

Sonaecom's comments to the European Commission's proposal concerning a recommendation on rates of fixed and mobile termination

Sonaecom, SGPS, SA (Sonaecom) welcomes the opportunity to comment on the European's Commission draft Recommendation on the Regulatory Treatment of Fixed and Termination Rates in the European Union.

Taking into account the knowledge coming from the market analysis that have been carried in the recent years as well as the discussion that has been promoted by the Commission on the issue of termination rates for fixed and mobile networks, Sonaecom considers that is now appropriate to examine deeply the impacts of the approach that has been followed and consider alternative approaches to termination rates.

Indeed, as further explained below, Sonaecom believes that this opportunity should be taken to change the approach that has been followed for the treatment of termination rates.

There are basically two dimensions in which termination rates are relevant. On one hand the call termination on fixed network and, on the other, the call termination on mobile communications network.

Considering the origination and termination of calls, there are four types of communications that may be affected by the termination rates:

- i) calls originated in fixed networks and terminated in mobile networks;
- ii) calls originated and terminated in fixed networks;
- iii) calls originated in mobile networks and terminated in fixed networks;
- iv) calls originated and terminated in mobile networks;

The receiving network operator (fixed or mobile) may increase the network effects and distort competition in telecommunications by the adoption of discriminatory practices. These effects are well known and the regulatory authorities have always worried about creating conditions for a "level playing field" that minimizes these adverse effects¹.

The economic literature acknowledges that the existence of fees for access to the networks of competitors (ie, the termination rates) can distort competition by increasing off-net calls compared to on-net. It is exactly in this way that operators can deepen the network effects and, thus diminishing competition by strengthening the barriers to entry (or expansion).

¹ Lafont et Tirole (2000). "Competition in Telecommunications". The MIT Press, Cambridge

Regulators have addressed these concerns by imposing asymmetric tariffs based on the cost of terminating calls. Experience, however, shows that these regulatory measures do not fully serve the purposes of balancing the incentives and competition in the market for communications services. In particular, it appears that the network effects in the past have not been fully resolved by asymmetric rates and other network effects - as the caused by traffic imbalance² - are not resolved in this way. Moreover, the network effects may even be deepened by some operators' pricing strategies³.

It is therefore appropriate to reflect on the termination rates system in order to strengthen the incentives to competition in the sector of telecommunications in the European Union. The regulation of network access for call termination may be an important tool to restore some incentives to the competition that the current regulatory framework does not seem able to address.

Sonaecom believes that this occasion should be used to reform the entire regulatory framework, evolving towards a system of bill and keep (BAK), which is capable of producing solutions that maximize competition and, concomitantly, efficiency in the resources allocation.

In Sonaecom's opinion, to the extent possible, the European Commission should follow this line of approach, which has the merit of returning to the market its "disciplining" power.

If, on the contrary, the European Commission persists in the current model of regulation of termination rates for calls based on costs, it should take into account the industry specificities, including the need to calibrate the cost models adjusted to the reality of each of the markets in order to achieve a balance for the trade-off between competition and efficiency. We believe, however, that this is more difficult to implement and could lead to regulatory gaps.

The termination rates have played a leading role in the competition dynamics of the European communications services, in particular, in mobile services segment.

Recognizing the impact that the termination rates may have on the retail market, the Portuguese regulator imposed to the fixed incumbent, designated as SMP in retail markets of fixed services, the obligation to set retail off-net prices not higher than on-net prices plus

² The traffic imbalance arises for reasons relating to demand segmentation. In practice, consumers are not homogeneous, nor appear evenly distributed between different operators, with the result that some companies may have portfolios of customers that make more calls off-net than those who receive the networks of competitors. This profile of demand will inevitably lead to imbalance of trade in the market for termination of calls.

³ Normally trade policies lead to off-net tariffs higher than the rates on-net in the sense of attracting customers

the difference, if it exists, between its own termination prices and the termination prices charged by alternative operators. Given this environment, potential harmful effects of termination rates in the retail market for fixed services are, to a large extent, controlled.

In the mobile market, in turn, there is no provision limiting the differences between on-net and off-net retail prices. Consequently, in this segment the termination rates have had greater impact on the dynamics of competition in the retail side.

In fact, and in what regards the Portuguese situation, ANACOM recognises that there is a market failure in mobile market that arises from the combination of mobile termination rates and retail pricing differentiation between on-net/off-net prices, which, despite the fall in termination rates, has persisted and shows that the decrease of termination rates is not appropriate to solve the detected market failure:

*"... All these figures point to the continued existence of a market failure linked to price discrimination as a strategy of foreclosure..."*⁴

The principle of cost orientation of termination rates has been seen as a way to mitigate the distortions caused by the termination rates. But, as stated by ERG in the consultation paper on the regulatory principles of IP interconnection, the decision on termination rates always carries the risk of regulatory distortions⁵. In the recent report "The setting of mobile termination rates: best practice in cost modelling" prepared for the GSM Association PricewaterhouseCoopers (PwC) reached the same conclusion⁶.

Different methodologies may be applied and there are several issues that must be set to define the most appropriate methodology:

- What kind of model to use: bottom-up, top-down or hybrid?
- Use incremental or average costs?
- Use historical, current or prospective costs?
- Which depreciation method should be considered?
- What are the characteristics of the network taken as reference?
- Which market share should be considered for the reference operator?
- What is the most appropriate cost of capital?
- Should we opt for a single price? Or should we estimate a single price for each operator resulting from the application of the same model but considering the

⁴ Decision of ICP - ANACOM on the wholesale market for termination of voice calls on individual mobile networks, specification of price control:

http://www.anacom.pt/streaming/decisao02072008.pdf?contentId=600897&field=ATTACHED_FILE

⁵ http://erg.ec.europa.eu/doc/publications/consult_ngn_2008/erg_08_26rev1_consul_ip_ngn_080604.pdf
p. 90

⁶ http://www.gsmworld.com/costmodelling/costm_thanks.shtml, p. 3

individual conditions of each operator? Or should it be a single price calculated as the average of the previous?

There are many questions and choosing the most appropriate solution is far from unanimous. The results can actually be very different depending on the assumptions made in the cost model.

It is recalled that the telecommunications industry responds strategically to regulatory measures. And it is not strange that in many regulated industries the regulatory failure replaces the market failure. It's worth highlighting that the regulatory failure can distort and remove the market from the balance that maximizes welfare. Regarding the Portuguese market, this is clearly the case. Rather than resolve the problem it intends to fight, the regulation of termination rates have been used strategically by the larger operators, reinforcing the network effect and increasing the market power, namely by allowing the financing/subsidization of bigger (and older) operators by the smaller competitors due to traffic imbalance. In that respect Sonaecom, stresses that Optimus, its mobile arm, has transferred more than 130 millions euros to its competitors – TMN and Vodafone – due to traffic imbalance. This situation prevents individual company to develop its natural market shares, as provided by economic models.

II. A new approach to termination rates

Considering what has been said and the distortions that the existence of termination rates may imply as well as the context of next generation networks development, Sonaecom believes that this opportunity should be taken to consider the adoption of a new paradigm for termination rates.

Given its experience in the telecommunications market, in mobile and fixed segments, in Sonaecom's opinion the adoption of a system of termination rates equal to zero, commonly, known as Bill and Keep system (BAK), seems the most appropriate system to eliminate distortions of competition caused by the termination rates. Moreover, its application to all types of voice communications can be an important step for the defence of competition and welfare's promotion.

The BAK system is a common practice in North America, in some countries of East and New Zealand. Furthermore, this form of regulation is not unprecedented in Europe as it was applied between French mobile operators⁷.

It is worth noting that the adoption of a BAK model does not require the amendment of the charging scheme of the retail traffic that is currently in place in Europe: CNPP (calling network party pays). Indeed, the adoption of BAK does not automatically imply that the receiving party has to pay for receiving a call. One possible adjustment of retail tariffs level does not mean a change of regime. In this respect, we highlight that the increase of competition in the retail market that the introduction of BAK promotes limits the possible increase of retail tariffs, which is sometimes presented as a drawback of BAK.

Additionally, the adoption of BAK may incentivize the convergence between on-net and off-net retail prices, gradually eliminating the widespread practice of subsidization of on-net calls by off-net calls that currently exists in the market.

Some disadvantages are pointed to the adoption of this system, in particular, the **hot potato effect**, the future framework for **transit traffic** and **arbitrage** behaviour adopted by operators not subject to BAK.

It is known that the adoption of the BAK system presents some challenges, indeed. However, the intense discussion on this subject has demonstrated that the challenges set out as BAK disadvantages are not insurmountable and some suggestions for resolution have already been advanced⁸. Besides, in contrast, the BAK adoption carries recognized advantages some of which are evidenced below.

The **decrease of regulatory costs** either for regulators and operators. The adoption of a BAK system waives the analysis of termination markets, the imposition and control of obligations, and the definition and implementation of model costs and billing costs between operators. This is particularly relevant because it acknowledges that the asymmetry of information between regulatory authorities and entities covered invariably leads to a lower than optimum balance. Certainly, the regulator may invest in the collection of information to minimize this effect, but the cost of doing so produces a "deadweight loss" that ultimately is passed on to consumers. As far as possible, regulatory practices should promote the market mechanism, building a system of incentives compatible with the maximization of welfare, that is to say, the promotion of competitive markets principles.

⁷ The end of BAK between French mobile operators was determined by ARCEP as a mean to stop arbitrage opportunities that arisen because BAK did not apply to interconnection between fixed and mobile operators

⁸ In this regard see, for example, suggestions made by the ERG in section 6.2 - 6.10 of the public consultation document about regulatory principles of IP – IC/NGN Core (ERG Consultation Document on Regulatory Principles of IP-IC/NGN Core)

The adoption of a BAK system has the advantage of being **technologically neutral** since it does not lead to different termination rates depending on the technology used. Thus, BAK promotes the **fixed and mobile services convergence**, which in turn encourages **competition and innovation**. Operators will develop strategies that use the infrastructure in the most economically efficient way, facilitating the development of new products and new solutions, preventing the diversion of resources to solutions that are economically inferior. This appears associated to the issue of asymmetry of information as mentioned above. The return to the market's function of choosing the most suitable technology to provide telecommunications services on the voice will inevitably lead to superior solutions in terms of economic efficiency and welfare.

Finally, experience shows that - according to studies released – telecommunications services **have a higher rate of use and lower price levels** in countries where BAK was adopted⁹.

In this sense, the BAK presents as a **neutral system either from a competitive point of view** since it discourages and allows a more sustainable combat of competitive distortions arising from differentiation practices of the retail on-net/off-net prices. The BAK system, thus, promotes **innovation in retail prices**, including the extension of flat rates to mobile communications.

In line with the previously indicated, the BAK also eliminates the effect of reimbursement of the larger operators by smaller operators due to traffic imbalances, which, as mentioned above, has been identified as a competition constraint in retail mobile markets in several countries.

Following that, Sonaecom believes that this moment of reflection is appropriate to move towards a model of BAK. Its adoption can play a very important role to address, in a definitive way, the market failures - which have gained particular relevance in mobile market - and thus promote a competitive market in its maximum extent, including the competition between platforms for communications, eg, the convergence between fixed and mobile services.

Finally should be highlighted the role of negotiating freedom, an essential pillar of the competitive market. Of course, Sonaecom understands that the imposition of a system of BAK should never override the negotiation freedom between operators that should be free to decide distinct interconnect systems, since competition and the adoption of measures

⁹ Merryl Lynch Wireless Matrix 1Q07, 15 June 2007, referred in ERG consultation on IP Interconnection

consistent with the "most-favoured-nation clause" - ie , not negative discrimination of others, is assured.

III. The Commission proposal

The acceptance of the proposal made by Sonaecom in the previous paragraph waives the need to establish concrete guidelines on costing methodology for fixed and mobile termination, as set out in recommendation now under consultation. However, without prejudice to the position expressed before, below we will present some specific comments about some of the aspects incorporated in the current Commission's draft recommendation:

- Definition of symmetric rates with reference to an "efficient" operator
- Technical aspects of the costing methodology

a. Definition of symmetrical tariffs based on an efficient operator costs

Sonaecom has already disclosed its position about the criteria for the definition of interconnection tariffs in different *fora*. Hence, we will not repeat the arguments previously delivered. Instead we refer to the position expressed by this company in the public consultation promoted by ICP - ANACOM on the draft decision of October 2007 on wholesale market for termination of voice calls on individual mobile networks¹⁰ and to the response to public consultation promoted by the ERG on the treatment of termination rates fixed and mobile launched in December 2007¹¹.

In summary, the concerns previously expressed warn for the dangers of imposing symmetrical tariffs when operators have different market shares, not due to inefficiencies, but because the dynamics of the market has not yet allowed them to reach the minimum efficient scale. In general these are circumstances in which companies have failed to exploit economies of scale for reasons related to imperfections in the product / service and factors markets.

Accordingly, the adoption of symmetrical tariffs deepens the distortions and hinders competition. Sonaecom's experience suggests that if a single tariff applied resulting from the application of the cost model to the :

¹⁰ http://www.anacom.pt/streaming/sonaecom_4072008.pdf?contentId=600816&field=ATTACHED_FILE

¹¹ http://erg.ec.europa.eu/doc/publications/consult_symmetry_mf_tr/sonaecom.pdf

- i) reality of the smaller operator: the larger operators are subsidized by its competitors;
- ii) reality of the larger operator: the smaller operator will fail to recover its costs, which becomes a competitive disadvantage in comparison to larger operators.

It is true that the Commission proposes to consider as a reference for calculating the costs of termination, not the operators who are in business, but an efficient operator, defined in terms of theoretical characteristics. Despite this difference of methodology, the distortions mentioned above will remain:

- i) Operators that have a smaller dimension than the reference operator would feel obliged to provide the service termination at prices lower than its costs, even if incurred effectively given its characteristics;
- ii) Operators with a higher dimension than the reference operator will benefit from prices above their costs.

In addition, the Commission's concern with efficiency only in its productive dimension neglecting the importance and relevance of dynamic efficiency is a paradox in a context where the industry presents strong economies of scale and the regulatory authorities have advocated the competition and sector's liberalization. The balance between competition and efficiency is very delicate, but has to be found, otherwise economy will depart from the balance that maximizes welfare.

To sum up, is Sonaecom's concern the absence of references by the Commission on the impact of the adoption of a uniform and symmetrical tariff in the smaller operators' ability to continue to exert competitive pressure on the market.

B. Technical aspects regarding the method of cost

Notwithstanding what was said about the distortions caused in competition because of the adoption of symmetrical rates based on costs of a reference operator, at this point we present comments on the technical principles concerning the methodology for costing proposed by the Commission, regardless of operator's reality to which the cost model is applied.

In general, Sonaecom believes that the cost model principles proposed by the Commission are adequate. Still, there are some points, especially in terms of its implementation, which, in Sonaecom's opinion, must be properly weighted and/or clarified:

- The implementation of current costs may require some adjustments if the method of Modern Equivalent Assets (MEA), not mentioned in the draft recommendation, is applied:
 - The adjustments will be imposed because of additional features and greater efficiency resulting from the natural technological evolution. The completion of these adjustments is complex and subjective and as such should be considered in a cautious manner;
- The implementation of LRIC bottom-up models is complex
 - LRIC models require, among others, the estimation of demand and cost of equipment, which is a very subjective exercise. Given the subjectivity of the estimation exercise the process should be robust;
- The report does not address the impact of NGN's development;
- The accounting demarcation point of the relevant costs for termination service on fixed networks should be better explained to avoid problems of implementation;
- The consideration of costs for calculating the residual costs of wholesale termination service may lead to an increase in its costs due to the allocation of joint and common costs. Indeed, if the costs are first assigned to other services, such as SMS, MMS and broadband, in the case that there are common or joint costs they tend to be allocated to the last increase, calculated by difference as is suggested in recommendation;
- The criteria for definition of costs related to traffic (traffic related costs) should be further detailed, since it is not clear which costs and/or proportion should be considered traffic related costs, for example should billing and IN platforms costs be allocated to wholesale termination service.

Finally, it is desirable to clarify the method/regulatory framework for the definition and implementation of the model proposed by the Commission. Specifically, it is not clear for Sonaecom what role is up to national regulators, nor the involvement/obligations of operators in the cost model definition and implementation at national level. Obviously, this issue will only be relevant if a BAK system is not adopted, since, by definition, BAK dispenses cost models definition and implementation.