Submission to the Australian Competition and Consumer Commission

vodafone

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Draft report reviewing the declaration of the domestic mobile terminating access service

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1. Summary

1.1 Vodafone welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (the Commission) *Draft report* reviewing the declaration of the Mobile Terminating Access Service (MTAS).

1.2 We support the extension of the MTAS declaration, without variation, for a period of five years resulting in an expiry of 30 June 2014. Vodafone agrees with the Commission's view that the current MTAS service description should not be altered to:

- exclude mobile-to-mobile (MTM) termination or separately describe fixed-to-mobile (FTM) and MTM voice termination;
- include termination of SMS, MMS and other data services; or
- include mobile network services deployed in aircraft operating in Australia.

1.3 An extension to the declaration of the MTAS is necessary but not sufficient to promote the Long Term Interest of End-users (LTIE). For the Commission to achieve its objective of promoting the LTIE it must ensure that any pricing principles released during the declaration period are appropriately set.

1.4 Extending the MTAS declaration will improve regulatory outcomes in the market in which the MTAS is provided but it may introduce distortions in other relevant markets. The integrated nature of Australia's telecommunications industry means that such distortions may ultimately reduce, but not eliminate, the MTAS declaration's effectiveness in achieving the Commission's objectives.

1.5 Under the previous declaration, the Commission pursued pricing principles that rapidly lowered the indicative MTAS price. As part of extending the MTAS declaration, the Commission must consider the risk (and impact) that below-cost indicative MTAS prices would have on competition and investment by MNOs, and the subsequent impact on the LTIE.

1.6 Lack of FTM pass-through has provided integrated operators (that is, operators that provide both fixed line and mobile services) with a margin not available to mobile-only operators. The margin may have enabled integrated operators to cross-subsidise their mobile network operations and may be detrimental to competition and the LTIE.

1.7 Business certainty would be enhanced by extending the MTAS declaration for the maximum period possible (that is, five years). Certainty is critical to encouraging economically efficient investment in mobile network infrastructure.

2. MTAS service definition

2.1 Vodafone agrees with the Commission that the current definition of the MTAS, which includes both FTM and MTM voice termination services, remains appropriate and should not be altered. The definition, as set out in Appendix A of the Commission's 2004 *Mobile Services Review*, states:

> *The **domestic digital mobile terminating access service** is 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.*
>
> *Where the **B-party** is the end-user to whom a telephone call is made.*

2.2 We do not believe that there is sufficient evidence to warrant varying the definition of the MTAS. Specifically, the definition should not be altered to include termination of SMS/MMS nor should it include mobile network services deployed in aircraft operating within Australia. In the case of the latter, it would be inappropriate for the Commission to regulate a service (mobiles on aeroplanes) that, as Vodafone understands, is not yet commercially available in Australia.

2.3 As the Commission notes, competition in retail SMS services is strong with growth in SMS volumes, accompanied by a sharp decline in revenue per SMS from 14.6 cents to 8.6 cents.[1] We are not aware of any evidence to suggest that wholesale SMS termination rates are having an adverse impact on competition in the retail market.

2.4 The incentives and dynamics of SMS termination are different to those influencing the MTAS. For instance, the absence of a significant FTM (or mobile-to-fixed) market for SMS termination services means that countervailing bargaining power is more likely to constrain the use of 'market power' by MNOs with respect to SMS termination services. Hence SMS termination services are not well-suited to the existing framework for the declaration of the MTAS.

2.5 Vodafone concurs with the Commission's view of that MMS and other data services such videoconferencing are immature services. On principle, the MTAS declaration should not be varied to include such services as they have not been widely adopted by the market and have not, therefore, exhibited any signs of a durable market failure.

[1] ACMA (2008), *Communications report 2007-08*, p171.

3. Legislative framework

3.1 The current declaration of the MTAS expires on 30 June 2009. The Commission is required under section 152ALA (7) of the *Trade Practices Act 1974* to consider whether extending, revoking, varying or expiring the declaration promotes the LTIE.

3.2 In considering whether a particular service promotes the LTIE, the Commission must have regard to the extent to which particular actions would:

- promote competition in markets for listed services;
- achieve any-to-any connectivity; and
- encourage the economically use of, and the economically efficient investment in infrastructure by which listed services are supplied or are capable of being supplied.

3.3 In considering whether particular actions encourage the efficient use of and investment in relevant infrastructure, the Commission must consider both the commercial interests of suppliers of the MTAS and the impact on incentives for investment.

3.4 Declaration of the MTAS is necessary but not sufficient for achieving the LTIE. An extension of the MTAS declaration would not, by itself, meet the three criteria that comprise the LTIE. The MTAS declaration requires appropriate pricing principles if it is to achieve the objective of promoting the LTIE. In the absence of appropriate pricing principles the declaration of the MTAS may not help the Commission to meet its objective.

3.5 Vodafone submits that to promote the LTIE, the Commission must retain the current MTAS definition and extend the MTAS declaration for a period of five years.

4. Declaration will promote competition

4.1 The previous declaration has, in part, helped to support stronger retail competition for mobile services and provides evidence that the declaration, in its current format is appropriate, and should be extended.

Appropriate pricing principles are required

4.2 Declaration of the MTAS will promote competition if and only if the Commission's pricing principles are set appropriately. We note and support the Commission's recently released *MTAS Pricing Principles Determination for the period 1 January 2009 to 31 December 2011* (2009 Pricing Principles), which specifies the MTAS at 9 cents per minute (cpm) for the specified period.

4.3 The 2009 Pricing Principles indicate that the Commission will, in certain circumstances, use other tools including international benchmarking and Regulatory Accounting Framework (RAF) data in conjunction with the WIK model to estimate the cost of supplying the MTAS. Vodafone welcomes this approach particularly given our previous commentary on the WIK model.[2]

4.4 Over the last five years, the Commission's MTAS pricing principles have led to a rapid reduction in the MTAS price. The constant 3 cpm reduction in the MTAS indicative price each year has led to an increasing annual percentage change. The largest percentage changes in the MTAS indicative price came as uncertainty over the beneficial impacts on some relevant downstream markets (e.g. FTM) was increasing.

Year	MTAS indicative price (cpm)	Change on previous period (%)
1 Jul 2004 – 31 Dec 2004	21	na
2005	18	-14.3
2006	15	-16.7
2007	12	-20.0
2008	9	-25.0

4.5 Australia's indicative MTAS prices are low compared to other parts of the world (see Chart 1). Vodafone understands that, in terms of Australia's pricing principles, substantive reliance cannot be placed upon international benchmarks due to differences in technology, network usage and scale, population density and a range of other factors. Nevertheless, the Commission has not provided compelling reasons to indicate why the productive efficiency of MTAS suppliers in Australia is so much higher (and hence supplied at lower cost) than in most of Europe and in New Zealand.

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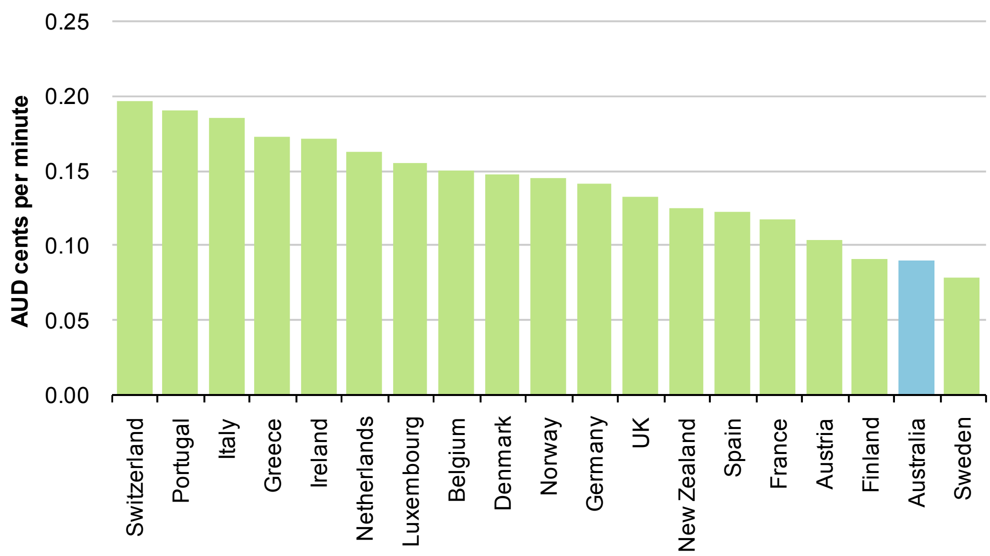
[2] See for example: Vodafone 2008, *Submission to the Draft MTAS Pricing Principles Determination and indicative pricing for the period 1 January 2009 to 31 December 2011*, 16 December 2008.

Chart 1: International comparison of mobile termination rates as at 1 July 2008



Notes: 1 AUD = 0.5772 EUR = 1.194 NZD – Average daily exchange rate for 2008.
New Zealand is FTM only.
Sources: European Regulators' Group (ERG); Vodafone; Commerce Commission; RBA.

4.6 Previously, the Commission's approach to pricing principles focused on prices being set above cost. However, the cumulative reductions in the indicative MTAS price means that the Commission now has a limited margin for error in estimating future MTAS prices (excluding the 2009 Pricing Principles). It is, therefore, appropriate for the Commission to consider how the new risk profile for indicative MTAS prices impacts the MTAS declaration.

Declaration cannot address problems in downstream markets

4.7 The Commission indicates that, in considering competition, the markets most likely to be affected by declaration are "downstream services rather than the market in which the eligible service is supplied (where these markets are separate)".[3] The Commission indicates that this is a key rationale for access to essential inputs (such as MTAS) at reasonable terms and conditions.

4.8 Declaration is not sufficient to promote competition in downstream markets. Instead, such markets are likely to reflect their own competitive dynamics. For instance, in downstream markets with perfect competition the benefits from declaration of an essential input will be passed on to end-users. However, in monopolistic downstream markets the benefits from declaration will be shared between end-users and the monopoly firm.

[3] ACCC (2009), *Draft report on reviewing the declaration of the mobile terminating access service*, March, p15.

Relevant markets

4.9 The MTAS is a service, which is primarily sold as a wholesale input in two relevant downstream retail services – FTM voice calls and MTM voice calls. The latter is a subsection of the markets in which retail mobile services are supplied, which includes mobile-to-fixed voice calls, video telephony, voicemail, SMS/MMS and a range of other data services.

4.10 Vodafone agrees with the Commission that the MTAS is a separate market to the markets in which retail mobile services are supplied. Furthermore, as mobile network operators (MNOs) have exclusive control over access to end-users on their own networks the MTAS may also be regarded as an essential bottleneck facility in the provision of voice calls due to the lack of practical substitutes.

4.11 Competing communication technologies such as Voice over Internet Protocol (VoIP), SMS/MMS and email are not effective substitutes for FTM and MTM voice calls. At present, such technologies provide a weak constraint on FTM and MTM retail competition; however the Commission should be mindful that industry dynamics could rapidly change in the future.

State of competition in relevant markets

4.12 The three relevant markets for the MTAS are: the MTAS market; the retail mobile telephone services market and the FTM market.

The MTAS market

4.13 The wholesale market for MTAS has monopoly features due to the lack of practical substitutes for termination services. Interconnection would occur (and has previously occurred) in the absence of regulation however in such instances the price of MTAS would depend on the incentives and relative bargaining power of each network operator.

4.14 The presence of countervailing bargaining power is an important consideration in the market for MTAS. Interconnection, whether FTM or MTM, requires two-way access and the presence of countervailing bargaining power may mitigate some of the economic incentives for above cost pricing of the MTAS.

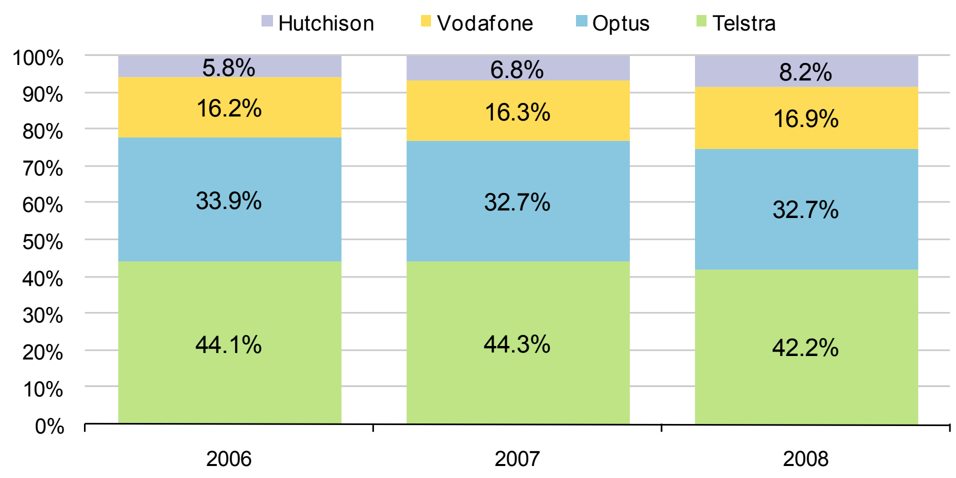
4.15 The current regulatory environment, where the Commission sets the indicative MTAS price precludes an assessment of the existence of countervailing bargaining power in Australia. That said, countervailing bargaining power may not be sufficient to preclude mobile operators from exerting "market power when it comes to terminating fixed-to-mobile calls on their network".[4]

Retail mobile telephone services market

4.16 Competition in the retail mobile telephone services market has been relatively strong during the last five years. The Commission indicates that the prices for mobile services (excluding 3G services) have been on a downward trend in the four years to 2006/07.[5]

4.17 The retail mobile telephone services market has seen a gradual shift in market shares measured by both subscribers (see Chart 2) and revenue. Over the past three years Telstra has lost market share in terms of subscribers but managed to retain its market share in terms of revenue. Vodafone and Optus have had little change in their market shares of both subscribers and revenue during the same time period, and Hutchison increased its market share of both subscribers and revenue.

Chart 2: Market share by subscribers



Source: Vodafone.

4.18 A shift in market share is not necessarily evidence for sustainable competition. For instance, a competitor may price their services below cost (and operate at a loss) to generate subscriber or revenue growth. Such a strategy may be viable in the short-term but is not sustainable in the long-term particularly for industries, such as mobile telecommunications, with large infrastructure investment costs.

[4] ACCC (2004), *Mobile Service Review – Mobile Terminating Access Service*, p vi.
[5] ACCC (2009), *Mobile Terminating Access Service: An ACCC draft report on reviewing the declaration of the mobile terminating access service*, March, p23.

Retail fixed to mobile services

4.19 During the last five years, the declaration of the MTAS has not helped to significantly promote competition in the downstream market for FTM services. Vodafone notes that despite a 25% reduction in the indicative MTAS price, Telstra's residential FTM prices increased in the first half of 2008 and the business FTM prices were flat during the same period.[6]

4.20 Indeed, as the Commission indicates while the indicative MTAS price fell by 12 cpm between H2, 2004 and H1, 2008, the average residential FTM price has fallen only 5cpm over the same period and the average business FTM prices is virtually unchanged.[7] Vodafone notes that the Commission is "disappointed with respect to reductions in retail FTM prices" but the Commission must do more to consider how the lack of FTM pass-through impacts competition in the mobile services industry.[8]

4.21 The lack of FTM pass-through indicates that the declaration of MTAS has done little to promote competition in the market for FTM services. The result is hardly surprising given that markets for the supply of fixed line services feature one dominant firm, Telstra, and they have significant barriers to network entry. Between 2002/03 and 2005/06 Telstra's FTM market share was stable, accounting for around 75% of FTM revenue and just under 75% of FTM call minutes in the Australian market.[9]

4.22 A secondary effect from the lack of FTM pass-through is the increased margin provided to fixed line providers, notably Telstra (see Chart 3). Over the last four years, the estimated worth of the margin caused by the divergence between Telstra's actual average FTM price and an FTM price that reflects full pass-through is in excess of $300 million.[10]

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[6] ACCC (2009), *Domestic Mobile Terminating Access Service Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011*, March, p23.

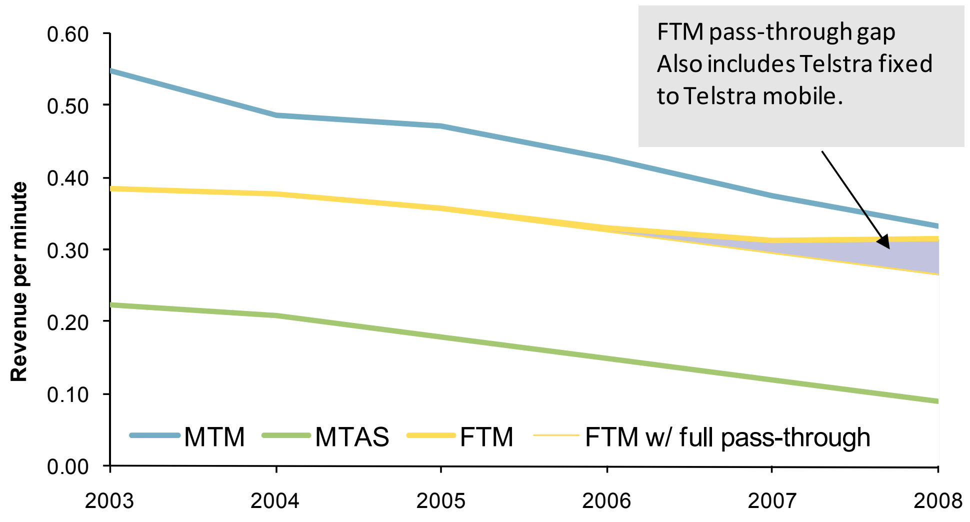
[7] Ibid.

[8] ACCC (2008), *Domestic Mobile Terminating Access Service Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011*, p22.

[9] ACCC (2007), *Telecommunications market indicator report 2005-06*, August, pp5 and 8.

[10] Vodafone calculations based on Telstra's annual reports and Optus (2009), *Submission to ACCC Domestic Mobile Terminating Access Service Discussion Paper*, Public Version, p16.

Chart 3: Telstra revenue per minute for FTM, MTM, the ACCC's indicative MTAS price and estimated Telstra FTM revenue per minute with full pass-through



Sources: Telstra annual reports and ACCC.

4.23 Some of the FTM margin is likely to represent a revenue transfer from Telstra's mobile wholesale to Telstra's fixed line retail. However if, for example, half of Telstra's FTM traffic was to non-Telstra mobiles then the reductions in indicative MTAS prices may have led to a revenue transfer of more than $150 million from other MNOs to Telstra over the last four years.

4.24 The lack of FTM pass-through highlights that the declaration of MTAS is necessary but not sufficient to promote the LTIE. The aggressive reduction in the indicative MTAS prices has not been matched by similar reductions in retail prices in the FTM market. The failure to promote competition in the FTM market has meant that the pricing principles that accompanied the previous MTAS declaration have resulted in a revenue transfer from mobile-only operators to integrated players.

4.25 The revenue transfer is an excess margin (i.e., a 'windfall' gain) for integrated operators. The margin arises because the cost of a wholesale input, the MTAS, has been reduced but the reduction has not been fully passed-on to end-users.

4.26 The margin provided to integrated players could be used to cross-subsidise mobile network operations. The capacity for cross-subsidisation means that the matter is relevant in considering whether declaration of the MTAS (and the accompanying pricing principles) promotes competition and the LTIE.

4.27 Intervention in the upstream 'monopoly' market (i.e. the market for MTAS) should be matched by consideration of the extent to which benefits are passed on to end-users in uncompetitive downstream markets. The concern is particularly pertinent in the Australian context given the significant market shares of integrated operators.

4.28 Lack of full FTM pass-through may adversely impact the LTIE because it mitigates the benefits to end-users from the declaration of MTAS and, more significantly, because the lack of pass-through provides a margin to integrated players that could be used to cross-subsidise their mobile network operations. The latter may have a detrimental impact on competition in the long-term.

4.29 The regulatory effectiveness of the MTAS declaration is impacted by the lack of FTM pass-through. In a market with two integrated network operators, the emergence of an FTM margin facilitated by 'regulated' indicative MTAS prices is material to the LTIE.

Promoting competition and the LTIE

4.30 The extension of the MTAS declaration will help underpin retail competition particularly in the market for retail mobile telephone services. However, the Commission's decision to declare the MTAS cannot be viewed as distinct from the determination of appropriate pricing principles and indicative MTAS prices. The LTIE can only be satisfied if the pricing principles reflect the economic cost of providing the service.

4.31 The Commission should recognise that extending the declaration of the MTAS will not, by itself, promote competition in the retail FTM market. Furthermore, the Commission must be mindful that the MTAS declaration creates the potential for integrated players to increase their FTM margin even if they reduce their retail FTM prices. Under such circumstances, the determination of appropriate pricing principles is particular relevant.

5. Declaration assists any-to-any connectivity

5.1 Declaration is not essential to promoting any-to-any connectivity among established operators. In the absence of declaration, MNOs with sufficient market share still have incentives to establish interconnect agreements with every other established MNO. For instance, interconnection agreements exist with respect to the supply of SMS/MMS services even though these services are not declared.

5.2 Nevertheless, extending the MTAS declaration moderately promotes any-to-any connectivity for voice termination services. In particular, the declaration of the MTAS provides access seekers, particularly prospective new entrants, with additional certainty over their ability to achieve inter-network connectivity on reasonable terms with existing access providers.

5.3 The relative bargaining of MNOs (including integrated players) is relevant to achieving any-to-any connectivity. In the absence of sufficient countervailing bargaining power, the monopoly power associated with the MTAS may lead to hold-out or opportunistic behaviour. To that end, the declaration of the MTAS may help minimise the risk of potential breakdowns in any-to-any connectivity.

6. Economically efficient use of infrastructure

6.1 The extension of the MTAS declaration will encourage the economically efficient use of infrastructure to the extent that indicative MTAS prices reflect their costs and demand for MTAS moves toward allocative efficiency.

6.2 Demand for the MTAS – a wholesale input – is derived from demand in the relevant downstream markets in which MTM and FTM voice calls are supplied. To that end, (perfectly) competitive downstream markets would ensure the economically efficient use of infrastructure associated with supply of the declared MTAS because, under such circumstances, the price in the relevant downstream markets would be set efficiently.

6.3 As noted in paragraph 4.21, the retail FTM market is characterised by a lack of competition. The lack of FTM pass-through means that retail FTM prices are higher than if full pass-through had occurred. In correlation, demand for FTM services is likely to be lower than would otherwise be the case. If demand for FTM services is less than efficient then the MTAS declaration may not achieve the economically efficient use of infrastructure. In such circumstances, the infrastructure would be under-used. That said, relative to the counterfactual, extending the MTAS declaration is likely to encourage a move toward the economically efficient use of infrastructure even if it does not fully achieve it.

6.4 Strong competition in the market for retail mobile telephone services is likely to ensure that the derived demand for MTAS associated with MTM voice calls is likely to reflect the economically efficient use of infrastructure associated with such calls.

7. Economically efficient investment

7.1 The maximum (five year) extension to the MTAS declaration will do most to encourage economically efficient investment in infrastructure. In particular, it will provide MNOs with certainty over the regulatory regime and, to a lesser extent, the accompanying pricing principles. Business certainty is critical to MNOs having the confidence to undertake major network investments.

7.2 An extension of the MTAS declaration must be capable of coping with emerging technologies. The Commission should be mindful that the proposed declaration time period may see the emergence of new network technologies (e.g. Long Term Evolution). The MTAS declaration (and accompanying pricing principles) should be flexible enough to encourage and accommodate such investment should any MNO elect to pursue such a strategy. A mid-declaration review of pricing principles is most likely to provide the appropriate balance between business certainty and regulatory flexibility.

7.3 The presence of integrated players means that the MTAS declaration could have unintended consequences for infrastructure investment. For instance, indicative MTAS prices could facilitate an additional margin in the retail FTM market which could then be used for excessive investment in mobile network infrastructure (or substitutes for retail mobile telephone services).

7.4 Excessive infrastructure investment may be harmful to competition and detrimental to the LTIE. Infrastructure-based competition between MNOs is important for attracting and retaining customers. Therefore, if the MTAS declaration provides integrated operators with an opportunity to make investments that they would not otherwise make it may provide them with a competitive advantage.

7.5 Over the long-term, the difficultly mobile-only operators would have in matching excessive infrastructure investment may adversely impact the Commission's objective to promote competition. Mobile-only operators would either need to make uneconomic infrastructure investments or offer a range (or quality) of services that does not match that provided by integrated operators.

8. Concluding remarks

8.1 Vodafone supports a five year extension to the current declaration of the MTAS. The maximum extension will result in the declaration's expiry on 30 June 2014.

8.2 The extension of the MTAS declaration is necessary to promote the LTIE by promoting competition, assisting with any-to-any connectivity and providing certainty to business so as to encourage economically efficient investment.

8.3 While the extending the MTAS declaration is necessary to promote the LTIE it will not be sufficient to achieve this objective. The pricing principles set by the Commission under the declaration will play a critical role in whether the declaration promotes the LTIE.

8.4 The Commission must consider the impact that lack of full FTM pass-through has on the LTIE. In particular, the Commission should consider the implications for cross-subsidisation and investment that an increase in the FTM margin might yield.