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Link between termination rates and retail prices in Namibia, Kenya and South Africa

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ABSTRACT

This paper analyses the link between mobile termination rate reductions and retail prices. It draws on in-depth case studies of South Africa, Namibia and Kenya where regulators have reduced termination rates towards the cost of an efficient operator. To varying degrees these have all led to lower retail prices and significant market expansion. While retail prices in both Namibia and Kenya dropped following substantial termination rate reductions, the South African case demonstrates that termination rate reductions are not always passed on to consumers as is hoped by such regulatory interventions. In South Africa, it was only after the second reduction in March 2012 that smaller operators were able to reduce their off-net prices to a level that could tempt the subscribers to dominant operators to switch. All the case studies confirm nevertheless that retail prices do not go up in response to termination rates going down as contended by dominant mobile operators around the world. This is in contrast to a body of literature stating that termination rates and mobile retail prices constitute a two-sided market and that termination rate reductions will lead to a so-called “waterbed effect”.

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1. Introduction

Call termination is a monopoly and overwhelming international evidence exists that show cost-based termination rates to encourage competition and more affordable pricing.² Cost-based termination rates remove market distortions and provide efficient investment incentives. The net effect of fairer competition is the decreased cost of communication, better services and more equitable returns on investment for all operators (Stork, 2011a, 2012).

This is not surprising. Ordinarily, retail prices are a function of wholesale prices within a market, where lowering wholesale prices allows the lowering of retail prices. The same holds for off-net retail prices and mobile termination rates as well as for mobile to fixed-line calls and fixed termination rates.

In justification of high termination rates, dominant mobile operators have argued that that this is not the case in the telecommunications industry. They have argued that lowering termination rates will lead to increases in access and use prices, resulting in fewer people being able to afford communication services and lower profits that limit operators' capacity

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to invest.³ They have argued that this is because the telecommunications market is two-sided and an adjustment to pricing in one market automatically creates pricing effects in another.⁴ A body of academic literature developed around this proposition argues that termination rates and mobile retail prices constitute a two-sided market and that termination rate reductions will lead to a so-called “waterbed effect”.⁵ However, the two fundamental principles for price setting in two-sided markets, identified by Evans (2007) and described below, do not apply to the relationship between termination rates and retail prices:

- *Interdependent prices*: Prices are determined interdependently, i.e. changing the price for the one side will change the price of the other side.
- *No cost causation*: No direct link between the incremental cost of a good or a service and their prices exists.

First, cost causation exists since mobile termination rates (MTRs) set a floor for off-net call prices and for the prices of calls from fixed lines to mobiles. Off-net prices below a set MTR would, for example, result in a loss for every off-net minute dialled. Thus, the level of MTRs is a cost factor for outgoing calls (off-net calls).

The reasons why MTRs and retail prices are not interdependent are:

- Termination rates are not prices that are set to maximise profits; they are contractual arrangements between operators to enable them to gain reciprocal access to each others' networks. These are unlikely to change unless it is in the interests of the operators involved to change them, but because they are costs recovered in effect from the other network's customers, it is not in the interest of operators to do so, prompting regulators to intervene.
- An operator cannot increase MTRs because its market share has increased, something that would be suggested in a two-sided market. Termination rates are mostly symmetrical between mobile operators, and as such, contradict the two-sided market argument. Both networks get the same nominal value for terminating calls irrespective of their customer base. If rates are asymmetrical due to regulatory intervention, then the smaller network is allowed to charge more.
- MTRs are wholesale costs and wholesale revenue at the same time. Reductions in termination revenues are accompanied by reductions in termination expenditure.
- MTR reductions can be passed on to subscribers, which leads to a decrease in off-net prices. Should it not be passed on, then the operator makes more money for each outgoing minute, compensating for the loss in the termination revenue through the MTR reduction. These are concrete choices an operator can make depending on what it thinks will maximise profits. Thus, changes in termination rates do not bring with them automatic alterations to retail prices.
- Retail prices are complex and diverse. Pricing strategies are driven by user profiles, market niches and competitive pressures, not revenue replacement.
- Operators can only set their own retail prices and not those of other operators. Yet other operators' off-net prices will influence how many calls are being received from other operators and, hence, the level of termination rate revenue.
- If termination rates and retail rates were interdependent, then one would also be able to observe increases in termination rates when retail prices decrease. Price interdependence has to work in both directions.
- Termination rate payments are payments between operators. The industry consists of net-payers and net-receivers of termination rate payments. Termination could not be a two-sided market for net-receivers and an ordinary market for net-payers. Net-payers will benefit directly from lower termination rates and may, in response, set their prices differently to net-receivers.

Waterbed effect theorists argue against lowering the arbitrarily set termination rates to the cost of an efficient operator, without providing an alternative basis for determining termination rates. No one has proposed to increase termination rates in order to lower retail rates, which would be the logical consequence if it were truly a two-sided market.

From this discussion it is clear that termination rates and retail rates do not constitute a two-sided market, and that there is no unified response from operators as a result of termination rate reduction – certainly not one in favour of raising retail prices. New operators or smaller operators are likely to be the first to reduce their off-net prices so as to compete with the on-net prices of dominant operators. How far retail prices are lowered following termination rate cuts depends on many factors, in particular, the competitive pressure within the sector.

Three cases are presented in this paper.⁶ The Kenyan example demonstrates how the market reacts to an incumbent mobile operator that does not reduce prices after termination rate cuts while the smaller operators did. It also demonstrates the impact on traffic and subscriber numbers if the incumbent tries to unilaterally increase retail prices. The mobile termination reductions in Namibia did not lead to the same radical price cuts witnessed in Kenya, but instead led to a

³ Examples include: www.vodafone.com/content/dam/vodafone/about/public_policy/policy_papers/public_policy_series_7.pdf, <http://www.accc.gov.au/content/item.phtml?itemId=700366&nodeId=5cdb00ba048a0dd1a4df11721e754e1&fn=Letter%20re%20Frontier%20report%20on%20waterbed%20effect%20-%20July%202005.pdf> and <http://stakeholders.ofcom.org.uk/binaries/consultations/wholesale/responses/vodafone.pdf>.

⁴ For a more detailed account see Stork (2012).

⁵ For example Genakos and Valletti (2012) and Sandbach and Hooft (2009).

⁶ These three cases are discussed in brief and do not include a full sector analysis which can be downloaded from: www.researchictafrica.net/publications.php

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