Cellphone rates Allison Gillwald

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Lower termination fees may spark telecoms turnaround

MUCH has been made of Vodacom's R800m loss of revenue in the six months to September, owing to the reduction in termination rates from R1,25 to 89c in March, reported in its interim results last week.

As if to confirm the dire warnings by MTN and Vodacom following the decision by the Independent Communications Authority of SA (Icasa) late last month to cut further the rates of dominant operators, this loss of revenue has been used to flag the threat of a future loss of earnings that would have been received from terminating the calls of their competitors on their networks.

From a policy and regulatory perspective, these results demonstrate a far more positive outcome than was widely reported in the media. Despite the loss of earnings from interconnection — an expected outcome of the introduction of regulated cost-based pricing following years of extractive pricing — overall revenue and operating profits have continued to grow.

It is true that this was at a slower rate, with Vodacom's earnings before interest, tax, depreciation and amortisation (ebitda) increasing by only 7% in the first six months of this year, compared with 10,5% for the whole of last year. But ebitda margins remain constant at a healthy 33,2% over the past three years, and Vodacom's share price is constantly on the rise.

Historically, prices have been exceptional as a result of unregulated pricing in a duopoly market. In the five years before the impending entry of the third cellphone operator, Vodacom and MTN increased their termination rates by 500%, where they have remained since 2002, despite world prices dropping to a fraction of this.

Cost-based termination rates limit these pricing distortions in the market and reduce barriers to fair competition.

The transfer between operators caused by above-cost termination rates is generally to the disadvantage of fixed-line operators, small cellphone operators and new entrants to the markets, while it is to the advantage of the dominant cellphone operators.

While the focus has been on the loss of revenue, reduced termination rates of course also decrease the costs of termination for operators. This produces efficiencies in the network that can reduce end-user prices and offset losses in interconnection revenue through increased demand and usage, and the more productive use of the network.

Usage has indeed increased, with average revenue per user and minutes of use up, though this is best explained by the disconnection of millions of subscribers unable to comply with the statutorily required registration of SIM cards.

From a policy perspective, the Regulation of Interception of Communications and Provision of Communication-Relation Information Act (Rica) has alienated poorer South Africans from communications services, with debatable security gains. With the effects of this stabilising, however, Vodacom gained more than 1-million voice subscriptions in September alone. This, together with MTN's continued subscriber growth over this period, suggests SA will soon follow the trends elsewhere in the world, where subscriber growth has accompanied the reduction of termination rates. The speed and degree to which this happens depends on the speed and degree to which the reduced cost of terminating calls on competitors' networks is passed to consumers.

Despite warnings from the dominant operators that this cost saving in interconnection charges does not automatically get passed through to customers and that retail prices could even be used to offset termination-rate losses, Vodacom reports that effective rates per megabyte have fallen by 16%, and effective rates per minute on voice have declined by 16,9% in the six months to September 30, demonstrating some competitive pressure on pricing, most likely attributable to greater pricing flexibility enabled by reduced termination rates.

The question for the regulator is whether these reductions are sufficient in relation to the termination-rate reductions of about 30% and, if not, will it prompt a review of cellphone retail rates?

In most countries where termination prices have already been reduced to bring them towards cost, this has not been necessary. Where these have been significant, they have resulted in retail price reductions with enormous consumer gains.

Icasa regulations will require MTN and Vodacom to reduce their peak cellphone call-termination charges to 73c a minute by March next year, to 56c a minute by March 2012 and to 40c by 2013. Off-peak cellphone termination rates will drop to 65c a minute by March next year and to 52c a minute by March 2012, with the off-peak charge reaching 40c a minute by March 2013. This will finally bring South African termination rates in line with some of the more dynamic telecommunication markets in Africa, which have emerged in the past few years from effectively regulated wholesale prices.

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Ghana, Kenya, Tanzania and Uganda have already seen the positive effects in increased usage, with more affordable prices and, in many cases, as we see with Vodacom, greater profitability. Of course some of these more dynamic markets, such as in East Africa, are already undergoing second-round reviews of the interconnection rates, which will by 2013 be far lower than SA's.

An analysis of those countries that have reduced termination charges indicates that, far from what was predicted by their dominant operators, their subscriber bases have grown, their traffic volumes have increased, and their overall profitability has been sustained. The competitive benefits are greatest in those markets with more than four players, though many more can fragment the market to the incumbents' advantage.

What we also see is that where markets are most competitive, such termination-rate reductions positively affect end-user prices most quickly and dramatically, with new entrants able to exploit reduced termination rates to undercut the historical price floor of the dominant operators on the basis of their dominant share of the market.

After the latest dramatic reduction of termination rates in Kenya, end-user prices plummeted, with Zain, recently bought by Indian budget operator Bharti-Airtel, reducing prices by a dramatic 67%. This was followed by a 50% cut by Orange, which has the second-largest market share. Even the hugely dominant Safaricom had to drop prices by nearly 12%. The effect of the next round of termination reductions should show whether the reductions are enough for more smaller players to exploit, and whether SA's market is competitive enough to exploit this intervention in consumers' favour.

So, despite the first round of termination-rate reduction coinciding with one of the worst economic downturns yet and the costly introduction of Rica, judging from Vodacom's results, the sector has shown all the robustness that it has exhibited globally.

The results of other operators and service providers should confirm the competitive benefits of cost-based wholesale rates, which should start filtering through to the end users. This may turn around the suboptimal access and usage of information communication technologies in SA and start its ascent up the global indices instead of the steady decline of the past decade.

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