SUBMISSION TO THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

Mobile Services Review 2003

Discussion Paper

13 June 2003

About this submission

This submission provides Vodafone's view on a range of issues raised in the ACCC's discussion paper on the Mobile Services Review 2003. In particular, this submission focuses on our view on the current declaration of mobile origination and termination services.

We will be providing a supplementary submission to the ACCC shortly that will include additional material on issues that have not been covered in this submission.

1. Introduction

1.1 Vodafone welcomes the opportunity to present our views on the issues raised in the ACCC discussion paper – Mobile Service Review 2003.

1.2 In submissions to the ACCC over the last few years, Vodafone has been a strong supporter for a first principles review of the current declaration of mobile termination and origination. Both services has not been through a formal Long Term Interests of End-users (LTIE) test – but has been subject to regulatory oversight for 6 years. Hence, we applaud the ACCC in finalising conducting a first principles review.

1.3 We note that the Commission has also decided to review other aspects of the mobile services market, such as national and international roaming. This is sensible, given the dynamic nature of the market. Much has changed since the services were deemed under the 1997 legislation. We will be providing detailed comments on these additional areas of interest in a supplementary submission to the Commission.

2. What has been happening in the mobile services market since 1997

2.1. Since 1997, when the current regulation on mobile services was first introduced, the mobile services market has undergone an intense period of change. Key developments have been:

- More and more people now have mobile phones (penetration rates are now around 70 per cent of the population);
- Cheaper prices for mobile services (the ACCC's Division 12 report indicates that on average retail prices for mobile services have declined by 24.8% in real terms between 1997-98 and 2000-01);
- A more sophisticated range of services are now available for mobile phone customers, including a range of services that did not even exist in 1997 (such as picture messaging, WAP services and a range of M-commerce services);
- Significant market entry (e.g. Hutchinson, AAPT, Virgin, One-Tel) and market exit (e.g. One-Tel);
- Changing market shares across the industry (as highlighted in the discussion paper);

- Large investments in infrastructure, including substantial upgrading of both coverage and capability for all existing networks and the building of one new GSM network, 2 separate CDMA networks and a 3G network.

- Large investments in radio spectrum by new and existing mobile players (including bids of $1.3 billion for 1800 spectrum and $1.2 billion for 2Mhz spectrum);

- Introduction of mobile number portability introduced in September 2001;

- Ongoing changes in industry structure, ownership and internal structures (as well as substantial changes globally in the industry and investor sentiment).

2.2. There are few industries that can point to such dramatic changes over a 6 year period – and this is for an industry that is less than 15 years old.

2.3. It is clear form this that the mobile services market has been subject to significant change since the introduction of formal regulation. There is little evidence to suggest that over the next 6 years that similar changes will not be experienced.

2.4. Indeed, change appears to be one of the only certainties in the mobile services market. This appears to be markedly different to the trend of industry developments in other market areas that are subject to industry specific regulation, overseen by the ACCC (such as the railways, electricity and gas). In these areas, the basic penetration levels and suite of products and services has remained basically unchanged since 1997.

2.5. With this in mind, the rest of the submission concentrates on the issues raised in the discussion paper regarding the current declaration of termination and origination services.

3. Mobile Termination

3.1. Before providing our views on the questions posed in the discussion paper, it is useful to recap on Vodafone views on the current regulation of mobile termination services.

3.2. We consider that the central question that the Commission should answer in reviewing the appropriateness of the current regulation is whether the market for mobile services is effectively competitive. We believe that it is.

3.3. What do we mean by 'effectively competitive'? In a perfectly competitive market, firms compete to supply undifferentiated products, and prices converge to the marginal cost of supply. However, it is rare to find these types of markets in the real world. If the market for mobile services displayed these

characteristics, then firms could not expect to recover more than the marginal cost of supply, and, in the presence of economies of scale, there would be no incentive on mobile carriers to invest further in the development of their networks and other services.

3.4. In practice, firms offer differentiated services and tariffs to different customer groups, and thereby seek to recover their fixed and common costs, and to earn a sufficient return to justify further investment.

3.5. To that extent, the market deviates from the perfect competition model, but there is no reason to conclude that there is, as a result, any public interest problem that would justify intervention on normal competition law principles.

3.6. As discussed above, Vodafone considers that the market for mobile services is effectively competitive, in the sense that – whilst it falls short of being perfectly competitive – it delivers, in broad terms, cost-reflective prices, value for money and incentives to innovation and investment that are in the long term interest of end users. As a result, no regulatory intervention can be justified on competitive grounds.

3.7. In Vodafone's view, the only question that remains, is whether the structure of charges is inappropriate – in particular, the question is whether mobile subscribers are paying too little and incoming callers are paying too much. If this is true, this could lead to two adverse outcomes to society:

- Incoming callers subsidising mobile subscribers; and
- Charges fail to provide allocative efficiency: that is, there could be excessive consumption of the services provided to mobile subscribers (because they are priced too low) and consumption of incoming calls could be unduly restricted (because they are priced too high).

3.8. Hence, the broader question raised is whether there is either a distributional problem or an allocative inefficiency problem. We would argue no on both counts.

3.9. Mobile penetration is now at around 70%. Given this, it is likely that the vast bulk of incoming calls to mobiles are made by persons who are also mobile subscribers (even if they make those calls from their fixed line phones). In other words, the two classes of person are likely to largely coincide.

3.10. It is very difficult to assess whether the market is allocatively efficient. Detailed and complex cost modelling would be required to provide guidance, and even then would be open to significant debate on methodological issues. We can, however, make some broad statements on why the price of some mobile services may differ from their marginal cost, but still be consistent with welfare maximisation. The two key reasons concern (1) the extent of and scale of fixed and common costs and (2) the presence of externalities.

3.11. The presence of fixed and common costs may mean that pricing at marginal cost would lead to firms making losses and so not producing at all. In these circumstances, fixed and common costs are most efficiently recovered, in the sense of generating welfare maximising outputs, by the Ramsey mark-up rule: prices of different goods are marked up relative to marginal cost in inverse proportion to their relevant super-elasticities. Given the large amount of fixed and common costs that exist for the provision of mobile services, we consider that this is an important determinant of the commercial prices set for the suite of mobile services offered by Vodafone.

3.12. Externalities are relevant if the production or consumption of a good has an impact on the welfare of individuals not involved in the market. In these cases, the competitive market equilibrium can be expected to maximise the private welfare of the consumers in the market, but will not maximise social welfare because the market does not by itself take into account the social cost of benefit imposed on others. In the mobile services market, we consider that there are two externalities that are relevant:

- The subscription externality; and
- The option externality.

3.13. The subscription externality arises from an individual consumer's decision to subscribe to the mobile network, since that decision generates benefits to existing phone subscribers who place value on calling the new subscriber on his or her mobile phone.

3.14. The option externality arises from the ability of the subscriber to make calls or of others to call the new subscriber, regardless of whether any calls are actually made.

3.15. These two positive network externalities lead to further adjustment to Ramsey prices.

3.16. As we discuss later, we believe that in general, the current set of prices that we offer in the market largely reflect the underlying economics, as discussed above. However, it is never an exact science, with the central determinant of commercial rates driven by the competitiveness of the mobile services market. With effectively competitive markets, prices tend toward efficient and welfare maximising levels. This does not mean that Vodafone conducts a regular detailed and rigorous cost modelling exercise that guides our pricing strategy. Rather, the commercial rates offered will be constrained by the competitive dynamics of the market. In setting prices for our services, it has always been a trial and error process but one that, over time, we consider delivers a close approximation of the theoretical 'best practice' that could be achieved. In this environment, regulators can rest easy, with intervention not needed and unwarranted.

3.17. We now turn to the set of questions posed by the Commission in its discussion paper.

Question 1: In order to achieve the objective of promoting the LTIE, should the domestic GSM and CDMA terminating access service declaration continue unchanged, be varied or be revoked? Please explain your answer with reference to the objective of promoting the LTIE.

3.18. Vodafone considers that the current declaration should be revoked. Since 1997, when the service was first declared, the market has witnessed tremendous change (some of which has been outlined above). Hence, it is important to review the rationale and appropriateness of existing regulatory intervention.

3.19. Vodafone considers that access regulation should only be applied to services where problems exist. We do not believe that problems exist for mobile voice termination.

3.20. Vodafone has consistently stated that the arguments used in favour of regulatory intervention, such as those outlined by King and Gans when the ACCC first begun its review of the pricing principle for GSM termination services, were open to dispute, and if existing, were likely to be transitory in nature. In the interests of proper market development, the time is now ripe for this regulation to be removed and to allow the market to develop and deliver commercially agreed and efficient outcomes.

3.21. There are two key factors that drive our view about the need to revoke this regulation. These are (1) the changes in the market driven by mobile penetration; and (2) the particular market dynamics of the regulatory regime in Australia that acts to promote commercial outcomes.

3.22. Since 1997, market penetration has increased dramatically. With this, there has been a substantial increase in traffic across mobile networks (both between mobile networks and to and from fixed networks). For some people, mobile phones have now become a real alternative to the fixed line. Over time, we believe that fixed to mobile substitution will continue, particularly for voice services.

3.23. One of the main reasons for the increase in penetration rates has been the intense competitive dynamics of the Australian mobile services market. In 2003, there are now four competing mobile network carriers and six separate mobile networks. When service providers and mobile virtual network operators are added to the mix, it is clear that the Australian mobile consumer has a range of choice when selecting a mobile service. Mobile number portability has provided additional freedom to the consumer, allowing them to switch networks without having to change their mobile number.

3.24. We consider that industry development in the mobile services market has, in large part, been driven by these competitive dynamics. Compare the increase in usability and features of a mobile phone over the last 10 years with that of

the fixed and you begin to appreciate why mobile penetration has been so spectacular. In addition, as penetration has increased, prices have fallen. There are few industries that can point to such significant innovation in product and service offerings combined with large price reductions for these same (enhanced) services in recent years.

3.25. In all of this, it is competition – not regulation - that has driven consumer outcomes.

3.26. Terminating access charges are one of three main revenue sources available to mobile carriers (along with access charges and usage). In deciding how to price these three revenue sources, a mobile carrier needs to take into account a number of complex factors. Chief among them is to agree on the appropriate combination of prices that will deliver a profitable outcome for the company.

3.27. Given the large capital investments that Vodafone has made since entering the market in the early 1990's, it has taken until 2002 for Vodafone to make its first cash return to its shareholders. Across the industry, a similar story exists (particularly for mobile only carriers), with strong evidence that no super-normal profits are being made by existing competitors.

3.28. Increased penetration and usage means that problems of consumer ignorance and control over access are diminished.

3.29. We believe that revocation of the current regulation will promote the Long Term Interests of End users (LTIE) for the following reasons:

- We believe that the current regulation has an adverse impact on the development of innovative pricing strategies for wholesale services. As penetration has increased, the focus of many mobile players has shifted from a pure customer acquisition strategy to exploring ways to promote greater usage of mobile services by existing customers. For Vodafone, this has translated to re-examining wholesale termination agreements in order to provide incentives for fixed carriers to promote greater levels of fixed to mobile traffic onto the Vodafone network. We consider that the existence of regulation of termination services represents an obstacle to agreeing to these innovative wholesale agreements by creating uncertainly about the application of the existing pricing principle. While some of these deals have been commercially agreed, we have found it difficult to roll out these agreements more widely – and we consider that the existing declaration have contributed to this.

- Regulation is not focused on durable market failure. As discussed above, we consider that the current regulation is unwarranted and does not address a market problem. As a result, the energies of mobile carriers are unduly taken up with addressing the compliance and commercial risks

caused by the application of the regulation – instead of delivering commercial products and services to mobile customers.

- Regulation results in value shifting rather than delivering benefits to consumers. We consider that the impact of applying the current regulation is to shift value from one part of the industry (mobile carriers) to another (fixed carriers). Given that there is no imperative on fixed carriers to 'pass through' lower wholesale rates, there is little evidence that consumers have in any way benefited from the declaration. To the extent that the existing declaration has driven lower wholesale termination rates, we believe that the benefits of this has been to weaken the competitiveness of mobile-only players and strengthen the balance sheets of fixed carriers, particularly Telstra. This is likely to have led to detrimental impacts on the competitiveness of the market – with corresponding adverse impacts on the LTIE.

3.30. Also, in a purely practical sense, there is powerful evidence to suggest that the time is ripe to remove regulation in this area of the market. Since 1997, there have been no commercial disputes that have required ACCC arbitration. In addition, termination rates have been falling consistently since 1997.

Question 2: If the service description were varied, should it be broadened to include termination of calls on 3G networks?

3.31. Vodafone does not support the regulation of 3G voice termination. The same arguments against 2G voice termination apply to 3G voice termination. We do not consider that a market failure exists. Regulation is not warranted.

3.32. Further, we consider that a move to regulation of 3G voice will create a worrying precedent. Consistent with our views expressed at the time that the Commission considered extending regulation to CDMA voice, we believe that it is not appropriate to apply regulation to markets where there is no evidence of a problem.

3.33. In particular, only one 3G network has yet been deployed in Australia – and it has only been launched a matter of months ago. We are not aware of any disputes that have been raised with respect to terminating access charges to this network. If this is correct, it appears that the market has delivered a commercial outcome – without the need for regulatory intervention.

3.34. It is critical that regulation is applied sparingly and only to areas where there is demonstrable and durable market failure.

3.35. The ACCC recently extended the scope of the existing declaration for GSM termination services to CDMA services. The ACCC argued that similar economic arguments in favour of regulation applied to CDMA termination – and

hence, regulation was extended to cover this extra range of services. Our view at the time was that the ACCC approach was flawed. This was because there was no evidence that parties had any difficulties in negotiating access terms of CDMA termination services. Given the unanticipated impacts that regulation can have on the development of markets, it is critical that when it is applied that there is actual evidence of durable market failure. Without such evidence, there is a real risk that regulation gets extended to areas of the market that do not require regulatory oversight – with a range of unnecessary costs occurring as a result.

3.36. We believe that similar parallels can be drawn with moves to extend the existing declaration to 3G services.

3.37. The existing declaration should not be expanded to include 3G voice termination for the following reasons:

- The market for 3G voice services is still in its infancy. In fact, it is still too early to say whether a separate economic market exists (refer to the Frontier Economics paper, which is provided as an attachment to this submission - it provides further details on our views on market definition for 3G). The market should be given the chance to work before regulation is considered. Regulation should only be applied if a problem has been demonstrated and that intervention is likely to lead to net benefits;

- Given the infancy of the 3G market, it is likely that 2G roaming will be a common feature of the 3G customer experience for some time. Hence the commercially negotiated termination rates for 2G termination is likely to have a significant impact on the termination rates set for 3G voice. From a customer's perspective, it will make little difference to them whether a voice call is carried over a 2G or 3G network (or both in the case of a soft handover in a roaming environment) it will be difficult to charge differential retail rates for 3G voice services. Given that, it will be difficult to imagine that carriers will be able to negotiate significantly different rates for 3G voice termination.

3.38. Hence, the very fact that there is little difference from a customer perspective – and the fact that F2M customers are unlikely to be able to differentiate between making a call to a customer on a 2G or 3G network, we consider that current 2G commercial negotiated rates have a powerful constraining influence on the 3G interconnection rate.

3.39. Regulating 3G voice at this time will have no influence on the rates negotiated for 3G termination as these are already constrained by the commercial rates agreed for 2G termination.

3.40. Given this, it may appear from one perspective that regulating 3G voice at this time is costless. However, this is not the case. Applying regulation where it is

not required and where there is patently no problem will send a strong signal to investors about the Commission's approach to the regulation of new services in telecommunications. In particular, if investors are not confident that new services will be free from regulatory intervention (in the absence of durable market failure) this will temper the incentives to invest in new services and innovate and expand current services.

3.41. We note that the potential exists in the legislation to allow parties to apply for an exemption from declaration for certain services. Our view is that this is a second best solution to the issue. A preferable approach is to apply regulatory forbearance for 3G services at this time – and look to remove the current declaration on 2G services (which is no longer required, as discussed above).

Question 3:In which market/s is the mobile termination service supplied? Does a "single operator" market definition apply to this service? What are the relevant downstream markets?

3.42. We commissioned Frontier Economics to provide advice on market definition issues.

3.43. The Frontier Economics work is attached to this submission and provides a detailed discussion on market definition issues and the appropriate, or otherwise, of applying a single operator definition to this service. Frontier also provides views on the relevant downstream markets for the termination service.

3.44. Vodafone's views are consistent with those expressed in this paper.

Question 4: To what extent, if any, should the Commission be concerned about differential pricing between mobile-to-mobile "on-net" and "off-net" calls?

3.45. Vodafone offers differential mobile retail prices for on-net and off-net voice calls on some of its consumer and business plans.

3.46. There are a number of reasons why creating an on-net/off-net pricing differential makes commercial sense. In particular, to the extent that closed user groups exist, a lower on-net price drives customer acquisition. Prima facie, there is no reason why an on-net/off-net pricing differential is a problem in a competition sense. Indeed, to the extent that it drives customer acquisition, such a strategy drives competitive outcomes.

3.47. As the market develops, pricing strategies change. For instance, the Vodafone 'no plans' retail offering in the market does not have an on-net/off-net pricing differential. One of the main drivers for this commercial offering was a desire to provide a simple pricing plan for consumers. Consistent with that strategy, the no plans product has no peak or off peak pricing either.

3.48. We note that our competitors offer a range of different price and service offerings. This is consistent with an intensely competitive market – where customers have the ability to choose a range of different mobile offerings consistent with their needs.

3.49. In our view, the existence of differential on-net pricing should not be a concern *per se*. However, to the extent that an on-net pricing differential allows integrated carriers to engage in a price squeeze, then this may result in competition concerns.

3.50. Indeed, we believe that the potential of integrated carriers to engage in an anti-competitive 'price squeeze' should be one of the main areas of focus by the Commission. As a mobile only player, we have little commercial experience of competing in the fixed to mobile retail market (apart from the Challenger product – which offers a wireless PABX service to corporate customers).

3.51. However, it is difficult to see how pricing differentials used by mobile only carriers should be regulated. Where price squeezes occur, these should be regulated by behavioural rules – not through the regulation of mobile termination rates.

Question 5: To what extent are consumers ignorant of the network a party they choose to call is directly connected to?

3.52. The Commission has argued previously that the consumer ignorance of network calls contributes (along with control over access) to allow mobile carriers to sustain termination prices above cost.

3.53. In previous submissions to the ACCC on this issue, we have argued that there is powerful evidence to suggest those consumers are not ignorant of the network called.

3.54. Our view has not changed. The impact of consumer ignorance should be largely discounted as a reason for regulating mobile termination. For example, we note that an on-net/off-net pricing differential is a common pricing feature offered by both mobile and fixed carriers (including integrated carriers). Given that the commercial rationale for such a pricing structure is based on the assumption that consumers are aware of the network called, it seems difficult to sustain a view that consumer ignorance exists across the market. If consumer ignorance did exist, then there would be no commercial benefit from offering a differential prices for on-net and off-net calls.

3.55. Vodafone, Telstra, Optus and Hutchinson have commissioned a consumer survey to gain a richer insight into the extent of consumer ignorance. We expect that the results of this work will be available before the end of June

2003. We intend to provide additional views to the Commission on this issue once these results have been finalised.

Question 6: How would continuing the existing mobile termination declaration, varying the declaration or revoking the declaration affect competition in the market in which the service is supplied and in the relevant downstream markets?

3.56. We commissioned Frontier Economics to provide advice on this issue.

3.57. The Frontier Economics work is attached to this submission. Vodafone's views are consistent with those expressed in this paper.

Question 7: To what extent have past decreases in the price of mobile termination services been passed through to end-users in the form of lower fixed-to-mobile prices? To the extent they have not, what implications does this have for declaration of mobile termination services? Would regulation still be in the LTIE if there was no guarantee of "pass through"?

3.58. We note that the current regulation on wholesale termination does not require fixed line operators to 'pass through' lower regulated wholesale rates in the prices of fixed to mobile services.

3.59. While we do not have detailed data on the extent of 'pass through', we have compared our termination rates offered to Telstra with the retail rates that are offered to residential customers for making a fixed to mobile call (see Figure 1).

3.60. It is clear from this graph that pass through has not occurred for these customers. For this call scenario, Telstra has benefited from significant and increasing margins over the last 3 years as a result of the lower termination rates that we have offered.

Figure 1: Telstra Consumer fixed to mobile Retail Rates v GSM Rates[1] [Commercial-in-confidence]

[commercial – in – confidence]

3.61. If the outcome of wholesale regulation is forced lower termination rates – but no pass through of these rates to 'fixed to mobile' retail rates – then the impact of the regulation is to shift value from mobile operators to fixed operators.

3.62. This is not in the long term interests of end-users for two key reasons:

- Regulation is applied in the wrong area. The problem in the market (lack of competition in the retail market) has not been addressed by regulating termination rates.

- shift in value creates opportunities for fixed operators to pass on margin to consumers – but the lack of competition in this area of the market means that the impact of regulation has resulted in regulatory subsidies being delivered to fixed operators – which has related impacts on the efficacy the market and the competitive interplay between fixed calling and mobile calling.

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[1] Notes: Average consumer retail rate is average price per minute for F2M calls for Telstra's Homeline Plus service (on-net and off-net). It assumes average call duration of 2 mins and 60% of calls are peak. GSM Termination rate is the actual agreed Interconnect rate between Vodafone & Telstra (as per Access Agreements). [rates of commercially sensitive]
Source: Macquarie Research Equities (Telstra SFOAs) Jan2000-Dec2002 and Vodafone internal data.

3.63. We do not consider that LTIE are promoted by regulating wholesale termination. As discussed earlier, the current regulation is applied to solve a problem that may, in fact, reside elsewhere in the market. We consider that the lack of 'pass through' may be evidence of a lack of competition in the fixed to mobile retail market. We consider that the Commission should refocus its regulatory efforts to examining the competitiveness of the fixed to mobile retail market and remove regulation from the mobile wholesale market. We provide some regulatory options for the Commission later in this submission.

Question 8: How could concerns regarding the level of fixed-to-mobile pass through be addressed through other regulatory means?

3.64. Our view is that the Fixed to Mobile (F2M) retail market is a market in transition. Dynamic markets tend to follow their own path – and it is likely that this will be the case in the F2M retail market. Over time the margins that Telstra traditionally earned in the international and national long distance markets have been eroded away by competitors. It appears that carrier pre-selection has helped drive this change – as it has allowed consumers to actively choose an alternative provider (without needing to use an over-ride code on a call by call basis).

3.65. As margins are competed away, the focus of competitive pressure is likely to shift to new areas where margins can be earned. As discussed in this submission – and in earlier ones to the Commission – our view is that there appears to be substantial margins being earned for F2M calls (see Figure 1) – especially in the residential sector. However, there are an increasing range of substitutes available for a fixed to mobile call (not least being the significant increase in mobile penetration – which allows people to use mobile to mobile calls as an alternative to fixed to mobile calls).

3.66. Recently, it appears that many fixed carriers are introducing innovative retail deals into the residential market to attract consumers. In particular, the introduction of capped calling plans by AAPT and others provides evidence that the focus of competitive pressure is moving to the F2M retail market. We consider that over time, the margins that currently exist will be competed away through competition.

3.67. If our assessment is incorrect and the Commission considered it appropriate, there are a number of ways that regulation could be applied to speed this market outcome. For instance, a move to multi-basket pre-selection (with fixed to mobile as a separate option) would allow customers to choose a separate provider for fixed to mobile calls. This would increase the competitive pressure on current providers to pass through lower wholesale termination rates and to compete away existing margins – while at the same time create opportunities for 'F2M only' providers to enter the market.

3.68. In New Zealand, multi-basket pre-selection was introduced in 2001. While it has been in place for only a short time, the Commerce Commission has already publicly stated that it appears that its introduction has spurred competition in the F2M retail market.

> A number of parties have agreed that the emergence of fixed-to-mobile carrier preselection is likely to reduce barriers to entry into this market by allowing non-integrated carriers to compete with full-service carriers. Telecom submits that the introduction of pre-selection since August 2001 has led to an increase in the volume of PSTN to 025/027 calls made via other carriers.
>
> This effect is also reflected in figures provided by TelstraClear …
>
> It therefore appears that entry conditions in relation to retail fixed-to-mobile call services have improved following the introduction of fixed-to-mobile carrier preselection.[2]

3.69. Vodafone would not support the introduction of additional retail price controls on the fixed to mobile retail market. We consider that retail price controls are likely to be a blunt instrument in addressing the lack of 'pass through'. More sophisticated methods are required, which we discuss in more detail later in the submission.

Question 9: How would continuing the existing mobile termination declaration, varying the declaration or revoking the declaration affect the achievement of the objective of any-to-any connectivity?

3.70. Our view is the mobile services market has developed to such an extent that a concern for any-to-any connectivity is no longer relevant in the debate on the appropriateness of the declaration.

3.71. The mobile services market is characterised by a network of networks – with a myriad of transit opportunities that exist for parties where they choose to do so to avoid the need for direct interconnection with every network, while still allowing all parties to provide peer to peer communications without having to connect with every network.

3.72. Forcing "every to every" connectivity is likely to burden the industry with unnecessary costs and will not deliver improved end-user outcomes.

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[2] New Zealand Commerce Commission (2003) *Determination on the TelstraClear Application for Determination for "Wholesale" Designated Access Services : Decision 497*

Question 10: How would continuing the existing mobile termination declaration, varying the declaration or revoking the declaration impact on the efficient use of and efficient investment in infrastructure?

3.73. Our view is the current declaration has an adverse impact on the efficient use of and efficient investment in infrastructure. While the practical impact on the declaration (the retail benchmarking approach) has yet to be applied in any arbitration, we believe that the existence of the regulation (in the absence of durable market failure) creates a negative impact on future investment decisions. In particular, we have significant concerns about the expansion of the regulation to 3G networks and to non-voice services. Expanding the declaration to cover these services significantly expands the extent of regulatory risk and threatens the market development of these services.

3.74. The threat of regulatory intervention changes the commercial dynamics of markets and forces businesses to adopt an overly conservative approach to wholesale pricing.

3.75. Where competitive markets exist, regulation should be used sparingly – with a strong focus on commercially delivered outcomes as opposed to regulated ones.

Question 11: What are the costs of providing mobile termination services?

3.76. The short answer to this question is that we do not know. Why? Because, Vodafone's wholesale commercial negotiations are not guided by detailed cost modelling on what it costs to provide a termination service. Our negotiations are based on mutual to-ing and fro-ing between parties on prices for commercial outcomes that meet the requirements of both parties. In competitive markets, our negotiating teams use a wide range of tools and tactics to deliver commercial outcomes for the company. None of these strategies require Vodafone to conduct a detailed modelling exercise to guide the commercial team.

3.77. This is not to say that Vodafone has no idea of the costs of providing products and services on our network. At the end of the day, the bundle of services and prices that we offer in the market place needs to be sufficient to cover our cost of capital and ensure an adequate return to our shareholders.

3.78. The calculation of termination costs is complex, requiring detailed information not just on the direct costs but also judgements on how common fixed costs should be allocated. These issues were discussed at a broad level earlier in the submission.

3.79. The cost of mobile termination is often compared to the cost of terminating a call to a fixed network – with the question being: what explains the difference between the two wholesale rates?

3.80. The long run incremental cost of terminating a call on a mobile network is many times higher than terminating a call on a fixed network. The difference is the result of the fundamentally different technologies and economies of mobile and fixed networks.

3.81. Mobile networks need to perform additional functions beyond those required of fixed networks. They need to continually and actively manage scarce radio spectrum to deploy capacity efficiently and minimise radio interference. They also need to be able to handle traffic between users that are on the move. This entails keeping track of the location of particular handsets/subscribers, so that calls can be delivered to them and handling individual calls originated or received by a particular subscriber who is on the move while they makes and/or receive the call.

3.82. This in turn entails the use of home locating updating systems, to update registers of each subscriber's location at any given time. It also requires using technology to hand over a call from one base station to another during the course of a call, at a rate that enables subscribers to make or receive calls even when travelling at speed.

3.83. As a separate matter, proportionately more of the costs of a mobile network are incremental to the carriage of traffic, and proportionately less of the costs are incremental to subscribers. In particular, in a fixed network, each subscriber has their own fixed line local loop, the cost of which is incremental to subscribers. In contrast, in a mobile network, there is no equivalent part of the network (other than the handset) that is dedicated to serving a particular subscriber. Mobile customers compete to use general capacity on the network to make and receive calls. The cost of capacity is incremental to traffic. This means that the incremental cost of terminating a mobile call will be proportionately larger than the incremental cost of terminating a fixed line call.

3.84. The termination of a mobile call uses more of the mobile network infrastructure than the origination of a mobile call. This reflects the fact that, when a mobile subscriber originates a call, their call joins the mobile network at the closest accessible point to where the caller is located, and is then routed as efficiently as possible to the destination number. In contrast, where a caller calls a mobile subscriber, the call is delivered to the destination mobile network at a point of interconnection with the originating or transit operator's network; the mobile network will then 'consult' the home location register to ascertain where the destination handset is, and the call will be routed across the mobile network to be terminated on the destination handset. The incoming call thus consumes more network assets than the originating call.

Question 12: How significant do network effects continue to be when determining an appropriate price for mobile termination?

3.85. As discussed above, we consider that network effects have an important impact on Ramsey efficient pricing for the mobile termination service. However, as discussed, we do not carry out detailed and sophisticated modelling of the impact of network effects with setting the prices for a bundle of mobile services. Hence, we do not have any detailed data to provide on the impact of network effects.

3.86. We intend discuss this issue in more detail in a supplementary submission.

Question 13: What are the costs of compliance of the mobile termination service?

3.87. Vodafone is still assembling data on this issue and will provide further advice in a forthcoming submission to the Commission.

Question 14: Have retail charges for mobile services increased, as indicated by the data collected under the Commission's monitoring program? Is the retail benchmarking pricing methodology still an appropriate pricing principle for use with this service?

3.88. Vodafone has reviewed the data that we have supplied to the Commission on changes in our retail outbound prices (as defined in the ACCC's methodology). Our data indicate the following price changes:

[Commercial – in – confidence]

3.89. **[Commercial – in – confidence]**

3.90. We consider that the retail benchmarking approach has served a useful purpose – but that it is now time to revoke the declaration and scrap the benchmarking approach. The benchmarking approach has been useful for a number of reasons; including:

- it has provided a practical and reasonably low-cost regulatory approach, in the event of commercial disputes between parties that required an ACCC arbitration;
- the methodology recognises that there are strong incentives on parties to reach commercial agreements – a more interventionist cost-based approach would, in our view, have created significant adverse impacts on

the incentives to agree to commercial outcomes, as well as substantially increase the regulatory cost on the market.

3.91. The fact that the pricing principle has never been applied in practice provides strong evidence that there are strong incentives to agree on commercial outcomes. In many ways the retail benchmarking approach has provided the Commission with a 'safety net' to test whether regulation is actually required in practice. The evidence of the last two years is that commercial incentives are at play and that a 'safety net' regulatory approach is no longer required.

3.92. Vodafone considers that the Commission should focus on developing a revocation strategy for the current declaration.

Question 15: If the Commission were to determine that continued declaration of a mobile termination service were in the LTIE, which pricing principle would be the most appropriate for determining a price for this service? Why?

3.93. It the Commission is minded to continue the declaration of mobile termination services, Vodafone considers that the best way to ensure the commercial outcomes are provided would be to continue to adopt a light handed 'safety net' approach to the service.

3.94. A pricing principle for this service should have the following characteristics:

- It should not frustrate attempts by parties to agree to commercial outcomes. It should operate as a regulatory 'safety net' for parties. This will ensure, as much as possible, the regulation does not adversely impact on the commercial incentives that currently exist.

- It should recognise and account for the interdependencies of the mobile termination service with the other source of mobile revenue. Our view is that the broad market for mobile services is competitive – and hence that regulation of the termination service will impact on other elements of the mobile services market.

- Take account of the differing impact that regulation may have on an integrated carrier (where a reduction in termination rates mean both lower revenues and lower costs – and potentially a neutral impact at an aggregate level) when compared to a mobile only carrier.

- The pricing principle should operate as a guide for negotiating parties – rather than as a rule to be applied across all cases.

3.95. Given these principles, and if the Commission chose to continue with a pricing principle, Vodafone considers that the appropriate pricing principle should continue to be based on a benchmarking approach. We draw attention to

Vodafone's submission on the retail benchmarking approach (submitted to the Commission in September 2001). The views expressed in this submission still have practical relevance to this debate and should be reviewed in the event that the Commission decides to continue to regulate the service.

Question 16: If the Commission were to move to some form of cost-based pricing principle such as TSLRIC, should it construct a cost model to estimate costs, or benchmark against overseas measures of cost? Further, what, if any, mark-ups should be adopted to a pure TSLRIC measure if TSLRIC were to be used as the appropriate pricing principle for a mobile termination service?

3.96. Vodafone strongly objects to any moves by the Commission to adopt a cost-based pricing principle (such as TSLRIC).

3.97. Vodafone will provide further views on this in a forthcoming submission to the Commission.

A suggested way forward for mobile termination

3.98. Vodafone considers that the ACCC should shift its regulatory focus to the F2M retail area of the market – it is this area of the market where there appears to be a lack of competitive pressure. From publicly available data, it appears that there has been little 'pass through' of lower GSM termination rates to consumers in the form of lower residential fixed to mobile prices.

3.99. As discussed above, our view that the Fixed to Mobile (F2M) retail market is a market in transition. Dynamic markets tend to follow their own path – and it is likely that this will be the case in the F2M retail market. Carrier pre-selection has provided consumers with a degree of choice over the provider of their residential telecommunications services.

3.100. As margins are competed away, the focus of competitive pressure is likely to shift to new areas where margins can be earned. There appears to be substantial margins being earned for F2M calls – especially in the residential sector. However, there are an increasing range of substitutes available for a fixed to mobile call (not least being a significant increase in mobile penetration – which allows people use mobile to mobile calls as an alternative to fixed to mobile calls).

3.101. We consider that the next steps for the Commission are as follows:

A: Signal to the industry that the declaration of mobile termination services will be revoked. The declaration should cease once the sunset of June 2004 (as proposed by the ACCC) has been reached.

B: Examine the competitiveness of the fixed to mobile retail market; including:

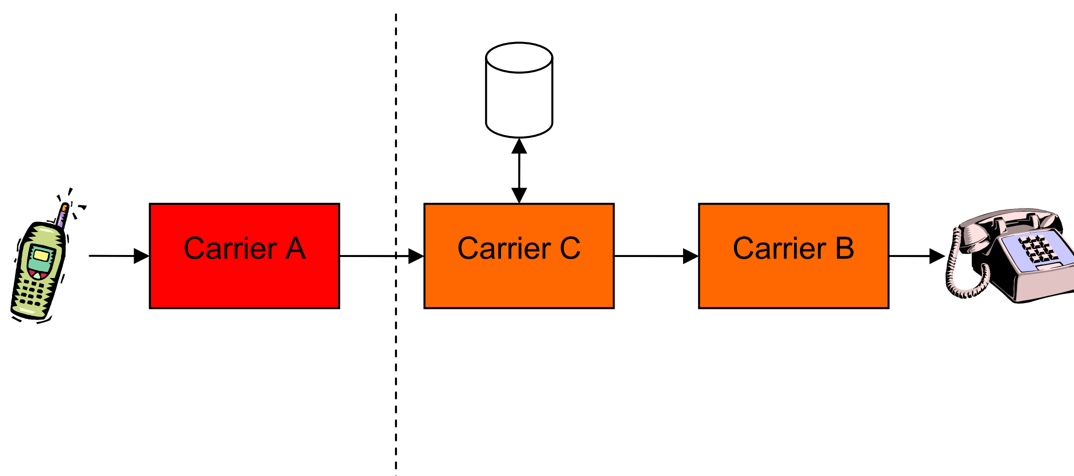
a. a review of the potential ability of integrated carriers to engage in 'price squeeze' activities – and the impacts of that on the competitiveness of the fixed to mobile retail market;

b. the potential benefits that may be delivered by introducing multi-basket pre-selection; and

c. the potential benefits of introducing measures that would force Telstra to offer a fixed to mobile wholesale service to access seekers on a retail minus basis (as proposed in New Zealand).

4. Mobile Origination

4.1. The ACCC deemed a GSM originating service in 1997, and amended it to include CDMA originating services in 2002. As Vodafone has stated in previous submissions to the ACCC, we do not consider that such a service exists. As such, Vodafone supports the revocation of the GSM and CDMA originating access (OA) declaration.



Mobile call to 1300 number

A (mobile carrier) sets the calling charge and bills the caller

Carrier C charges Carrier A network termination rate

Carrier B charges Carrier C network termination rate

4.2. In the case of revoking the OA declaration, the long term interest of end users (LTIE) is promoted through market competition – that is the competition between mobile operators: six networks, four network operators and various mobile virtual network operators (MVNOs) including AAPT.

4.3. Our view is that fixed line carriers providing 1800/1300 or 13 inbound services do not purchase GSM originating access services in order to provide these services to mobile subscribers. As such there is no OA market in Australia.

4.4. To illustrate this, the end to end call service from a mobile to an inbound service is supplied to the mobile subscriber by the mobile carrier – it is the mobile carriers that sets the tariff for the call, and bills the subscriber for the call.

4.5. By definition, without the origination part of the service, the end to end service cannot be supplied. Equally by definition, without the inbound segment of the call, the end to end service cannot be supplied. This illustrates an equal dependency between the originator of the service and the inbound service provider –to ensure commercial agreements exists to provide a viable/successful end to end service.

4.6. The above outline is similar to a mobile to mobile call, where it is clear that both parties have commercial imperatives to reach an agreement. In the current competitive market, an organisation making a commercial decision not to enable connectivity between mobile origination and inbound services, or mobile to mobile, would be punished through customer churn. This is fuelled by customers seeking substitute mechanisms for making the call, and competitive service offerings provided by competitors. This further substantiates our view that regulatory intervention, that is the current OA declaration, is unnecessary and should be revoked.

4.7. Furthermore, parties have strong incentives to set efficient prices as inbound 1300/1800/13 services are able to selectively 'block' calls from an outbound network. This discourages customers from using the 'blocked' network and seek substitute mechanisms to make the 1300/1800/13 call.

4.8. Interestingly, the ACCC indicates the necessity of establishing pricing principles associated with an ongoing declaration. Vodafone draws the attention of the ACCC to the fact that pricing principles have not existed since1997 – the inception of the current OA declaration. Vodafone is unaware of any attempts to establish pricing principles during the period of the current declaration, which indicates that such principles are unnecessary due to a lack of market failure – and corroborates that an OA market does not exist. This further underscores Vodafone's position that the declaration is redundant

4.9. Lastly, as evidenced in the marketplace, there are mutual commercial incentives to connect, for example, CDMA and GSM connectivity, and GSM

and 3G connectivity. Again Vodafone believes the OA declaration should be revoked as there is no basis for intervention.

4.10. We commissioned Frontier Economics to provide advice on market definition issues for the origination service. Frontier's work is attached to this submission and is aligned with Vodafone's views.

4.11. The key point Frontier Economics makes on this issue is that it is critical when examining the market definition issues to look for 'where the money flows'. This will provide important information on whether an origination service actually exists. Given that current commercial arrangements work essentially as payments between parties for termination services, it is difficult to argue that an origination service exists and that regulation is required.