Telefónica

Telefónica comments to the ERG draft Common Position on symmetry of mobile /fixed termination rates

General questions

QUESTION G1: Do you think that the principles outlined in the general economic introduction cover adequately the underlying economic situation of both mobile and fixed termination markets?

- **If yes, do you think they are sufficiently reflected in the two parts on "MTR symmetry" and "FTR symmetry" and that they are consistently applying the principles?**
- **If no, what do you think is missing and which reasoning should be added?**

Telefónica broadly agrees with the general principles of the introduction and the scope of the consultation. Notwithstanding this, if a finding of dominance is found on a termination market, then NRAs need to satisfy themselves that operators have both the incentive and the ability to price excessively and there is not sufficient countervailing buyer power to constrain the behaviour of the operator. Telefónica believes that these factors will become increasingly important going forwards and should not be lost in a dry debate about the mechanics of remedies.

QUESTION G2: Any further comments regarding consistent regulation of both MTR and FTR with regard to symmetry is welcome.

Regarding symmetry on fixed networks, there is an element missing: mainly the existence of capacity – based interconnection in Spain (there is some debate now in other countries), which provides a substantially lower termination price than per minute charged interconnection, leading to increased asymmetry.

Compared to time-based interconnection, alternative operators benefit from lower effective termination prices when they contract capacity based interconnection. Beyond a certain threshold of minutes, the per minute cost decreases substantially. This implies that (except for the smaller operators), it is a very convenient system for interconnection.

When comparing interconnection prices, almost all benchmarks compare per-minute charges, as it is the almost universal system for tariffing interconnection. However, when comparing FTRs and their degree of asymmetry, a mere comparison of per minute charges does not provide the right picture if an operator provides capacity based termination rates and other operators do not provide it.

The way to get rid of asymmetries in this case is that all operators in a market should offer capacity based interconnection, in order to get symmetry for FTRs (both prices and all the conditions that influence effective prices).

(See also comments on the fixed part questions).

QUESTION G3: Finally we would like to ask you to elaborate on the question of converging MTR and FTRs and the timeframe you envisage for this.

Cost oriented price control regulation should allow operators to make a return on their efficiently incurred costs. If the costs of mobile operators and fixed operators converge then, mathematically, their respective TRs will converge.

However a number of studies over recent years have pointed to a stabilisation of Fixed and Mobile Termination rates at a ratio of somewhere between 6:1 and 9:1 (Ovum 2003). MTRs and FTRs in Europe will, with a few exceptions, be in this range over the next year or two if they are not already there. On that basis it is unclear what justification there could be for trying to drive them beyond this point.

So, if their costs do not converge, (which is likely given the capacity constraints inherent in radio spectrum, versus virtually unlimited capacity on fixed networks), then there is no basis under which MTRs and FTRs could converge, unless:

- NRAs were to propose that mobile operators should not be able to recover their efficiently incurred costs for call termination services, thereby undermining future investment (i.e. mobile TRs converge to fixed TRs); or

- NRAs were to propose that fixed operators could recover supernormal profits from their termination services (i.e. fixed TRs converge to mobile TRs).

The mobile and fixed markets are both going through major investment cycles against a background of sustained competition.

Currently fixed and mobile markets have different dynamics, network technology, business models and recover costs (access, traffic) in different ways. Artificially playing with the commercial fixed and mobile business models in an attempt to gain some "unified model" is likely to increase risk and flow through to the cost of capital for both – in effect increasing costs.

Fixed part

Telefónica broadly agrees with the general approach of the fixed part of the consultation, especially with the principle to get rid of asymmetries. Given the current situation of the fixed markets, this evolution should be almost automatic, and not subject to a new market analysis.

QUESTION F1: How do you think termination should be regulated in a converging fixed mobile market?

Telefónica does not see major issues yet on this topic, mainly due to the low development of converging products/ networks. It would be necessary to let the market evolve and see how business models and the assets involved are affected.

QUESTION F2: Do you agree on the methodology and assumptions underlying the asymmetry index calculation?

These type of indexes could be used to provide a reference. However, it would necessitate a deep reflection and assessment using economic data to understand the implications of the index. Unfortunately this is not possible within the time frame of this consultation.

There are some issues that may affect substantially the result and which probably cannot be fixed at EU level, such as the traffic distribution between peak /off peak periods, or the mix of local/single transit traffic. It is necessary to be very cautious when adopting this type of parameters and study the impact at national level.

There are other elements such as capacity based interconnection (where existing) that should be incorporated in the model, if existing in a given Member State. In Spain, this service implies that Telefónica provides lower effective termination prices than time-based charges. This issue increases the asymmetry with regard to time based interconnection. A mere comparison of FTRs based on the time based charges would not provide the right picture with regard to the asymmetry degree.

And when dealing with getting rid of asymmetries, the solution would be to establish a symmetrical obligation for OAOs to offer capacity based interconnection.

QUESTION F3: Do you think the list in paragraph 7.1 constitutes an exhaustive list of the possible reasons justifying the adoption of asymmetric tariffs?

From Telefónica's viewpoint, given the current market situation, it is very difficult to justify an asymmetric FTR regime.

As the ERG points out, after ten years the market has now solid and well established alternative players, they have significant market shares in their coverage areas and good customer basis. Some operators, such as cable operators in Spain, have undergone important concentration processes, increasing size and economies of scale.

Maintaining asymmetries implies a distortion in retail market competition, as the retail services of the other fixed operators that have to pay higher termination rates will have to face lower margins. In a scenario of competition in retail services, this introduces a distortion of fair competition dynamics in the retail market. It is necessary to keep in mind in this context that the new Relevant market Recommendation has removed the retail fixed calls markets from it, due to their high degree of competition.

QUESTION F4: Do you agree on the fact that any entry assistance policy for the future based on higher OAOs' FTRs is likely to be less effective than in the past?

It seems clear that the current situation does not provide reasons to maintain asymmetries. Alternative network operators have focused their activities and network footprint in geographic areas with high density. Market shares are considerable in those areas. Traffic imbalances in those areas are not considerable. There is no reason to treat differently new network investments of some players with regard to others.

QUESTION F5: Could you please provide a definition of the "efficient operator" NRAs should refer to in fixing FTRs? What are the costs an efficient operator would incur to provide termination services?

The most practical way is to use the incumbent operator as the reference for FTRs. In most cases, there is an accounting system developed jointly with the NRA, as well as a cost accounting separation obligation.

QUESTION F6: Do you agree on the fact that OAOs should be as efficient as the incumbent?

In some cases, cable networks may present higher efficiencies than the incumbent network, as they have developed with more up to date technologies and footprint has been only dictated by commercial profitability. This implies also lower maintenance and operating costs.

QUESTION F7: Do you agree on the fact that there are less reasons for fixed operators compared to mobile operators that justify the adoption of asymmetric tariffs?

There are significant differences between the fixed and mobile markets in terms of the freedom to enter the fixed market and the limitations (spectrum and regulatory conditions) that exist on

entering the mobile market. This can in some cases lead to possible asymmetries of costs. The asymmetries should not however be permanent. For further discussion see the answers to the mobile questions.

QUESTION F8: Do you agree on the fact that if all call termination charges were based strictly on incurred costs there would be a distortion of competition?

The reasoning of the consultation document (page 36) would be largely applicable to many other regulatory circumstances in which regulators force lower prices of regulated operators in order to reach efficient prices. As pointed out above, the most practical solution for reaching symmetry would be to use the prices of the incumbent as the reference for FTRs.

QUESTION F9: Do you agree on the fact that symmetric tariffs would allow to avoid transaction and regulatory costs?

It is clear that it would imply less conflicts. History shows that it has been a permanent source of debates and disputes.

QUESTION F10: Do you agree on the fact that NRas should reach symmetry in fixed termination tariffs within a reasonable period of time?

Yes, but the timeframe suggested in the consultation document seems too long (wait to the next market analysis and then establish a glide path = four or five years). Achieving symmetry for FTRs should be almost immediate: just a variation of the remedies (a short glide path) established in the already undertaken market analysis.

QUESTION F11: Do you agree that it would be reasonable for NRAs to allow a transition period to move to symmetric FTRs? How long should this transition period be?

See F10.

QUESTION F12: In your opinion what criterion should NRAs adopt to set the glide path?

See F10.

QUESTION F13: As the length of the glide path is a controversial point, in your opinion, should the time period to reach symmetry be the same for all NRAs or should each NRA determine it according to national circumstances?

The reasons included in the consultation document (date of market opening, actual number of OAOs and their respective market shares) do not seem to provide a solid basis for variations. An approach as harmonised as possible would be highly desirable.

Mobile part

QUESTION M1: Do you agree with the general principle promoting symmetry: "Termination rates should normally be symmetric"?
Exception to take into account exogenous factors, not related to a late entrance

If price controls for MTRs are appropriate, then Telefónica agrees that economic principles tend to recommend the setting up of a unique and uniform mobile termination rate for all network operators in a Member State, save for:

- Exogenous cost differences outside the control of the operator; and
- That the debate should not be limited to "national players" but should address all operators offering termination services on mobile numbers such as those without national rollout obligations or where the numbering range is used for other services (see M2).

Telefónica does not agree that termination rate regulation should be used in the future as a tool to:

- Stimulate market entry – Across Europe NRAs have found retail mobile markets to be effectively competitive. No party has SMP, no remedies are applied in the relevant market. It would undermine the basis for market definitions if, on the one hand, regulators found retail markets to be effectively competitive, but, on the other hand, used remedies in an entirely separate market (the wholesale call termination market) to effect an outcome in the retail market. Regulators should not perpetuate this unsatisfactory approach, especially as with declining MTR rates across Europe future assistance via this method would be increasingly distortive and lead to high differential prices for customers calling those numbers.
- Account for traffic imbalances: traffic imbalances can have two sources, a lower than "normal" volume of inbound calls, and/or a higher than "normal" volume of outbound calls. The latter is predominantly driven by the retail pricing strategy of an operator in its retail market, whilst the former is driven by the mix of subscribers that it targets in the retail market (pre-pay versus post-pay). Therefore, the balance of inbound/outbound traffic is to some degree within the control of the operator and a result of its strategy in an effectively competitive market. Therefore traffic imbalance on its own is not a reason for regulatory intervention and further analysis of the cause and its effects would be required before a regulator decided to take action. It is questionable whether it is economically efficient to "compensate" for traffic imbalances by creating asymmetric termination rates.

QUESTION M2: Do you agree with the exception to take into account exogenous cost differences: "asymmetry is only acceptable to take into account exogenous factors, outside the control of operators"? The only example, which is not related to a late entrance, identified by ERG is cost differences due to the spectrum licensing holdings. Can you identify other exogenous factors?

The consultation is written to suggest that all operators are in ostensibly the same circumstances. In the UK, Ofcom has undertaken a number of spectrum auctions which have led to the

emergence of small niche operators, whose fixed cost bases bear no relation to the five MNOs. In particular, the licences of the MNOs have (or have had) rollout obligations that have meant that their networks are of a given minimum size and scale. By contrast, many of the new operators do not have large fixed costs or radio networks, yet they still provide termination services and given consistent evaluation by Ofcom would be found to have SMP on their own call termination market.

In light of their lower fixed costs, it is entirely plausible that such operators would have considerably lower long run costs, given that they operate limited networks and in particular do not operate network in rural areas. It would not therefore be appropriate to set cost-oriented prices for such operators at the level of the common price control for the MNOs, rather their price control should be substantially below that of the MNOs.

There are a number of other factors that in some markets may lead to exogenous costs. These factors may include 3G licence costs, or the additional costs of national roaming agreements. These costs may support asymmetric rates for a period of time but should not justify permanent asymmetry.

QUESTION M3: Do you agree with the following principle: "Assuming that cost differences due to different spectrum allocation are properly evaluated, they may justify an asymmetry"?
Transitory exception to take into a significantly late entrance.

Spectrum based cost differences vary with time and the traffic loading on networks. In lightly loaded networks, coverage is the binding constraint and therefore MNOs with lower frequencies may experience lower unit costs for a certain period. However, in the long term, when capacity is the binding constraint it is overall aggregate spectrum capacity which is the predominant factor affecting costs. MNOs with more spectrum have to perform fewer cell splits to carry an increasing volume of traffic. Such dynamic effects will vary by Member State and so it is difficult to arrive at a mechanistic rule regarding the natural derivation of MTR asymmetry from differential spectrum holdings, particularly when the overall amount of spectrum is the same, but the frequency range is different.

Furthermore, the differences in unit costs derived from spectrum may be small within the context of the overall uncertainties of the cost model. For example if exogenous cost differences from spectrum were evaluated at 0.5c but that the overall modelling error were 2c then it is harder to justify a priori that spectrum differences make a significant impact. Indeed, within the context of MNOs which may make several Euro billion in EBITDA, MTR differences of 0.5c may only mean an impact on profits of c. 10mEuro.

Given the administrative benefits and public policy benefits identified by the ERG for symmetric pricing, Telefónica believes that if differences are really small then there is a robust case for equalising MTR prices. On the other hand if the differences are not negligible in one country [case / market], accordingly consideration of legacy spectrum assets have to be taken into account.

Telefónica agrees that the existence of or prospect of effective spectrum trading will mitigate against cost differences. If unit cost differences are sufficiently large to create demand for certain spectrum assets then trades will take place (or operators will be exposed to the opportunity cost of not trading), providing that the cost of clearing spectrum for trading is not excessive. The presence of spectrum trading may mean that spectrum cost differences are either:

- No longer exogenous; or

- So small as to not stimulate trading.

Spectrum redistribution is under discussion in some countries, because of legacy issues. This may however imply a considerable cost to society, in clearing already heavily utilised spectrum (mainly 2G) in some countries [markets]. As the costs of such spectrum clearance will be exogenous (i.e. outside of the control of the affected party), it would need to be accounted for in voice call termination regulation and may, ironically, lead to asymmetric termination charges as a result. Hence regulators must take full account of current and future market conditions in each country before embarking on any plans for spectrum redistribution.

QUESTION M4: Do you agree with the following principle: "If the level of competition in the mobile retail market asks for measures which create incentives for new network level entry or measures that strengthen the position of small new entrants, substantial differences in the date of market entry can justify an asymmetry for a transitory period" ?

There are two different cases to address:

(1) entry into markets before ex ante price controls were introduced under the existing regulatory framework; and

(2) future entry into the market in the full knowledge of regulatory practice under this framework and the future framework and in light of an ERG common position on MTRs/remedies.

Dealing with (2) first, such entry happens with full knowledge of the regulatory framework and its operation.

In relation to (1), there is precedent in many markets for two key variables to be assessed:

a) the time between entry and price control regulation; and

b) the assumed time over which an efficient operator is assumed to have achieved market share parity, within any LRIC model.

Furthermore, it is a matter of record that in many Member States (Ireland, NL, UK for example) the prices of unregulated companies have fallen by virtue of the threat of regulatory intervention by NRAs. It would appear therefore that a reasonable period for the introduction of asymmetric price controls can be determined by NRAs and that glide paths can be used to ensure a smooth transition to price control (however determined) in order to mimic observed behaviour of previous market entrants (which may have entered before the current framework was in place). Market share should not be used as a target to determine the duration of any asymmetries. Glide paths that incorporate incentives for efficiency and are time limited are the appropriate model.

QUESTION M5: Do you agree with the principle of keeping the level of asymmetry "reasonable"?

Yes, the problem is determining what is "reasonable". It should be clearly limited in time and amount.

QUESTION M6: Do you agree with the fact that an initial level should be accompanied by a

glide path towards symmetry?

Yes

QUESTION M7: Do you agree with the fact that national factors should be taken into account to evaluate the length of the transition period?
Transitory exception before MTRs are at cost, to limit distortions created by MTRs above costs:

Yes (see above).

QUESTION M8: Do you agree that in specific market circumstances (MTRs tariffs are significantly above MTR costs, there are high traffic imbalances between mobile operators and benefits of a transitory asymmetry outweigh any short term disadvantages of doing so), a temporary asymmetry may limit competitive distortions?

No, see above response to M1. The issue here is in circumstances where MTRs tariffs are significantly above MTR cost. Following the previous arguments MTR's should be cost orientated, therefore prolonging asymmetry does not address the fundamental problem rather it exacerbates it.

QUESTION M9: Do you agree that NRAs should first try to set MTRs at costs?

Figure 13 of the consultation shows MTRs in Europe converging to around 5-7 Eurocents by 2010/11. In many countries there appears to be little annual change in cost-oriented prices. Increasingly, with capacity now the binding constraint in networks, more traffic leads to more cell sites being deployed – unit costs have stabilized in 2G networks.

NRAs which have favoured mechanistic approaches (e.g. LRIC) to calculating cost oriented prices have had to grapple with increasing complexity, when compared to 2G networks which delivered two products (voice and SMS). Specifically:

- accounting for 3G spectrum costs; and
- migration of customers and traffic to 3G networks which are multi-service platforms; and
- dual running of 2G and 3G infrastructure; and
- uncertainty over future traffic growth – including the extent of fixed to mobile substitution; and
- networks which terminate traffic on both mobile and fixed networks.

Between 2008 and 2011 we can expect to see unprecedented changes to the structure of mobile markets in Europe and changes in technology, such as:

- consolidation; and
- new spectrum assets (2600MHz);

- potentially refarming of 900MHz and 1800MHz to UMTS; and
- femtocells.

This can only devalue the use of mechanistic approaches, the range of outcomes that any model can produce will be so large that NRAs will effectively be relying on their discretion. The use of a model to determine the range within which they can exercise that discretion will, in Telefónica's view, lack precision going forwards. It is therefore unrealistic to believe that it will be possible with any model to determine an exact cost for MTRs and this should be build into any thinking at the outset.

Within the context of static or slowly declining MTRs, it may be pragmatic for NRAs which have previously adopted cost-oriented regulation based on LRIC to take a fresh look at termination rate regulation in its totality. Given that:

- by 2010/11 all MNOs will have been regulated to costs and those costs are near static (as assessed today); and
- by 2010/11 it may be hard to determine "average efficient operators" if there is a divergence of MNO strategies (voice centric versus data centric) and assets (spectrum / network technology); such that
- effectively, cost differences significantly above or below the 5-7 Eurocent benchmark would need to be objectively justified with regard to specific operators rather than a generic model; then there may be a greater role for market forces to shade prices down towards costs; as
- excessive pricing is unlikely in that:
    - prices are at or near costs and costs have stabilised; and
    - contractual arrangements between MNOs and FNOs create a "ratchet effect", if termination markets were left unregulated, MNOs are left constrained in their ability to increase prices by countervailing buyer power.
- Negotiation backed up by the credible threat of effective dispute resolution proceedings may be used to allow parties to negotiate cost-oriented prices around a "reasonable" benchmark of 5-7EuroCent (depending on Member State).

As stated earlier Telefonica wish to point out that any model, including LIRIC (models) can only give an approximation of cost. Currently regulators using the same model come up with significantly different results and to a degree this is to be expected because these models are not simple input out machines. Therefore whilst agreeing that MTRs should be cost orientated, Telefonica believe that it is important that NRAs take a pragmatic view, whatever method they use to determine a cost orientated price.

25-1-2008