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Dear Richard

Mobile Services Review

I refer to the meeting between representatives of Vodafone, the ACCC and Frontier Economics that occurred on 5 September 2003 in relation to the Mobile Services Review ("the Review"). An outworking of the meeting was for Vodafone to consider providing the Commission with further information regarding the competitive issues pertaining to the Review.

By way of background, Frontier Economics has prepared three papers on behalf of Vodafone which have all been forwarded to the ACCC. One of the Frontier papers discussed principles governing the regulation of mobile termination and listed potential remedies that the ACCC could consider.[1] In the context of the objectives contained in s152AB of the Trade Practices Act, a key conclusion of the Frontier paper was that the declaration of mobile termination is "…unlikely to have any significant effect on competition in a market for a listed service because it is unlikely to affect the structure of any of the relevant markets or to create or eliminate any monopoly profits… [and also it] is unlikely to have any significant effect on any-to-any connectivity".[2]

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[1] Frontier Economics, *Principles governing the regulation of F2M termination*, Sept. 2003.

[2] Ibid. pages 1-2.

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Frontier therefore concluded that the principal objective for the ACCC in this Review was economic efficiency. That is, when considering whether to declare mobile termination, the ACCC should be only focusing on the promotion of economically efficient use or investment in infrastructure through which listed services are provided.

In the meeting referred to above, the ACCC indicated that many submissions raised a number of potential competitive issues that may be relevant in the ACCC's decision to revoke or renew the declaration of mobile termination. This submission specifically reviews and addresses the competition issues that have been raised by these various submissions.

Given that this submission only deals with the competition aspects of the Review, it does not include all of Vodafone's views on the matters pertaining to the Review. Therefore to fully understand Vodafone's views on the Review this should be read in conjunction with previous Vodafone submissions and papers by Frontier Economics.

This letter is structured in the following way:

- Introduction
- 'Cost based' pricing and Ramsey pricing principles
- Differential on-net and off-net prices
- Vertical price squeeze
- Competition in F2M
- Competition in mobile services
- Conclusions

1. Introduction

1.1. A number of stakeholders raised competition issues in their submissions and believed that declaration - and in most cases the adoption of 'cost-based' regulation - of mobile termination was necessary for the promotion of competition.

1.2. AAPT goes one step further and submits that "the continued declaration of mobile termination services is the most effective means of promoting competition".[3] Vodafone disagrees with this comment and believes that declaration of mobile termination is certainly not the most effective regulatory tool to promote competition. Furthermore, Vodafone agrees with Frontier that any regulation of the mobile termination service is unlikely to promote competition.

1.3. Declaration of mobile termination will not address the key competition issues that are raised by the submissions because it will not result in any significant structural change to the market. It is the existence of integrated carriers and

[3] AAPT submission, 13 June 2003. page 23.

their market power which goes to the heart of the competition issues. Regulating mobile termination will not alter these market structures and if anything, will curtail the strong competition that we have seen in the mobile services space.

2. 'Cost based' pricing and Ramsey pricing principles

2.1. Vodafone would also like to comment on the terminology used by various submissions in reference to cost-based pricing. AAPT and MCI refer to mobile termination charges currently being charged at 'above-cost' and PowerTel refers to the 'true cost' for mobile termination. Vodafone would like to reiterate that one must be particularly careful when referring to costs when considering the supply of goods and services that involve substantial fixed and common costs (both capital and operating). This is the case for the provision of mobile telephony services and in particular the mobile termination service.

2.2. Economic theory tells us that pricing services that involve fixed and common costs at their respective marginal costs is not optimal. Doing so may result in firms making losses (unless these fixed and common costs can be recovered somewhere else) and it may prohibit the providers of capital to earn a fair return on the funds they invest. Therefore services that involve fixed and common costs need to be priced according to Ramsey pricing principles. The prices are marked up from marginal cost based on the inverse of their elasticities. The more inelastic the service, the higher the allocation of fixed and common costs.

2.3. As stated in previous submissions however, Vodafone does not seek to consciously price each individual product and service it offers at Ramsey optimal levels. Further, Vodafone does not undertake detailed cost modelling for each individual product and service it offers (including mobile termination). Rather, the prices are set by the market and subject to commercial negotiations and competitive pressures. Vodafone also seeks to structure its prices for the suite of products and services it offers, such that it maximises the return to its shareholders.

2.4. Importantly, deviation from Ramsey optimal prices is not necessarily a sign of market failure and therefore does not mean that regulation is necessary. As stated by Frontier "…deviation of per-unit prices from their Ramsey-optimal levels (by itself) should not be classified as an instance of market failure".[4] Provided the market is effectively competitive, economists would not normally recommend regulation because prices were not set at Ramsey optimal levels. Markets work in rough and ready ways so that at any given point in time a set of "perfect" Ramsey optimal prices may not be observable.

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[4] Frontier Economics. page 13.

2.5. The following competitive issues are now addressed – inside the brackets indicate which party/parties raised the issue:

- Differential retail mobile pricing between off net and on net prices (AAPT and CCC[5]);
- Vertical price squeeze by integrated carriers (AAPT, MCI and CCC);
- Competition in the fixed to mobile (F2M) retail space will intensify as a result of reducing F2M termination prices and therefore the level of pass through (particularly to residential customers) will increase as a result (PowerTel); and
- Competition in the mobile services space will remain relatively unchanged as a result of regulating the mobile terminating service (CCC).

3. Differential off-net and on-net prices

3.1. Two submissions raise competitive issues regarding differential off-net and on-net prices. These will be dealt with in turn.

3.2. It is AAPT's view that differential pricing between on-net and off-net M2M calls reflects the market power of the mobile network operators.[6] Further, AAPT contend that this price discrimination contributes to 'network effects' which creates an advantage for large mobile carriers and creates artificial switching costs for customers. Customers, in selecting their preferred mobile carrier (and therefore network), are likely to select the mobile carrier based on the probability that a high proportion of their outgoing calls are made to subscribers to the same network. According to AAPT, the network effects are therefore greater for larger mobile network operators.

3.3. Vodafone believes AAPT's argument is flawed and can be explained as merely a behaviour that can be expected by firms operating in a competitive market. It is this behaviour which is at the heart of competition in mobile telephony – carriers being innovative with their pricing structures in order to retain their existing customers, attract new customers and to encourage usage patterns that will result in increased profitability. Vodafone's pricing decisions are made in the context of a fiercely competitive market – individual pricing decisions are based on whether or not the company as a whole will be better off as a result of the decision.

3.4. A smaller mobile network operator should be able to offer similar or the same on-net and off-net prices as the larger networks so long it is as efficient and its cost base is proportionally similar. Although a large mobile network operator

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[5] The CCC comprises of PowerTel, Comindico, Primus Telecom and Macquarie Corporate Telecommunications.

[6] AAPT submission, 13 June 2003. pages. 21-22.

may be able to offer low prices for on-net calls, to remain in the market in the long term, its prices for mobile telecommunications services must enable it to recover its total (fixed and variable) costs.

3.5. If a smaller network is unable to match the prices of a larger network the reason is most likely to be that the smaller network cannot match the costs of the larger network. This may be due to network economies such that the larger network has lower average costs. But if that is the case, this is an instance of cost-based competition rather than an anti-competitive use of monopoly power. A larger network should not be penalised as a result of its network economies and therefore its lower average costs. It should not be forbidden from pricing in a manner that reflects its cost advantage.

3.6. Differential prices similar to those offered in the telephony markets can be observed in many other markets. For example, any product or service that involves subscription or membership typically involves different prices to members versus non-members (e.g. differential prices applied to members versus non-members at the recently held 2003 Australian Mobile Telecommunications Association Congress). Also, companies may sell some of their products and services at below cost for short periods of time in order to attract new customers (e.g. supermarkets), however, in the long term, their prices for their entire suite of goods and services must derive enough revenue to cover their fixed and variable costs. Importantly, the purpose of this pricing behaviour is equivalent to that occurring in the telephony industry – to retain existing customers and attract new ones. It is not an instance of market power; rather it is an indication of competitive forces at work.

3.7. Finally, differential on-net and off-net prices are quite common in the telephony industry particularly for mobile services but also for fixed line services. Carriers have adopted these pricing structures in order for carriers to increase usage and to encourage the development of closed user groups. It has also been in response to the fact that many customers are (and more and more are becoming) cognisant of the network they are calling. This is the assumption underpinning the 'network effects' argument of AAPT. This is supported by the results of the research that was undertaken on behalf of Hutchison, Vodafone, Telstra and Optus.[7] Customers are (and are increasingly) taking into account which mobile carrier to subscribe to based on *inter alia* the network that their most commonly called numbers are connected to. This further supports Vodafone's arguments for not regulating mobile termination.

3.8. The CCC raises similar concerns with internal transfer pricing and on-net M2M calls. The CCC state that "M2M calls (both on-net and off-net) and M2F calls now compete directly with, and substitute for, national long distance calls… arising from what appears to be the discretionary pricing of the mobile

[7] See report by AMR Interactive. June 2003.

terminating service by the MNOs".[8] The CCC appears to be concerned with the competitive implications arising from the ability of mobile carriers to price on-net mobile calls low. Vodafone has a number of comments in addition to those made above in regard to the concerns of the CCC.

3.9. Firstly, players like Vodafone are relatively small niche players in the corporate segment of the market. Therefore, Vodafone considers itself to be a price taker rather than a price maker. Vodafone is actively encouraging customers to substitute fixed calls with mobile calls with a number of customer offerings. For example, Vodafone has a product called GroupCHOICE™ which enables SMEs and corporate customers to consolidate their mobile-originated and F2M calls into one offering. In pricing products like GroupCHOICE™, Vodafone will take account of - amongst other things - the pricing of similar products in the market. Therefore, Vodafone is responding to pricing behaviour by other players in the market who may have the ability to set the price.

3.10. Secondly, Vodafone considers that it is important to focus on the entire market when analysing competition issues not on specific segments of the market. Focusing on a market segment – such as the corporate segment for F2M calls - may derive incorrect conclusions about the competitiveness of a market generally. Further, Vodafone considers that recognition by the CCC that there is competition between M2M and F2M is in fact acknowledging that mobile services are part of a broader telephony market. This therefore supports arguments that it is not appropriate to focus on mobile termination when deciding whether to regulate – the focus should be on the market as a whole when analysing competition issues.

3.11. In summary, differential off-net and on-net prices demonstrates the price competition that exists in the Australian mobile industry. Vodafone therefore believes that there is no argument to declare and regulate mobile termination based on price differentials, nor are there any competition issues that need to be addressed in relation to differential on-net and off-net prices.

4. Vertical price squeeze

4.1. Three of the four outlined submissions to the Review - AAPT, MCI and CCC - raise the issue of vertical price squeeze.[9] Essentially, they all argue that the vertically integrated carriers have market power and therefore the incentive and the ability to instigate price squeeze behaviour. This works by the integrated carriers taking advantage of their market power and charging high prices for interconnection to fixed line carriers. Generally speaking, the submissions argue that this may enable integrated carriers to offer lower retail prices for these services and essentially limit the ability of the fixed line only operators to

[8] CCC submission, page 25.

[9] AAPT submission, 13 June 2003, pages 23-25. CCC submission to the Review, pages 22-24. MCI submission to the Review, 13 June 2003, pages 10-11.

compete. Vodafone's comments on the issue of vertical price squeeze are outlined below.

4.2. Firstly, regulation of mobile termination is not the appropriate regulatory tool to promote competition in the F2M retail space. If the market failure that has been identified is the limited or non existence of competition in the F2M retail space, regulating mobile termination is not the appropriate regulatory tool to remedy that failure. One of the fundamentals of welfare economics, as pointed out by Frontier, is that once the market failure has been identified, regulation should be targeted at the source of *that* market failure. Regulating mobile termination would not eliminate the existence of vertical price squeeze. What would prevent the integrated carriers from always transferring the price internally at less than the wholesale price no matter how it is determined? In this instance, it is the structure of the market and the existence of integrated carriers that are the cause of the "problem".

4.3. Secondly, Vodafone believes that mobile termination is part of an effectively competitive market – a cluster market of mobile telephony services which exists due to the strong complementarities between the services mobile carriers offer (termination, subscription, origination etc). This is discussed in more detail in the Frontier paper on market definition. Vodafone therefore believes that mobile carriers, including integrated carriers, are not able to sustainably lift prices for mobile termination beyond efficient competitive levels.

4.4. Thirdly, vertical price squeeze arguments only apply to integrated carriers and not mobile only carriers like Vodafone. AAPT state that without the declaration of mobile termination it "…will allow mobile service providers to take advantage of the ineffective competition for termination services by engaging in anti-competitive behaviour".[10] Arguments relating to vertical price squeezing can only be directed at integrated carriers. As a mobile only carrier, Vodafone has no ability to engage in vertical price squeeze behaviour.

4.5. Fourthly, it is Vodafone's experience that mobile termination rates have reduced significantly. Vodafone's mobile termination rate has dropped by 45 per cent in real terms in less than five years. While we are not privy to the mobile termination rates of other carriers, we are confident that similar reductions have occurred. Further, it also Vodafone's understanding that F2M margins for residential customers are widening (see our previous submission for commercial in confidence data). While we understand that there have been reductions in the corporate F2M prices, these are not publicly available. Nonetheless, Vodafone believes that F2M margins are high and probably widening overall. If the assertions of APPT, MCI and CCC are correct and vertical squeeze is occurring, which we believe is not the case; one would expect F2M margins to be falling.

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[10] AAPT submission, 13 June 2003 . page 25.

4.6. Finally, Vodafone would question the incentives of Telstra – assuming that it could – to undertake vertical price squeeze against fixed line carriers. It is widely recognised that Telstra is a net payer of mobile termination such that increases in termination prices would have a negative impact on their revenue.[11] While instigating vertical price squeeze by increasing mobile termination prices to fixed line carriers may benefit Telstra in terms of retaining a greater share of total F2M calls, it may also have an impact on its costs by increasing the prices it pays for mobile termination services from other carriers.

5. Competition in F2M

5.1. PowerTel recommend the adoption of a TSLRIC model to determine the level of charges for mobile termination and origination services. According to PowerTel, this will result in "…more competitive offerings, and appropriate reduction in cost to the residential customer".[12]

5.2. Vodafone believes that competition in F2M retail will not intensify as a result of regulating wholesale terminating prices and will not necessarily result in lower prices to residential customers. As mentioned earlier, Vodafone's terminating rates have fallen by approximately 45 per cent in real terms in less than five years and yet there have been only slight reductions (or possibly increases) in the F2M retail price to residential customers.[13] Regulating mobile termination will not guarantee the pass through of lower terminating rates to residential customers.

5.3. Also, regulation of mobile termination is not going to alter the structure or dynamics of the industry. Therefore it is unlikely to have any effect on promoting competition in the F2M retail space.

5.4. As an aside, Vodafone understands that PowerTel's target customer segment is corporate and large customers. Unless PowerTel is planning to offer services to residential customers, we would question whether PowerTel would be able to pass through cost savings from reduced termination rates to residential customers. For PowerTel, regulation of mobile termination could only lead to reductions in F2M prices to corporate and large customers.

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[11] See for example Macquarie Research *Mobile termination rates – the regulator's dilemma*. 7 April 2003.

[12] PowerTel submission to the Review. page 5.

[13] Vodafone refers the ACCC to the respective websites of the fixed line carriers where most F2M retail prices for residential customers are posted.

6. Competition in mobile services

6.1. The final competitive issue to be discussed is the potential implications for competition in mobile services. The CCC believes that regulation of mobile termination "should not impact the level of competition between the MNOs… because such intervention would be neutral as between the MNOs".[14] This comment appears to be a reflection on the conclusions of the recently completed review of mobile termination prices by the Competition Commission in the United Kingdom.

6.2. The impact of significantly reduced mobile termination rates in the UK is likely to be neutral. This was acknowledged by the UK Competition Commission in their decision on mobile termination prices.[15] The reason for this is market structure. In the UK, there are no integrated carriers who compete in both the fixed line and mobile space such that all players that compete in the mobile market are mobile only. Assuming that the mobile market in the UK is competitive and the mobile carriers are breaking even but not earning excessive profits in the long run, which Vodafone believes is the case, it is likely that in time there will be an equal and counterbalancing increase in retail prices to mobile consumers.

6.3. Given the existence of integrated carriers, the same conclusion would not apply in Australia. That is, Vodafone does not expect that there will be a corresponding increase in retail prices to mobile customers if there were significant regulated reductions in mobile termination prices. This is due to the existence of integrated carriers and the unbalanced impact that significant reductions in mobile termination prices would have on the players that are competing in the mobile market.

6.4. It is widely accepted that the regulation of mobile termination rates in Australia would see a net benefit to vertically integrated carriers, such as Telstra who is a net payer of terminating rates and would be to the detriment of net receivers such as Vodafone and – to a lesser extent - Optus.[16] If mobile terminating rates are reduced by 50 per cent, as sought by some parties to the Review, this

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[14] CCC submission. page 26.

[15] The Competition Commission believes that there will be a "waterbed effect" – that is, most of the reductions in terminating revenue for the MNOs will be recovered from the retail market by increased prices to customers. See "Reports on references under section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed and mobile networks." December 2002. page 130.

[16] Macquarie Research Equities estimate that a reduction of 15 per cent in mobile termination rates combined with a 5 per cent reduction in F2M retail prices will increase Telstra's net position with respect to F2M by $7M but reduce Vodafone's net position by $27M.

will impact Vodafone's revenue by approximately $ [commercial-in-confidence] per annum. This is a straight hit to the profitability of Vodafone.

6.5. The longer term impact of regulating mobile termination prices on the Australian mobile telephony market is difficult to predict. It is even more difficult to predict the impact on individual players like Vodafone. Having said that Vodafone believes that there could be a number of consequences of significantly reduced mobile termination prices if, as a result, a mobile carrier is unable to break even; that is, earn an adequate return on their investment. This could include one or more of the mobile carriers doing one or a combination of the following:

- Writing down the value of their assets but continuing to compete in the market (assuming debt and equity holders accept this write down);
- Reducing investment in future infrastructure in an attempt to reduce capacity and lift retail prices; and/or
- Exit the market (although we consider this unlikely to occur due to the extent that investments are already sunk).

6.6. Vodafone believes that to continue to compete in the mobile telephony market, will require continued and significant investment in infrastructure and services to deliver new and innovative products to customers. The current examples of this are 3G, redSIM™, Vodafone live!™, and iBurst. Vodafone has committed to investing in 3G in Australia with commercial service available by mid-2005. While Vodafone stands by its commitment in regard to 3G, implementing binding regulation of mobile termination has the potential to adversely impact on incentives to invest in new infrastructure and service development.

6.7. Significant reductions in mobile termination prices as a result of the imposition of regulation may have two adverse effects on investment incentives by:

- increasing the perceived risk, and therefore the return on investment sought by providers of capital; and/or
- decreasing the forward looking economic cash flows of capital investments due to reduced mobile terminating revenue

6.8. Lower profitability and cash flows may dampen the appetite of providers of capital, both debt and equity, to invest in infrastructure, technology and new innovative products for customers. Debt and equity providers may alter their required return as a result of perceived greater risk in the cash flows of a mobile only carrier. There may also be greater uncertainty due to perceived regulatory risk. This means that as a result of the regulation of mobile termination, the cost of capital for a mobile only carrier may increase and therefore cash flows of potential investments will be discounted more heavily. Undoubtedly, this will affect the level of investment in new infrastructure.

7. Conclusion

7.1. Vodafone believes that the competition issues that are raised by the various parties to the Review either do not exist or if they do, do not justify the imposition of regulation of mobile termination prices.

7.2. In summary, Vodafone believes that:

- the competitive issues that were raised in relation to differential on-net and off-net prices can be explained as characteristics that could be expected of a competitive market;
- the issue of vertical price squeeze does not exist, but if it does, the arguments can only be directed at integrated carriers not mobile only carriers. More importantly, however, the regulation of mobile termination prices will not address the issue; and
- competition in the F2M segment of the market would not intensify and residential customers would not necessarily see the benefit of reduced terminating prices.

7.3. Competition in the mobile services space has been widely regarded as the most vigorous competitive segment of the Australian telecommunications industry. However, Vodafone strongly believes that if there were significant reductions in mobile terminating prices imposed as a result of regulation, the effect will be weaken Vodafone's competitive position and therefore the competitive pressures in the mobile services space. Vodafone also believes that incentives to invest in new infrastructure and innovative products and services will also be reduced.

7.4. Due to the existence of integrated carriers, the impact will be imbalanced among the players - it will harm mobile only carriers like Vodafone but will benefit the integrated carriers such as Telstra. We do not expect a counterbalancing increase in retail prices for mobile services like that expected in the UK.

If you would like to discuss any of the matters raised in this letter, please feel free to contact me on (02) 9425 9499.

Yours sincerely

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