Data Market Inquiry

Afrihost

Agenda

- Key Questions

- Openserve fixed line pricing
  - Introduction
  - Excessive pricing evidence
    - IP Connect technical diagram
    - IP Connect input costs & cost comparison
    - IP Connect competitor price comparison
    - Margin squeeze in fibre
    - ADSL retail pricing
    - Upstream profits & downstream losses
    - IP Connect price decreases and volume increases
  - Abuse of dominant position

- Recommendation

afrihost

Key Questions

Are data prices in South Africa (whether mobile, fixed or other) higher than they ought to be?

- Yes

To the extent that data prices in South Africa are higher than they ought to be, what are the factors that drive these outcomes?

- Our submission focuses on fixed data prices, specifically ADSL/VDSL and fibre. There is one over-riding factor causing excessive pricing – the price charged by Openserve for IP Connect.
- (Mobile data also appears to be overpriced but we have not done sufficient research in the mobile market to comment further at this stage. We do however know that mobile operators offer some retail packages at rates below wholesale prices so it is almost impossible for a reseller to compete with a mobile network operator)

How can these factors be effectively remedied?

- Fortunately, this IP Connect factor is easy to remedy. Openserve need to be forced to comply with the spirit and principles of the settlement agreement entered into between Telkom and the Competition Commission in 2013. IP Connect pricing must be reduced to a reasonable cost plus model in as short a time-frame as

Key Questions

- Afrihost recommends a decrease to a reasonable cost plus price of R10 per Mbps. If necessary, this could be done over a period of time. For example, with a glide path of R55 decrease per annum commencing immediately and continuing as follows:

Current price =	R175 (cost per Mbps per month)	
2018	=	R120
2019	=	R65
2020	=	R10

- Openserve have defined their IP Connect product and provided a technical diagram on their website. It should be relatively easy to obtain and evaluate their costing model to validate the excessive pricing argument.
- With a good benchmark competitor in the fibre market (Vumatel) , it is easy to compare the wholesale fibre pricing model to that of Vumatel.
- Once IP Connect is reduced, the competitive ISP landscape will quickly lead to price decreases in fibre and ADSL to benefit end-users and the economy in general.

Key Questions

What is the impact of data prices and access to data more broadly on lower-income customers, rural customers, small businesses and the unemployed?

- Many SME's use fixed line services for their business connectivity needs. Lack of access to high speed, high volume data impacts SME's ability to function and grow thereby inhibiting employment in the economy
- Lower income and rural earners cannot afford or access high volumes of data. This impacts many spheres of life including education; access to employment opportunities; communication and entertainment.

How important are affordable data prices for these customers?

- Very important. Just looking at how much low income earners spend on very small mobile data packages shows the significance of data in their lives.

- Interesting quote from a McKinsey research report: "Public-sector leaders ought to promote broad access to the Internet, since Internet usage, quality of infrastructures, and Internet expenditure are correlated with higher growth in per capita GDP".
    - *Source: https://www.mckinsey.com/industries/high-tech/our-insights/internet-matters*

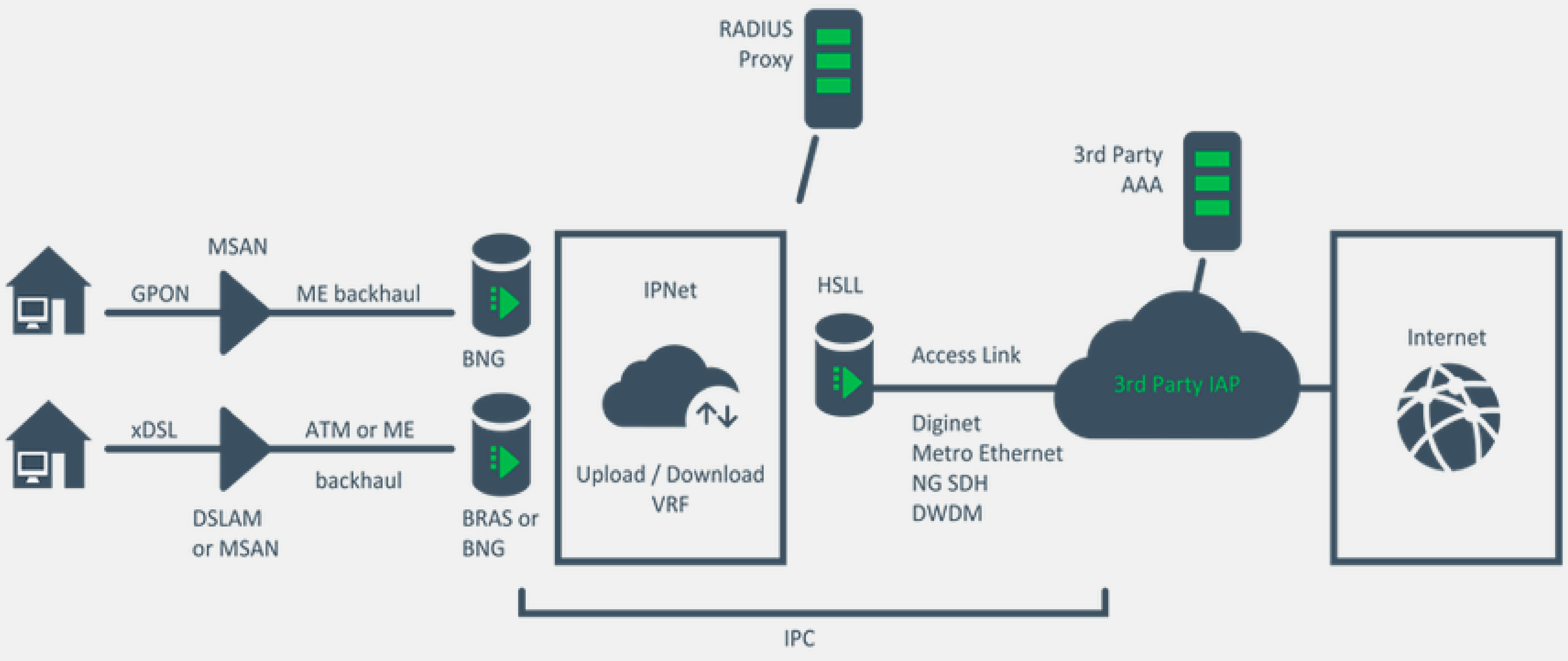
Openserve Fixed Line Services - Introduction

1. Openserve fixed line wholesale services, specifically ADSL/VDSL and Fibre are excessively priced.
2. This is as a result of the IP Connect Service which remains exorbitant in relation to competitors and in relation to input costs.
3. In the case of fibre, the impact is felt primarily in the downstream ISP market where ISPs are providing Openserve fibre at retail prices which are below cost.
4. In the case of ADSL, the impact is felt primarily at the end-user level where end-users pay too much for an average service when one considers the cost of the telephone line rental, the ADSL line rental and the ISP data charge.
5. Openserve is a dominant player in fixed line and is abusing this power.

IP Connect Technical Diagram

Why Openserve? | Browse Products | About | Queries | Client Centre | Login | Check Coverage

Technical Diagram



IP Connect Input Costs & Cost Comparison

- IP Connect is from the BRAS/BNG to the ISP infrastructure.
- Costs include access links and equipment which should not be excessive.
- Costs to connect the end-user to the BRAS/BNG are covered in the Resell DSL product or the fibre line rental.
- IP Connect is essentially the cost of local backhaul from the Openserve point of aggregation to the ISP infrastructure, located in Teraco data centres in Johannesburg, Cape Town and Durban.
- International bandwidth pricing, which traverses huge distances and involves undersea cables and maintenance, is a fraction of the cost of IP Connect, approximately R30 per Mbps for a fully redundant solution. How can a local IP Connect solution cost 6 times more than international bandwidth?
- A cost of R175 per Mbps per month cannot be justified.

IP Connect Price Comparison

1. Openserve's largest competitor in the fibre fixed line market is Vumatel.
2. Vumatel's IP Connect equivalent, connecting the ISP network with the Vumatel network, is outsourced to Automation Exchange.
3. The Automation Exchange charge is approximately R6 per Mbps per month.
4. The Openserve IP Connect charge is R175 per Mbps per month.
5. Openserve is 30 times more expensive!
6. Many of the fibre operators don't charge at all for an IP Connect equivalent. They recover their costs in the line rental charge. A cost which Openserve charges in addition to IP Connect.

IP Connect Margin Squeeze

- Using Afrihost as an example, the monthly **loss** on Openserve fibre is approximately 10% of revenue.

- For every R1m revenue, Afrihost loses approximately R100,000.

- The loss is even more if we take into account:
  - Overheads and employee costs.
  - Subsidies on installation and activation costs.
  - International bandwidth costs

- At a high level, for every R1m revenue on Openserve fibre, we incur costs of approximately:
  - R550,000 on line rentals.
  - R550,000 on IP Connect.

- Why do we sell Openserve fibre below cost?
  - To remain competitive in the market against Telkom Retail and other ISPs.
  - To ensure clients have a decent fibre experience (we cannot manage IP Connect unreasonably).
  - In expectation of IP Connect decreases which should be inevitable BUT have been too little too late

ADSL Retail Pricing

- ADSL pricing is too expensive when one factors in the 3 cost components. Openserve is no longer investing significantly in its copper network and doesn't have obligations to provide fixed line solutions to under-serviced areas.

- Using a 4Mbps 100GB cap and an uncapped 20 Mbps business package for illustrative purposes:

	100GB Cap	Uncapped
• Retail line rental incl. VAT:	R200	R200
• Retail ADSL line rental incl. VAT:	R301	R503
• ISP data charge incl. VAT:	R109	R1,917
• **Total cost to end-user:**	**R620**	**R2,620**

- In the capped example, the ISP gets only R109 revenue and has to pay approximately R80 of that for IP Connect.
- The end-user pays R620 for a capped service at a relatively low speed.

- In the uncapped scenario, the ISP gets a bigger portion of the revenue but most of it goes to funding the IP Connect costs
- The end-user/SME pays R2,620 for an uncapped business ADSL solution

Telkom Segmental Reporting – March 2018

	Openserve Rm	Consumer Rm
Revenue	**17 570**	**17 157**
Fixed	17 570	9 208
Mobile	-	7 949
Cost of Sales	49	3 615
Payments to other operators	1 296	1 247
Net Revenue	**16 225**	**12 295**

Other income	345	807
Operating expenses	10 656	13 285
Employee expenses	4 145	1 003
Selling, general and administrative expenses	4 415	11 483
Service fees	1 502	323
Operating leases	594	476
EBITDA	**5 914**	**(183)**
EBITDA margin (%)	**34%**	**-1%**

Source: TELKOM SA SOC LIMITED - Group Provisional. Annual Results for the year ended 31 March 2018

Upstream profits & downstream losses

- The Telkom segmental reporting provides strong evidence that Telkom may have contravened their 2013 agreement with the Competition Commission

- IP Connect is grossly over-priced leading to excessive profits in Openserve of R5.9 billion at an EBITDA margin of 34%

- Consumer (Telkom Retail) shows a loss of R183 million. However, Telkom disclose in their annual results that their mobile division made a profit of R1,7 billion. This profit is included in the Consumer loss of R183 million.

- This means that Telkom have made a loss of R1.9 billion in their fixed line consumer business.

- This is anti-competitive because ISPs are having to compete with a business that can suffer significant losses downstream while their upstream division reaps the rewards of excessive profits.

IP Connect price decreases & volume increases

- Openserve pricing as at November 2016 was R322 per Mbps per month (volume dependent).
- Openserve pricing today is R175 per Mbps per month.
- This is a price decrease of 46%.
- Using Afrihost as an example, IP Connect usage is up approximately 50% since November 2016.
- The unit price may have decreased but because of the huge increase in volumes, Openserve's IP Connect revenue remains excessive in relation to its input costs.

Evidence regarding Openserve being a dominant provider

- Openserve is dominant by definition in that it has approximately 75% of the fixed line market when aggregating ADSL/VDSL and fibre.

- ADSL/VDSL market share is 100% because of the legacy monopoly.

- The fibre market is a bit more complex. In essence, each suburb or geographical area is a market of its own. This is because it is not commercially viable for too many fibre providers to enter the same suburb. Sometimes there will be only one fibre provider in a suburb so the first provider to install their infrastructure will own that market.

- Often there is place for a second provider to invest but one seldom finds more than two providers in a market (suburb).

- The result is that Openserve have 100% of the fibre markets where they are the only provider and approximately 50% of the markets where there are 2 providers

Conclusion & recommendation

- The undertakings and principles of the 2013 settlement agreement must be complied with by Openserve ensuring that IP Connect is priced on a non-discriminatory basis, using a cost plus reasonable margin methodology.

- At current IP Connect pricing, Openserve is abusing its dominant position with:
  - Excessive pricing; and
  - Margin squeeze

- Afrihost would consider R10 per Mbps to be a reasonable price point for IP Connect

- The ISP market is very competitive and IP Connect cost decreases would inevitably lead to decreases in the retail market benefitting SME’s, end-users and the economy.

Thank you