VODAFONE SUBMISSION TO THE AUSTRALIAN CONSUMER AND COMPETITION COMMISSION

Issues associated with implementation of a retail benchmarking approach

5 September 2001

1. Introduction

1.1 Vodafone welcomes the opportunity to provide further feedback to the ACCC on the practical implementation of regulation of GSM Access prices.

1.2 Given the ACCC's stated views on the need for such regulation, Vodafone has not attempted in this submission to revisit our earlier arguments about the appropriateness of such regulation. The focus of this submission is to provide practical feedback on the ACCC's proposals for the retail benchmarking approach.

1.3 However, we would state again that we consider that the regulation of GSM access prices is unwarranted and will result in unnecessary pricing distortions in an already fiercely competitive marketplace.

2. A Pricing Rule versus a Pricing Principle

2.1 As Vodafone has outlined in previous submissions to the ACCC, it is critical that this approach to price regulation remains a pricing principle, as it was initially intended and not used to as a hard and fast pricing 'rule'. Vodafone strongly urges the ACCC to apply the regulation in a flexible way to ensure that does not lead to regulated pricing outcomes becoming the norm for this service.

2.2 If the ACCC chooses to apply a narrow approach to the practical implementation of the regime, this is likely to chill commercial negotiations and mire the industry in a complex, costly and drawn-out set of regulatory debates.

2.3 There are a number of reasons why the ACCC should be wary of adopting a rule-based approach. Vodafone considers that it is not reasonable to make arbitration determinations in isolation from what is happening in the market place. For instance, one could argue that the application of the pricing principle should be positively related to the number of arbitrations being considered by the ACCC. Vodafone considers that where commercially negotiated outcomes for the service is the norm, a more market-orientated approach to regulation should be used by the ACCC.

2.4 If it is clear to all parties that the pricing principle is only a guide and not a pricing rule, this will allow the ACCC flexibility to take into account other relevant factors in arbitration disputes. For example, suppose an Access Provider has commercially negotiated GSM termination rates with nine out of ten Access Seekers. For the tenth Access Seekers, Vodafone considers it would be unwise for the ACCC (through arbitration) to apply a pricing rule that produced a substantially different result (either higher or lower) than rates delivered to the other nine access seekers.

3. Date of the initial starting point

3.1 The ACCC has proposed that 1 July 2001 be the starting point for the benchmarking approach. Vodafone supports this starting date because regulation should be forward looking, not backward looking.

3.2 An earlier starting date would be unworkable and would ignore the market reality, where arbitrations are the exception rather than the rule. There are only two arbitrations currently before the ACCC. All other rates in the market have been commercially negotiated and agreed.

3.3 Vodafone supports a period-on-period approach to the regulation of GSM termination rates. This is because this approach has a greater likelihood of being aligned to market realities when compared to a cumulative approach.

3.4 The correct starting point for future arbitrations should be the most recent access price agreed between the access seeker and access provider.

4. Time period for assessing retail price movements

4.1 Vodafone supports a six monthly assessment of retail price movements. This would strike an appropriate balance between minimising administrative costs and maintaining the market relevance of prices.

4.2 Our understanding of the practical implications of having a six monthly assessment is outlined below:

- Initial starting point is set at 1 July 2001;
- Initial benchmark termination price floor is 24.5 cents. Actual rates could be higher than this, depending on each parties individual circumstances (for instance, this rate could be higher due to scale issues, the number of points of interconnect, or the proposed term of the agreement).
- Initial starting price is set for the period 1 July 2001 to 31 December 2001. At the end of this period, the initial benchmarking price would be adjusted depending on price trends over that six-month period. Hence, the 24.5 price floor would apply for the first six-month period.

4.3 The ACCC is silent on the relevance or otherwise of backdating. We understand that this is a major issue for some parties. With this in mind, Vodafone has provided some initial thoughts on how the issue of backdating could be accommodated within the benchmarking approach.

4.4 Since the declaration of mobile termination services was first announced, there have been a large number of successful commercially negotiations between access providers and access seekers on the termination service. Indeed, commercially negotiated deals represent the majority of agreements in the marketplace.

4.5 With this in mind, Vodafone considers that the backdating of pricing regulation to periods earlier than the 1 July starting point should only be considered in rare cases. These include:

- where the rates offered to the access seeker in the earlier period were not consistent with the market rates that existed at the time; or

- where the access seeker can show that the access provider did not provide 'reasonable' commercial offers to the access seeker during the period.

4.6 If the ACCC considers that the circumstances for backdating apply, Vodafone considers that access seekers should be required to 'pass through' these backdated rates to end users, unless the access seeker can show that they were forced through competitive pressure in the fixed to mobile retail market to price their services below their input costs and a normal commercial return.

5. Determining average price per minute and retail price movements

A yield approach versus a 'retail basket' type approach

5.1 There are a number of factors that need to be taken into account in deciding what methodology to choose for the benchmarking approach. A 'first best' option would be to choose a method that results in the most accurate measure of retail price movements. Comparing the approaches presented in the discussion paper against this objective would appear to favour the CRU retail basket approach. This measure, while complex and potentially time consuming to calculate, is likely to produce the most accurate measure of price movements faced by customers in the market place.

5.2 However, we see a number of problems with the CRU approach. Firstly, given that the benchmarking approach is to be used as a guideline for ACCC and not as a hard and fast rule, it may be preferable to use a simpler approach that is less open to debate about its interpretation. Also, the potential complexity of the CRU calculation provides opportunities for access seekers and providers to game the approach to their own commercial advantage.

5.3 On balance, we would prefer that the ACCC uses simpler 'yield' approach. This has a number of advantages that we discuss below.

5.4 Vodafone considers that a yield approach based on average price per minute has the following advantages:

- It will be relatively easy for access providers to compile - and for the ACCC and other interested parties to interpret - the information;

- It will be transparent, meaning that all parties will have a degree of certainty on the implications of retail price movements over time;

- It reduces the opportunities for access providers to 'game' the benchmarking approach by structuring their retail pricing in such a way to avoid being adversely impacted by the regime; and

- Given the relatively simplicity of the approach, it is likely that there will be a faster resolution of arbitrations, whether as a result of commercial negotiation or through ACCC direct intervention.

5.5 It is not appropriate to use an Average Revenue Per Subscriber (ARPU) approach**.** ARPU can be influenced by a number of factors that have no causal link to retail price changes for mobile services. This is because ARPU reflects consumer spending decisions not retail price movements. For example, ARPU is influenced by seasonal and other external factors (such as one-off changes like the GST introduction) that are not directly related to retail price changes. ARPU is also impacted by customer type. An increase in the number of low usage customers will skew outcomes, even where they pay a higher rate per minute.

5.6 However, the adoption of a simple yield approach, while being the most appropriate in the circumstances, also creates some significant problems that would need to be explicitly addressed by the ACCC in its practical implementation of the benchmarking approach. Vodafone considers that there are two issues that need to be taken into account if a yield approach is to be adopted:

  - The existence of innovative pricing in the retail market to take advantage of available network capacity should be taken into account in determining the appropriate form of any regulated wholesale price; and

  - The need to take account of cost drivers that only impact on wholesale termination rates (and have no direct causal link to retail rates).

The impact of innovative retail pricing

5.7 As discussed in earlier submissions there tends to be significant differences in pricing structures in mobile retail services compared to the wholesale termination service. One of the key differences is that retail pricing structures are frequently adjusted to generate more efficient network usage. For instance, most carriers offer discounted or 'included' minutes in off peak times. This pricing strategy is aimed at generating revenue through more efficient network usage and recognises that there are different network cost implications of a 'peak' minute versus an 'off-peak' minute.

5.8 However, at present, wholesale termination prices tend to be structured in a less sophisticated way. This is hardly surprising, given the traditional characteristics of wholesale markets, where long-term contracts and 'commoditised' product offerings are the norm. It is also true that to date there has been no commercial incentive to pursue this sort of sophistication as movements in retail fixed to mobile rates seem to have a low correlation to movements in mobile terminating rates.

5.9 The introduction of a formal link between retail and wholesale prices will create pressures to restructure wholesale prices in a more sophisticated way, so that it mirrors some of the characteristics of retail pricing structures. In particular, we consider that one of the key pressures on access providers will be to offer a mixture of peak/off-peak pricing, 'included minutes' and/or capped termination rates. These changes in wholesale pricing structures are an entirely appropriate market based response to the ACCC regulation and the ACCC should explicitly provide for the restructuring of wholesale pricing in this way when dealing with arbitrations on GSM termination.

5.10 Vodafone considers that, without the opportunity to meet regulated GSM termination rate reductions through innovative wholesale pricing restructuring, the adverse impacts of the ACCC approach will be more pronounced and will potentially reduce innovation in retail price structures.

5.11 The best way to illustrate the impacts of the yield approach and the need to allow for innovative wholesale pricing structures is through an example:

- Assume that there are two mobile carriers that are subject to the ACCC's regulatory approach.
- Suppose that Carrier B decides to offer discounted call minutes to customers in off-peak times (and take advantage of its unused capacity in those time periods). Suppose this strategy increases revenues without an increase in network capacity (that is, traffic and revenues are increased due to more efficient network use);
- When measured using the simple yield approach, suppose that this results in the retail prices of Carrier B falling by 5 per cent.
- As a result of this, the ACCC requires that wholesale rates charged by Carrier B fall by a uniform 5per cent. Carrier B is likely to be at a competitive disadvantage compared to Carrier A as a result of this decision – as the measured falls in its retail prices have simply been the result of more efficient network utilisation. This is because Carrier A, which has not made any changes, will be able to keep their wholesale termination rates unchanged.

5.12 This example shows the risk of adopting a pricing rule compared to a pricing principle. A proscriptive approach by the ACCC is likely to result in disincentives on carriers to offer innovative and network efficient pricing options for customers in the retail market.

5.13 To address this potential distortion, Vodafone recommends that carriers should have flexibility to deliver regulated price falls in wholesale markets in ways that reflect the context of the retail price change.

5.14 In the above example, this would mean that Carrier B would have the flexibility to deliver the five per cent fall in wholesale rates by offering discounted off-peak wholesale minutes to the access seeker that it is in arbitration with.

5.15 In summary, Vodafone would support the yield approach, subject to a formal understanding from the ACCC that carriers would have flexibility in how regulatory price reductions forced by measured reductions in retail price changes are reflected in the wholesale market.

<u>The impact of non-common costs should be reflected in the methodology</u>

5.16 A great number of costs associated with building and operating a mobile network are common to both call origination and call termination. A minority of costs can be clearly related to either one service or the other. Under the retail benchmarking approach it is presumed that these directly related costs remain in constant proportion between call origination and call termination. Where this is clearly not the case then an adjustment should be made to protect against the risk of an efficiency distortion.

5.17 A significant cost that has been incurred by mobile network operators recently is the redevelopment of systems associated with Mobile Number Portability (MNP). Such developments are more causally related to call termination than call origination (that is, the costs of MNP then to be borne more heavily on call termination that call origination). Obviously customers can change carriers and originate calls irrespective of whether they keep their own number or not. The MNP functionality is developed to ensure they can still receive calls destined for them.

5.18 The ACCC should make adjustments to the benchmarking approach to take account of any major change in cost structures that have a clear casual relationship to call termination.

Services for inclusion under a yield approach

5.19 Vodafone largely supports the range of services outlined in the ACCC discussion paper for inclusion in the retail price basket. This is likely to cover the entire range of material retail revenues earned by Vodafone. However, we note some problems with the approach that need to be addressed.

Competitive advantages gained by integrated carriers

5.20 We note that the services included in the price basket do not cover the entire range of services offered by our competitors. This is because Vodafone is the only 'mobile only' company that provides GSM termination services. Both Telstra and Optus provide a broader range of telecommunication services (extending to fixed network services, Internet and pay television). Vodafone notes the widespread use of 'bundling' of fixed and mobile services by both Telstra and Optus to cross sell and cross promote the range of services offered.

5.21 Given this, Vodafone notes the potential for integrated carriers to game the regulatory regime by substituting price reductions in the retail basket of mobile services with price reductions in services in other areas of their business. For example, Telstra could offer discounts on fixed line calls or Internet access instead of lower mobile prices and still stimulate demand in the retail mobile market. It appears that this already happens to some extent since Telstra differentiates the retail price it charges its fixed network customers for fixed-to-mobile calls depending on whether the customer calls the Telstra or Vodafone mobile network. This is despite termination rates being the same at a wholesale level.

5.22 The retail benchmarking approach combined with the competitive pressure delivered through non-mobile services would impact more heavily on Vodafone (as a mobile only carrier) than other access providers. This would have an unintended adverse impact on the state of competition in the mobile market.

5.23 This example lends weight to our earlier arguments that the ACCC should not use the pricing principle as a hard and fast rule. Rather, the pricing principle should be used as a guide to be used on a case-by-case basis. The ACCC should take account of the influence of different market drivers when deliberating on arbitrations between access seekers and providers. We would strongly urge the ACCC to provide an acknowledgment to the industry of the potential problems that may be caused by a strict adherence to the pricing principle.

The inclusion of services provided by resellers

5.24 Vodafone does not support the inclusion of revenues from the resale of services in the benchmarking calculation. Due to contractual obligations, Vodafone anticipates having difficulties in collating the information from our service providers. Vodafone considers that it would be more appropriate to rely on the retail prices offered by Vodafone's direct channels (which represent the majority of Vodafone's customer base) and to use this data as the basis for calculating retail price trends more generally.

The treatment of handset subsidies

5.25 The benchmarking approach must take into account the impact of handset and/or dealer subsidies. In today's market, consumers expect that handsets will be provided at little or no charge. However, as the market becomes more heavily penetrated this phenomenon is beginning to change. As carriers move towards 'SIM-only' plans (post MNP), and are increasingly looking to reduce the amount of subsidies paid, networks will become less reliant on access fees and higher airtime charges to recoup these subsidies.

5.26 Under the current pricing principles calculation this movement will appear as a reduction in the retail rate when there has merely been a re-balance in payments by the end consumer. In the case of 'SIM-only' plans the network does not need to recoup the handset subsidy. Where the handset subsidies have been reduced or removed the consumer will be asked to contribute towards the handset or pay for it in its entirety.

5.27 Another way to consider this structural change in how mobile services are sold and marketed is to consider it a change in quality. Previously customers have been purchasing a product that included both a handset and call minutes. Going forward they are more likely to be only purchasing call minutes.

5.28 A way of reflecting this likely shift in market behaviour in the benchmarking approach is to take both connection related costs and connection related revenues into account in the calculation (a net cost figure). However, connection related net costs cannot be calculated simply by dividing one months net costs by minutes of use for that month. Minutes are not a cost driver for connection net costs but gross connection levels are. It is more appropriate to take connection related net costs and divide by the number of gross connections for each month. This figure should then be spread over the average contract period (say 24 months).

5.29 A practical example would be if 10,000 gross additions were made in Month 1, earning $60,000 in connection revenues (handsets and connection fees) and costing $300,000 in connection costs (handsets and dealer subsidies) the resulting net connection costs would be $240,000. This cost would be spread evenly over the next 24 months at $10,000 per month and deducted from retail revenues. This would happen in each month. To determine the net connection costs for July 2001, the ACCC would need to include net connection related costs for up to 24 months prior to July 2001 (or longer if longer contract periods are in place).

5.30 We consider that this would be a relatively simple calculation to make and would have the benefit of ensuring that the changing market conditions are accurately reflected in the retail benchmarking calculation.

Allowing for credits under the yield approach

5.31 As discussed above, we support a period on period approach, where the minimum regulated price change would be driven by retail price trends in the previous six months.

5.32 Adopting a cumulative approach would introduce a series of added complexities into both the commercial negotiations and any subsequent arbitration. For instance, it appears that the cumulative approach would make arbitrated outcomes the rule rather than the exception because there would be incentives for all paries to seek ACCC arbitrated outcomes in the event that commercially negotiated prices did not align with their expectations for retail price changes.

5.33 For instance, in one scenario, the cumulative approach would protect the access seeker from any down-side of agreeing to access prices based on expected reductions in the access providers retail prices. In this case, the commercial risk is placed at the feet of the access provider. The opposite would apply if the retail prices at the end of the period ended up higher than expected. Either way, the cumulative approach will create distortions in the incentives to negotiate commercial terms.

5.34 The potential for the ACCC to apply 'credits' adds an extra complexity – and uncertainty – into the potential arbitrated outcome. On balance, Vodafone favours certainty and simplicity over additional efforts in search of the 'right price'.

Adjusting for quality

5.35 Quality is difficult to measure quantitatively and will be hard to account for. It is difficult to judge the impact of quality on retail price trends.

5.36 However, given the competitive environment, it is likely that carriers will adopt different commercial strategies in order to differentiate themselves in the marketplace including non-price strategies. For instance, a high quality customer service experience may be one such market differentiator. This would not be accounted for under the ACCC's approach – allowing carriers that adopt such strategies to be at a competitive advantage in the market. Without trying to discourage such innovation, it appears that the regulatory approach has the potential to distort commercial strategies.

5.37 To address this issue, Vodafone suggests a more flexible approach to the practical application of the benchmarking approach. As discussed above, we recommend that the ACCC use the retail benchmarking approach as guidance for arbitrations. It should not be narrowly applied as a prescriptive pricing 'rule'.

5.38 The issue of quality change is also relevant in the wholesale market. As discussed above with respect to the impact of MNP on wholesale services, if there is any change in quality of the terminating service then the retail benchmarking approach must be adjusted to take this into account.

6. Collection of information in an aggregated form

6.1 Vodafone acknowledges that one of the impacts of the regulation will be the requirement for all mobile carriers to provide to the ACCC detailed information to aid in arbitration disputes. However, Vodafone notes that this information should only need to be given to the ACCC in the event that the mobile carrier becomes engaged in a formal arbitrated dispute.

6.2 Vodafone would not support the ACCC requiring carriers to include this detailed information in the annual reporting requirements of the Regulatory Accounting Framework, through the imposition of a Record Keeping Rule. This would be unwarranted, given that the information will only be used in the event of arbitration. Based on our current experience and the general desire by all parties for commercially negotiated outcomes, Vodafone would consider that such arbitrations would be rare.

6.3 A more efficient solution would be for each mobile carrier to voluntarily collate information on an ongoing basis that would be provided to the ACCC in the event of arbitration involving that carrier.

6.4 Vodafone considers that the information collected by the ACCC as a result of this regulation should not be publicly disclosed. Public disclosure of this information (particularly each carrier's input data and the retail price trends) has the potential to distort commercial outcomes (which, at present, are the norm for this service).

6.5 There is a large amount of publicly available information about prices and other terms and conditions in the market. For instance, financial analysts regularly report and offer predictions on the mobile market. Companies themselves already release detailed financial and non-financial information on a regular basis. It is unclear what the benefits would be of public disclosure of additional information (particularly if it is of a commercially sensitive nature).

7. Other Issues

The need to formally link regulated wholesale reduction with pricing reductions in the fixed to mobile retail market

7.1 One of the major concerns that Vodafone has with the proposed regulation is that it does not provide any guarantee of benefits to end-users. As outlined in numerous submissions to the ACCC, Vodafone considers that if there is a market problem with fixed to mobile retail prices, it exists in the fixed to mobile retail market.

7.2 Our arguments are outlined in this passage from our submission to the ACCC's Draft Report on the Pricing Methodology for the GSM Termination Service (commercially sensitive information has been removed):

> 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.
>
> 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. [1]
>
> The cost of a two minute fixed-to-mobile call in December 1997 was 100 cents (peak) and 50 cents (off-peak). [2] This compares with a January 2001 rate of 108 cents (peak) and 77 cents (off-peak). [34] 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. [56]
>
> 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.

7.3 We are not aware of any evidence, produced by either the ACCC or by other parties, to challenge this analysis.

7.4 We acknowledge and support the ACCC proposed program to monitor fixed to mobile retail price. However, we recommend that the monitoring program be extended so that access seekers benefiting from lower regulated termination rates are unable to receive these benefits unless lower (regulated) rates are 'passed through' completely to end users in the fixed to mobile market.

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

[2] 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.

[3] 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.

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

[5] 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.

[6] 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.

7.5 Further work is required to work out the practical details, but one approach is outlined below:

- Say the ACCC determines (through its benchmarking analysis) that termination rates offered by a certain access provider to a certain access seeker should decrease by 5 per cent in next period;

- During this period the ACCC would conduct detailed monitoring of the access seekers fixed to mobile retail rates;

- If, as a result of this monitoring, the ACCC finds that the access seeker have not passed in full the lower termination rate to end-users, the access provider would not be obliged to offer these regulated prices in subsequent periods. Nor would the access seeker be able to pursue an arbitrated outcome for this service in subsequent periods.

7.6 The impact of this approach will be to ensure that the objective of the regulation (lower retail prices for fixed to mobile end-users) is achieved.