‘yes’ OPTUS

Optus Submission to

The Australian Competition and Consumer Commission

on

Vodafone’s revised mobile terminating access service undertaking lodged 23 March 2005

August 2005

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1. Executive Summary

1.1 This submission presents Optus' views on Vodafone's undertaking for the domestic digital mobile terminating access services (MTAS), which was lodged with the ACCC on 26 November 2004.

1.2 This submission addresses Vodafone's proposed fixed to mobile (FTM) pass-through mechanism (the "FTM safeguard"), and whether it is consistent with the legislation in terms of its likely impacts in the FTM retail market.

1.3 Optus does not support the inclusion of a FTM safeguard in the MTAS undertaking terms and conditions. Linking an access price offer to specific retail price targets is beyond the scope of the undertakings process and is inconsistent with the legislative criteria outlined in section 152 of the *Trade Practices Act 1974* (the 'TPA').

1.4 The TPA specifies the process and criteria to be applied by the ACCC in its assessment of an undertaking. Optus submits that the FTM pass-through mechanism condition of the undertakings does not satisfy a number of those criteria, and this element of the undertaking should therefore be rejected by the ACCC. Vodafone's FTM pass-through condition:

- goes beyond the scope of the access undertakings process;
- does not meet the threshold test for accepting an undertaking (section 152BV of the TPA) - namely the reasonableness criteria; and
- is likely to be administratively difficult to effectively implement and monitor.

2. Introduction

2.1 The Domestic GSM Terminating Access Service (MTAS) was first deemed a declared service in 1997. Following the expiry of that declaration on 30 June 2004, the ACCC declared the 'Domestic Digital Mobile Terminating Access Service' with the declaration to be effective for 5 years from 1 July 2004.

2.2 The current service description for the declared Domestic Digital Mobile Terminating is described as an access service for:

> *"the carriage of voice calls from a point of interconnection, or potential point of interconnection, to a B-Party directly connected to the access provider's digital mobile network."*

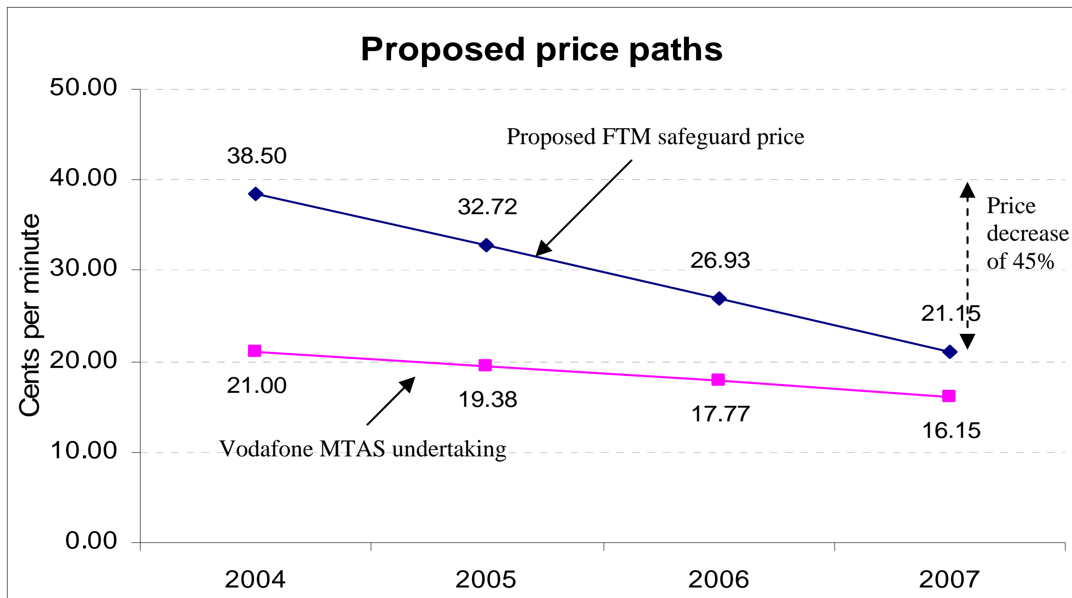
2.3 Vodafone has lodged an ordinary access undertaking with the ACCC, which specifies the price and non-price terms and conditions upon which Vodafone will provide access to a MTAS. The Vodafone undertaking applies to the calendar years ending 31 December 2005, 31 December 2006 and 31 December 2007.

2.4 As a necessary condition of its MTAS undertaking, Vodafone has proposed a FTM safeguard which requires access seekers to reduce the retail price of

FTM calls. The mechanism retrospectively links Vodafone's declining MTAS annual access prices to specific FTM retail price targets over the three year time period of its undertakings.

2.5 The diagram below (from Vodafone's supporting submission) depicts how the FTM safeguard is intended to be linked directly to the undertaking access price glidepath.

Figure 1: Vodafone's proposed glidepath for the MTAS and retail FTM service



2.6 The administration of the FTM safeguard is not entirely clear from Vodafone's submission in support of its undertaking. However, it is evident that for an access seeker to receive the glidepath of prices offered in the MTAS undertaking (pictured above), it would be required to reduce its FTM retail prices by approximately 15% to 21% each year, and by approximately 45% over the total three year undertaking time period.

3. Consistency with Part XIC

Compliance with the standard access obligations

3.1 Optus does not consider that an undertaking lodged under Division 5 of the Trade Practices Act (TPA) allows for an access provider to impose terms and conditions directly on any downstream price offers. Section 152BS of the TPA provides the legislative scope for an ordinary access undertaking. It is a legislative mechanism designed to deal with price and non-price terms and conditions of access.

3.2 Under s.152BS(1), the legislation states that the undertaking is "*…to comply with the terms and conditions specified in the undertaking in relation to the applicable standard access obligations.*" However, the FTM safeguard goes

beyond the standard access obligations (SAOs) and what is required to comply with these under s.152AR.

3.3 If the ACCC were to accept Vodafone's proposed pass-through mechanism as part of an ordinary undertaking, it would be fundamentally misinterpreting the access regime provisions and permitting it to be used to achieve a purpose that was not the intended purpose of Part XIC and the rules that govern the regulatory environment.

Consistency with any Ministerial pricing determination

3.4 The Government has intentionally elected not to control FTM retail prices via its retail price control regime, nor through any specific Ministerial Direction.

Reasonableness of the terms and conditions

3.5 Section 152BV of the TPA sets the criteria that the ACCC is required to consider for acceptance or rejection of an ordinary access undertaking, where the undertaking does not adopt the model terms and conditions set out in the telecommunications access code.

3.6 It is relevant that the ACCC consider the FTM pass-through mechanism in Vodafone's MTAS undertaking against these acceptance criteria, as set out in section 152BV(2) of the TPA:

The Commission must not accept the undertaking unless:

(a) the Commission has:

(i) published the undertaking and invited people to make submissions to the Commission on the undertaking; and

(ii) considered any submissions that were received within the time limit specified by the Commission when it published the undertaking; and

(b) the Commission is satisfied that the undertaking is consistent with the standard access obligations that are applicable to the carrier or provider; and

(c) if the undertaking deals with price or a method of ascertaining price — the Commission is satisfied that the undertaking is consistent with any Ministerial pricing determination; and

(d) the Commission is satisfied that the terms and conditions specified in the undertaking are reasonable; and

(e) the expiry time of the undertaking occurs within 3 years after the date on which the undertaking comes into operation.

3.7 In order to accept an undertaking, section 152BV(2)(d) of the TPA requires the ACCC to be satisfied that its terms and conditions are reasonable. In this regard, Optus considers that the FTM pass-through mechanism, which is a necessary pre-condition of Vodafone's undertaking, does not meet the reasonableness criteria.

3.8 The reasonableness of the undertakings is assessed having regard to the non-exhaustive list of matters outlined in section 152AH of the TPA. These are:

- *whether the undertakings will promote the long-term interests of end-users (LTIE) of carriage services or of services supplied by means of carriage services;*
- *the legitimate business interest of the carrier or provider, and the carrier's or provider's investment in facilities used to supply the declared service;*
- *the interests of all persons who have rights to use the declared service;*
- *the direct costs of providing access to the declared service;*
- *the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else;*
- *the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and*
- *the economically efficient operation of a carriage service, a telecommunications network or a facility.*

3.9 The remainder of this section deals with each of the reasonableness criteria from the list above that we see as most relevant, and lead to the conclusion that the undertaking is unreasonable and should be rejected.

The FTM safeguard does not promote the LTIE

3.10 The legislation requires that the terms and conditions of the undertaking promote the long-term interests of end users (LTIE). That is, in assessing the undertaking, regard must be had to the extent to which it is likely to result in the achievement of the following objectives in s.152AB(2) of the TPA:

- *The objective of promoting competition in markets for listed services;*
- *The objective of achieving any-to-any connectivity in relation to carriage services that involve communication between end-users;*
- *The objective of encouraging the economically-efficient use of, and the economically efficient investment in, the infrastructure by which listed services are supplied.*

3.11 In determining the extent to which a particular event is likely to result in the promotion of competition and the economically-efficient use of infrastructure, regard must be had to the extent to which it is likely to remove obstacles to consumers gaining access to the service.

3.12 Therefore, to determine whether competition is promoted by the FTM safeguard, the environment for improving competition in a market must be compared to what it would be without the condition. That is, for the FTM safeguard to promote competition, it would have to put in place better conditions for competition to occur than currently exist.

3.13 Optus considers that the required price reductions of the FTM safeguard do not improve the competitive environment prevailing in the fixed voice telephony market. The proposed FTM safeguard is likely to harm competition and the economically-efficient use of infrastructure, because:

- prices for FTM services impact directly on the prices for the national long distance ("NLD") and international direct dial ("IDD") services that are sold in a preselected services bundle, and will therefore inefficiently reduce pricing flexibility;
- margins in the wider fixed voice telephony market do not reveal monopoly profits; and
- an appropriate degree of pass-through will occur regardless of the level of competition – the elasticity of demand for FTM calls and the degree of competition in the market will determine the most efficient level of pass-through.

Impact of the FTM safeguard on NLD and IDD prices

3.14 Optus maintains the view that the preselected calling market is workably competitive, as demonstrated by the fact that:

- there are a considerable number of firms selling closely related products in each important market area;
- there is nothing to suggest that firms are setting prices in collusion;
- the long run average cost curve for a new firm is not materially higher than for an established firm; that is, market entry does not require significant capital investment; and
- on the demand side, there is a strong willingness of customers to churn with significant net savings as a result of their churning decisions.

3.15 The FTM calling service is supplied within the wider preselected calling service bundle: that is, carriers generally only provide FTM calls as part of the preselected bundle. This view is in line with that presented by the ACCC in its final decision on mobile termination.[1]

> *"To the extent that FTM calls are, due to a single-basket preselection, provided in a bundle that includes NLD and IDD calls, the Commission notes that it is appropriate to define the market within which FTM calls are provided as the broader market that includes NLD and IDD calls. In this instance, it is worth considering whether competitive forces exist over the provision of the full bundle of these services to ensure that the market within which FTM calls are provided is competitive."*

3.16 This is also consistent with the ACCC's recommended move toward a broad-based retail price control (in its final recommendation to the Government on

[1] ACCC, *Mobile services review, mobile terminating access service: Final decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service*, June 2004, page 107

the retail price control regime). It indirectly recognises that there are associated efficiency benefits of flexible pricing within a bundled basket of services.

3.17 The Trade Practices Tribunal (now the Australian Competition Tribunal) has stated the importance of flexible pricing for the promotion of competition:

> "*In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers*."[2]

3.18 The Government, in recognition of the benefits of pricing flexibility, has not dictated what level or what glidepath a competitive FTM price should follow. When faced with a decision on whether to regulate or to specifically cap FTM retail prices, the Government has treated FTM, IDD and NLD consistently and has not regulated FTM separately.

3.19 In any case, any perceived competition issues that might directly relate to FTM services have been addressed by the ACCC in its decision to directly regulate the MTAS. With the removal of this perceived barrier, there is nothing that differentiates FTM from NLD and IDD in the preselect market, and they should be treated consistently.

There is no evidence of monopoly profits in the wider fixed telephony market

3.20 The FTM safeguard directly reduces the retail margin on FTM services. Carriers rely on these preselect margins in order to ensure that their total fixed telephony bundle is profitable, hence any reduction in this margin will tend to result in carriers exiting the fixed voice and data telephony market.

3.21 There is no evidence of supernormal economic profits in the retail fixed telephony market. An examination of the imputation analysis for Telstra shows that whilst there is a loss on the local call line rental component of the bundle, the margin on the total fixed bundle has ranged from 9% to 15% for each quarter over the past year.[3] This does not represent a monopoly level of return.[4]

Welfare is reduced by the FTM safeguard

3.22 A prescribed reduction in the FTM price could distort efficient price structures within the preselected calling basket, thereby leading to direct net welfare losses.

3.23 This is shown by the graphs below which are based on the adjustments to the prices within the preselected calling basket in order for service providers to

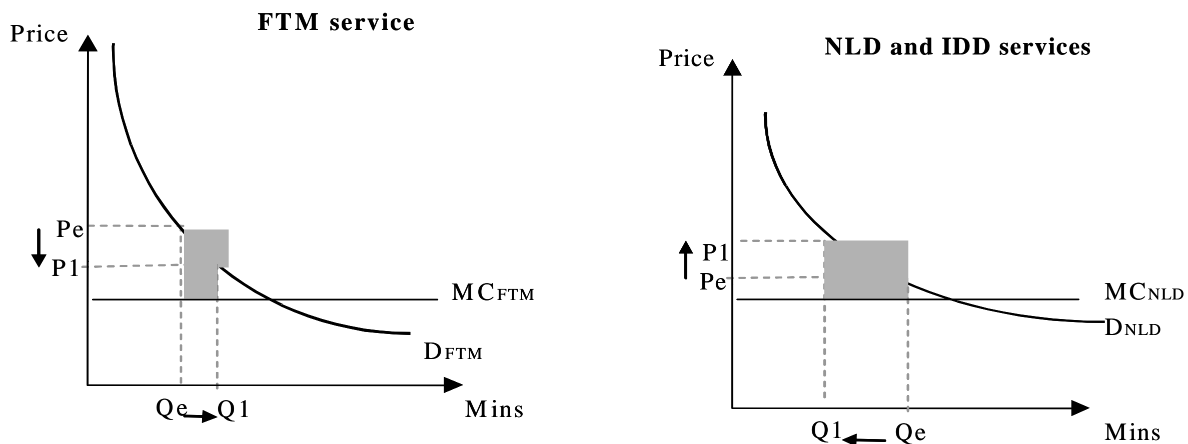
[2] Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd (1976), *Australian Trade Practices Reporter* 40-012, at 17,245.

[3] ACCC, *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra for the March Quarter 2005*, June 2005, page 16

[4] This does not show true economic profit, it only shows the net accounting profit after taking into account the opportunity cost of capital. True economic profit requires recognition of such things as returns for ex ante risks and intangibles, the latter of which may be significant in the retail space

maintain reasonable margins (to the extent possible) in the fixed telephony market. Generally, FTM prices will be pushed down by the FTM safeguard, whilst NLD and IDD will increase to maintain margins; this leads to the welfare losses.

Figure 2: Welfare consequences of a forced reduction in FTM retail prices



3.24 If the price of the FTM service is pushed below the efficient level (represented by Pe on the FTM service diagram above), welfare increases by the shaded area.

3.25 As carriers seek to maintain preselect revenues they will adjust the prices of the NLD and IDD services appropriately. The efficient price Pe is pushed up to P1 in the diagram on the right for both NLD and IDD services (represented by the one diagram above). The result is a reduction in welfare equal to the shaded area.

3.26 The net reduction in consumer welfare is due to a distortion of NLD and IDD prices – where a regulated reduction in the FTM retail price will necessarily lead to an increase in NLD and IDD prices above their efficient prices.

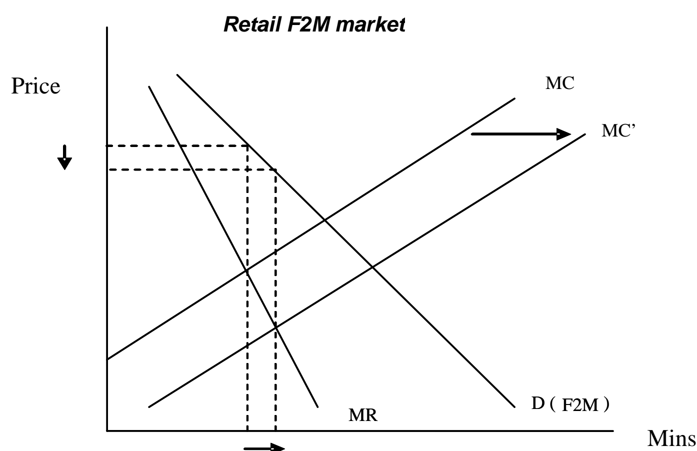
Some degree of retail pass-through is likely to occur

3.27 When an input cost changes, economic theory shows that some degree of pass-through will occur (absent some exogenous factors such as regulation that might directly control the retail price).

3.28 Even if there were some degree of market power in the FTM retail market, there would still be some amount of pass-through of the MTAS input cost savings. An unregulated monopolist will pass on some of the decrease in input costs.

3.29 A hypothetical FTM retail monopolist's pricing decision, when faced with a reduction in the MTAS, is depicted in the diagram below.

Figure 3: Retail pass-through by a monopolist



3.30 The reduced MTAS cost equates to a downward shift in the marginal cost curve faced by the monopolist to supply FTM calls. In setting its profit maximising retail price for FTM calls the monopolist will reduce the retail price to the point where marginal revenue intersects marginal cost.

3.31 The amount that a firm passes on depends on the slope of the demand curve (the own-price elasticity) and the degree of competition in the market (the slope of the marginal cost curve).

3.32 The ACCC has expressed the same view in its final decision on the regulation of mobile termination:

> "*Basic economic analysis would suggest that a profit-maximising monopolist would pass-through 50% of any cost reduction, while a totally competitive market would pass-through the entire costs saving in lower retail prices…In the Commission's view the market in which FTM services are provided lies within these bands – albeit closer to the monopoly end of the spectrum…* " [5]

3.33 Optus estimates that the degree of pass-through is related to the elasticity of the FTM demand curve. In arriving at the figure of 50% pass-through by a monopolist the ACCC was likely applying a unitary elasticity for demand for FTM services.

3.34 The reality for the FTM market, however, is that it is workably competitive, and that pass-through is likely to be greater than the 50% figure estimated by the ACCC. If industry elasticity of demand for FTM calls is -0.3 (an estimate used by both Vodafone and Optus in their access undertakings), considerably more inelastic than unitary elasticity, then the degree of pass-through by a monopolist would be greater than 50%.

[5] ACCC, *Mobile service review Mobile terminating access service: Draft decision on whether or not the Commission should extend, very or revoke its existing declaration of the mobile terminating access service,* March 2004, page 169

3.35 Applying this to the case of Vodafone's undertaking, even if 50% pass-through were to occur this would still not be enough to satisfy Vodafone's undertaking which requires pass-through of more than 358% over the three year period of the undertaking.[6]

3.36 Neither the ACCC nor the Government have placed direct pass-through requirements or retail price control regulation on FTM calls. This is because of the significant risk that such intrusive regulation creates, in terms of distortion of efficient prices (discussed above), as well as a belief by both parties that pass-through of some degree is likely to occur.

3.37 Similarly, the UK Competition Commission's report on termination charges concluded that forced pass-through or some pass-through safeguard was not required. In its response to claims by Orange that a pass-through condition to FTM retail prices was required, the Commission stated that:

> "*We do not accept this argument. In so far as the largest FNO, BT, is regulated by reference to a basket of retail prices, the benefit must be passed to BT's customers rather than being retained by BT itself, albeit not necessarily proportionately to the extent to which its customers make fixed-to-mobile calls … We expect all customers to benefit from a reduction in termination charges, either directly or indirectly*."[7]

3.38 More generally, the Commission concluded that:

> "*We are satisfied that the reduction in the call termination charges of the MNOs that would follow a charge control on them would be substantially if not wholly passed through by BT and the other FNOs to their customers, although not necessarily in the price of fixed-to-mobile calls. This is because of the competitive pressure that would be brought on BT by the other FNOs and the incentive of all the FNOs to increase their call volumes by offering more attractive prices. Even if the reduction in mobile termination charges was not wholly reflected in lower fixed-to-mobile prices, customers of the FNOs would benefit from price reduction in other areas*." [8]

3.39 A good indication of the degree of pass-through to expect from price reductions in the MTAS is to examine the degree to which pass-through has been observed in FTM prices in the past. The graph below shows the decrease in the residential FTM retail price and the overall FTM retail price that has occurred in line with the decline the MTAS rate.

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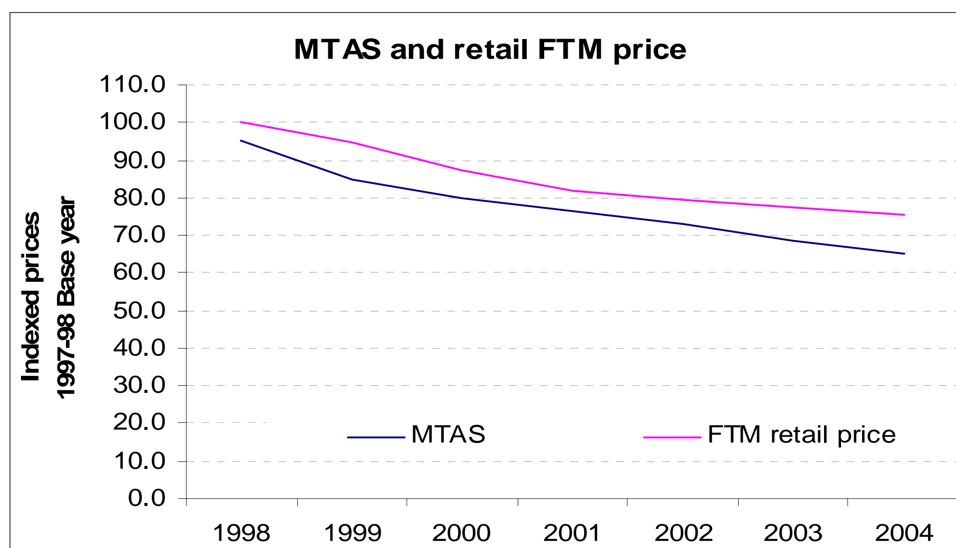
[6] This is based on the requirement in Vodafone's undertaking that a 4.85 cent/min reduction in the MTAS (over the three year period) be matched by a 17.35 cent/min reduction in FTM retail prices. This represents a factor of 3.58 or 358%.

[7] Competition Commission. *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.* January 2003, page 94

[8] *Ibid*. page 109

Figure 4: Price of MTAS versus FTM retail prices



3.40 Note that the ACCC's retail price benchmarking of the MTAS would have limited influence on this relationship, as the regulation capped the change in the MTAS price to the change in mobile retail prices, not FTM retail prices.

3.41 This evidence is contrary to Vodafone's claims that "… *average FTM prices had not reduced at anywhere near the same rate as the prices for the MTAS*"[9]

3.42 This does not necessarily mean that the full costs savings will be passed through to FTM calls *per se*, it simply means that prices will be pushed toward competitively efficient levels within the bundle of services in the most efficient way. That is, in a workably competitive market – which has been demonstrated to be the case for preselected services - it may be more efficient to pass on the costs saving to the more elastic services such as NLD or IDD, rather than passing the cost savings on in only FTM services.

Encouraging the economically-efficient use of infrastructure

3.43 An assessment of whether the FTM safeguard encourages the efficient use of infrastructure is related to the promotion of competition. This is because the terms and conditions of access to infrastructure, which impact on competition, will determine the extent to which the infrastructure is efficiently utilised in the FTM market.

3.44 Retail prices set below the efficient levels can undermine the incentive to invest in new technology and quality improvements. Prices should therefore be set to recover efficiently incurred costs, including a contribution to fixed and common costs. If these fixed and common costs can be recovered in the most efficient manner possible, the reduction in allocative efficiency (associated with charging above marginal cost) can be minimised.

[9] Vodafone, *Submission to the ACCC: Access Undertaking Mobile Termination Access Service, 23 March 2005*, page vi

Consideration of the interests of those who have a right to use the service

3.45 Setting a MTAS contingent on certain FTM retail prices does not give due consideration to those access seekers who have a right to use the service. In setting the glide path to the target price, Vodafone has not reasonably considered the significant adjustment in FTM prices and the material negative impact on suppliers of FTM services. It would therefore be unreasonable to accept Vodafone's undertakings.

3.46 The FTM safeguard does not give sufficient regard to access seekers' investment plans, business planning and commercial pressures to maintain a reasonable return on investment and stability in cash flows and operations for the business over the next three years.

3.47 The FTM pass-through condition requires that prices fall by 15%, 18% and 21% in each respective year of the undertaking (this equates to an overall reduction of almost 45% over a three year period).

Substantiation of claimed costs

3.48 As part of any lodgement of undertakings access providers are required to substantiate their claimed costs. Consideration of the direct costs of providing access to the declared service is included in the reasonableness criteria in order to ensure that:

- access providers are compensated for the cost of providing access; and
- access prices are not inflated by the access provider to recover any increase in costs as a result of the increased competition arising from increased access to the facilities.

3.49 This requirement can equally be applied to the associated FTM safeguard because, as a condition of the undertaking, it directly impacts on the access price that is charged to access seekers.

3.50 The direct costs associated with providing end-users access to FTM services include:

- Cost of the MTAS to terminate the FTM call;
- Cost of PSTN access to originate the FTM call;
- Costs of transmission access to carry the FTM call; and
- Retailing and other costs.

3.51 Vodafone has used an unsubstantiated price for FTM services in its FTM safeguard proposition. Firstly, Optus does not agree with the methodology applied to determine the very steep glidepath for the FTM safeguard. Secondly, we consider that the methodology is based on an unsubstantiated cost estimate provided by the ACCC.

3.52 The FTM glidepath is particularly steep; it drives prices down at a faster rate than the MTAS glidepath in Vodafone's undertakings. This is because it is based on delivering a FTM retail price of 21.15 cpm by January 2007. The

price of 21.15 cpm is, in turn, based on an ACCC estimate of 5 cpm for other costs, including originating a FTM call on the PSTN, carrying that call and the retail costs associated with the FTM call. The estimate by the ACCC is substantiated by no more than a statement to the effect that the figure is based on "*evidence submitted by interested parties, market inquiries and regulatory accounts*".

3.53 It is unlikely that the FTM retail costs would be as small as 5 cpm for a fixed operator, particularly for those operators that have not built up scale. The ACCC's proposed 5 cpm for FTM retailing, PSTN origination and transmission costs is likely based on Telstra data, which would be at the lower end of the cost estimates. It is not appropriate to take Telstra's costs in this respect, as for all other fixed operators they are likely to be greater than 5 cpm.

3.54 It is not appropriate or reasonable that Vodafone to take such an unsubstantiated and untested estimate, without any further analysis or benchmarking, and apply this price within its undertakings.

3.55 Based on Frontier's modelling work, which incorporates the externality and Ramsey-efficient mark-ups, Vodafone states that the welfare maximising price for mobile termination is in fact between 22.32 and 32.73 cents per minute. Therefore, forcing FTM retail prices to levels that are below this level can only be harmful to the LTIE.

3.56 However, even if it were the case that FTM calls did cost only 21.15 cents per minute to provide to consumers (a view which Optus does not support), this glidepath is too steep and would involve significant and detrimental rate shock to fixed providers.

Optus' estimate of an appropriate FTM retail margin

3.57 Optus' analysis shows that the ACCC's estimate of 5 cpm for retail and other incurred FTM costs is too low. Optus' MTAS undertaking analysis shows that the average retail costs are **[Start commercial-in-confidence [End commercial-in-confidence]**

3.58 This average historic cost estimate for Optus is based on costs reported in Optus' regulatory accounting framework (RAF) accounts for business, residential and small and medium enterprise (SME) customers. It represents a more reasonable proxy for the retail and other costs than the ACCC's unsubstantiated estimate of 5 cpm.

4. Administration of the FTM safeguard

End user billing issues

4.1 At the retail level, the proposed FTM safeguard requires the access seeker to reduce its average price for those calls that terminate on the Vodafone network. This may lead to differentiated FTM prices to customers based on the network to which their specific call terminates.

4.2 The degree of customer confusion arising from this would be substantial. Customers would potentially receive a bill with different rates based on whether their calls terminated on Vodafone's or another carrier's mobile network.

4.3 The tariff structure used by retail carriers with their retail customers should be a decision for the telcos, based on what they consider will be most appealing to their customers within their tailored offers. It should not be mandated by regulation – particularly when what is mandated is confusing compared to the current market standard.

Administration of the FTM safeguard

4.4 It is questionable as to how the ACCC would be able to administer such a scheme. The ACCC does not have jurisdiction to set retail prices. The Government's retail price controls are in place to perform this function.

4.5 Applying the adjustment retrospectively is likely to be difficult and would mean significant ongoing regulatory involvement in what are essentially commercial inter-carrier arrangements.

4.6 Vodafone has nominated in its undertaking submission that the Access Commercial Disputes Centre (ACDC) could be responsible for undertaking the analysis of the FTM prices and whether carriers are pricing within the proposed FTM safeguard. Introduction of a third party, such as the ACDC could be problematic. Firstly, the ACDC are not specialists in this area, and secondly, it is not appropriate to introduce a third party into the regulatory monitoring of access prices.

4.7 There are likely to be additional costs associated with the ongoing compliance work, whether it be undertaken by the ACDC or the ACCC. It is not clear how the additional monitoring costs would be funded.