



**Report on Telstra's compliance with the
price control arrangements:
January 1998 to June 1999**

July 2000



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Letter to Minster

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1. Overview

1.1. Introduction

Under paragraph 151CM(1)(b) of the *Trade Practices Act 1974* (the Act), the Australian Competition and Consumer Commission must report to the Minister on Telstra's compliance with the price control arrangements. This report satisfies that requirement for the 18-month period from 1 January 1998 to 30 June 1999.

The price control arrangements affecting Telstra over this period are set out in two determinations:

- *Telstra Carrier Charges — Price Control Arrangements, Notification and Disallowance Determination 1997* (the first determination) for the 1998 calendar year; and
- *Telstra Carrier Charges — Price Control Arrangements, Notification and Disallowance Determination 1997 (Amendment No. 1 of 1998)* (the second determination) which extended the first determination from 31 December 1998 to 30 June 1999, after which a new determination came into effect.¹

Under the determinations the Commission only has to ascertain whether Telstra has complied with the price control arrangements. It does not have any additional role if Telstra has failed to comply.

The price control measures in both determinations were substantially the same, with the services covered by the price cap arrangements not altered. In particular:

- the eight telecommunications services provided by Telstra subject to the main price cap were connections, line rentals, local, trunk and international calls, domestic and international leased lines and cellular mobile telephone services;
- Telstra's telecommunications services subject to the individual annual price caps were the provision of individual connections, line rentals, trunk call and international call services to residential customers. The price movement for the individual services is calculated using standard prices;
- the weighted average untimed local call price for residential and charity customers in non-metropolitan Australia in the current period is not to exceed the weighted average local call price for residential and charity customers in metropolitan Australia in the previous period;

¹ The first and second determination will be referred to as the determinations when used in the context of provisions that are substantially the same.

- the weighted average untimed local call price for business customers in non-metropolitan Australia in the current period is not to exceed the weighted average local call price for business customers in metropolitan Australia in the previous period;
- a cap of 25 cents per call for untimed local calls made from a residential or business phone, and a cap of 40 cents per call for untimed local calls from Telstra public payphones;
- Telstra may not increase any charge subject to the price control arrangements by more than the CPI without prior consent from the Commission; and
- Telstra must notify the Minister in advance of an intention to alter charges for Directory Assistance (013) services, with the Minister able to disallow the proposed changes if he or she considers that the changes would not be in the public interest.

The second determination amended the first determination to incorporate the extended period. The amendments were:

- the price cap applicable to the eight telecommunications services subject to the main price cap in 1998 was halved from CPI–7.5 per cent to CPI/2–3.75 per cent for January–June 1999;
- the individual annual price caps were halved from CPI–1 per cent in 1998 to CPI/2–0.5 per cent for January–June 1999;
- Telstra could carry forward any credits earned in 1998 into the extended period for the overall price cap and sub-caps;
- Telstra could elect to defer its obligations to reduce prices under the price cap on the eight core services to the extended period; and
- halving the limit on price increases before the Commission’s consent was required.

1.2. Summary of Telstra’s compliance

Telstra informed the Commission about its compliance with the price cap arrangements for the 1998 calendar year and January–June 1999. Having assessed the information, the Commission is satisfied that Telstra has complied with the price cap requirements for both periods. However, Telstra has not complied with the metropolitan/non-metropolitan pricing parity requirement, albeit to a very small extent. (For example, the Commission understands the average effect of Telstra’s non-compliance was just over one local call per non-metropolitan residential and business account over the first half of 1999.) In 1998 Telstra did not meet the pricing parity requirement only for business customers, while in the first six months of 1999, Telstra failed to comply for both business and residential customers.

1.3. Auditing of Telstra's information

Under subclause 9(3) of the determination, price movements are calculated according to a methodology the Commission established in consultation with Telstra.

Accordingly, the *Methodology for Administration of the Telstra Price Control Arrangements* for both the 1998 calendar year and January–June 1999 was prepared.

Under the methodology, Telstra must provide an externally audited statement of its compliance.² Initially, Telstra gave the Commission an audit report for its 1998 price control arrangements, but not for January–June 1999. (Telstra's view was that there was uncertainty about whether an external audit was required for January–June 1999.) The Commission clarified that an external audit report was required, which Telstra provided on 1 June 2000.

² Details of the auditing requirements are set out in the attachment.

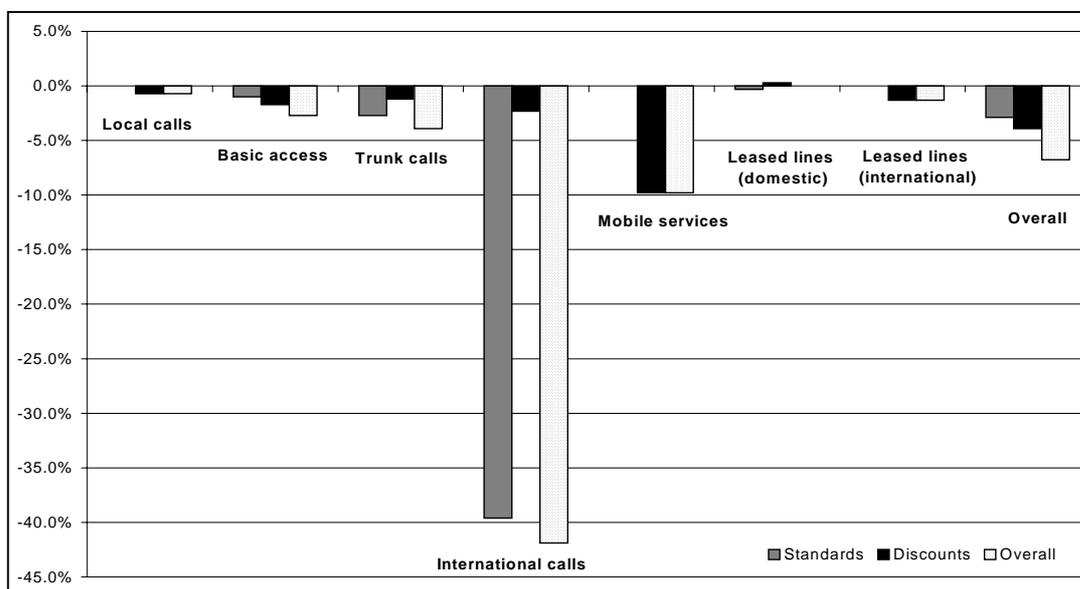
2. Telstra's compliance with the price control arrangements in 1998

At the end of 1998, Telstra gave the Commission information about its compliance with the price cap arrangements for that year. Having assessed the information, the Commission is satisfied that Telstra has complied with the 1998 price cap requirements for both the overall CPI-7.5 per cent basket and the individual service CPI-1 per cent sub-baskets. While Telstra has complied with the metropolitan/non-metropolitan pricing parity requirement for residential customers, it has not complied with the requirement for business customers by 0.08 cents. That is, business customers in 1998 in non-metropolitan areas paid 0.08 cents per call on average more than business customers did in 1997 in metropolitan areas. Telstra's non-compliance is explained further in section 4 of this report.

2.1. Overview of price movements in Telstra's services in 1998

Figure 2.1 shows the size of price movements in Telstra's services subject to the price cap obligations. It shows revenue weighted changes in standard prices and non-standard prices, and overall price changes. Figure 2.1 is based on the calculations shown in Table 2.1.

Figure 2.1 Standard and discount components of Telstra's price changes for price-capped services in 1998



Prices for basic access and local calls

Telstra's reduction in average prices of 2.7 per cent for basic access and 0.7 per cent for local calls occurred largely through discounts. Take-up of the Easysaver flexi-plans continued to grow. These plans offer customers a more expensive basic access price for cheaper local calls, with Easysaver 15 the most popular package for residential customers during this time. It offered \$15 per month access with 20 cents local calls.

Prices for trunk long distance calls

Prices for trunk long distance calls were subject to increased competition in 1998 with a number of carriers and service providers offering various pricing structures for national long distance calls. Telstra reduced prices for these services by 3.9 per cent in the year.

Telstra offered discounts in the form of temporary specials (i.e. short term discounts off standard tariffed rates for weekends) and amendments to, or introduction of, volume-based discount pricing plans. This included the \$3 'all you can talk' offer, introduced initially as a special promotion for long distance calls made between Monday to Friday 8 p.m.–midnight.

Prices for international calls

Telstra reduced prices for international call routes by 41.9 per cent during the year and introduced a new form of charging (Easy Half Hours) allowing customers to be charged a flat fee for calls made in half-hour blocks.

Prices for mobile services

Prices for mobile services in the AMPS and GSM networks decreased by a combined total of 9.8 per cent in 1998. Telstra has indicated this was attributable to free or discounted connection to the network. It also introduced the Budget 10 flexi-plan for low spend customers on GSM.

Prices for leased line services

Overall, prices for domestic leased line service were unchanged for the year although international leased line prices decreased by 1.3 per cent in 1998.

2.2. Telstra's compliance with the overall CPI–7.5 per cent price cap

As mentioned above, the first determination provides that the price movement of the basket of services must not exceed CPI–7.5 per cent. The basket of services include connections, line rentals, local, trunk and international calls, domestic and international leased lines and cellular mobile telephone services. Because the relevant CPI in 1998 was 0.3 per cent, the resulting figure for Telstra's overall price cap formula (CPI–7.5

per cent) was minus 7.2 per cent. This means Telstra was required to *reduce* its overall charges by a revenue-weighted average of 7.2 per cent for 1998.

Table 2.1 Telstra compliance with overall CPI-7.5 per cent price cap in 1998

Service(s)	Change in standard prices ³ (%)	Change in non-standard prices (discounts) ⁴ (%)	Overall price change (%)
Local calls	0.0	-0.7	-0.7
Basic access ⁵	-1.0	-1.7	-2.7
Trunk calls ⁶	-2.7	-1.2	-3.9
International calls ⁷	-39.6	-2.3	-41.9
Mobile services ⁸	0.0	-9.8	-9.8
Leased lines - domestic - international	-0.3 0.0	0.3 -1.3	0.0 -1.3
Overall price cap (revenue weighted)	-2.9 ⁹	-3.9 ¹⁰	-6.8

Table 2.1 shows that Telstra actually reduced its revenue-weighted price capped charges by 6.8 per cent. With a carry over from 1997 of 0.46 per cent, Telstra has satisfied the CPI-7.5 per cent cap and carries over a credit of 0.03 per cent into 1999.

2.3. Telstra's compliance with the individual CPI-1 per cent sub-caps

The determination also specifies that charges for connections, line rentals, trunk calls and international calls are subject to individual CPI-1 per cent sub-caps. Price movements for the individual service are calculated using standard prices. Table 2.2 compares the changes in Telstra's standard prices for residential customer services subject to individual CPI-1 per cent sub-caps together with the corresponding CPI-1 per cent requirement. Under the CPI-1 per cent caps, Telstra was required to decrease its prices for the services covered by each sub-cap by at least 0.7 per cent

³ 'Change in standard prices' reflects movements in retail prices, excluding discounted prices and packages, as a proportion of gross revenue for that product.

⁴ 'Change in non-standard prices (discounts)' reflects the sum of (i) changes in flexiplan discounts in the current year from the previous year and (ii) specials, as a proportion of gross revenue.

⁵ 'Basic access' includes charges for connections and line rentals.

⁶ 'Trunk calls' includes STD (Telstra's brand name for its fixed network domestic long distance call service), community calls, pastoral calls and fixed line calls to mobile services. As a result, the method of calculation differs from the other types of services. Both changes for standard prices and non-standard prices are calculated using gross revenue from STD calls and fixed line calls to mobiles as weights.

⁷ 'International calls' refers to Telstra's IDD and international operator assisted call products.

⁸ 'Mobile services' refers to Telstra's mobile network access and call charges.

⁹ The overall price cap for change in standard prices is weighted by the gross revenue of each service.

¹⁰ This is a balancing item.

during 1998. The comparisons show that Telstra met this requirement in the case of all four sub-caps.

Table 2.2 Telstra's compliance with CPI-1 per cent sub-baskets in 1998 (standard changes for residential customers)

Sub-basket	Price cap requirement	Credit from 1997 (%)	Total allowable price change (%)	Change in standard prices (%)	Compliance
Connections	CPI-1 = -0.70	5.2	4.5	0.0	Yes
Line rentals	CPI-1 = -0.70	5.2	4.5	-1.2	Yes
Trunk calls	CPI-1 = -0.70	18.3	17.6	-2.7	Yes
International calls	CP-1 = -0.70	8.6	7.9	-39.6	Yes

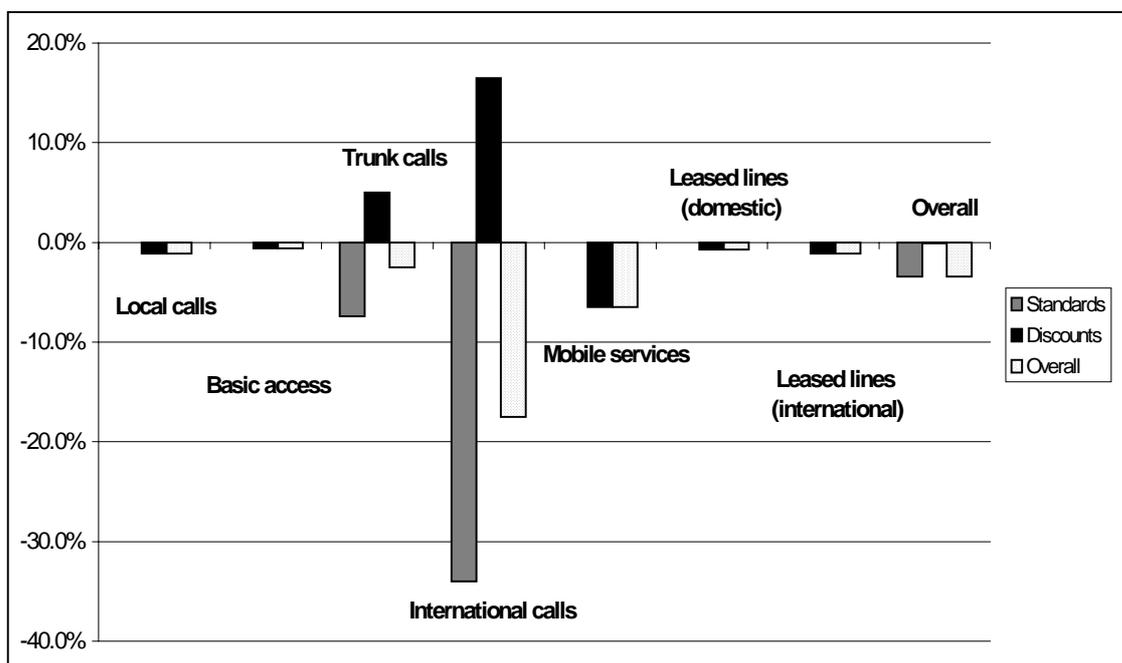
3. Telstra's compliance with the price control arrangements for January–June 1999

At the end of 1999, Telstra informed the Commission about its compliance with the price cap arrangements for January–June 1999. Telstra, however, did not include an audit report. The Commission requested that Telstra provide it with the audit report, which it did on 1 June 2000. Although Telstra complied with the price caps over this period, it has not complied with the metropolitan/non-metropolitan pricing parity requirement for both residential and business country customers by 0.08 cents.

3.1. Overview of price movements in Telstra's services during January–June 1999

Figure 3.1 shows the size of the change in prices for Telstra's services during the first half of 1999. As for Figure 2.1, the price changes reflected in Figure 3.1 are for standard prices, non-standard prices and overall change and are based on the calculations in Table 3.1.

Figure 3.1 Standard and discount components of Telstra's price changes for price-capped services for January–June 1999.



Telstra reduced prices by 0.6 per cent for basic access and 1.1 per cent for local calls although standard prices for both basic access and local calls did not change. Telstra reduced overall prices for trunk calls services by 2.5 per cent and international calls by 17.5 per cent in the first half of 1999. Telstra changed its discount plans for trunk and

international calls, including removing flexi-plans. This resulted in the non-standard prices of trunk and international calls increasing in January–June 1999.

Prices for mobile services in the AMPS and GSM networks decreased by a combined total of 6.5 per cent. As with previous reporting periods this reduction was largely attributable to discounting on mobile flexi-plans and special promotions, as standard rates in this basket of services did not change.

Telstra reduced the overall price of its domestic and international leased line services by 0.7 and 1.1 per cent for the first half of 1999. Standard prices for these services did not change with reductions in both domestic and international leased line services achieved through discounts.

3.2. Telstra’s compliance with the overall CPI/2–3.75 per cent price cap

With a CPI of 0.9 per cent in 1998, the resulting figure for Telstra’s overall price cap formula (CPI/2–3.75 per cent) was minus 3.3 per cent. This meant Telstra was required to *reduce* its overall charges by a revenue-weighted average of 3.3 per cent for the first half of 1999. Telstra’s carry-over credit from 1998 was 0.03 per cent, which reduces the overall decrease required to 3.27 per cent.

Table 3.1 shows that Telstra has satisfied the CPI/2–3.75 per cent cap by reducing their revenue-weighted price capped charges by 3.4 per cent.

Table 3.1 Telstra compliance with overall CPI/2–3.75 per cent price cap (January–June 1999)¹¹

Service(s)	Change in standard prices	Change in non-standard prices (discounts)	Overall price change
Local calls	0.0	-1.1	-1.1
Basic access	0.0	-0.6	-0.6
Trunk calls	-7.4	5.0	-2.5
International calls	-34.0	16.5	-17.5
Mobile services	0.0	-6.5	-6.5
Leased lines			
- domestic	0.0	-0.7	-0.7
- international	0.0	-1.1	-1.1
Overall price cap (revenue weighted)	-3.4	-0.1	-3.4

¹¹ The description of Table 3.1 is identical to Table 2.1.

3.3. Telstra's compliance with the individual CPI/2–0.5 per cent sub-caps

Under the CPI/2–0.5 per cent price cap for January to June 1999, Telstra was required to decrease the prices for services covered by each sub-cap by 0.05 per cent during 1999. Table 3.2 compares the CPI/2–0.5 per cent requirements with the changes in Telstra's standard prices for residential customer services subject to these price caps. The comparisons show that Telstra met this requirement for all four sub-caps.

Table 3.2 Telstra's Compliance with CPI/2–0.5 per cent sub-baskets for January–June 1999 (standard changes for residential customers)

Sub-basket	Price cap requirement	Credit from 1998 (%)	Total allowable price change (%)	Change in standard prices (%)	Compliance
Connections	CPI/2–0.5 = –0.05	5.2	5.2	0.0	Yes
Line rentals	CPI/2–0.5 = –0.05	6.4	6.4	0.0	Yes
Trunk calls	CPI/2–0.5 = –0.05	21.0	21.0	–7.4	Yes
International calls	CPI/2–0.5 = –0.05	48.2	48.2	–34.0	Yes

4. Metropolitan/non-metropolitan pricing parity

The determination also includes a price control measure for Telstra's untimed local calls. It will mean that price reductions in Telstra's untimed local calls in geographic areas with effective competition flow on to customers in areas where competition may not yet have developed. The price control measure requires that:

- the price of weighted average untimed local calls for residential and charity customers in non-metropolitan Australia in the current period does not exceed the weighted average untimed local call price for residential and charity customers in metropolitan Australia in the previous period; and
- the price of weighted average untimed local calls for business customers in non-metropolitan Australia in the current period does not exceed the weighted average untimed local call price for business customers in metropolitan Australia in the previous period.

The Commission and Telstra developed a methodology to measure this price comparison. Telstra was required to provide the Commission by March 1999 the average local call prices in metropolitan areas for 1998. However, due to difficulties in collecting the data, Telstra did not provide this information until 28 April 1999.

Based on that information, the Commission is not satisfied that Telstra has fully met this requirement in both periods. In 1998, Telstra met its compliance requirement for residential customers by 24/100 of 1 cent (0.24 cents), but not for business customers, by 8/100 of 1 cent (0.08 cents). For January–June 1999, Telstra did not meet its compliance requirement for both residential and business customers by 8/100 of 1 cent (0.08 cents). In 1998, Telstra reduced its non-metropolitan residential local call pricing by \$5.2 million beyond the cap requirement, while for non-metropolitan business local calls it failed to reduce prices by \$860 000. The net outcome was a reduction of \$4.34 million beyond the cap requirements.

Although the Commission does not have any additional role if Telstra has failed to comply with the price control arrangements, it did ask Telstra why the requirement had not been met. Telstra submitted that exact compliance is a practical impossibility. The determination and accompanying methodology for local call pricing parity compliance is based on the average yield of local calls in the metropolitan and non-metropolitan regions. The average yield in a region is derived from the number of local calls made under each of the local call pricing options available. However, Telstra cannot determine the actual year-end average yield until after the last local call has been made in the year. According to Telstra, the compliance task requires it to correctly estimate in advance the number of local calls and the price of each call in the non-metropolitan areas.

Attachment: Auditing requirements

Overview

In consultation with Telstra, the Commission developed a methodology, *Methodology for the Administration of the Telstra Carrier Charges Price Control Arrangements*, which sets out the procedures in administering the price control arrangement under the determination. The Commission requires that the information be audited to ensure Telstra is complying with the methodology and the price cap obligations. The Commission then uses this information to fulfil its statutory obligations to the Minister for Telecommunications, Information Economy and the Arts.

Objectives

The audit objectives are:

- to determine whether Telstra has met the procedural requirements as specified in the agreed methodology. The auditor should form an opinion as to whether Telstra has complied with the procedures and policies set out in the methodology;
- to determine whether the information produced and supplied by Telstra can be relied upon by the Commission in the calculation of the price cap requirements. The auditor should form an opinion as to the accuracy and completeness of the information produced by Telstra in accordance with the methodology; and
- to determine whether Telstra has followed a structured approach in its compliance with the methodology and an audit trail exists. The auditor should form an opinion as to the adequacy of the internal documentation, which is relied upon by Telstra in the development of the compliance information.

The Commission envisages that the auditor would:

- ascertain whether Telstra has consistently applied the requirements of the methodology;
- review models, surveys and samples undertaken by Telstra to examine such matters as data collection techniques and procedures including consistency across Telstra divisions, interpretation of the data and the use of statistics in the allocation process;
- ensure that any material changes in the internal accounting practices and introduction of new amendments to established functions comply with the agreed methodology and compliance information; and
- undertake transaction testing, such as mapping of information produced for price cap purposes by Telstra to its data capture systems.

Approach of the audit

The audits used a risk-based approach, which allow for an acceptable level of risk that the audit will not detect:

- errors that are of such a scale as to result in a minimal distortion; or
- shortcomings in the information provided under the specifications of the methodology.

This approach is designed to be cost-effective in accordance with modern auditing techniques.

The risk-based approach incorporates both compliance testing and substantive testing of detail, and uses analytical review techniques to determine, for example, significant ratios and trends. Compliance testing audits the effectiveness of a carrier's internal control procedures to ensure adherence to the methodology. The audit conclusions must be supported by substantive testing and analytical review to determine whether transactions are accurate, bona fide and complete.

An independent auditor completed reports for 1998 and January–June 1999, in accordance with the guidelines set out above, and submitted them to the Commission on 22 November 1999 and 1 June 2000, respectively. In general, the audit has not identified any price movements that are calculated other than in accordance with the methodology. The price movements contained in the information provided by Telstra have been calculated using supported determinants.