

**Sonaecom contributions on ERG public consultation on a draft Common Position on  
symmetry of mobile/fixed call termination rates**

**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?

In pursuing consumer welfare and economic efficiency regulators are faced with a difficult trade-off between static efficiency (seeking allocative and productive efficiency in the short term, in simple terms by setting prices at cost), and dynamic efficiency which involves promoting greater investment and competition to the long-term benefit of consumers, sometimes via higher prices.

Sonaecom considers that the general economic introduction of ERG document does not present this trade-off in a balanced way.

We think that the economic principles are presented aiming at the defense of symmetry. Therefore the impact of static efficiency (allocative and productive efficiency) is outweighed, while the (positive) importance of dynamic effects and the contribution of asymmetry for the establishment of a level playing field in the communications market is not enough highlighted.

The economic introduction should avoid stating that economic theory favours symmetry. In fact, economic theory has not been able to present a definitive answer about the best way to deal with the trade-off previously mentioned. In particular, economic theory has not been able to define the right balance between static and dynamic efficiency effects that maximizes global welfare in presence of asymmetries across operators.

Moreover, the communications sector is characterized by economies of scale and scope. Thus, operators with smaller market share have high average costs. Therefore, the imposition of an equal and unique termination rate distorts competition disadvantaging the smaller operators. This is the case even if the price is set at the smaller operator unitary costs. In that case the higher operator would benefit from a subsidy paid by smaller(s) operator(s). On the other hand, if the price was set at the level of the operator with the highest market share the smaller company would be unable to recover in full the production costs, and a deficient return of its investment is imposed upon it. This, we recall, is not in line with the article 13 of the Directive of

the European Parliament and of the Council on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive):

*National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved.*

To sum up, Sonaecom considers that it is too earlier to assume that the setting up of a unique and uniform termination rate for all networks operators (symmetric termination rates) should be taken as an objective to be pursued by NRAs. This requires further discussion before it can be considered as an absolute principle.

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

Please see the answer to question G1.

**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.

MTR and FTR are technically different and operate with different commercial models. Mobile and fixed services are not substitutes and are not valued equally by the consumers.

Moreover, the cost models that have been applied by the NRAs have demonstrated that MTR and FTR costs are effectively different.

Thus, Sonaecom believes that the convergence of MTR and FTR should not be a matter of concern.

➤ **Mobile questions**

**QUESTION M1:** Do you agree with the general principle promoting symmetry: “*Termination rates should normally be symmetric*”?

Sonaecom would agree with the general principle that termination rates should normally be symmetric if all the operators had had the same conditions since market entry and the sector was not characterized by economies of scale and did not present network effects. We know that this is not the case. Mobile operators entered the market in different moments in time and have benefited from different regulatory and commercial environment. Hence, first entrants have

better conditions to exploit economies of scale and adopt specific behavior to foreclose the market through the exploitation of network effects.

It is not possible to anticipate how long it will take to have the necessary conditions for symmetry. Thus, neither the promotion of symmetry nor the promotion of asymmetry should be set as an absolute principle or objective as it seems ERG intend to do in page 73 of the document. Instead, ERG should highlight that NRAs should take into due account the evolution of its market in order to decide whether the market has already reached the necessary conditions to define symmetric termination rates.

Nonetheless, we note that we can expect to achieve symmetric mobile termination rates as market – namely with the contribution of an asymmetric intervention – becomes effectively competitive.

***Exception to take into account exogenous factors, not related to a late entrance:***

**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?

Sonaecom agrees that exogenous factors that affect costs and are outside operators control may and should justify asymmetry.

Entry date/market share<sup>1</sup> and spectrum allocation differences affect costs and then justify asymmetry. Besides these factors, the presence of economies of scale and network effects also affects costs and should justify asymmetry in favor of smaller operators.

The impact of the exploitation of network effects by first entrants (with higher market shares) cannot be dissociated from costs. In fact, the exploitation of network effects undermines smaller operator's growth which in turn prevents the latter from take advantage of the economies of scale in the same extent as first entrants and results in higher unit costs.

Below we detail the impact of each of the factors that affect operators unit costs and should therefore justify asymmetry:

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<sup>1</sup> Although market shares may be determined by other factors the operators that initiated their commercial activities earlier have a competitive advantage to gain market share

### *Market entry date/market share*

The companies that first entered into the market benefited from several advantages that leverage future growth. Earlier entrants have more time to acquire customers, establish their business operations and understand market features. These allow first entrants to:

- Get higher network utilization that diminish unit and average costs
- Attract the earlier and heavier consumers of mobile services
- To know consumers and perceive market dynamics within a less competitive environment
- Set higher prices because of the soft competition
- Obtain the best places to roll out their network

Additionally, the date of entry may also be relevant because it means that operators have had different regulatory conditions to develop their activities. In general first entrants benefited from protection measures of mobile services. That was the case in Portugal. Considering that mobile service was a new service national authorities decided to set specific measures to incentive and promote mobile services, namely, giving the opportunity of mobile operators to set the retail price of fixed to mobile traffic. Vodafone and TMN benefited from this incentive during 8 years while Optimus operated under this exception during 2 years.

### *Spectrum allocation*

As stated in ERG document, the allocation of spectrum in different bands as well as the allocation under different conditions may lead to differences in costs. Therefore differences in spectrum and its allocation conditions may justify asymmetry in mobile termination rates.

### *Economies of scale and scope*

Mobile industry is characterized by economies of scale and economies of scope which imply that smaller operators will face higher average and unit costs of supplying each minute of traffic. This outcome is even more relevant in countries where regulator requires ambitious coverage obligations as happens in Portugal.

There are several studies that confirm the presence of significant economies of scale in supplying mobile services. There is also specific evidence that scale effects are present in Portugal. For example, as part of the merger proceedings with Portugal Telecom, Sonaecom presented evidence that Optimus' units costs were 20% higher than TMN's costs. In its consultation document ANACOM also describes evidence that Optimus has a higher ratio of base stations to traffic relative to both TMN and Vodafone. Also in the scope of the analysis of

the aforementioned takeover Portugal Telecom Group concluded, based on the LECG study regarding “Competitive effects of the proposed takeover of Portugal Telecom by Sonaecom”, that the minimum scale for an operator in Portugal corresponds to 5 million subscribers.

#### *Network effects*

As described in ERG document, operators with higher market share may adopt a strategy based on on-net/off net differentiation retail prices that forecloses the market by arming the acquisition (or even retention) of customers by smaller operators. In such situation smaller operators are put in a competitive disadvantage to gain market share and are not able to exploit economies of scale in the same extent as the higher market share operators.

Network effects undermine static and dynamic efficiency. First, network effects contribute to higher unit costs of smaller operators by preventing the increase of market share and, thus, the exploitation of economies of scale. Second, the exploitation of network effects in presence of asymmetries across operators weakens the level of competition in the market which, in turn, affects the global welfare in the medium/long run.

For further details please see answer to Question M8.

**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”?

Yes. Since allocation of frequencies in different bands may imply different network rollout costs may justify asymmetry in mobile termination rates.

#### ***Transitory exception to take into a significantly late entrance:***

**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”?

Yes. As we stated above, whenever intervening in termination rates regulators should consider static efficiency as well as dynamic efficiency. The latter justifies the adoption of measures to maintain the competition in the long run. Moreover, the date of market entry is an exogenous factor outside operators’ control that affects their unitary costs and then should justify higher termination rates.

In what regards the length of time to asymmetry, as long as we expect regulatory intervention to be effective and market to become effectively competitive, we may say that asymmetry will be set for a transitory period. However, the end of asymmetry only should happen when the factors that justify its introduction are addressed. The end of asymmetry should not be in itself a concern. NRAs must first of all to analyze whether the market conditions continue to justify/require asymmetry.

**QUESTION M5:** Do you agree with the principle of keeping the level of asymmetry “reasonable”?

Yes where *reasonable* comprises the cost differences among operators and a compensation for smaller operators due to larger operators’ strategies to foreclosure the market as a way to assure the competition level in the market.

**QUESTION M6:** Do you agree with the fact that an initial level should be accompanied by a glide path towards symmetry?

Sonaecom considers that asymmetry should be kept as long as factors outside operators control prevail, including larger operators’ behavior to prevent later entrants’ market share growth. Given that it is not possible to anticipate when factors that justify asymmetry will not be relevant anymore, we consider that the setting of a glide path towards symmetry should not be set as a rule.

Moreover, its worth to highlight that asymmetry should not constitute a problem, since the regulatory system may comprise a mechanism for endogenous adjustment. If the rate level ends up by being leveled by the production costs – through a price cap related with each companies’ positioning with reference to the average industry costs (i.e. the degree of exploitation of economies of scale) – then, the conditions are created to ensure that standardisation (or symmetry) can be reached, at the same time that operators start to share balanced market shares and technological progress enables a much faster attainment of economies of scale.

**QUESTION M7:** Do you agree with the fact that national factors should be taken into account to evaluate the length of the transition period?

Yes. The level of asymmetry and its length must take into account the national specificities, such as:

- The entry delay;
- The maturity of the market (a later entrant will face more difficulties in a mature market);

- The number of competitors;
- Different regulatory obligations attached to the license, including coverage obligations;
- The differences of regulatory environment after entry: in case of Portugal the first two operators benefited from specific regulatory measures to promote mobile services
- Whether later entrants have benefited or not from specific measures to compensate for late entrance in the past: for instance, Optimus entered into the market 6 years later than its competitors but has never benefited from asymmetry while it was practice in other European countries. Optimus - that initiated its operations 9 years ago - has been face increasing difficulties to grow because of the higher unit costs that it faces and on-net/off-net strategies on retail prices that have been followed by the larger operators. Thus, even if one NRA decided that asymmetry should end 9 years after the market entry, the decision could not be applied to the Portuguese situation because asymmetry has never been in place in Portugal before (which of course has required an additional effort from Optimus to compete in comparison with other 3<sup>rd</sup> operators that have benefited from asymmetry for years)
- Market competition dynamics, namely, whether first entrants adopt strategies to prevent market expansion from later entrants (such as on-net/off-net differentiation on retail side)

***Transitory exception before MTRs are at cost, to limit distortions created by MTRs above costs:***

**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?

Yes.

Sonaecom fully agrees that asymmetric MTRs are an adequate instrument to address the market failure that arises from larger operators' strategy of retail price on-net/off-net differentiation that undermines smaller operators' growth.

A framework of symmetric MTRs and traffic imbalance leads to net payments of smaller operators to its competitors which is to say that larger operators are subsidized by smaller operators. This transfer of money from smaller operators to larger operators further weakens the competitive position of smaller operators.

In view of that we fully agree that competition distortions arising from on-net/off-net differentiation of retail prices by larger operators also justify the setting of asymmetric rates.

About that, we point out that the issue of network effects has been recently noted with concern by both the competition and regulatory authorities in Portugal. There is evidence that Sonaecom is adversely affected by network effects and that this is impeding its ability to become an effective competitor. Additionally, asymmetric MTRs in favour of Optimus was indicated as an effective instrument to address the identified bottleneck arising from network effects in Portugal.

In its decision on the Sonaecom/Portugal Telecom transaction, AdC noted that smaller operators in the mobile market are at a disadvantage due to network effects and that this can affect their ability to exercise effective competitive pressure:

*“The sector is still characterized by externalities or network effects, which result in the price differential on-net/off-net practiced by the various operators.”* (Paragraph 859 of the final Decision on the Sonaecom/PT merger, of December 2006)

*“Given the gap between on-net/off-net prices customers show a preference to bind themselves to operators of larger dimension, which creates a clear competitive disadvantage for newer or smaller market players - that is, we are in presence of network economies.”* (Paragraph 862 of the final Decision on the Sonaecom / PT merger, of December 2006)

*“This phenomenon influences the competitive pressure that small operators may exert on larger operators, on the one hand, and constitutes a barrier to entry (and growing) in the market for new entrants, in particular, at phase in which the rate of market penetration has already exceeded the 100%,”* (paragraph 863 of the final Decision on the Sonaecom / PT merger, of December 2006)

The AdC also noted that only a reduction in the network effects operating against Optimus (possibly through asymmetric regulation of termination rates) would allow the third player to aggressively compete in the market and that should be pursued by an asymmetric decrease of MTRs:

*“AdC considers that only a significant mitigation of network effects and costs of change could contribute to Optimus<sup>2</sup> recover its competitiveness. However, in current scenario*

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<sup>2</sup> Optimus is the mobile arm of Sonaecom



*it does not foresee ways to significantly mitigate the network effects - unless through an asymmetric reduction of tariffs for call termination, solution that has been denied by the regulator - in that case operators of smaller dimension, in casu Optimus, will face increasing difficulties to adopt aggressive competitive postures. "(Paragraph 963 of the final Decision on the Sonaecom / PT merger, of December 2006)*

Its worth noting that Vodafone Portugal in its comments on AdC's draft decision about Sonaecom/PT merger also agreed with the application of specific measures to address the drawbacks in competition arising from network effects and claimed for the application of such measures to itself if the merger of TMN and Optimus succeed:

*"Vodafone agrees that the commitments offered by Sonaecom, whether regarding compensation of any new MNO by a hypothetical imbalance of the balances of interconnection, whether referring to the price differential on-net/off-net, are possible means of mitigation of benefits of network effects caused by the high market share of the operator resulting from the operation". (Paragraph 2708 of the final Decision on the Sonaecom / PT merger, of December 2006)*

*"[Vodafone] believes that the commitments made by Sonaecom with a view to mitigate the effects of network should necessarily be applicable to Vodafone because, otherwise, it will be greatly hampered in its ability to exercise a real competitive pressure." (Paragraph 2709 of the final Decision on the Sonaecom / PT merger, of December 2006)*

More recently in their comments to ANACOM's draft decision on MTRs, AdC confirmed its preference for an asymmetric MTR in order to mitigate the competitive disadvantage faced by a smaller operator, especially in a context where the latter entered at a later stage (ANACOM's draft decision document, p 19).

The data reported by ANACOM in its draft decision of October 2007 reviewing MTRs in Portugal also confirms the existence of large network effects in Portugal.

Furthermore, the presence of network effects appear exacerbated in Portugal by the traffic imbalance that has consistently worked against Optimus. The transfers of Optimus to TMN and Vodafone due to the imbalance of traffic and symmetric MTRs already amount to 120 million euros! It undoubtedly distorts competition in favour of larger operators at cost of Optimus and requires the introduction asymmetric tariffs between Optimus and its competitors.

Lastly, we point out that must be kept in mind that cost orientation of MTRs does not assure by itself that larger operators would not use on-net/off-net retail prices differentiation as a mean to “lock” their current customers and attract smaller operator customers and then weakening competition. Therefore, even in a scenario of cost oriented MTRs, NRAs should follow on-net/off-net retail prices differentiation by larger operators carefully.

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

In principle we agree that prices should be oriented by production costs. Nevertheless, they should be set at an incentive compatible level, such as to promote the efficient use of resources in a competitive environment. In doing so, the regulator should keep in mind the effects that this regulatory policy has on the final prices charged to consumers. Mobile operators receive revenues both from wholesale (MTR) and retail (final consumers) activities. They seek to optimize this mix as to allow the required return on capital. If we impose a regulatory change on one part, the firms will strategically adjust the other. Overall, the change in consumers’ prices depends on many constraints, which should be subject to detailed examination on each particular case. *As such, the application of such principle could not ignore the conditions of each national market, namely, the way competition evolved among operators and their current relative position. In particular, NRAs must take into account the impact of strong and abrupt decline of MTRs on operators capacity to compete, in particular, on smaller operators.*