termination rates to lower fixed-to-mobile retail rates; and

4. if 'pass through' is not occurring, consider further intervention to ensure end-users reap the benefits of lower mobile access rates.

9.3 Our modified approach protects the competitive environment of the market by providing incentives for players to seek commercial outcomes where possible. However, it does provide the ACCC with a pricing principle that it can apply in access disputes. The essential change to the ACCC proposed approach is to move the solution away from a strict pricing rule that would apply to all players irrespective of size or circumstance.

9.4 The modified approach is a move away from a strict 'starting point' and 'glide path'. In its place is a more flexible approach that allows different carrier's marketing strategies and service offerings to be taken in account as well as the impact of economies of scale and scope. It also allows the ACCC to approve the rate set by the access provider if it is considers that this rate is within the range of reasonableness.

9.5 Under the modified approach it is Vodafone's expectation that most access seekers will agree commercial terms with access providers without

[16] The Commission states, "there is an increasingly greater number of call minutes being made from and to mobile services" (page 6). This understates a real change in the market structure. Today, the majority of calls terminating on mobile networks originate from other mobile networks, not from the fixed network.

regulatory intervention. Likely expectations are that the trending down of GSM terminating access rates observed over the last three years will continue. For access seekers who are unable to reach commercial agreement the modified benchmarking approach outlined above can be applied by the ACCC. The ACCC could apply this pricing principle during any arbitration.

9.6 In the unlikely event that commercial benchmarks do not evolve during the period, for whatever reason, the modified approach allows the ACCC to take into account other carriers rates, and/or retail price trends.

9.7 The practical impact of this approach will be to drive commercial negotiations, with a regulatory backstop within known parameters. Carriers will still have the opportunity to differentiate themselves in the market place in terms of their termination rates, without this type of market behaviour automatically flowing through to the rates offered by other carriers through a formal ACCC pricing rule.

9.8 Vodafone remains of the view that the Commission should steer clear of a 'one size fits all' pricing approach. A less prescriptive approach that allows the ACCC to set arbitrated rates within a range would allow the Commission to judge each arbitration on its merits.

10. Monitoring Program

10.1 Vodafone supports the concept of a monitoring program over the next two years followed by a review of the pricing principles.

10.2 The presumption must be that at the end of the two year period any regulatory intervention will be removed. This should be clearly stated and acknowledged. Any intervention should only be extended if there is clear evidence demonstrating that such extension is absolutely necessary.

10.3 The reason for making this presumption is outlined in the draft report:

> the Commission is conscious that an increasingly competitive market can generate outcomes that can not be replicated by a regulatory pricing approach[17]

10.4 Vodafone agrees with this assessment.

[17] ACCC (2000), *Pricing Methodology for the GSM Termination Service*, p. 50.

11. Conclusion

11.1 Vodafone considers it was an error to declare the GSM Termination service when the new access regime was introduced in 1997. We consider that the service would not have been declared if it was required to go through the standard LTIE test. The mobile market is intensely competitive. Introducing specific regulatory oversight will dull incentives to innovate and invest and distort prices in other areas of the mobile market.

11.2 Notwithstanding our broad view against regulation of GSM terminating rates, we consider that the ACCC is correct in basing the proposed regulation on a form of benchmarking rather than some form of cost based approach.

11.3 However, this submission has outlined a number of significant problems in the benchmarking approach proposed by the ACCC. The deficiencies of the model add up to a serious risk to existing and future investment in the industry right at the time when major investment is required for third generation networks. This proposed regulation is also occurring at a time when it is increasingly difficult to attract investment funds in the telecommunications industry. Vodafone considers that the risks of regulatory invention far outweigh any perceived benefits and we strongly caution against proceeding with the ACCC's proposal.

11.4 Vodafone recommends as alternative to the ACCC's proposed approach. This modified approach still meets the ACCC's objectives but reduces the potential for harm to the mobile market. We strongly recommend that the ACCC introduce this modified approach.

Appendix A

Originating Access

Vodafone disagrees with the Commission's analysis of the GSM origination service.

Vodafone does not consider that a fixed line carrier providing 1800 or 13/1300 inbound services purchases GSM originating access services to supply these services to mobile subscribers. The end to end call service from the mobile to the inbound service is supplied to the mobile subscriber by the mobile carrier. It is the mobile carrier who sets the tariff for the call, and bills the subscriber for the call.

It is true to say that without the origination service the service cannot be supplied. It is equally true to say that without the inbound segment of the call, the end to end service cannot be supplied. There is an equal dependency between the mobile provider and the inbound service provider to come to an arrangement which makes supply of the service viable and attractive.

This particular call case is much more akin to the mobile to mobile call case. Both parties have commercial imperatives to reach agreement. Regulatory intervention is definitely not required.