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SEPTEMBER 2010

Third time lucky

MOBILE TERMINATION REGULATION IN NEW ZEALAND

The Minister for Communications and Technology in New Zealand has finally accepted a recommendation from the New Zealand Commerce Commission (NZCC) to regulate mobile termination rates (MTRs). This follows two previous decisions to reject NZCC recommendations to regulate these rates. In this note, we discuss some of the controversy around the latest NZCC inquiry into whether to regulate the service, and consider the likely next steps in New Zealand. We conclude that the NZCC needs to improve greatly its current approach to benchmarking to estimate credibly the cost of mobile termination in New Zealand. We also consider the implications of the latest New Zealand decision for MTR regulation in Australia.

To all but hard-core mobile telecommunications regulatory enthusiasts, mobile termination is a largely unknown wholesale service that telecommunications companies provide to each other. Whenever someone calls (or texts) you on your mobile phone in Australia, New Zealand and most countries in Europe, your

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mobile network operator (MNO) normally does not charge you to receive the call. In these countries, the convention is that the "calling party pays".

To cover its costs of ensuring you can receive calls and texts on your mobile phone, your MNO usually levies a wholesale charge on the telecommunications carrier of the person who contacts you. This fee is called a termination fee – a fee for putting through (or completing) the call that someone else starts (or originates). While most consumers are unaware these wholesale transactions are occurring, they represent an important source of revenue for mobile operators. While MTRs have been decreasing in most jurisdictions over the last decade or so, they still represent around 10-15 per cent of revenues for MNOs in many jurisdictions.

Regulators throughout Europe and many other parts of the OECD have long been concerned about the impact MTRs have on retail prices paid by consumers for calls made to and from mobile networks. In particular, regulators have been concerned MNOs can have the incentive to raise the price of MTRs above cost, and that this can lead to efficiency concerns.

Many regulators have therefore regulated MTRs so the price of mobile termination more closely reflects their estimates of the cost of providing it. Given the importance of mobile termination revenue to the business models of MNOs, however, regulators have typically allowed MNOs to reduce the price of regulated MTRs over a staged "glide path" of rate reductions.

THE NEW ZEALAND CONTROVERSIES

MTRs have not previously been formally regulated in New Zealand. This is not without controversy, however, as the national regulator – the NZCC – has unsuccessfully twice previously recommended to Ministers of the New Zealand Crown that the service should be subject to regulation. In the first instance, the relevant Minister asked the NZCC to re-consider its decision. In the second instance, the relevant Minister rejected the NZCC's recommendation and instead accepted voluntary undertakings from Vodafone and Telecom to lower their voice MTRs.

The genesis for the NZCC's decision to commence a third investigation into whether to regulate MTRs appears to have been the impending entry of a new MNO (2Degrees) into the New Zealand mobile market. The NZCC was concerned that a new mobile entrant may not be able to compete with existing operators who combined above-cost MTRs with discounted prices for so-called "on-net" calls. On-net calls are those made between consumers on the same network (e.g. when a Telecom consumer calls another Telecom consumer).

During an investigation with enough twists and intrigue to match the *da Vinci Code*, the NZCC initially made a controversial 2:1 split majority recommendation in February 2010 that MTRs should not be formally regulated. Instead, it recommended that voluntary undertakings provided by two mobile operators – which had involved prices falling faster and more quickly than the existing undertakings – should be accepted. However, in a final twist, a decision by one of the operators to launch an on-net pricing proposition in April 2010 seems to have led the NZCC to change its mind, and recommend to the Minister that MTRs should be regulated in preference to the new undertakings. In July 2010, the Minister accepted this recommendation.

THE NZCC WILL NEED TO IMPROVE ITS COST ESTIMATES

Giving the NZCC the power to regulate MTRs is only the first stage in setting prices for this service. The NZCC will next conduct a "standard terms determination (STD)" process to set regulated rates for the service. Based on previous STD processes conducted for other services in New Zealand, this could take anywhere up to a year and will involve a number of rounds of submissions and public hearings.

Developing a reasonable estimate of the cost of providing mobile termination will not, however, be quick or easy. To date, the NZCC has used a "quick and dirty" approach to get a feel for the likely cost of mobile termination in New Zealand. In reaching its view that MTRs were substantially in excess of costs, the NZCC did not seek to estimate directly the cost of providing mobile termination in New Zealand. Instead, it chose to adopt a basic benchmarking technique that:

- surveyed cost estimates from a small number of overseas countries;
- converted these estimates into New Zealand currency equivalents using a combined purchasing power parity and 10-year long-term exchange rate;
- ranked the resulting estimates from lowest cost to highest; and
- estimated the cost of mobile termination in New Zealand was likely to range between the 25th percentile and the median of this range.

On the basis of this technique, it concluded in its final recommendation to the Minister that cost-based MTRs are likely to lie within a range of between 5.4 NZ cents per minute (cpm) and 8.3 NZcpm. This compared with the existing undertakings that set MTRs at 14.4 NZcpm.

Now the NZCC is actually going to set MTRs, it will need a more sophisticated approach to estimating the actual costs of providing the service in New Zealand. Experienced cost modellers recognise that the cost of providing mobile termination varies substantially from one country to the next, and depends on a range of factors including network scale and usage, population density and distribution, spectrum allocations etc. Unless the NZCC adjusts overseas estimates to take account of New Zealand specific values for such variables, there can be no confidence that a benchmarking approach will provide a robust estimate of the cost of providing the service.

AUSTRALIA WILL BE WATCHING

The outcomes of processes "across the ditch" are likely to influence the Australian Competition and Consumer Commission's (ACCC's) future considerations of appropriate MTRs in Australia. The decision has already been made in Australia to regulate MTRs, and the ACCC has issued pricing principles for voice MTRs that apply until the end of 2011. These set an MTR of 9 Australian cpm. We expect the ACCC will commence a process soon to determine appropriate MTRs for the period after 2011.

We do not believe debates in New Zealand regarding the interplay of termination rates and on-net mobile pricing will be as significant in Australia. This is because there is no suggestion that a new entrant is considering building a mobile network and entering the market in Australia.

We do believe, however, that debate in New Zealand about the actual cost of providing mobile termination will be of relevance to the regulatory discussion in Australia. Evidence collected as part of any detailed benchmarking and modelling conducted by the NZCC throughout the second half of 2010 and early part of 2011 is likely to be of particular interest to the ACCC in 2011 when it starts its deliberations on the future level of MTRs in Australia.

Debate in New Zealand may also focus on whether estimates of cost should include a contribution toward the fixed and common costs of running mobile networks. This debate between so-called "TSLRIC" and "TSLRIC+" pricing has become a significant issue in Europe, where the European Commission has suggested pricing for MTRs should not include a contribution towards fixed and common costs. Removal of the fixed and common cost "+" from TSLRIC+ would have a significant impact on cost estimates in both New Zealand and Australia. For instance, the UK regulator (Ofcom) has recently issued a consultation document indicating that MTRs reflecting 'pure LRIC' could be significantly lower than MTRs set on the basis of LRIC+. If New Zealand decides to exclude the + from TSLRIC+, this may also lead the ACCC to consider this issue more closely.

CONCLUSION

While New Zealand has come late to regulating MTRs formally, the outcomes of its regulatory processes over the next year may, when combined with events in Europe, have a significant bearing on regulatory events in Australia during 2011. Given the importance of mobile termination payments made between telecommunications carriers in Australia, these debates will be well worth keeping an eye on.

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