TELSTRA CORPORATION LIMITED

Submission in response to the Commission Discussion Paper:

Vodafone's Undertaking in relation to the Domestic Digital Mobile Terminating Access Service

August 2005

1 Introduction

1.1 Background

On 26 November 2004, Vodafone Network Pty Limited and Vodafone Australia Limited (collectively "Vodafone") provided the Australian Competition and Consumer Commission ("Commission") with an ordinary access undertaking ("the initial Undertaking") that specifies the terms and conditions on which Vodafone will comply with its standard access obligations ("SAOs") in respect of Vodafone's domestic digital mobile terminating access service ("MTAS"). Vodafone provided the Undertaking following the Commission's declaration of the MTAS with effect from 1 July 2004.

Due to changes made to the calculation of usage charges for Vodafone's MTAS, Vodafone withdrew the Undertaking and lodged a new ordinary access undertaking ("the revised Undertaking") on 23 March 2005.

The Commission issued a discussion paper regarding the revised Undertaking on 13 April 2005 ("Discussion Paper") and called for submissions from the public. Telstra welcomes this opportunity to comment on the revised Undertaking and respond to the matters raised in the Commission's Discussion Paper.

1.2 Statutory criteria

Where an ordinary access undertaking is provided to the Commission under Part XIC of the *Trade Practices Act (Cth)* 1974 ("TPA"), the Commission must either accept the undertaking or reject it. As the Commission has previously acknowledged, it is unable to accept an undertaking in part.

However, section 152BV(2) of the TPA provides that the Commission must not accept the undertaking unless:

- a public consultation process has been undertaken by the Commission;
- the Commission is satisfied that the undertaking is consistent with the applicable SAOs;
- the price, or method of calculating price, if specified in the undertaking, is consistent with any Ministerial pricing determination;
- the Commission is satisfied that the terms and conditions in the undertaking are reasonable; and
- the undertaking expires within 3 years of it coming into operation.

Thus, in order to accept an undertaking, the Commission must be satisfied, amongst other things, that all the terms and condition it contains are reasonable.

In determining whether the terms and conditions are reasonable, the Commission must have regard to the following matters set out in section 152AH of the TPA:

- whether the terms and conditions promote the long term interests of end-users ("the LTIE");
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or carriage service provider's investment in facilities used to supply the declared service concerned;
- the interests of persons who have rights to use the declared service concerned;
- the direct costs of providing access to the declared service concerned;
- 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 telecommunication network or a facility.

The LTIE is defined in section 152AB(2) of the TPA in terms of the following three objectives:

- the promotion of competition in the markets for carriage services and services supplied by users of carriage services;
- achieving any-to-any connectivity in relation to services that involve communication between end-users; and
- encouraging the economically efficient use of and investment in infrastructure.

1.3 Summary of Telstra's submissions

In Telstra's view, the Commission should reject Vodafone's MTAS undertaking. The prices proposed by Vodafone are, by their own admission, inconsistent with welfare maximising prices, as they fail to take into account important Ramsey principles and externality effects. The pass-through mechanism proposed by Vodafone would restrict the ability of fixed carriers to price their services in response to consumer demand which would clearly be inconsistent with the LTIE, it would encourage regulatory gaming, is inconsistent with basic

economic principles that Vodafone itself supports and would impose a costly and unnecessary regulatory burden on fixed line carriers. Telstra is also concerned with a number of the non-price related terms of the undertaking.

2 The Undertaking

2.1 Price related terms and conditions

Vodafone, in its initial Undertaking, put forward a "target Usage charge" of 17.5 cents per minute ("cpm") for its MTAS. Subsequently, in the revised Undertaking, Vodafone amended its target Usage charge to 16.15cpm which is described as representing the "*forward looking efficient economic costs of the MTAS on Vodafone's network*".

In the revised Undertaking, Vodafone has proposed that the target Usage charge be achieved via an adjustment path as follows:

Period	Revised usage charge
1 July 2004 - 31 December 2004	21.00cpm
1 January 2005 - 31 December 2005	19.38cpm
1 January 2006 - 31 December 2006	17.77cpm
1 January 2007 - 30 June 2007	16.15cpm
Any subsequent Validity Periods	16.15cpm

In Telstra's view, the target rate proposed in the Vodafone undertaking will fail to encourage welfare-maximising outcomes, as it ignores important Ramsey cost allocation principles and externality effects. Given that both the original and revised usage charges ignored these effects, Telstra believes that both fail to reflect the efficient forward-looking costs of providing MTAS. Telstra understands Vodafone's reasoning with respect to the need to implement the proposed target rate over time, particularly given the substantial changes in pricing structures that would be required as a result of the proposed reduction in MTAS. However, Telstra does not believe that the glidepath need be in equal increments, but rather a larger one-off change could be made with smaller increments to reach the target rate. If the target rate were welfare maximising (which Telstra believes it is not), then this would deliver benefits to consumers more quickly.

2.2 Fixed-to-mobile pass through

Vodafone, in its revised Undertaking, has included a proposed fixed-to-mobile ("FTM") pass-through safeguard ("FTM Safeguard") which requires access seekers to reduce the price

that they charge end-users for FTM calls as a pre-condition to the access seeker receiving Vodafone's lower MTAS prices. The FTM Safeguard would establish a target FTM retail price of 21.15cpm which would be achieved via a three year adjustment path as follows:

Period	Target average retail price
1 July 2004 - 31 December 2004	38.5cpm
1 January 2005 - 31 December 2005	32.72cpm
1 January 2006 - 31 December 2006	26.93cpm
1 January 2007 - 31 December 2007	21.15cpm
Any subsequent Validity Periods	21.15cpm

Telstra submits that the FTM Safeguard is inconsistent with the LTIE and is unworkable from a practical perspective. These concerns are set out in detail below.

At the outset, Telstra notes that FTM pass-through mechanisms (like that which is presently proposed by Vodafone) were the subject of consideration by the Commission in its Mobile Services Review. That consideration arose out of the submissions of various interested parties (including Vodafone) which expressed concern that any reduction in MTAS pricing resulting from the declaration of that service would not be passed through to end-users by way of reduced FTM pricing.[1] In considering these issues the Commission concluded that the incorporation of a pass-through mechanism was inappropriate.[2] Telstra submits that the reservations expressed by the Commission in this regard are equally true of the FTM Safeguard proposed in the revised Undertaking. Accordingly, Telstra sees no good reason why the Commission should (and good reasons why it should not) depart from its previously expressed views.

Telstra's main concerns with the Safeguard concept outlined by Vodafone are that:

- it is not appropriate for, and contrary to the purpose of, an access undertaking to seek to regulate retail prices. If such prices require regulation (which Telstra does not accept), that regulation is properly the function of the responsible Minister, not an access undertaking;

[1] See 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) ("*MTAS Final Decision*") at 104ff and 223-226.

[2] *MTAS Final Decision*, at 226.

- it is premature for the Commission to consider the issue of FTM regulation at this time;
- even if the Commission was to assess FTM regulation at this time, it should be cautious about accepting Vodafone's proposal as being indicative of the 'competitive benchmark';
- it follows from the previous point that the Commission's acceptance of Vodafone's undertaking could significantly restrict fixed network service providers' ("fixed providers") ability to recover common costs in the least distorting manner;
- Vodafone's undertaking has inconsistent approaches to the recovery of common costs for mobile and fixed operators;
- the Commission's acceptance of Vodafone's undertaking would likely result in gaming by fixed providers and otherwise distort commercial decision-making;
- the Commission's acceptance of Vodafone's undertaking would create a further unnecessary layer of regulation; and
- the Safeguard is, from a practical perspective, unworkable.

Not appropriate for an access undertaking to regulate retail prices

If the Commission were to accept the revised Undertaking, it would be, in effect, regulating retail prices via interconnection agreements made between Vodafone and access seekers. Telstra submits that this is not appropriate. The purpose of an access undertaking is to set out the terms and conditions upon which the access provider, not the access seeker, supplies services.

If retail prices (including FTM prices) require regulation (which Telstra does not accept), that regulation is properly the function of the responsible Minister. Any such regulation will generally follow an inquiry where interested persons are afforded the opportunity of making submissions. It is not appropriate for Vodafone to seek to perform this function by imposing its own retail FTM call price on access seekers. Further, given that Vodafone does not even supply FTM call services, it would clearly not be best placed to be determining FTM prices since it would have none of the demand information that is necessary to set prices at efficient levels.

Premature to be considering FTM price regulation

The Commission has only recently made its indicative decision to use TSLRIC pricing for mobile termination regulation. One of the Commission's reasons for making this decision was that it would promote competition for the supply of FTM services. It stated that lower FTM prices will likely result from lower MTA rates and greater competition for supply of FTM services:

> *Over time…as competition develops in this market, the Commission expects that retail prices will decrease because of both decreases in termination charges and through the market becoming more competitive.*[3]

If the Commission considers that the continued declaration and use of TSLRIC pricing will promote competition in the supply of FTM services, it is reasonable then to provide the opportunity for competition to develop before considering the implementation of prescriptive retail regulation. This is particularly so when the Commission's MTA pricing principles provide for a staged implementation of lower mobile termination prices.[4]

Further, a well recognised risk of attempting to remove all rents from the market through regulation is that of diminished incentives for new entry or even the exit of existing suppliers in some circumstances. This would be compounded by the restrictions that Vodafone's proposal would place on price/quality trade-off decisions and on the recovery of common costs. Both these issues are discussed in more detail below.

Assessing competition in the FTM sector

Vodafone's FTM glide path relies on the Commission's view that the '*combined cost of originating, transmitting and retailing FTM calls* (is) ***around*** *5 cpm* (emphasis added)."[5] Ultimately, the FTM glide path falls to a requirement that FTM prices are no greater than 5 cpm more than MTA rates. This is considered by Vodafone to be the 'competitive level'.[6]

If Vodafone's view is accepted, it may result in an erroneous view that any difference between MTA rates and FTM prices greater than 5 cpm will mean the FTM market is not competitive. Fixed-to-mobile services are supplied jointly with other PSTN services, and common costs will not necessarily be most efficiently recovered in the manner implied by the Commission's calculation that the costs of transforming the MTA service to the FTM retail service are 5 cpm.

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3 *MTAS Final Decision*, p. 223.

4 *MTAS Final Decision*, p. 216.

5 *MTAS Final Decision*, p. 101.

6 For example, it describes the FTM retail glide path to link 'proposed reductions in Usage Charges for the [mobile termination] Service to an Access Seeker gradually reducing its average retail F2M prices to competitive levels': Vodafone (2004), p. 27.

Rather, the Commission's assessment of FTM competition should consider a range of indicia, such as barriers to entry and market structure. Importantly, it also needs to consider competition intensifying from new sources, such as voice over internet protocol, supply of fixed-line services using the unbundled local loop access service by Telstra's competitors and greater substitutability between mobile and fixed telephony (including from third generation mobile networks).

Inconsistent and inefficient approach to retail price controls

Adoption of Vodafone's proposition by the Commission would be inconsistent with the Commission's proposed recommendation to the Minister on retail price controls (and the Commission's previous advice and the approach adopted by the Minister in the current retail price controls). The Commission view is that clear benefits can accrue from implementing price controls via broad baskets, by allowing greater flexibility (and associated greater efficiency) in recovering common costs.[7] The Commission has stated that:

> *One way of minimising this efficiency loss is for the firm to use Ramsey pricing. One implication of this pricing is that it may be efficient for a firm to set prices for some of its services well above their costs of production because they have a low own-price elasticity of demand. Accordingly, setting an individual price cap on every service may lead to inefficient outcomes. This is because it could push the price of all services towards cost in a uniform way, rather than encouraging the firm to structure its prices for all services such that it minimises the efficiency loss of recovering common costs.*[8]

The Telstra-specific retail price controls also do not require average retail prices to move to particular cost estimates, as the Vodafone proposed undertaking would require for FTM prices.

It is also inconsistent with good regulatory practice, which is to enable pricing flexibility for firms where possible so that prices can reflect relative demand characteristics. The 5 cpm estimate appears to be based on an equi-proportional approach to allocation of common cost, which does not allow cost recovery from consumers in a way that minimises the welfare distortions of above marginal cost pricing.

Any decision by the Commission to accept Vodafone's proposed FTM glide path should therefore assess the costs of not allowing FTM providers to minimise the efficiency

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[7] ACCC (2004), *"Review of Telstra's price control arrangements – an ACCC draft report"*, November 2004, pages 39-40.

[8] Ibid., page 40.

distortions of above marginal cost pricing, by requiring pricing that reflects equi-proportional mark-ups. In an efficient industry configuration, it would be expected that the mark-up over marginal costs would reflect the price elasticity of demand for the market. That is, less distortion will occur if those services with lower own-price elasticity have a relatively greater mark-up to recover common costs.

When making this assessment, there appears to be common agreement that FTM calls are relatively inelastic compared to the other calls in the pre-selection basket (national long distance and international calls).[9] If so, this would suggest that the efficient proportion of mark-up for FTM calls should be relatively greater than the mark-up provided from an equi-proportional allocation of common costs.

Internal inconsistency in Vodafone's undertaking

Vodafone states that the pricing for mobile termination in the undertaking:

> *[I]mplicitly adopts Ramsey pricing concepts to allocate and recover fixed and common costs across the various products and services it supplies.*[10]

However, in Vodafone's proposed FTM glide path, the allowed margin between MTA and FTM pricing is set according to an equi-proportional mark-up to recover common costs. Vodafone makes no attempt to explain why it believes that this cost allocation is preferable to Ramsey pricing for this service, or of why mobile termination charges should be set taking account of demand elasticities but FTM charges should not.

Gaming of the FTM glide path and distortion of commercial decisions

Vodafone's proposed retail glide path only makes reference to capping the per minute charge or usage rate of FTM providers and not flagfalls. Failing to apply constraints on all components of FTM charges leaves the option of rebalancing open to FTM providers. Telstra notes that rebalancing of revenues through higher flagfall charges creates significant opportunities for gaming the glide path, which diminishes its effectiveness and distorts commercial decision-making by all access seekers.

Potentially of even greater concern is that the glide path can impact on the ability of firms to differentiate themselves. Firms seek to differentiate themselves in the supply of national long distance, international and FTM calls not only via marketing, billing services and other retail support services, but also in terms of the relative prices in the set of services they provide. This can also increase the options open to customers to choose the set of relative

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9 See, for example, ACCC (2001), "*Review of Price Control Arrangements*", Table 5.1, page 43. The demand elasticities calculated by the Commission clearly indicate that FTM calls are relatively inelastic compared to STD and IDD calls.

10 Vodafone (2004), op. cit., page viii.

prices as well as the level of service they value most highly. In short, imposing the proposed retail price path upon the retail FTM market may reduce the opportunity and incentive to produce or invest in higher levels of retail service and marketing.

The proposed retail price path would place an eventual cap on pricing that is set by an estimate made by the Commission. It has no regard to the potential costs faced by the many different firms in the market supplying FTM services. Without an understanding of these costs, the Commission could have little confidence that it may not restrict the incentive and opportunities for new entry by differentiating the FTM services, or otherwise restrict the range of offers that may be made to consumers.

The importance of permitting quality/ price trade-offs is highlighted in the current Telstra-specific retail price controls. These provide that Telstra can deviate from the price controls due to quality improvements (subject to the Commission's approval).

Competitive differentiation does not, of course, only refer to differences in quality. Experience in Australia and elsewhere shows that telecommunications firms innovate in the structure of their pricing, as well as in the range, quality and presentation of the services they provide. The proposed glide path would hinder that innovation, as it would impose constraints both on firms altering the structure of FTM charges (for example, in terms of multi-part pricing options) and on their ability to bundle charges for FTM with charges for other services.

Potential for over-regulation

Vodafone's access undertaking imposes compliance costs on all access seekers using its mobile termination service.[11] These costs include ensuring average prices fall according to the stipulated FTM glide path, and the potential for expert determination if a dispute over the access seeker's compliance cannot be resolved between the parties. Determining the average price fall may not be trivial, due to the variety of different offerings to end-users. Further, for each mobile network that followed Vodafone's approach, the compliance costs would grow accordingly.

It is important to stress the many practical difficulties implementation and compliance monitoring of Vodafone's proposal would entail (some of these are discussed in Appendix 1). The reality is that FTM is increasingly provided as an element within a bundle of services that extends beyond the PSTN alone, with that bundle being priced in ways that seek to provide benefits to consumers from the bundled acquisition. As a result, the "price" of FTM within the bundle can be complex, as it will depend both on the package or plan the

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[11] Service Schedule – Vodafone Domestic Mobile Terminating Access Service in Vodafone's proposed *'Agreement for the Provision of Mobile Terminating Service'*.

customer has selected and on the customer's actual usage in the billing period. Determining the "price" of FTM will therefore require the determination of rules for revenue allocation within bundles.

As well as being costly for access seekers to implement, these rules will inevitably be contentious. As a result, greater monitoring and adjudication burdens will be placed on the Commission as disputes arise. As well as their direct cost to society (in the form of the resources that will need to be devoted to dispute resolution), these disputes will create further uncertainty in the regulatory arrangements.

Conclusion

Telstra believes that the Vodafone proposed retail glide path will likely have many potentially harmful impacts.

Telstra's view is that the submission will provide an unnecessary third layer of regulation that would restrict opportunities for the efficient recovery of common costs. It would also likely inefficiently distort commercial decision-making by FTM providers.

Further, Vodafone's proposal would cause potentially inconsistent approaches to those in Telstra-specific retail price controls and to Vodafone's own treatment of common cost recovery from the supply of mobile termination services.

Finally, the proposal potentially may have an adverse impact on competition for the supply of FTM services, including by increasing the compliance costs of regulation.

Therefore, it is difficult to see how the proposal could achieve the objectives of efficiency and promotion of competition in Part XIC of the Act and, in Telstra's view, should be rejected.

2.3 Non-price related terms and conditions

Attachment A to Vodafone's revised Undertaking contains provisions relating to a number of non-price terms and conditions that apply to Vodafone's supply of MTAS. There are also a number of additional terms and conditions that are not included in Vodafone's revised Undertaking that must be negotiated and agreed between Vodafone and the access seeker or resolved via an arbitration conducted by the Commission under section 152CP of the TPA.

In general, Telstra submits that a number of the non-price terms and conditions are not reasonable in that they:

- are not in the LTIE;

- go well beyond what is required to protect Vodafone's legitimate business interests, and
- do not adequately address the interests of those with rights of access to the declared service.

Telstra's views in this regard are set out in more detail below.

(a) Quality of service

Section 152AR of the TPA sets out the relevant SAOs in respect of the supply of a declared service. Relevantly, s152AR(3) sets out SAOs relating to the quality that the supply of the declared service must adhere to. These include:

- ensuring that the technical and operational quality of the declared service supplied by the service provider is equivalent to that which the access provider provides to itself: s152AR(3)(b); and
- ensuring that the service provider receives, in relation to the active declared service supplied to the service provider, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself: s152AR(3)(c).

A number of clauses in the revised Undertaking relate to quality of service issues, including clauses 5, 8, 9 and 10. Clauses 5(a)(i) and (ii) are drafted in near identical terms to, and are clearly consistent with, the SAOs contained in s152AR(3)(b) and (c). Both these provisions incorporate the statutory quality standard of equivalence 'to that which the access provider provides to itself'.

However, other clauses import different standards. For example, clause 8.2 concerns the quality standard to be adhered to in the management of the parties' respective networks. This clause adopts a number of different quality standards including as follows:

- Vodafone is required, in the event of failure of the Service, to correct faults "as soon as is reasonably practicable"; and
- Vodafone must manage, notify and correct faults arising in its network which affect the provision of the Service "as it would in the ordinary course for similar faults affecting the provision of other services by it".

These various standards appear to differ from the quality standard provided for in the relevant SAOs and in any case differ from those in clause 5. Furthermore, clause 8.2 is so vague as to offer little guidance as to how fault management is to take place.

(b) Interconnection

Section 152AR(5) of the TPA sets out the relevant SAOs in respect of the interconnection of facilities including the quality and fault rectification of that interconnection. Clause 4.2 of the revised Undertaking provides that the parties must supply "Interconnection Services" to each other in accordance with the relevant terms of the revised Undertaking and the "Interconnection Manual". The "Interconnection Manual" (which forms Annexure 3) remains to be agreed between the parties. Furthermore, clause 5 has no application as it is limited to the supply of the "Service" which is defined so as not to include "Interconnection Services". As a result the revised Undertaking does not provide for the standard to be adhered to in relation to the quality and fault rectification of the interconnection services. Further, the extent and nature of Vodafone's obligation to supply interconnection services is uncertain.

(c) Suspension

Telstra accepts that an access provider should be entitled to suspend and terminate the services in certain circumstances. However, the circumstances in which Vodafone is entitled to suspend or terminate the service supplied pursuant to the revised Undertaking are in many cases overly broad, based on subjective criteria and go beyond what is required to protect Vodafone's legitimate interests.

Vodafone's various rights of suspension, contained in clause 15(a), are all triggered by reference to the "reasonable opinion of Vodafone". Telstra accepts that in some circumstances it is appropriate that an access provider should have an immediate right to suspend which is subject to a subjective test. Examples of such circumstances include where, in the reasonable opinion of the access provider, the continued supply of the service poses a threat to life or other serious hazard or where there is some other emergency requiring suspension.[12] However, in other circumstances the incorporation of a subjective test is not appropriate. For example, in the revised Undertaking Vodafone is given an immediate right of suspension if in its reasonable opinion:

- Vodafone is entitled to terminate the Agreement for any reason;
- the Access Seeker suffers an Insolvency Event; or
- the continued operation of the Agreement or the supply of the Service would be unlawful.

[12] Telstra therefore accepts that the suspension right contained in clause 15(a)(ii) is reasonable. However, the same is not true of the suspension right contained in clause 15(a)(iv). This clause allows Vodafone to suspend where in its reasonable opinion there is an emergency that "in Vodafone's opinion" requires suspension. Vodafone's opinion as to whether suspension is required should also be subject to a reasonableness test.

The incorporation of a subjective test is not reasonable in such circumstances. The Commission has previously expressed concerns about the use of subjective standards such as those incorporated in the revised Undertaking.

In addition, the overly broad definition of "Insolvency Event" further and unreasonably widens the ambit of Vodafone's discretion. For example, the mere fact that a person threatens to take possession or control of any of the assets or undertaking of the access seeker for the purpose of enforcing a charge will constitute an insolvency event. That is, irrespective of whether or not the threat is in fact well-founded or acted upon. The result is that Vodafone has a right to suspend if in its reasonable opinion a threat to enforce a charge has been made - even if no such threat has been made or even if a threat has no merit.

In this light, the cursory comment in the Vodafone Submission that "Vodafone may only suspend the supply of services under the agreement in a few exceptional circumstances" is simply incorrect.[13]

(d) Termination

Clause 16 concerns the parties' respective rights of termination. While Telstra accepts that some aspects of these provisions are reasonable, others are overly broad and suffer from many of the same problems set out above in respect of suspension. For example:

- the termination rights conferred by clause 16.1(a) and (b) are both subject to a subjective test; and
- there is a right to terminate with immediate effect if a party suffers an "insolvency event" (clause 16.2(b)).

Telstra also has a number of specific concerns with the termination provisions. First, the right conferred by clause 16.1(a) allows Vodafone to terminate if in its reasonable opinion the access seeker "has attempted to use, is likely to use, or has used" the service in contravention of any law irrespective of whether Vodafone authorised or permitted such use. This gives Vodafone the right to terminate irrespective of whether the access seeker has actually used the service in contravention of any law.

Secondly, either party may terminate without reason on six months' notice. In effect, this means that the Agreement has no certain duration and may last for no longer than six months. This does not facilitate commercial certainty as to the supply of MTAS by Vodafone and, concomitantly, is not in the LTIE.

[13] *Vodafone Submission* at 37.

Thirdly, pursuant to clause 16.2(b), Vodafone may terminate immediately if the service is validly suspended for more than 30 days. This would enable Vodafone to terminate in circumstances where the suspension was due to no fault of the access seeker.

(e) Creditworthiness and security

Telstra agrees that Vodafone should be entitled to assess the creditworthiness of, and demand security from, those to whom it supplies access. However, the provisions in the revised Undertaking go beyond what is required to protect Vodafone's legitimate commercial interests.

First, various of the circumstances in which Vodafone can review the creditworthiness of an access seeker are unreasonable. Vodafone may review the creditworthiness of the access seeker irrespective of whether the circumstances reasonably require such a review. For example, such a review may take place in Vodafone's absolute discretion within six months of the entry into the Agreement.

Secondly, the circumstances in which Vodafone can demand security from an access seeker are unreasonable. Vodafone may request the provision of security if it "forms the view that the Access Seeker does not meet its reasonable security requirements". Hence, the precondition to the right to demand security, namely "Vodafone's view", is not even subject to a reasonableness test (i.e. "Vodafone's reasonable view" or "Vodafone's reasonable opinion"). In addition, Vodafone's "security requirements" are not specified and therefore uncertain.

(f) Confidential information

Telstra accepts that both access providers and access seekers have legitimate interests in protecting their respective confidential information. It also accepts that those provisions may legitimately require the return or destruction of such confidential information in certain circumstances. However, Telstra submits that aspects of the provisions in the revised Undertaking concerning confidential information are unreasonable. These aspects are discussed below.

First, clause 11.4 confers upon Vodafone the ability to use "Network Information" in circumstances where it is reasonable. That clause expressly recognises that "Network Information" is the confidential information of the access seeker. Nevertheless, it allows Vodafone to "use and disclose Network Information provided that it is aggregated with other network information and is disclosed on an anonymous basis". Telstra notes that the provisions in this regard - unlike the other confidentiality restrictions in the revised

Undertaking - are not mutual.[14] Further, these provisions are inconsistent with the obligations imposed by s152AYA of the TPA and with the 'springboard doctrine' which is a well established plank of the law of confidence.[15] Accordingly. Telstra submits that these confidentiality provisions give Vodafone an unfair commercial advantage over access seekers and are unreasonable.

Secondly, the definition of 'Confidential Information' is overly broad. That definition relevantly includes:

- information designated by a party as confidential; and
- information disclosed prior to the entry of the Agreement.

The mere fact that a Party designates information as confidential does not mean that it is in fact confidential. Accordingly, the mere designation of information should not be a sufficient criterion by itself to attract obligations of confidence in respect of any given information. In addition, there is no basis to impose the confidentiality obligations of the Agreement on information obtained by a party prior to the entry into that Agreement.

Thirdly, the circumstances in which the return or destruction of another party's confidential information can be demanded are impractical, unduly restrictive and onerous and most likely unworkable. Telstra accepts that it is legitimate to require a party to return or disclose the confidential information of another when the need for that information ceases or when the relevant agreement terminates or expires. However, clause 11.8 relevantly requires a party to destroy or return the other party's confidential information "as directed and when requested by the Disclosing Party at any time". This is irrespective of whether the confidential information is required for the ongoing supply of the services or otherwise in connection with the rights and obligations of the parties in connection with the Agreement.

(g) Liability and indemnity

Telstra accepts that parties to access agreements should generally be able to limit their liability and be subject to mutual indemnities. Telstra notes that in large part the liabilities and indemnities in the revised Undertaking appear to have been drafted with regard to

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[14] In this regard, note also clause 11.4(a) which allows Vodafone to disclose "Network Information" as required by the ACA or the Commission without provision for notification prior to disclosure. This should be contrasted with clause 11.7 which provides that if a party is required to disclose confidential information by order of a government agency it must give notice to the other party before so doing.

[15] That is, the use of confidential information in conjunction with other (non-confidential) information as a 'springboard' will constitute an 'unauthorised use': *Terrapin Ltd v Builders' Supply Co (Hayes) Ltd* [1960] RPC 128; *Cranleigh Precision Engineering Ltd v Bryant* [1965] 1 WLR 1293 at 1317-1318; and *Ansell Rubber Co Pty Ltd v Allied Rubber Industries Pty Ltd* [1967] VR 37 at 44.

the Model Terms (although these terms are not strictly applicable to MTAS).[16] For the purposes of this submission only, to the extent that these provisions follow in substance, if not form, the Model Terms Telstra does not raise objection. However, there are some noteworthy departures which are not reasonable. In particular:

- the subject of the indemnity in clause 14.5(a)(i) extends only to claims arising out of "the death or injury to the People of the Indemnified Party". The indemnity should properly extend to the death or injury of third parties;[17]
- the indemnities in clause 14.5(a) apply to the extent that the claim "relates to" a breach of the Agreement by the indemnifying party or an act or omission of the indemnifying party. The words "relates to" (and their derivatives) have been subject to much judicial interpretation and have been taken to be words of very broad import and may not require a causal connection between two events.[18] In the context of the present indemnity the words are too broad and have a potentially unreasonable operation. The appropriate qualifier is "caused by";[19] and
- clause 14.5(a)(iv) extends liability under the indemnity to "any act or omission" of the indemnifying party - that is irrespective of whether the relevant act or omission was negligent. Accordingly, these words are also too broad and have a potentially unreasonable operation. Liability should only extend to negligent acts or omissions.[20]

Telstra does not accept that clause 14.7(b) is reasonable. That clause provides:

> *"If Vodafone breaches any quality of service requirement prescribed in this Agreement, the Access Seeker's sole remedy is limited to:*
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> *(i) Vodafone taking all reasonable steps to comply with that quality of service requirement in the future; and*

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16 Commission, *Final Determination - Model Non-price Terms and Conditions* (October 2003) ("*Model Terms*").

17 Cf. clause C.7 of the Model Terms which adopts the language of "any person". Note also that the indemnity in clause 14.5(a)(ii) extends to the property of "any third Party (sic)".

18 See for e.g. *Western Australia v Ward* (2002) 213 CLR 1; *Queensland Heritage Council v The Corporation Of The Trustees of the Roman Catholic Archdiocese Of Brisbane* [2001] 2 Qd R 504; *Law Society of New South Wales v Bruce* (1996) 40 NSWLR 77; and *O'Grady v Northern Queensland Co Ltd* (1990) 169 CLR 356.

19 The standard "caused by" is that which is adopted in the Model Terms (see clauses C.7 and C.8 of those terms)

20 The qualifier "negligent" is incorporated in the equivalent Model Terms (see clauses C.7 and C.8 of those terms).

(ii) Vodafone making available or offering to the Access Seeker the specific remedy for that quality of service requirement, prescribed in this Agreement."

Telstra submits that this clause renders Vodafone's various quality service requirements nugatory. There is no real incentive for Vodafone to meet those requirements in circumstances where the only "remedy" available to an access seeker is Vodafone taking reasonable steps to comply with such a requirement in the future. This is not a "remedy" properly so called. Further, the revised Undertaking does not provide for any other "specific remedy" for any of the quality service requirements prescribed therein.

(h) Unresolved matters

Telstra notes that a number of important matters are not addressed by the revised Undertaking and are left to be agreed by the parties at some other time or determined by arbitration. These matters include:

- ordering and provisioning (annexure 1);
- interconnection manual (annexure 3);
- dispute resolution procedures (annexure 4);
- network operation and fault management (annexure 5);
- Vodafone's security requirements (clause 7); and
- the term of the Agreement (cf. clause 16.1(c)).

While Telstra accepts that an access undertaking need not contain all the terms and conditions upon which the access provider proposes to comply with the relevant SAOs, Vodafone contends that the revised Undertaking provides "clear and concise terms covering all relevant issues and potential concerns".[21] In light of the matters left open (as noted above), that statement is demonstrably false. However, as Vodafone itself contends:[22]

> *"...certainty* [in relation to the terms and conditions on which the Service will be provided] *is important for future investment and business decisions for both Vodafone and Access Seekers."*

The revised Undertaking does not meet this objective.

[21] *Vodafone Submission* at 37.
[22] *Vodafone Submission* at 2.

3 PriceWaterhouse Cooper cost modelling

In its Discussion Paper, the Commission has called for submissions in respect of the modelling performed by Pricewaterhouse Coopers ("PwC") in support of Vodafone's revised Undertaking and, in particular, the target Usage charge proposed by Vodafone.

Telstra has reviewed this material and provides the following comments on the specific issues raised in the Discussion Paper are provided below.

General approach to modelling

Vodafone has developed a top-down fully allocated cost model to estimate the forward-looking efficient economic costs of the MTAS.[23] It notes that this approach is underpinned by current cost valuation principles to ensure a close approximation of forward looking efficient costs. These costs are based on Vodafone's current network architecture, which is assumed to be efficient given the competitiveness of the Australian mobiles market as well as Vodafone's position in the world market and its access to global expertise. Given it is a fully allocated cost model it does not distinguish between costs that are incremental and costs that are common across two or more services, i.e costs which are fixed and common. Further, relevant network and non-network costs are allocated across the following services: incoming calls, outgoing calls, on-net calls, SMS messages, GPRS services and subscription.

While Telstra believes that "bottom-up" costing of the network of an efficient MNO would be the optimal approach to determining efficient MTAS prices, Telstra also recognises that, for mobile networks, an actual network is likely to provide a reasonable approximation of these costs and that there are significant benefits associated with a top-down approach. This is further supported by the fact that Australian mobile networks have been built relatively recently and competition in the mobiles market has been intense. Therefore, the usual arguments put in favour of a bottom-up approach are less relevant in the case of mobiles. In addition, Telstra supports the use of a top-down approach as an important sanity check on bottom-up modelling.

In Telstra's view, the main benefit of a top-down cost model is that it is grounded in reality and hence captures the costs that are necessarily incurred in providing the service at issue. In the case of bottom-up modelling, it has been Telstra's experience that many of the costs that are necessarily incurred in providing the service are too easily assumed away as inefficiencies or unnecessary. There is little scope for testing the assumptions in a bottom-up model, including those relating to allocation of fixed and common costs, as the network

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[23] *Vodafone Submission* at 8-9 and Appendix at 4-6.

in question will never actually be built. As a result, the top-down approach provides an important discipline on bottom-up modelling, requiring the modeller to justify the exclusion of cost items.

Telstra also recognises the substantial effort, cost and time required to develop a bottom-up model and hence understands why Vodafone has developed a top-down model for its current purposes.

In Telstra's view, it would be optimal to apply the 'efficient network operator' standard in top-down cost modelling of the efficient cost of MTAS. In other jurisdictions, the size of the efficient operator has been interpreted as a MNO with a market share achievable by all operators.[24] The rationale for this approach is that it does not penalise MNOs for succeeding in the market. If MNOs can secure scale efficiencies through successful marketing campaigns, excellence in customer service or other forms of product differentiation then this should be encouraged by allowing the MNO to use the gains it can secure as it chooses.

If MNOs are required to pass on all efficiency gains to consumers in MTAS prices then this type of innovation will be discouraged, particularly if the costs associated with achieving economies of scale are ignored in the calculation of the efficient costs.

Telstra supports the efficient MNO approach and believes it is important to set a single industry wide rate for MTAS. This will encourage MNOs to out-perform the industry wide rate by achieving efficiencies through scale or other means.

However, Telstra also recognises the difficulties, effort and time associated with building an efficient network model for this purpose. Accordingly, Telstra is not opposed to the use of Vodafone's network technology, spectrum allocation and traffic volumes for the use of estimating the cost associated with an efficient MNO so long as the appropriate adjustments are made and the approach is taken into account when interpreting the results of the costing study. As the mobiles market is very competitive and the technology is relatively new, Telstra accepts that Vodafone's mobile technology may well provide a reasonable approximation for the efficient MNO. In addition, although not well detailed, Telstra understands that asset values were updated using price trends, an approach that Telstra has adopted itself in the past.[25]

Input data

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[24] For example, see the UK Competition Commission *Calls to mobiles report*, 2003, p. 69.

[25] Telstra's submission in relation to the methodology used in deriving prices proposed in its undertakings dated 9 January 2003, p. 9.

In populating its cost model Vodafone has used a mixture of accounting and operational data.[26] Its sources include: the general ledger, the fixed asset register and call data recording systems as well as information from experts within Vodafone such as network engineers. The operational cost information provided by Vodafone required further disaggregation by PWC to allow for improved accuracy of allocation and this was done based on PWC's experience in other jurisdictions as well as estimates provided by Vodafone. Further, working capital information was only available on an aggregated basis. The information used in the cost model relates to the year ending 31 March 2003 and its submission notes it was verified by Vodafone.

Telstra considers that it is appropriate to use information of the nature detailed above in undertaking a top-down modelling approach – which is based on actual costs. As discussed above, Telstra considers that top-down modelling has benefits and is an important sanity check for an optimised bottom-up approach. This said, Telstra has not specifically examined the various inputs and is not in a position to comment on their validity. Telstra would suggest that as a first step these inputs should be compared against previous information that has informed the Commission's decisions. It may be possible to assess PWC's proposed disaggregation of operational costs, and any potential arbitrariness, in this way.

While Telstra accepts that Vodafone's mobile technology may well provide a reasonable approximation for an efficient MNO, it considers that any cost estimates should be based on the most recently available information at the time of modelling. In this regard, information for the year ending 31 March 2003 does not appear to be that timely and Telstra believes that more recent data should be used.

Fixed and common costs

Vodafone contends that fixed and common costs have been estimated by PWC based on best practice definitions adopted in jurisdictions such as Sweden and Greece.[27] The submission notes that base station costs represent the majority of fixed and common costs but that non-network costs relating to central overhead functions such as finance and human resources are also included. To estimate the fixed and common costs associated with base stations, the different types of base stations were identified along with their relevant fixed and common / incremental costs. This information was then combined with the relevant unit costs and the estimated number of coverage related cells to arrive at an estimate of network related fixed and common costs.

26 *Vodafone Submission*, Appendix I at 4-16.
27 *Vodafone Submission*, Appendix I at 13.

While Telstra has not sought to verify what best practice definitions have been adopted in other jurisdictions such as Sweden and Greece, it agrees that, in the main, fixed and common costs will be related to base stations. Further, Telstra supports the inclusion of non-network fixed and common costs – such costs, including overheads, are legitimately incurred costs that will be incurred in supplying the MTAS and further would be included in any bottom-up modelling approach.

Routing factors

Vodafone's top-down fully allocated cost model allocates network and non-network costs to the following services: incoming calls, outgoing calls, on-net calls, SMS messages, GPRS megabytes and subscription. These costs are allocated either directly via routing, or usage, factors or indirectly through secondary allocations.[28] Specifically, routing factors are applied to network costs that are directly related to conveyance services – this does not include subscription services. The routing factors used in the cost model are said to reflect the extent to which different services drive network usage. The estimates of these factors were apparently provided by Vodafone's network engineers.

Telstra considers it is appropriate to use routing factors and has itself used this approach in relation to the PSTN. For example, in its most recent PSTN undertakings Telstra used routing factors, determined through a study of PSTN traffic, to establish the average cost per minute of PSTN and LCS traffic.[29] In relation to mobile services, Telstra is of the view that Vodafone's approach of establishing routing factors for various network elements across the incoming, outgoing, on-net, SMS messages and GPRS calling categories is sensible and a reasonable way in which to reflect network usage, and therefore allocate network costs directly related to conveyance services.

Telstra has not assessed the specific routing factors that Vodafone has employed and at this stage cannot comment on their appropriateness. This said, Telstra notes that routing factors for backbone transmission links may differ for different MNOs depending on their network architecture, but that a MNO should have the same factors for incoming and outgoing services.

SMS and GPRS conversion

An important category of input information provided by Vodafone is service volumes for incoming calls, outgoing calls, on-net calls, SMS messages and GPRS megabytes. It notes that in order to enable the allocation of network costs between these different conveyance

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[28] *Vodafone Submission*, Appendix I at 6 and8-10.

[29] Telstra's detailed submission in support of its undertakings dated 9 January 2003, 31 July 2003, p. 44.

services, SMS messages and GPRS megabytes were converted to minute equivalents.[30] This was done using the 'standard' conversion calculations that have been used in costing models in other jurisdictions and in particular the UK, Sweden and Greece.

Telstra considers that it is appropriate to employ minutes of use as the usage measure, particularly as they currently represent the most significant usage measure of all the conveyance services given their application to voice calls. While SMS messages and GPRS megabytes are growing, and likely to continue to grow, it is considered that over the next two to three years voice call services will continue to be the main conveyance services used by customers and therefore the key driver of costs. Given this, Telstra is of the view that minutes of use are the most appropriate measure of usage.

In relation to the conversion of SMS messages and GPRS megabytes into minutes of use, Telstra has not been able to confirm that the approach proposed by Vodafone is that used in other costing models. For example, it appears that the cost model used by Ofcom to consider the costs associated with a voice only network and that the data was adjusted to ensure only the costs relating to voice services were included.[31] This said, subject to the comments below it appears that the conversion approach used by Vodafone is a reasonable basis on which to change messages and megabytes into minutes of use. In relation to the methodology used to convert SMS messages into minutes of use, Telstra notes that it is not clear on what basis the 'voice channel rate for SMS messages' factor, at 767 bps, has been derived. Also, it is not clear why, in the conversion of GPRS megabytes to minutes of use, the packetisation allowance is only 50 per cent – it is expected this would be much higher and closer to 100 per cent.

Depreciation and the WACC

In its cost model, Vodafone determined the cost of capital (depreciation of assets and the required return on those assets) by applying a tilted annuity approach to its network capital costs.[32] It used this approach as it explicitly takes into account the timing of cash flows relating to an asset over its useful economic life. The replacement costs of the network assets, and the expected forward-looking annual price changes, were provided by Vodafone's procurement team. In relation to non-network capital items a straight line depreciation approach has been used.[33] PWC notes that the book value of Vodafone's network assets account for approximately 80 per cent of Vodafone's total assets and that as

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[30] *Vodafone Submission*, Appendix I at 7.

[31] Wholesale Mobile Voice Call Termination, Proposals for the identification and analysis of markets, determination of market power and setting of SMP conditions, Explanatory Statement and Notification, Oftel (now Ofcom), 19 December 2003, p. 229.

[32] *Vodafone Submission*, at 9-11 and Appendix at 10-11.

[33] *Vodafone Submission*, Appendix I at 11.

a result it does not expect this dual approach to represent a material distortion to the results.

In Telstra's view, a tilted annuity approach, which allows full cost recovery over the useful life of the asset and no more, is an appropriate approach to annualise capital costs. Such an approach should ensure that the cost of the assets is recovered in full over their useful life and should reflect a time path of cost recovery that would occur in a competitive market as the price of inputs change. However, it is not clear that the specific formula proposed by Vodafone is appropriate in this regard. The formula presented only applies for the first year (t=1) and hence it is not possible to test whether or not full-cost recovery emerges over the useful life of the asset. Specifically the proposed formula does not have a mechanism to tilt the annuity. Normally, the driver of tilt is based on asset specific inflation and compounding over time with specific reference to a variable (usually denoted as t) indicating the particular year for which the annual cost costs are being identified. The absence of this time dependent component means it is not possible to critically examine whether the "tilted" annuity approach outlined by Vodafone achieves full cost recovery of the initial investment outlay (or under- or over-recovers, both of which would be inappropriate).

Another departure from normal annuity approaches is the inclusion of a particular component designed to capture a return over the period from when the capital was sunk (ie when funds were released to build the network) to the commencement of productive service.

Specifically, Vodafone propose the inclusion of:

$[(1+r)/(1+i)]^u$

Where r = Cost of Capital (%)

i= annual asset price change

u = period from payment to commencement of productive service (years)

Where u does not equal zero this approach will not provide a reasonable approximation of the efficient TSLRIC type costs incurred by a MNO. Rather, it will be more reflective of actual investment which may be lumpy (as it allows for a return on investment that is commensurate with when you forewent the capital).

Telstra supports the logic behind this approach as TSLRICdoes not reflect the true opportunity cost associated with constructing significant network assets which take years to complete. In this situation there is a gap between the timing of the opportunity cost (as

funds are expended in the construction phase) and when cost recovery commences (ie when production commences). The TSLRIC approach assumes that the network appears overnight and is fully productive the next day. In this artificial construct no return is necessary on the capital which has been expended in the period up to and before when the resultant capacity comes onstream and commences to recover costs. The modification proposed by Vodafone at least attempts to capture the opportunity cost due to staged construction and the associated sunk capital prior to the commencement of operations.

Although Telstra supports a modification along the lines suggested by Vodafone, it is not clear that the actual adjustment proposed is fully appropriate. The approach suggested by Vodafone does not seem to allow for the progressive release of funds during the construction phase. In other words, the entire TSLRIC of the network is not incurred at the beginning of the construction period (as appears to be assumed in the proposed Vodafone adjustment).

In addition, the tilted annuity approach has only been applied to network capital costs and not non-network capital costs. It appears this is because replacement cost and useful life estimates are not available for non-network assets. However, if this is the case it is not clear how a straight line depreciation approach could be applied as there would be no available information as to useful lives. In any event, it is difficult to assess whether use of straight line depreciation approach would materially distort the outcome as it would in part depend on the gap between the replacement costs and the written down book value and in part on what stage the asset is at in its useful life (which is not known). Further, it is not clear how a return on capital has been incorporated into the cost of capital calculations for non-network assets.

Telstra has not examined the specific asset valuations or prospective annual price changes proposed by Vodafone and therefore cannot comment on their appropriateness.

In order to determine the cost of capital, and specifically the weighted average cost of capital (WACC), Vodafone has started with the post tax nominal WACC formula developed by Officer.[34] It contends that this approach been adopted by the Commission in its recent regulatory decisions in relation to the costs of services of regulated industries. In the Officer formula, the cost of equity is adjusted for personal income tax savings associated with dividend franking credits. Vodafone convert the Officer post corporate tax nominal WACC to pre corporate tax (presumably using the statutory corporate tax rate) and apply that pre-tax WACC in their cost model. In this way, corporate tax is accounted for through the WACC estimate rather than being included as notional cash flows in the model.

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34 *Vodafone Submission*, Appendix II at 1-2.

On this basis, Vodafone contends that a nominal pre-tax WACC of [c-i-c] per cent is appropriate and uses this in its cost model. Further, it uses the capital asset pricing model (CAPM) in order to allow for a reasonable return on the equity invested in its mobile operations.[35] It notes that application of the CAPM represents standard regulatory and financial market practice. Telstra concurs.

As Telstra has previously noted, establishing the appropriate return on capital for a mobile operator is a difficult task.[36] While estimating many of the input parameters may have an associated degree of error, establishing the correct systematic risk (the beta) of a mobile operator is particularly difficult. This is because mobile telecommunications is a relatively new area of business and therefore has a relatively higher risk, suggesting a higher beta and WACC than would exist for the PSTN. In addition the unitisation approach is different for mobile networks, which are likely to experience more rapid growth as compared to the PSTN where growth is more steady.

Telstra considers that Vodafone's use of a pre-tax nominal WACC, based on the Officer approach, is generally appropriate as it seeks to reflect the tax burden an access seeker will face. As Telstra has submitted in the context of its ULLS undertakings, it considers that the following formula should be used to calculate the annual capital cost inclusive of the net tax burden. This formula is relevant when converting an annual capital cost based on a post-tax vanilla WACC into a pre-tax capital cost:

$$\Phi V_{pre\text{-}tax} = [\Phi V_{post\text{-}tax} - (V/N+I)*T_c*(1-\gamma)]/(1-T_c*(1-\gamma))$$

where:

$\Phi V_{pre\text{-}tax}$ = the grossed-up (pre-tax) annual capital cost;

$\Phi V_{post\text{-}tax}$ = the annual capital cost using the post-tax "vanilla" WACC;

V = the total build cost of the asset,

N = the useful life of the asset;

T_c = the statutory corporate tax rate,

γ = the imputation factor;

I = $D*V*i$ and represents interest expense deductible for tax purposes;

D = the debt ratio;

i = the interest rate applicable to the relevant debt.

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[35] *Vodafone Submission*, Appendix II at 2-3.

[36] Response to the draft decision on the mobile terminating access service, June 2004, at 17.

This gross-up equation effectively calculates the pre-tax amount of revenue required such that, after payment of tax, the access provider receives a residual amount commensurate with the required return on capital. In doing this, the gross-up equation specifically recognises:

- the tax deductibility of interest;
- the tax deductibility of depreciation (assumed for these purposes to be straight-line); and
- the benefit of imputation.

The tax rate which is used in this gross-up equation is the statutory corporate tax rate. This is because the tax benefit of depreciation (that is, its deductibility for tax purposes) is specifically captured in the gross-up equation by other variables (specifically V/N). To reduce the tax rate applied in this context because of depreciation would actually double count the benefit of depreciation.

Telstra has not assessed the specific parameter values that Vodafone has employed in establishing its nominal pre-tax WACC of [c-i-c] per cent.

Working capital

In its cost modelling Vodafone marks up all asset values in order to allow for working capital.[37] It states that this appropriately allows the capital charge, calculated as the mean capital employed multiplied by the cost of capital, to be applied to all assets present in the business, rather than just the fixed assets. Only aggregate working capital estimates were available. It is unclear to Telstra why such an approach is necessary when use of an annuity is employed.

4 Frontier report and the welfare maximising level of MTAS

A further report provided by Vodafone in support of its revised Undertaking has been prepared by Frontier Economics ("Frontier") which estimates that the welfare-maximising prices for the supply of MTAS is between 22.32 and 32.73cpm. Although Vodafone does not use the Frontier model as a direct input to its target Usage charge, the Commission has sought comments on the Frontier report.

For the reasons set out in Telstra's response to Optus' MTA undertaking[38], where a similar approach was taken, Telstra supports the principles adopted to estimate welfare

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[37] *Vodafone Submission*, Appendix I at 12.

[38] Telstra Submission in Response to the Commission Discussion Paper: Optus' Undertaking in respect of the Domestic Digital Mobile Termination Access Service, May 2005,at 17.

maximising prices. While Telstra has not sought to examine the Frontier analysis in detail, it is concerned about the wide range of results that were found, which presumably made the analysis unusable for the purposes of setting prices in the undertaking. In Telstra's view, it would have been preferable to extend the analysis in order to limit the range of results, which in turn would have allowed the results to be used in setting the undertaking prices.

As the Frontier analysis does demonstrate, the welfare maximising prices are substantially higher than the prices obtained from a fully distributed cost approach. Hence, Telstra is concerned that the prices in Vodafone's undertaking that fail to take these effects into account are inconsistent with welfare maximisation.

Appendix 1: Practical difficulties associated with the Safeguard approach

Telstra submits that the FTM Safeguard is unworkable in practice. Telstra's specific comments in this regard are set out below.

Compliance verification provisions are unreasonable

Telstra submits that the compliance verification provisions of the revised Undertaking and associated dispute resolution mechanisms are administratively burdensome and unreasonable. Furthermore, Telstra submits that Vodafone's contentions that these provisions promote the interests of access seekers because: (i) "compliance is to be ascertained through determination by independent experts"; and (ii) "at no stage will confidential information be required to demonstrate compliance with the FTM Safeguard be divulged (sic) to Vodafone; only the expert",[39] are wholly without substance.

Clause 4.1 of Part C of the Service Schedule requires an access seeker to provide a certificate from one of its directors stating "whether and how" the pass-through obligation has been complied with. It is not clear what the word "how" might require to be included in the relevant certificate.

As stated by the Commission in section 9.3.3 of the MTAS Final Decision, pass-through mechanisms are difficult to implement in practice and involve considerable complexity. The compliance verification requirements for the FTM Safeguard clearly illustrate this point. Telstra submits that it is not commercially acceptable from a corporate governance standpoint for a director to be required to certify - including in respect of third parties - all the matters required by the revised Undertaking. In addition, access seekers such as Telstra would be forced to expend considerable time and resources on compliance and monitoring tasks, thereby reducing their ability to focus on operational efficiencies and improving the quality of service to end-users.

The certification (and concomitant dispute resolution) process also effectively establishes Vodafone as a de facto regulator - monitoring compliance with its own retail price controls. This is simply not an appropriate role for a mobile operator.

Under the revised Undertaking, if Vodafone "reasonably considers" that an access seeker has not complied with the pass-through obligation it can trigger a dispute resolution

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[39] *Vodafone Submission*, at 37.

process culminating in expert determination.[40] Telstra submits that this is unreasonable because:

- the incorporation of a subjective standard to trigger the dispute process is inappropriate;
- contrary to Vodafone's submission, the expert determination process is likely to involve the divulging of the confidential and commercially sensitive information of the access seeker to Vodafone;[41]
- Vodafone and the access seeker would equally share the costs of the dispute process including those of the expert. Given that Vodafone has a broad discretion to institute the dispute resolution process it is not reasonable that an access seeker should be forced to incur significant costs in respect of what could be a baseless dispute;
- the requirement that the access seeker provide the expert with all information reasonably required by the expert to determine the average retail price or any other matter required to be determined is unduly onerous and will place additional costs on the access seeker for which they will not be compensated; and
- there is a very limited basis on which to challenge the expert's determination.

Accordingly, Telstra reject's Vodafone's submission that the procedure for the ascertainment of compliance results in the FTM Safeguard being in the interests of access seekers and submits that it is unreasonable.

Transit traffic

Clause 7 of Part C of the Service Schedule places obligations on an access seeker in respect of "Transit Carriage Service Providers". These provisions require an access seeker to:

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40 It is not true to say, as Vodafone does, that "[i]f Vodafone reasonably considers that an Access Seeker's retail prices are above competitive levels, Vodafone may require an independent expert to verify compliance under the Expert Determination Rules of the Australian Commercial Disputes Centre (ACDC)": *Vodafone Submission* at 28. First, Vodafone falsely assumes an equivalence between "competitive levels" and the levels set by Vodafone. Telstra does not accept the levels set by Vodafone are competitive and Vodafone does not provide evidence to substantiate this assertion. Secondly, the relevant rules specified in the revised Undertaking are not those of the ACDC but the Australian Institute of Arbitrators and Mediators.

41 Cf. Institute of Arbitrators and Mediators Australia, *Expert Determination Rules*, rule 9.2(b) and rule 5.3 (the rules are publicly available at http://www.iama.org.au/rulesedr.htm).

- ensure that "Transit Carriage Service Providers" will comply with the pass-through obligations;
- monitor that compliance; and
- provide a certificate from one of its directors for each "Transit Carriage Service Provider" to which the access seeker provides transit services which terminate on the Vodafone Network that:
  - (i) identifies each Transit Carriage Service Provider; and
  - (ii) specifies the volume of "Transit Traffic" of each such Transit Carriage Service Provider.

Telstra submits that these requirements are wholly unreasonable for the reasons set out above in relation to the requirements for certification in respect of the FTM TARP and for the additional reasons set out below.

Telstra notes that the requirements concerning the contents for the certificates in respect of "each Transit Carriage Service Provider" are in fact unrelated to whether such Transit Carriage Service Providers have complied with the pass-through obligations. Further, information concerning the identity of an access-seeker's customers (i.e. the Transit Carriage Service Providers) and the amount of custom received from those customers is obviously information that is commercially sensitive to the access seeker which Vodafone has no basis to request. Vodafone's submission that no confidential information in relation to compliance is required to be divulged to it is patently false.

The obligation to ensure that relevant "Transit Carriage Service Providers" comply with the pass-through obligation is also unworkable and unreasonable for the following reasons:

- where access seekers have existing agreements with "Transit Carriage Service Providers" that do not comply with the pass-through obligation, they will be forced to renegotiate those agreements; and
- given that the FTM TARP also regulates the retail prices that may be charged by transit carriage service providers, the pass-through obligation effectively caps not only retail FTM prices, but also mobile transit prices. No allowance or consideration appears to have been made for this in the calculation of the FTM TARP.

If an access seeker cannot ensure that Transit Carriage Service Providers will comply with the pass-through obligations or comply with the monitoring and certification requirements in respect of Transit Carriage Service Providers, "the access seeker must not send any Transit

Traffic to Vodafone for termination". This is unreasonable because it is likely to restrict competitive behaviour in this market. Furthermore:

- the prohibition is not limited to particular Transit Carriage Suppliers in respect of whom the requirements cannot be met. If an access seeker cannot meet the relevant obligations in respect of just one Transit Carriage Service Provider, it cannot send "any" transit traffic to Vodafone for termination; and
- the prohibition extends to all "Transit Traffic" which is defined in such a way that it would include voice and data calls and perhaps even mobile-to-mobile calls and SMS. This is despite the fact that the supply of services under the revised Undertaking is limited to voice FTM calls and does not extend to termination on Vodafone's 3G service.

The prohibition on sending Transit Traffic to Vodafone for termination is not in the LTIE as it compromises the objective of any-to-any connectivity and (as noted above) is likely to retard competitive behaviour in the relevant market. Nor is it in the interests of those with rights of access to Vodafone's MTAS to whose considerable commercial detriment it can operate. It is also difficult to see how it is in the legitimate interests of Vodafone given that it could operate to reduce the amount of traffic terminating on its network.