

Mobile Network Investment and Domestic Roaming

Supplementary report for Australian Competition and Consumer Commission Domestic Mobile Roaming Declaration Inquiry

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Stephen Myers



Introduction

Ovum provided an independent expert report (First Report) under the instruction of Gilbert + Tobin (on behalf of Telstra Corporation Ltd) to the ACCC's Inquiry into the declaration of Domestic Mobile Roaming. Ovum has now been asked to respond to a number of observations raised in the supplementary submissions of Vodafone Hutchison Australia Pty Ltd (VHA) and associated expert reports by Richard Feasey and Derek Ritzman. A copy of Ovum's instructions is set out at Annexure A.

Ovum wishes to briefly address a number of these points, as per the headings below.

Ovum has considered the matters raised by VHA and its experts. Ovum maintains that the methodology and assumptions it used in its First Report are appropriate.

Allocation of costs to remote mobile sites

The VHA submission suggests the allocation of non-incremental costs has been used to inflate Telstra's costs in Telstra-only areas.

Ovum provided the ACCC a view of the operational performance of Telstra-only sites and the degree they recovered

- direct costs,
- direct costs and depreciation,
- fully allocated operating costs & site depreciation, or
- fully allocated operating costs, site depreciation and the cost of capital.

This allows for a perspective on how Telstra-only sites individually perform.

The allocation of common costs recognizes the network and commercial operating costs of Telstra's mobile business and include line items such as site repair and maintenance, mobile content, customer service, billing, and product development. Incurring these costs all contribute to Telstra's mobile business, and support the opportunity for revenue to be generated in the remote Telstra-only areas.

As this was an operational performance assessment and not an attempt to value the sites (as implied by VHA's reference to the evaluation of a NPV), Ovum believes this is an appropriate approach.

Treatment of funding

Ovum undertook an analysis of the operational performance of individual sites considered to be in Telstra-only areas. This analysis did not attempt to recognise the original funding arrangements that supported those sites, including whether sites were entirely internally funded by Telstra, or subsidized by a government program to expand mobile coverage. Ovum has since been instructed that only two sites of the 448 included in Ovum's analysis received federal government funding as part of the first Mobile Black Spots Programme. As such, inclusion of federal government co-investment would not have had a material impact on the results of Ovum's assessment of the performance of Telstra-only sites.

Ovum's assumptions about a second entrant

In its commentary on Ovum's assessment of the potential for a secondary MNO to expand coverage in Telstra-only areas VHA raises a number of concerns.

Firstly, that a second entrant would take time to win market share. Ovum does not, nor would not, assume that Optus would immediately be able to secure 27% revenue share on building a new site. As noted above the analyses undertaken by Ovum were effectively snapshots of the potential profitability, not a site valuation or NPV. Ovum applied an equivalent methodology to the second entrant as used for the Telstra analysis to allow the ACCC comparison of returns, and so assessed potential profitability with regard to the likely revenue share the second entrant would have once established.

Equally it should not be assumed that share gains will be consistent across sites. For example, in the case of highway coverage, a second entrant wins 100% share of traffic from their existing customers passing through the areas, while the share of traffic that is won from churning local customer subscriptions is likely to be relatively modest. Thus, the overall revenue pool is expanded in these cases and share would immediately trend to the mix of customers transiting through the coverage. The First Report noted that there was substantial variance in returns depending on the site coverage (mining, highway, etc.).

Secondly, VHA highlights the need for complementary investments to support market share wins. VHA notes that advertising and marketing expenditures will be needed to change consumer perceptions. Ovum does not disagree, recognizing that a range of common costs should be included in the assessment of potential site profitability.

Other submissions made by VHA and its experts, Dr Ritzmann and Mr Feasey, suggest Ovum's assumptions are unreasonable but are not specific, nor offer alternatives. Mr Feasey in his discussion of revenue market shares also incorrectly purports to use Ovum's methodology and figures to calculate Telstra's market share. Mr Feasey divides Telstra's total mobile revenues (which includes handset and accessory sales) by Ovum's assessment of mobile market service revenues (which excludes revenue from equipment sales). By incorrectly using a different, and significantly higher, revenue figure for Telstra, Mr Feasey reaches a conclusion that overstates Telstra's market share.

Ovum is not able to further comment on the assumptions VHA has made in its modelling and how the assumptions adopted by Ovum have been recast in its analysis as this modelling has not been made available by VHA.

VHA suggests Telstra-only areas may be stand-alone profitable

The suggestion that the Telstra-only areas may be profitable in aggregate appears to rely on exclusion of a proportion of operating costs. Ovum again notes that there is a small number of Telstra-only sites that appear highly profitable (eg mining sites) and may be associated with large corporate contracts. For this reason, it is inappropriate (and misleading) to assess the profitability of Telstra-only sites on an aggregate basis – it would be entirely open to Telstra to invest in, and continue to operate, the profitable sites but not the unprofitable ones.

Assessment of natural monopoly

Ovum reiterates its view that many of the Telstra-only sites do not appear profitable on a stand-alone basis, and the profitable share of this coverage is susceptible to infrastructure competition should national market share shift with the closing of the coverage gap. The pool of sites that are assessed as unprofitable for Telstra and a second entrant (including an allocation of national revenue from improved coverage) was considerable. These sites are simply unprofitable rather than representing beneficiaries of natural monopoly conditions.

Telstra's price premium exceeds required cross-subsidy

VHA submits, in part by asserting that Telstra-only areas are stand-alone profitable, that Telstra's current pricing premium exceeds the required cross subsidy of Telstra's uneconomic coverage. As noted in the First Report, customers select Telstra as their mobile service provider on the basis of their consideration of a combination of factors including pricing, network coverage, and network quality. Actual (and perceived) network quality includes a range of factors including data speeds, call clarity and service reliability. Telstra's premium is also supported by providing an expansive content and product range, and its customer service.

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ANNEXURE A

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15 June 2016

By email

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Dear Mr Myers

Response to the Australian Competition and Consumer Commission regarding potential declaration of a wholesale domestic roaming service on behalf of Telstra Corporation Limited

1 Background

- 1.1 We refer to our letter to you dated 1 December 2016, engaging you on behalf of Telstra Corporation Limited (**Telstra**) to provide a report in relation to an inquiry commenced by the Australian Competition and Consumer Commission (**ACCC**) into whether to declare a wholesale domestic mobile roaming service (**ACCC Inquiry**).
- 1.2 As you are aware, the ACCC invited submissions to the Discussion Paper from mobile network operators. Submissions were provided by a number of operators, including Telstra and Vodafone Hutchison Australia Pty Ltd (**VHA**). VHA provided two sets of submissions. VHA's supplementary submission dated 23 March 2017 was accompanied by a number of expert reports, including:
 - (a) the second report of Dr Derek Ritzmann dated 8 March 2017; and
 - (b) the second report of Mr Richard Feasey dated 11 March 2017.
- 1.3 We have been instructed to engage you, on behalf of Telstra, to prepare a supplementary report based on your expert opinion. As with respect to your previous engagement, your report is for use by Telstra in relation to the ACCC Inquiry. Telstra may seek to rely upon your report in any subsequent review of the ACCC's final decision. If that occurs, we will contact you.
- 1.4 By this letter, we set out our written instructions to you.

2 Scope of work

2.1 You are retained to provide an expert report which addresses:

- (a) VHA's supplementary submission;
- (b) the second report of Dr Derek Ritzmann dated 8 March 2017; and
- (c) the second report of Mr Richard Feasey dated 11 March 2017,

insofar as each comments on the methodology and results of Ovum's report dated 1 December 2016.

3 Assumptions

3.1 You are instructed to assume that only two sites of the 450 sites used in Ovum's analysis have received government funding under the Mobile Black Spots Programme, Round 1.

4 Guidelines for preparing your report

4.1 While you have not been engaged in respect of any legal proceedings, Telstra is seeking a robust and rigorous independent expert report. We request that you prepare your report in accordance with Federal Court of Australia *Harmonised Expert Witness Code of Conduct*. A copy of the Code of Conduct is enclosed at **Attachment A**.

4.2 In particular, in preparing your report, we ask that you please:

- (a) identify your relevant area of expertise and provide a curriculum vitae setting out the details of that expertise;
- (b) only address matters that are within your expertise;
- (c) where you have used factual or data inputs please identify those inputs and the sources;
- (d) if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;
- (e) if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;
- (f) confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and
- (g) do not provide legal advocacy or argument and please do not use an argumentative tone.

5 Confidentiality and legal professional privilege

- 5.1 Presently, your report and all correspondence between us (excluding this letter) is subject to legal professional privilege. In addition, the information we have provided to you is commercially sensitive and confidential. For these reasons, we request you do not disclose or discuss your report, our correspondence or any information we provide to you with any third parties.

Yours faithfully
Gilbert + Tobin

A handwritten signature in black ink, appearing to read 'Peter Waters'.

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Attachment A

Harmonised Expert Witness Code of Conduct **(Annexure A to Federal Court of Australia Practice Note GPN-EXPT)**

APPLICATION OF CODE

1. This Code of Conduct applies to any expert witness engaged or appointed:
 - (a) to provide an expert's report for use as evidence in proceedings or proposed proceedings; or
 - (b) to give opinion evidence in proceedings or proposed proceedings.

GENERAL DUTIES TO THE COURT

2. An expert witness is not an advocate for a party and has a paramount duty, overriding any duty to the party to the proceedings or other person retaining the expert witness, to assist the Court impartially on matters relevant to the area of expertise of the witness.

CONTENT OF REPORT

3. Every report prepared by an expert witness for use in Court shall clearly state the opinion or opinions of the expert and shall state, specify or provide:
 - (a) the name and address of the expert;
 - (b) an acknowledgment that the expert has read this code and agrees to be bound by it;
 - (c) the qualifications of the expert to prepare the report;
 - (d) the assumptions and material facts on which each opinion expressed in the report is based [a letter of instructions may be annexed];
 - (e) the reasons for and any literature or other materials utilised in support of such opinion;
 - (f) (if applicable) that a particular question, issue or matter falls outside the expert's field of expertise;
 - (g) any examinations, tests or other investigations on which the expert has relied, identifying the person who carried them out and that person's qualifications;
 - (h) the extent to which any opinion which the expert has expressed involves the acceptance of another person's opinion, the identification of that other person and the opinion expressed by that other person;
 - (i) a declaration that the expert has made all the inquiries which the expert believes are desirable and appropriate (save for any matters identified explicitly in the report), and that no matters of significance which the expert regards as relevant have, to the knowledge of the expert, been withheld from the Court;
 - (j) any qualifications on an opinion expressed in the report without which the report is or may be incomplete or inaccurate;
 - (k) whether any opinion expressed in the report is not a concluded opinion because of

insufficient research or insufficient data or for any other reason; and

- (l) where the report is lengthy or complex, a brief summary of the report at the beginning of the report.

SUPPLEMENTARY REPORT FOLLOWING CHANGE OF OPINION

- 4. Where an expert witness has provided to a party (or that party's legal representative) a report for use in Court, and the expert thereafter changes his or her opinion on a material matter, the expert shall forthwith provide to the party (or that party's legal representative) a supplementary report which shall state, specify or provide the information referred to in paragraphs (a), (d), (e), (g), (h), (i), (j), (k) and (l) of clause 3 of this code and, if applicable, paragraph (f) of that clause.
- 5. In any subsequent report (whether prepared in accordance with clause 4 or not) the expert may refer to material contained in the earlier report without repeating it.

DUTY TO COMPLY WITH THE COURT'S DIRECTIONS

- 6. If directed to do so by the Court, an expert witness shall:
 - (a) confer with any other expert witness;
 - (b) provide the Court with a joint-report specifying (as the case requires) matters agreed and matters not agreed and the reasons for the experts not agreeing; and
 - (c) abide in a timely way by any direction of the Court.

CONFERENCE OF EXPERTS

- 7. Each expert witness shall:
 - (a) exercise his or her independent judgment in relation to every conference in which the expert participates pursuant to a direction of the Court and in relation to each report thereafter provided, and shall not act on any instruction or request to withhold or avoid agreement; and
 - (b) endeavour to reach agreement with the other expert witness (or witnesses) on any issue in dispute between them, or failing agreement, endeavour to identify and clarify the basis of disagreement on the issues which are in dispute.