



TELSTRA CORPORATION LIMITED

**SUPPLEMENTARY SUBMISSION IN RESPONSE TO THE COMMISSION
DISCUSSION PAPER ON DOMESTIC MOBILE TERMINATING ACCESS
SERVICE (MTAS)**

Public version

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1. INTRODUCTION

- 1 Telstra provides this supplementary submission on the basis that the Commission intends to publish a draft final access determination (**FAD**) in due course. The purpose of this supplementary submission is to provide further information to illustrate that:
 - a. pass-through of mobile terminating access service (**MTAS**) price reductions to fixed to mobile (**FTM**) retail prices is contrary to the long term interests of end-users (**LTIE**); and
 - b. regulating MTAS prices on an asymmetric bill and keep (**BAK**) basis will neither be efficient nor in the LTIE.

2. MANDATED PASS-THROUGH IS NOT IN THE LTIE

2.1. PASS-THROUGH TO THE FIXED BUNDLE IS IN THE LTIE

- 2 For the reasons set out in its July submission, Telstra considers that it is not in the LTIE to mandate pass-through of MTAS price reductions to FTM retail prices.
- 3 Telstra considers that pass-through on the fixed voice bundle rather than the FTM retail price alone is consistent with the LTIE.
- 4 FTM services are not sold in isolation, and changes in underlying costs for one service may be passed on across the bundle of services. Fixed voice service bundles include an access line, local, STD, International and FTM calls, as well as value added services such as Messagebank. In its *Review of Telstra's price control arrangements - an ACCC report*, March 2010, the Commission acknowledged that FTM calls are purchased as part of a fixed voice services bundle:¹

"...the ACCC notes that consumers normally buy their PSTN services including FTM calls in a bundle and hence consumers have benefited from the reduction in the average price of the PSTN basket of services."

- 5 Changes in underlying costs for one service in the bundle may, therefore, be passed through to the bundle of services. Pass-through on this basis already occurs, as demonstrated in Telstra's July submission: on the basis of Accounting Separation data from 2004-2010, the average revenue per user of the bundle of fixed voice services has fallen by more than the reduction in the unit cost of supplying the bundle (including the cost of terminating FTM calls). This shows that the reduction in the MTAS price has been more than passed through to customers in the bundled price. This decrease in the bundled price has also occurred at a time when input costs of other calling products through the PSTN OTA rates, has remained unchanged.
- 6 Telstra's estimates of elasticity demonstrate that pass-through on the fixed voice bundle is consistent with the LTIE. **[c-i-c]**² **[c-i-c]**.³

Table 1: Price responsiveness of fixed calling services and access service

[c-i-c]

¹ ACCC, *Review of Telstra's price control arrangements - an ACCC report*, March 2010, p. 28.

² **[c-i-c]**

³ **[c-i-c]**

- 7 These results indicate that the benefit to customers of any price reductions from a reduction in MTAS prices will be greater the more that those reductions are passed through on calling services other than FTM calls. That is, passing through savings solely to FTM calls will not be allocatively efficient, as consumers value pass-through relatively more on the other calling products (i.e. local, STD and international calls). Imposing a pass-through requirement on Telstra would harm its ability to meet its customer needs, which would not be in the LTIE.
- 8 For example, customers have increasingly demonstrated a preference for subscription plans, which provide for zero-priced calls on certain services. As is evident from Table 2, Telstra's HomeLine Ultimate and HomeLine Reach subscription plans⁴ have become increasingly popular over the past three years. Mandated requirements in respect of pass-through of MTAS rate reductions would hinder Telstra's ability to respond to customers preferences through offers such as HomeLine Ultimate and HomeLine Reach. This would be contrary to the LTIE.

Table 2: HomeLine Ultimate and HomeLine Reach subscriptions 2008-2011

[c-i-c]

- 9 A further example of innovation in response to customer preferences is Telstra's launch, in December 2010, of Mobile Value Packs that were designed to provide customers with the opportunity to access cheaper FTM calls.⁵ Telstra developed and launched Mobile Value Packs in order to address the needs of certain customers who are more price sensitive to FTM calling prices.

Figure 1: Mobile Value Packs

¹ Eligible HomeLine plans are HomeLine Complete, HomeLine Plus, HomeLine Advanced, HomeLine Reach, HomeLine Together and HomeLine Ultimate. Unused value expires at the end of each month. Calls to satellite phones not included. Only one pack per service.

- 10 Telstra is concerned that by mandating a pass-through to FTM calls, the Commission risks second guessing market developments and hindering innovation in pricing plans in response to customer preferences. This would likely inhibit commercial flexibility and the availability of competitive solutions to meet customer preferences in the fixed voice services market. Telstra's concerns are heightened by the fact that the Commission is

⁴ HomeLine Ultimate includes free STD and local calls, free on-net FTM calls when bundled with 200GB internet plans, and free FTM calling with 500GB internet plans. HomeLine Reach includes free local calls.

⁵ See, <http://www.telstra.com.au/home-phone/value-packs/>

attempting to assess the need for mandated pass-through in an environment where there has been no change in MTAS prices since mid-2007.

- 11 Telstra considers that its views are in line with the Commission's own submission in the context of the Vodafone application to the Australian Competition Tribunal (**Tribunal**) for review of the Commission's rejection of its access undertaking (2007), and the Tribunal's decision in that matter. In *Re Vodafone*, the Commission submitted that:

"... if the undertaking were accepted, the Pass Through Safeguard would deprive access seekers of the flexibility to determine competitively the form in which the reductions in the VMTAS would be passed through to the retail fixed services market. It submitted that this would retard allocative and dynamic efficiency, would not be in the long-term interests of end-users and was therefore not reasonable." [268]

- 12 The Tribunal agreed:

"We consider that the pass through provisions in the undertaking deprive access seekers of the flexibility to determine competitively the individual price elements for services within the basket of services that are supplied within the fixed-to-mobile market, and the form in which pass through will take place. This approach retards allocative and dynamic efficiency, inhibits competition, is not in the long-term interests of end-users and, in our view, is not reasonable." [290]

2.2. ASSESSING THE LEVEL OF PASS-THROUGH

- 13 Telstra submits that even if the FTM market was considered to be a standalone market (which Telstra believes is incorrect):

- a. it is incorrect to assume that there should be 100% pass through of any MTAS reductions; and
- b. if the cost savings to a horizontally integrated operator are properly assessed, it demonstrates that Telstra has already passed through its cost savings from MTAS reductions to FTM calls.

- 14 In theory, and as demonstrated in Box 1, Telstra submits that even in a competitive market, using a simple one-sided market analysis it is possible to show that substantially less than 50% of cost savings from an MTAS reduction may be passed-through, e.g. where there is an upward sloping supply curve.⁶ For example, Box 1 highlights that there is a lower level of cost pass-through in a competitive market the flatter the supply curve is relative to the demand curve.

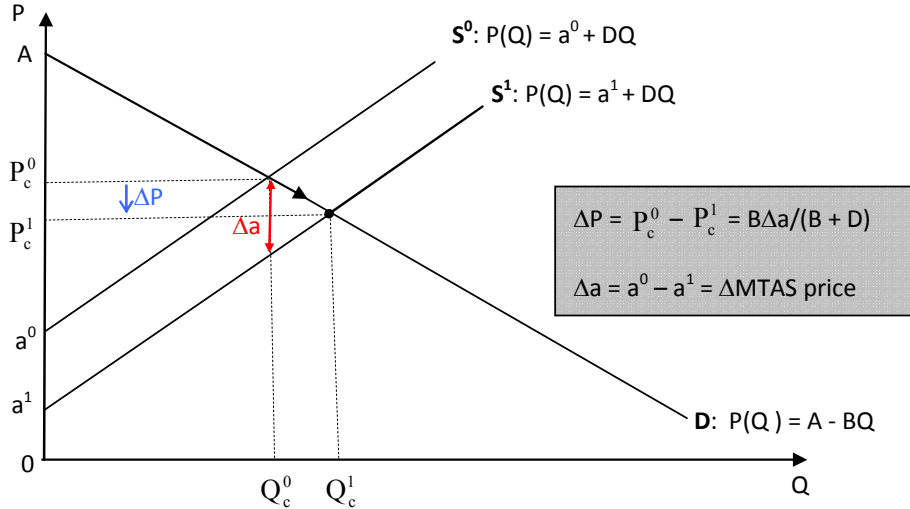
⁶ Note that this is a simple one-sided market analysis and in a two-sided market analysis, additional related market effects would need to be taken into account.

Box 1: Pass-through in a one-sided competitive market

It is assumed here that the competitive market for FTM services has a linear market demand curve of $P(Q) = A - BQ$ and where the term "a" denotes the MTAS charge, then the upward-sloping linear competitive market supply curve will be equal to,

$$P(Q) = a + DQ, \text{ where } a > 0 \text{ and } D > 0 \quad (1)$$

The diagram in the Figure below shows the resulting demand and supply curves in a competitive FTM retail market.



Equating the demand and supply equations and solving, the level of FTM minutes supplied in the competitive market will be,

$$Q_c = (A - a)/(B + D) \quad (1)$$

The price charged for each of the Q_c minutes of the FTM service supplied will then be,

$$P_c = (AD + aB)/(B + D) \quad (2)$$

From equation (2) a change in the MTAS charge (i.e. Δa) will lead to a change in the competitive market retail market price for FTM services of,

$$\Delta P = \frac{B\Delta a}{B + D} < \Delta a \quad (3)$$

It is evident from equation (3) that the level of cost pass-through in the competitive FTM retail market will be less than 100 per cent. This outcome is illustrated above, where a decrease in the MTAS price from a^0 to a^1 leads to a downward shift in the supply curve that is greater than the decrease in the retail price P_c^0 to P_c^1 . Further, if $B < D$, it is evident that in a competitive retail market for the FTM service, the level of cost pass-through will be less than 50 per cent. More generally, the result here shows that there is a lower level of cost pass-through in a competitive

15 More generally, pass-through of MTAS savings in any market will be influenced by a number of factors including:

- a. competition in the retail market;
- b. the shape of the retail market demand curve;
- c. the shape of the retail market supply curve; and
- d. the relative elasticities of supply and demand.

16 A number of submissions in response to the Commission's Discussion Paper suggested that, as Telstra is an integrated operator, there should be a greater expectation of pass-through occurring. Telstra disagrees with this view. It notes that, due to its horizontal integration, unlike a fixed-line only operator, the per minute cost savings to Telstra of a MTAS reduction in respect of FTM retail calls is the change in FTM MTAS wholesale liabilities from outgoing FTM off-net traffic divided by all outgoing FTM traffic (on-net and

off-net). In contrast, a fixed-line only operator would receive the full benefit from a reduction in MTAS across all its FTM traffic.

- 17 As shown in the July Submission, since 2004 the effective cost savings to Telstra from the 12cpm MTAS decrease is [c-i-c].⁷ Over a similar period, from December quarter 2004 to the June quarter 2011, Telstra's Accounting Separation data indicates a decrease in FTM yields of [c-i-c]. Accordingly, even if the FTM market were assessed separately Telstra, as an integrated operator, has passed through almost 100% of its cost savings to FTM calls. Given that Telstra has also passed through cost savings to other calls in the fixed voice bundle, Telstra has effectively passed through more than 100% of its cost savings in the relevant period.
- 18 Telstra's analysis of its cost savings and the pass-through of these since 2004, as set out above, provides the best information as to whether the market has been operating competitively, and whether cost-savings have been passed through to customers. In addition, Telstra notes that, as set out in Figure 2 below, its FTM yields have been decreasing since 2009. This decline is expected to continue in the future, especially given the likely further take up of mobile value pack offerings.

Figure 2: Telstra's FTM yields (June 2009 – June 2011)

[c-i-c]

- 19 In addition to passing through reductions in the MTAS price to its retail customers, Telstra has also seen reductions in FTM yields at the wholesale level, as illustrated in Figure 3 below.

Figure 3: Wholesale FTM yields

[c-i-c]

- 20 The data shows that wholesale FTM yields have declined from [c-i-c].

3. REGULATING MTAS PRICES ON AN ASYMMETRIC BAK BASIS IS CONTRARY TO THE LTIE

- 21 For the reasons set out in its July submission, Telstra is of the view that regulating MTAS prices on an asymmetric BAK basis will be neither efficient nor consistent with the LTIE. The purpose of this supplementary submission is to:
- a. draw the Commission's attention to additional issues, including further potential arbitrage scenarios and higher administrative costs of policing arbitrage, that could arise were the Commission to regulate MTAS prices on an asymmetric BAK basis; and
 - b. highlight further the inefficiencies of regulating MTAS prices on an asymmetric BAK basis by reference to Optus' Femtocell offering.

3.1. ASYMMETRIC BAK PRICING AND ARBITRAGE

- 22 Telstra believes that if the Commission implements differential MTAS rates for MTM and FTM calls, by introducing a BAK approach for MTM calling, this will lead to significantly increased opportunities and incentives for arbitrage and consequently carriers are likely to exploit opportunities to minimise their costs. It is important to recognise the potential for arbitrage and the difficulties (and costs) of detecting arbitrage.

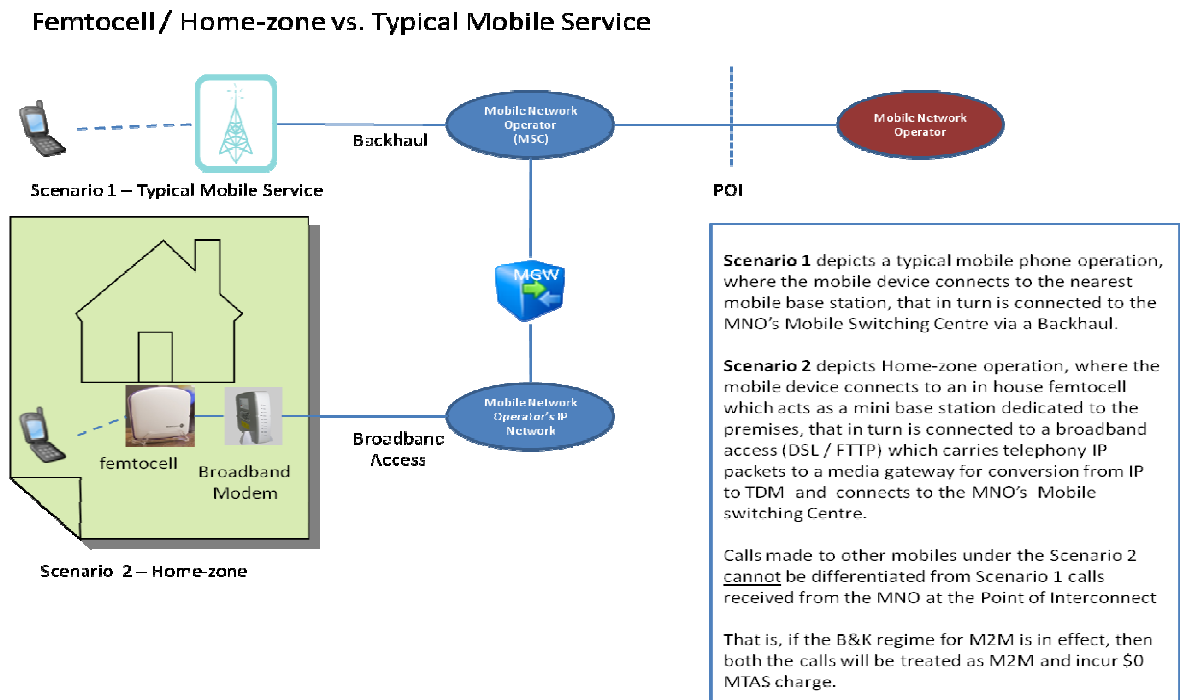
⁷ Telstra, *Response to the Commission Discussion Paper Discussion Paper on Domestic Mobile Terminating Access Service (MTAS)* (Confidential Version), July 2011, pp 42-43.

- 23 As set out in Telstra's July submission, arbitrage has previously occurred in France, where ARCEP mandated BAK for MTM MTAS; by 2004, it was estimated that up to 80-90% of FTM calls were being routed through mobile gateways. Further, Telstra outlined that such asymmetric rates would impose additional administrative costs on suppliers of the MTAS.
- 24 Where Telstra is presented with a fixed, mobile or dummy Calling Line Identification (**CLI**) (in the case of international calls) with symmetric MTAS rates, it is unnecessary to confirm that these numbers are a true reflection of the originating network. With the introduction of asymmetric rates, Telstra will need to know whether in fact a number presented is an accurate representation of the originating network. There are many ways to mask the network from which the call originates and this is currently done for either the purposes of arbitrage or for the benefit of end-users.
- 25 **[c-i-c]**
- 26 For the benefit of end-users, some operators are already representing calls from fixed networks as mobile numbers. For example, Skype encourages its customers to have their mobile CLI sent forward on 'Skype out' calls, so that they can then be called back on a mobile number. The implementation of this arrangement is currently done with the full knowledge and consent of the host carrier, an existing domestic interconnect carrier. Although currently done for customer convenience, this practice would inevitably expand to exploit arbitrage opportunities created by asymmetric rates.
- 27 Telstra expects that there would also be new ways in which arbitrage opportunities could be exploited. This would be done by presenting the receiving network with a domestic mobile phone number as the A-party CLI. For example:
- **[c-i-c]**
 - **[c-i-c]**; and
 - **[c-i-c]**.
- 28 Such practices will not be capable of easy detection or policing. Telstra cannot definitively detect the underlying network type from which a number has originated.
- 29 In Telstra's view, it would be unreasonable to impose the responsibility for monitoring and policing (to the extent that this is even possible) on the impacted MNOs. Telstra notes that the Commission, in its Discussion Paper, has expressed a desire to reduce carriers' transactional costs through implementing a BAK approach – in fact this seems to be the key stated driver. Telstra does not agree that a BAK approach would result in any savings (as outlined in our July submission) and, in fact, would require carriers to adopt a monitoring and policing function that would seriously increase transactional costs for carriers.
- 30 Finally, Telstra considers that there are definitional disputes that will be raised as a result of asymmetric rates. For example, questions will be raised as to whether calls from calling cards, over the top VoIP operators and international operators originate over a wireless network, a fixed or a mobile call.

3.2. INEFFICIENT FTM SUBSTITUTION RESULTS FROM ASYMMETRIC PRICES

- 31 In its July submission Telstra noted that, while there is FTM substitution already occurring, asymmetric MTAS rates would promote a level of FTM substitution over and above efficient market driven levels. Inefficient FTM substitution would decrease allocative efficiency in the overall fixed voice and mobile voice market, and is not in the LTIE. Telstra considers that an example of how asymmetric MTAS pricing would promote allocatively inefficient FTM substitution is highlighted by the potential benefits that such regulation would provide Optus' current Femtocell offering.

- 32 The operation of a Femtocell compared with standard mobile services is outlined in the diagram below.



- 33 Calls made to other mobiles via a Femtocell cannot be differentiated from a standard call made from a mobile service. Under the current arrangements, calls from a Femtocell onto a mobile network will be terminated as an MTM call at 9cpm.
- 34 If the BAK regime for MTM was to come into effect, calls from Femtocells will be treated as MTM calls and incur a 0cpm MTAS charge, while fixed calls to Femtocells would be charged at the prevailing FTM MTAS rate. The benefit derived from lower MTM MTAS rates would encourage and incentivise additional deployment and investment in Femtocell solutions over and above the normal efficient market driven levels. This inefficient Femtocell deployment will come at the expense of further investment in fixed line voice services.
- 35 Finally, Telstra notes that the distinction in pricing that the Commission is considering drawing between fixed and mobile originated calls comes at a time when there is increased technological and service convergence across the telecommunications sector. The proposed distinction comes at an inopportune time and risks distorting the market driven convergence that is currently occurring. The Femtocell service is a prime example of how this arises. These services are for all intents and purposes a fixed line service, which for the purposes of regulated MTAS prices would be classified by the regulation as a mobile service.