TELSTRA CORPORATION LIMITED

Response to Vodafone's supplementary submission to the ACCC's domestic mobile roaming declaration inquiry

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01 Executive summary

Telstra provides this submission in response to the ACCC's invitation in its Draft Decision for comments on Vodafone's supplementary submission dated 13 March 2017 (**Vodafone Supplementary Submission**). Telstra is responding separately to the ACCC's Draft Decision.

Vodafone is seeking a regulatory option over the Telstra and Optus networks to remedy its history of under-investment in regional and rural Australia. Vodafone justifies this position on the false premise that Telstra's greater coverage represents a market failure in regional Australia.

The fact is that the networks and customer bases that each mobile network operator (**MNO**) in Australia has today are the outcome of the strategic, competitive and capital planning decisions they have made over time.

Telstra's consistent strategy is to pursue coverage based differentiation from its competitors by making significant infrastructure investments in regional and rural Australia to the benefit of regional communities. By contrast, Vodafone's strategy has been to differentiate itself by providing a lower cost network, and in doing so, has not made the same investment that Telstra or Optus have in network coverage and quality over successive generations of technology. Vodafone can and does successfully compete on the network it has chosen to build, for the customers it has chosen to target, both in metropolitan and regional areas where it has chosen to deploy network (as well leveraging its extensive international network for competitive advantage).

If Vodafone considers its smaller metropolitan-focused coverage footprint places it at a competitive disadvantage, it has commercial options to rectify this other than leveraging regulation. These include seeking capital infusions from its global parents to build more network of its own, stepping up its participation in Government funded co-investment programs, co-operating with TPG on its upcoming network build or commercially negotiating roaming, or a combination of these things. The existence of these market-based options demonstrates that there is no market failure, and regulatory intervention to declare roaming is unnecessary.

Not only is declaration unnecessary, but it would not address coverage issues in regional and rural Australia:

- Declaring roaming will damage the currently strong investment incentives in regional and rural Australia because an MNO will gain no competitive advantage in extending or upgrading its network. MNOs will therefore delay or decline to be the first network investor in a region, and have limited incentive to be a second network investor. These altered investment dynamics will hinder improvements and expansion in coverage, to the detriment of regional and rural customers; and

- Customers will likely pay more for poorer quality mobile services. National uniform pricing, which has been a bedrock feature of telecommunications retail pricing in Australia, will likely unravel, with significant negative impacts on customers who live, work and travel in regional and rural Australia.

Telstra recognises and understands the frustrations among some customers that there are still areas with no or patchy coverage in regional and rural Australia. The evidence from submissions to the ACCC's declaration inquiry from organisations and individuals in regional and rural Australia reinforces that regional and rural customers care about getting more and better coverage – not resale choice for coverage they already have.

It is critical that consideration be given to these issues, and Telstra's submission in response to the ACCC Draft Decision outlines its recommendations for providing better coverage to rural and regional customers. Declaring roaming is not the right solution – it will not ensure continued investment in improving network coverage and quality in regional and rural Australia, because it only involves resale of existing coverage and will undermine investment incentives in better future coverage.

The recently announced additional investment which Telstra and Optus are prepared to make in the absence of declared roaming will provide more and better coverage in regional and rural Australia in the very near future. Therefore, the focus of addressing the concerns of regional and rural Australians should be on encouraging infrastructure-based competition, which has delivered world leading mobile coverage.

02 Vodafone's argument that roaming will improve investment in regional Australia is not credible

Vodafone claims that declaring roaming will facilitate its investment in regional and rural Australia. This is not credible in light of the history of Vodafone's strategic investment in its mobile network and its lack of any commitments to invest even if roaming were to be declared.

Telecommunications is a highly capital intensive business and the network in which an MNO chooses to invest is driven by its competitive strategy. As the MNOs in Australia have pursued different competitive strategies, it is to be expected that they will have invested in different networks. Difference in coverage is not, as Vodafone asserts, a defect in competition, rather it is the outcome of vigorous facilities based competition where MNOs compete with different value propositions.

History illustrates that Vodafone entered the Australian market with a business strategy that was clearly focused on providing lower priced mobile services to customers in metropolitan areas. This is reflected in the scale and nature of investments made by Vodafone, with a track record of repeated decisions to limit its network investment, especially in rural and regional areas. Instead, Vodafone has chosen to invest in a metropolitan-focused, low-cost network.

Vodafone's investment strategy is also evident in its historic approach to spectrum purchases which to date has not supported extensive regional and rural coverage:

- Vodafone did not participate in the digital dividend auction in 2013, which reallocated spectrum in the 700 MHz and 2.5 GHz bands. These spectrum bands, can be used in combination to effectively extend coverage into regional areas and satisfy capacity demands in regional towns. Both Telstra and Optus invested significantly in these spectrum auctions, spending $1.3 billion and $650 million respectively.[1] Although Vodafone participated in the subsequent auction in April 2017 for the 700 MHz spectrum left unsold after the 2013 auction, it only purchased 2x5 MHz for $285 million. By comparison, new entrant TPG purchased 2x10 MHz for $1.26 billion.[2]

- The regional 1800 MHz spectrum auction in December 2015 – January 2016 was specifically structured to improve the availability and performance of 4G telecommunications services across regional Australia. Both Telstra and Optus invested heavily in this auction, purchasing spectrum across all 12 regional areas that were auctioned. Vodafone's participation was much more limited, purchasing only a small number of lots in five of the 12 regional areas auctioned, with the majority of their investment focussed on Canberra at the expense of investment in spectrum for more sparsely populated regional areas.[3]

The perils of underinvesting in a capital intensive industry like telecommunications are no better illustrated than by the "Vodafail" event.[4] This resulted in a need for Vodafone to implement a major

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[1] ACMA, *Digital dividend auction – results,* available at: http://www.acma.gov.au/theACMA/digital-dividend-auction-results (accessed 17 May 2017).

[2] ACMA, *Sold! ACMA completes high-value spectrum auction,* 12 April 2017, available at: http://www.acma.gov.au/theACMA/Newsroom/Newsroom/Media-releases/sold-acma-completes-high-value-spectrum-auction (accessed 17 May 2017).

[3] ACMA, *1800 MHz band auction strong result reveals high demand for regional spectrum,* 5 February 2016, available at: http://www.acma.gov.au/Industry/Spectrum/Spectrum-projects/1800-MHz-band/1800-mhz-band-auction-strong-result-reveals-high-demand-for-regional-spectrum (accessed 17 May 2017).

[4] News.com.au, *How did Vodafone become Vodafail?,* 15 October 2012, available at: http://www.news.com.au/finance/business/how-did-vodafone-become-vodafail/story-fnda1bsz-1226496461128 (accessed 16 November 2016).

turnaround strategy, necessitating a spend of more than $3 billion in order to reinforce its core network from 2011 to 2014,[5] which enabled it to address its network shortcomings and recover its position.

Vodafone could have chosen a different strategic path, and it is still open to Vodafone to do so. With large, well-resourced global parents, Vodafone has access to substantial capital resources.[6] Its successful turnaround from the "Vodafail" fallout demonstrates that by investing more in coverage in regional and rural areas, Vodafone could "shift the needle" in competing against Telstra and Optus.

In contrast, without declared roaming, both Telstra and Optus have made significant network investments which now cover 99.3 per cent and 98.5 per cent of Australia's population respectively. Absent declaration, Telstra's commitment is to keep investing to improve and expand its mobile network in regional, rural and remote areas. Through Telstra's direct investment, as well as co-investment from others, Telstra expects to see $1 billion flow into improving coverage for small towns and regional centres across the country over the next five years.[7] Optus has also recently announced that the draft decision to not declare has provided certainty for Optus to invest $1.5 billion in its mobile network in 2017/18, which in part will go towards deepening its network capacity and coverage in regional Australia.[8]

[5] Vodafone, *Vodafone celebrates 21 years in Australia*, 16 October 2014, available at: http://www.vodafone.com.au/media/celebrating-21-years-in-australia/ (accessed 19 May 2017). See also The Australian, *Vodafone splurges on network to win back customers and restore brand*, 19 February 2013, available at: http://www.theaustralian.com.au/business/technology/vodafone-splurges-on-network-to-win-back-customers-and-restore-brand/news-story/f17fd8ade606904ee8aae6bc59da9c0e (accessed 24 May 2017).

[6] For example, in the year ended 31 March 2016, Vodafone Group Plc spent just under £8.6 billion (approximately AU $15 billion) on capital expenditure: see Vodafone Group, Media Release, *Vodafone announces results for the year ended 31 March 2016,* 17 May 2016, available at: http://www.vodafone.com/content/index/media/vodafone-group-releases/2016/prelim-31march2016.html (accessed 22 May 2017). Further, Vodafone Group Plc sold its stake in Verizon Wireless for approximately US $130 billion (approximately AU $175 billion): see Vodafone Group, Media Release, *Vodafone to realise US$130 billion for its 45% interest in Verizon Wireless,* available at: http://www.vodafone.com/content/index/media/vodafone-group-releases/2013/vodafone_to_realiseus130billionforits45interestinverizonwireless.yes.html (accessed 22 May 2017).

[7] Andy Penn, Investor Day Speech, 17 November 2016, available at: https://www.telstra.com.au/content/dam/tcom/about-us/investors/pdf-e/181116-Investor-Day-2016-Transcript.pdf (accessed 22 May 2017).

[8] Optus, Media Release, *Optus delivers a quarter of Revenue, EBITDA and Profit Growth,* 18 May 2017, available at: https://media.optus.com.au/wp-content/uploads/2017/05/Q4-FY16-17-Optus-Media-Release.pdf (accessed 22 May 2017).

03 Roaming will increase prices

3.1. Regional and rural customers currently benefit from low nationally uniform prices which continue to fall

A key pricing feature of the Australian mobile market is nationally uniform pricing. This ensures that regional and rural customers pay the same prices as metropolitan customers, regardless of the fact that they live and work in areas where the cost to supply mobile services is much higher.

Further, the benefits of the intense competition that occurs between Telstra, Optus and Vodafone in areas of overlapping coverage are passed onto customers in regional areas even where there is no overlapping coverage. As Optus continues to build out in regional and rural areas and can offer customers coverage approaching Telstra's coverage at a lower price point, this places additional competitive discipline on what Telstra can charge for the extra coverage it provides.

Telstra, and presumably Optus, have evolved business models which sustain this outcome. High-cost regional and rural networks generate a return from both customers who live in those areas and customers who don't, but who value the option of enjoying coverage in those areas at a nationally uniform price. Together, these two groups of customers enable otherwise uneconomic regional and rural network investments to be viably made, with both groups benefitting from greater network coverage and nationally uniform, falling prices.

Vodafone has erroneously suggested that if roaming is not declared, Telstra would continue to increase (or not decrease) its mobile retail prices. Vodafone asserts that the ACCC's annual telecommunications reports support this suggestion. This is plainly incorrect. According to the ACCC's mobile services index, average retail mobile prices have shown a strong and continuing decreasing trend, falling 53.4 per cent since 1997, with increases in data inclusions further improving the effective value of mobile offers.[9]

It is clear from Vodafone's own submissions and experts that the pricing dynamics which currently define the mobile services market will be at risk if roaming is declared, to the detriment of end users. Vodafone says that it wants to offer customers an "*optional premium coverage product*:"[10] that necessarily means higher prices for regional and rural customers than for metropolitan customer. Vodafone also says "*prices would unequivocally fall*" for all customers[11]: that would require wholesale prices that are below the cost of serving those regional and rural areas.

Set out below is an explanation of why Vodafone's two propositions cannot co-exist if roaming is declared.

3.2. Vodafone inherently assumes a below-cost wholesale price in roaming areas

To support its claim that prices will fall, Vodafone must be assuming that the ACCC will set a regulated wholesale access price that will allow scope for what Vodafone claims will be a "*significant price decline*".[12] This assumption about wholesale prices is problematic because any regulated wholesale access price would need to deal with two issues.

First, much of Telstra's infrastructure in regional and rural areas is uneconomic on a standalone basis. Therefore, retail prices could only fall in these areas if Vodafone is assuming that a wholesale roaming

[9] ACCC, *Telecommunications Reports 2015-16: Price changes for telecommunications services in Australia,* February 2017, pp 96-7.
[10] Vodafone Supplementary Submission, Part A, s 1.4.3.
[11] Vodafone Supplementary Submission, Part A, s 1.4.1.
[12] Vodafone Supplementary Submission, Part A, s 1.4.7.

charge will be below cost (eg, priced on a nationally uniform basis even though a declared roaming service will only be supplied in high-cost areas). It is not clear how this could be consistent with the statutory criteria that the ACCC would have to apply in an access determination, nor how this would preserve the incentives to maintain and expand mobile infrastructure in regional and rural communities.

Second, funding mobile network infrastructure in regional and rural areas (and continuing upgrades and extensions) depends on indirect revenues from customers in other areas. Therefore, the access price would need to compensate Telstra for the loss of indirect revenues or risk future network investment, upgrades and maintenance to the detriment of regional and rural customers.

While Vodafone conjectured a number of different regulatory pricing models,[13] none resolve these issues.

Vodafone's own expert, Mr Feasey, has in other proceedings acknowledged that domestic roaming costs might well be higher than nationally averaged retail prices. In the Canadian Radio-television and Telecommunications Commission inquiry into Wholesale Wireless Markets, Mr Feasey made the following observation in his expert statement against regulated roaming:[14]

> *[T]here are some obvious reasons why domestic roaming costs and charges might actually be expected to be significantly higher than an 'average domestic retail price'. First, domestic roaming tends to occur in rural areas which are more expensive and more difficult for the access seekers to serve with their own networks, whilst the retail prices charged by wireless operators will reflect the average costs they face in providing wireless services across the totality of their network. There is therefore no reason why the costs of providing domestic roaming in high cost areas should fall below the average costs of providing retail services across the network as a whole and every reason to suppose they could be higher.*

In the context of the ACCC's Declaration Inquiry, Mr Feasey has avoided saying where he thinks access pricing might end up relative to retail pricing, but he does acknowledge retail prices following declaration may be higher than current nationally uniform prices. Mr Feasey justifies any likely increases in retail prices stating that the increase "*ought to be because [customers] obtain value*".[15]

This clearly contradicts Vodafone's assertion that "*prices would unequivocally fall*" if roaming is declared.[16] It also means, under a nationally uniform pricing approach, that customers who do not value or require coverage may end up paying more for a feature that they do not want – unless, of course, Vodafone triggers an unravelling of nationally uniform prices (see below). In the absence of declared roaming those customers can already satisfy their preference for lower prices over coverage by buying an Optus or Vodafone mobile service.

3.3. Vodafone plans to geographically de-average retail pricing

Regardless of the wholesale price structure, Vodafone says it will offer an "*optional premium coverage product*" which means that customers who are "*willing to pay for full coverage in regional Australia would have the ability to 'opt in' to the full coverage*".[17]

This proposed pricing structure would mean that Vodafone's regional customers, as well as its metropolitan customers traveling in regional and rural areas, will need to pay more for mobile coverage

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[13] For example, Vodafone has identified multiple different price methodologies that could be used.
[14] Statement of Richard Feasey, *The regulation of mobile wholesale markets in the rest of the world (and its relevance to the CRTC's enquiry into wholesale wireless markets in Canada), Rogers Communications, Attachment 1 to May 15, 2014 Intervention, CRTC File No: 8620-C12-20140148,* [22].
[15] Report of Richard Feasey dated 1 December 2016, [82] (**First Report of Richard Feasey**).
[16] Vodafone Supplementary Submission, Part A, s 1.4.1.
[17] Vodafone Supplementary Submission, Part A, s 1.4.3.

than metropolitan customers who do not require or value that broad geographic coverage. This is exactly the type of geographically de-averaged pricing that Telstra has warned might result if roaming is declared and that Vodafone originally dismissed as "*entirely spurious*".[18]

Vodafone's expert, Mr Feasey, also contemplates the possibility that roaming may result in de-averaging of prices through the introduction of plans with varying degrees of coverage.[19]

Two points can be made about this alternative pricing outcome proposed by Vodafone.

First, charging customers who opt-in to roaming a retail premium could allow Vodafone to recover an access price set at a level which would compensate Telstra for its higher costs in roaming areas and the lost indirect revenues. However, this would only serve to reinforce higher prices for regional and rural Australians through geographically de-averaging retail pricing.

Second, the optional premium choice Vodafone says it will give customers with mandated roaming is already available from Telstra and Optus – and it is available without the risk of nationally uniform prices unravelling:

- Customers who do not value or require wide geographic coverage in regional and rural areas already have the option of declining the extra coverage at Telstra's price, by choosing lower priced Vodafone or Optus products without the coverage they do not value; and
- Customers who do value and require wide geographic coverage in regional and rural areas benefit from low prices as a result of the vigorous price competition in the national market and price averaging across lower-cost metropolitan markets.

Vodafone's own plans to use mandated roaming on Telstra's network to offer a premium product with greater coverage illustrate that its characterisation of Telstra's prices as *"monopoly rent"* is not correct. The current retail price differences across MNOs are based on product differentiation. Telstra's customers are not victims of a "*monopoly rent"*, they are willing to pay a price that reflects the added value of Telstra's greater coverage and superior network. Vodafone seeks through regulation the ability to ride on Telstra's greater coverage so that it too can offer a premium product without having to make an investment of its own.

3.4. One way or other roaming will lead to higher prices

Vodafone cannot leave its two propositions unresolved. Either prices remain nationally uniform and all customers pay more to recover the costs of roaming and, as Mr Feasey says, to reflect the increased value of Vodafone's coverage, even if they do not want it. Or prices de-average nationally so that metropolitan customers who do not want or need the extra coverage don't pay for it and those who live and work in regional and rural areas bear the full cost, including the lost indirect revenues. In both cases, prices will rise for regional and rural end users.

[18] Vodafone Supplementary Submission, Part A, s 1.4.4.
[19] First Report of Richard Feasey, [80]-[83].

04 Vodafone ignores historic benefits of strong infrastructure competition

4.1. Telstra's investment in regional Australia has not been for political reasons

Vodafone contends that Telstra has invested in regional and rural Australia to "meet regulatory and political requirements".[20] This is incorrect and fails to recognise the strategic business objectives and competitive basis for expanding coverage that underpin Telstra's significant investment in regional and rural Australia.

As explained in Mike Wright's statement, Telstra's consistent market strategy has been to differentiate itself by continuing to invest to remain the leader in network coverage, quality and technology.[21] Telstra's strategic decision to invest in Next G and build a new 3G network across Telstra's entire existing CDMA network footprint marked the beginning of this competitive differentiation.[22] At the time, Telstra was building three separate mobile networks across GSM, CDMA and the 3GIS 3G network. However, as 3G technology was limited to metropolitan areas, regional and rural customers often needed to purchase two handsets – one for use in regional areas on the CDMA network and the other for use in GSM regional towns and metropolitan areas.[23] Building a single nationwide network resolved this technology fragmentation, and improved customer experience and the competitiveness of Telstra's services.

Vodafone has argued that Telstra's investment in Next G was driven by its carrier licence conditions which required Telstra to maintain operation of its CDMA network until the Next G network provided equivalent or better coverage to the CDMA network as at 1 June 2007.[24] However, this licence condition was not introduced until 2007, well after Telstra made its strategic decision and announcement in November 2005 that it would roll out the new and innovative 3G technology across its entire network footprint.[25] Telstra's Next G investment was not driven by a carrier licence condition, but rather to differentiate Telstra's network from its competitors by building a better quality network with better coverage, particularly for regional and rural Australia.[26]

Further, Telstra has continued to invest in regional and rural areas since the closure of the CDMA network on 28 April 2008. Telstra's CDMA footprint as at 1 June 2007 covered 98 per cent of the Australian population, much less than the 99.3 per cent of the population that Telstra's network now covers. Expansion of coverage to 99.3 per cent of the population has seen approximately 800,000 km^2 of additional coverage, which equates to an increase in Telstra's geographic coverage of approximately 50 per cent since the closure of the CDMA network. The coverage race also has pushed the Optus network beyond the CDMA footprint to 98.5 per cent of the Australian population, and Optus has no rollout commitments in its carrier licence.

Vodafone has also stated that Telstra's announcement to expand 4G coverage to 99 per cent of the Australian population was only made after the declaration inquiry, suggesting that this announcement was driven by the threat of regulation.[27] This is also incorrect and misleading. Telstra has been planning and developing the expansion of its 4G coverage footprint well before this declaration inquiry

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[20] Vodafone Supplementary Submission, Part A, s 3.1.3.
[21] Statement of Michael James Wright dated 1 December 2016, s 9.2 (**Statement of Mike Wright**).
[22] Statement of Mike Wright, [80]-[81].
[23] Statement of Mike Wright, [76], [78] and [80].
[24] Vodafone Supplementary Submission, Part A, s 3.1.3.
[25] Telstra, Media Release, *Telstra unveils 3G city-to-country delivering mobile 3G broadband,* 15 November 2005 (Statement of Mike Wright, MJW-2).
[26] Statement of Mike Wright, [81].
[27] Vodafone Supplementary Submission, Part A, s 3.4.5.

commenced, with Telstra's CEO officially announcing in mid-2015 Telstra's plans to expand its 4G coverage footprint to 99 per cent of the Australian population, well before Vodafone started its roaming campaign and over a year before the ACCC announced the launch of this declaration inquiry.[28]

Plans to extend Telstra's 4G coverage to 99.3 per cent of the Australian population are in development. Subject to the continuation of existing regulatory settings, this would represent the next incremental step in Telstra's efforts to retain its competitive advantage in an environment where Optus continues to make strategic investments in regional and rural Australia.

4.2. Telstra's investment in regional Australia has been self-funded

Vodafone has also attributed Telstra's mobile investment in regional and rural Australia to subsidies it claims Telstra has received.[29]

As outlined in Telstra's supplementary submission, Vodafone's estimates of the Government funding that Telstra has received include a number of significant inaccuracies:

- Vodafone has included funding that is not related to Telstra's mobile network such as Universal Service Obligation (**USO**) funding (which is for the supply of fixed telephony service) and funding for the rollout of optic fibre to state-owned schools; and

- Vodafone has also double counted some co-investment initiatives. For example the projects being undertaken in Tasmania as part of Round 1 of the Mobile Black Spot Program and the USO funding for the years 2013 to 2016 are both counted twice.

Not only has Vodafone substantially over-estimated the Government funding that Telstra has received, but it is also incorrect that Government funding has driven most of Telstra's mobile investment in regional Australia. Government funding accounts for less than one per cent of Telstra's investment in its mobile network over the 11 financial years to FY16 (on a fully allocated basis, excluding spectrum purchases and renewals).

Telstra has long adopted an investment strategy that focuses heavily on regional and rural areas. Over the past decade about 15 per cent of investment in Telstra's mobile network has gone to servicing the most remote two per cent of the population – all of this investment has been funded by Telstra's shareholders based on its competitive strategy.

History clearly illustrates that it is strong competition that is driving investment in regional and rural Australia and facilitating the expansion of high quality, competing mobile networks. Vodafone's arguments ignore this reality and the benefits that competition has delivered to Australians in regional and rural areas.

4.3. Vodafone's survey of the regional community's view of regulation is heavily biased

Vodafone's reliance on a survey conducted by Empirica Research (**Empirica**) to claim that Telstra is trying to hide regional support for declared roaming is unfounded.[30] As outlined in Professor Heath

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[28] Andy Penn, *Keynote speech at CEDA in Sydney*, 9 July 2015, available at: https://exchange.telstra.com.au/connecting-with-the-future/ (accessed 22 May 2017). Vodafone announced its partnership with the National Farmers' Federation as its exclusive telecommunication partner in December 2015. This appears to be the start of its roaming campaign and post-dated Telstra's 4G investment announcement. See: Vodafone, Media Release, *Vodafone strengthens commitment to regional Australia,* 12 December 2015, available at: http://www.vodafone.com.au/media/strengthens-commitment-regional-australia/ (accessed 22 May 2017).
[29] Vodafone Supplementary Submission, Part A, s 3.1.3.
[30] Vodafone Supplementary Submission, Part A. s 1.2.6.

McDonald's report dated 15 June 2017, Empirica's survey cannot be relied upon because fundamental flaws in its research methodology produced biased results in favour of roaming.

Professor McDonald says of the Empirica survey:[31]

> *The sample, whilst substantial, does not reflect the regional or rural population of Australia*.
>
> …
>
> *The questions are asked in a manner likely to elicit highly positive responses, through a lack of balanced question framing.*
>
> *The responses, surprisingly, are not as positive as could reasonably be expected under these circumstances*
>
> *The use of an attitudinal survey is not appropriate for determining future customer behaviours or the relative importance of various product features, even if rigorously undertaken. Choice modelling or conjoint analysis are more appropriate techniques for determining the relative impact a change like mobile roaming regulation might make to customer preferences and actual choice behaviour.*

In summary, Empirica's survey asked questions framed in a manner intended to invite a particular answer that suited Vodafone's argument. The only surprise is the substantial proportion of respondents who did not answer as expected.

[31] Report of Professor Heath McDonald dated 15 June 2017, [1.6]-[1.9].

05 Vodafone's arguments are based on an incorrect view of "natural monopoly"

5.1. There is no natural monopoly, just varying degrees of investment in quality and coverage

Vodafone's assertion that the Telstra-only coverage area in regional Australia represents a natural monopoly is economically misconceived:[32]

- Optus is continuing to build in regional and rural areas, including in Telstra-only areas. While Telstra does not know how far the Optus overbuild will go, the uncertainty about where Optus will build is part of the competitive dynamic which drives Telstra to continue to improve and expand coverage, including in current or new Telstra-only areas. This dynamic and the changing pattern of overlap between the Telstra and Optus networks does not align with Vodafone's static view of current Telstra-only areas as a monopoly.

- The majority of sites in Telstra-only areas are unprofitable on a standalone basis.[33] That is, these sites are not natural monopolies – they are uneconomic. Telstra's decision to build these sites is an outcome of Telstra's longstanding business strategy to differentiate itself on coverage through significant investment in its mobile network infrastructure in regional and rural Australia, to win greater national market share. This strategy is available to others, and Optus appears to be pursuing a similar strategy while historically Vodafone has not.[34]

- Ovum's report dated 2 December 2016 demonstrates that where an MNO chooses to pursue a business strategy similar to Telstra, by competing on coverage and quality differentiation in order to derive indirect revenues from a broader customer base, the majority of sites in Telstra-only areas could also be profitable for a second MNO. This finding contradicts the natural monopoly proposition. As Ovum's supplementary report dated 15 June 2017 shows, Vodafone's criticisms of its analysis are misguided.

- Vodafone has said that it goes against economic logic to suggest that a natural monopolist would further invest in regional and rural Australia. Telstra agrees, and the clear conclusion from evidence of ongoing investment by Telstra and Optus is that Vodafone's argument that Telstra has a natural monopoly is false.

- Vodafone's static view that there is a natural monopoly is also inconsistent with the highly dynamic mobile market where the lifecycle for successive generations of mobile technology and investment is very short relative to other utility infrastructure such as rail and gas pipelines. The consequence is that if Telstra chose not to invest in successive mobile technologies where it is currently the only MNO, Optus and Vodafone could roll out those new technologies in these areas and beat Telstra in regional markets. Indeed, the only infrastructure that is relatively long lived – towers and facilities – are already subject to an open access regime which facilitates network deployment in current Telstra-only areas.

[32] Vodafone Supplementary Submission, Part A, s 1.5.3.
[33] Report of Ovum dated 2 December 2016, [1.4].
[34] See Optus, *Submission in response to ACCC Discussion Paper,* November 2016, ss 2.1-2.3.

5.2. Telstra's prices reflect quality, not a "monopoly rent"

In an effort to overstate the consumer gains from declaring roaming, Vodafone argues that the premium in Telstra's retail pricing for coverage must be a "*monopoly rent*". As outlined in section 3.3, this is incorrect and fails to take into account the higher quality and greater coverage offered by Telstra.

In support of its argument, Vodafone relies on reports by the Centre for International Economics (**CIE**) and a calculation performed by Mr Feasey.

The first report of Professor Pincus dated 24 January 2017 demonstrates that the CIE's analysis does not show a price premium related to market power, and cannot be relied upon for any public policy purposes. Professor Pincus found:[35]

- The CIE has merely estimated price differences between MNOs, without explaining why those price differences exist or why Telstra prices may be higher; and
- The calculation of those price differences are erroneous.

In response to Professor Pincus' first report, the CIE itself concedes that *"…the price premium for Telstra by itself is not sufficient evidence of market power*" and "*the CIE does not claim that the excess price premia can be taken as indicators of the extent of market power*".[36]

In light of this admission from the CIE in relation to Vodafone's claims, the second report of Professor Pincus dated 15 June 2017 states:[37]

> *On the basis of the CIE's regressions, it is entirely possible that one hundred per cent of Telstra's 'price premium', as estimated by the CIE, is due to Telstra's 'legitimate competitive premium', and that none is due to Telstra's alleged 'monopoly coverage'.*

In his report, Mr Feasey acknowledges that his calculation "*obviously need[s] to be treated with caution*".[38] It is based on a number of unsupported assumptions, with no modelling or detailed consideration to support it.

Telstra agrees that its prices are higher, however this is because of the additional value Telstra provides to consumers, including greater coverage, higher quality network in terms of speed, performance and a range of additional content inclusions. What Vodafone characterises as "*monopoly rent*" is in reality a return on investment based on pricing for the superior product Telstra provides, made possible by the significant investment Telstra has made in its network. As Professor Yarrow comments, the economic explanation lies not in the exercise of monopoly power but in product differentiation in a vigorously competitive market. As noted above in sections 3.1 and 3.2, both Mr Feasey and Vodafone say that post declaration Vodafone itself could offer a product with greater coverage at a premium price.

The CIE report itself found that the gap between Telstra and Optus pricing is significantly narrower than the gap to the "average" non-Telstra pricing. If anything of value is to be taken from the CIE report, it is that mobile operator pricing is on a spectrum, which suggests that a more probable explanation is that pricing relativities broadly reflect a range of market-related factors, including quality and coverage.

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[35] Report of JJ Pincus dated 24 January 2017, [1.1]-[1.9].
[36] CIE, Response to comments by JJ Pincus on CIE hedonic regressions, 23 February 2017, pp 2-3.
[37] Second Report of JJ Pincus dated 15 June 2017, [1.5].
[38] Report of Richard Feasey dated 11 March 2017, fn 16.

In conclusion, what Vodafone attempts to characterise as a market failure is the outcome of vigorous infrastructure-based competition. Customers are prepared to pay for the quality and coverage they are receiving and each MNO can only supply the quality and coverage in which it has chosen to invest.