Review of Price Control Arrangements

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1 Introduction and overview

In June 2004, the Australian Competition and Consumer Commission ("the Commission") released a discussion paper, ‘Review of Price Control Arrangements’, and requested submissions from interested parties on the matters raised in the paper to assist in its review of the current price control arrangements for Telstra.

Telstra welcomes this opportunity to comment on some of the issues identified in the Commission’s paper.

The stated objectives of the current price control arrangements are to:

- promote efficiency in markets not yet effectively competitive and pass on the benefits to consumers;
- allow Telstra to gradually rebalance line rentals and protect low-income consumers from any adverse effects of line rental increases;
- ensure rural and remote consumers share in the benefits from greater competition; and meet other social policy objectives.

The Commission contends that these objectives are consistent with those that apply to the regulation of telecommunications generally; the principle objective of which is the promotion of the long-term interests of end-users.

The purpose of this submission is to address the main issues raised in the Commission’s discussion paper. Telstra believes that, at this stage, the main questions are:

- what are the likely impacts of recent and future developments in the Australian telecommunications industry on the need for retail price controls?
- what are the likely impacts of recent and future developments in the Australian telecommunications industry on the appropriate form of retail price controls (if needed)?

Price regulation has been a feature of the Australian regulatory regime since 1989, before network infrastructure competition was allowed. At the time of its introduction there was a clear objective: to increase Telecom’s incentive to make productivity gains and to share those gains with consumers.

Since 1989 there has been a progressive increase in the level of service and infrastructure competition, in the types of service available (mobile, broadband cable, broadband wireless, ADSL, satellite) and what they are used for, and also in the quality of service offerings. The demands of consumers have also changed, with a shift from voice to data services and to the purchase of services bundled together.

These types of changes in the market have been recognised in the changing nature of price controls over time. A good example is the removal of mobile call prices from the regulatory arrangements in 2001 in recognition that this market had become highly competitive.

It is important that the Government’s decisions about future price controls (the need for them, form and duration) fully recognise current market characteristics and the changing nature of the economic welfare benefits that can flow to the community through the telecommunications services of the future. The Government has done this in the past, and should continue to do so. Any future retail price controls placed on Telstra must be supported by a clear identification of resulting benefits to the nation, and not continued just because of historical precedent.

When price controls were first introduced, the market environment was much simpler than it is today: a single network was used to supply most voice services; the possibility of large productivity
improvements directly associated with the regulated services could be readily identified; services were generally not bundled; and while the development of competition was recognised as very important it was in its infancy – so too was what we know today as access regulation.

However, as competition has increased and the nature of telecommunications services has evolved, the basis for price regulation has changed. The risks associated with getting price controls wrong have increased.

In Telstra’s view, the long-term interest of end-users is best promoted by having an efficient price structure for telecommunications services. Telstra recommends that the future requirement for price controls be given serious consideration by the Commission. Should the Commission recommend the continuation of a price cap regime, the primary aim should be restricted to maximising efficiency through telecommunications pricing. Efficient pricing is that which reflects underlying cost and is responsive to market demand. Prices more closely aligned with cost will result in a more efficient consumption of telecommunications services. For consumers the more flexible the price control regime the greater the level of total demand and the greater the level of flexibility for Telstra to meet individual customer needs. For the industry a more efficient pricing structure will send the correct signals as to the potential for appropriate returns on new investments.

Consumers will gain from facilities-based and service level competition, as well as the emergence of new technologies and new services. If the Commission recommends a continuation of controls, then a single broad basket, including line rentals, local calls, fixed to mobile calls, STD and IDD should be applied, with a cap that provides industry with sufficient price flexibility.

Such a price control should be accompanied by targeted measures aimed at ensuring that the related social policy objectives of Government are achieved. Rather than recommending distortionary sub-caps, the Commission should recommend continuing cooperative arrangements between the Low-income Measures Assessment Committee (LIMAC) and Telstra.

As a consequence of the uncertainty surrounding future market developments – in particular the advent of voice over internet protocol (VOIP) and the growing substitution of fixed line services by mobile services, the duration of the next price control period should be two years, with a systematic review conducted towards the end of that period.

This submission points to the changed nature of the market environment, the likely future source of the main economic welfare gains for consumers and how inappropriate price regulation may affect consumers accessing those gains, and what this situation means for future price control arrangements. The remainder of the submission is structured as follows:

- Section 2 discusses the future role for price caps. It questions the ongoing rationale for price caps, given the intensity of infrastructure-based competition, and given that Australia has an extensive access regime which underpins robust service level competition. It stresses the need for price control arrangements to take into account the challenges faced by the Australian telecommunications industry in the transition to next generation networks;

- Section 3 sets out what Telstra considers as the key issues involved in the Review of price control arrangements. These include the efficient design of future control, and the question of sub-caps; and

- Section 4 discusses the role of social policy objectives. It stresses that social policy objectives are better addressed through direct and transparent mechanisms rather than through controls on the retail prices of only one competitor.
2 Future role for price caps

Telstra's view is that the rationale for price caps has largely fallen away, due to both increases in the competitiveness of the telecommunications market, and the existence of an extensive access regime with strong service level competition. Telstra also believes that future market developments are likely to further challenge the continued applicability of the price control regime.

2.1 Infrastructure based competition reduces the need for price caps

Price controls were introduced as a temporary measure in 1989 to ensure that the benefits of competition flowed through to all Australians, rather than only those exposed to the limited competition at the time. The efficiency grounds for retail price controls were well established at the time and formed the basic rationale for regulatory intervention: operators faced with high barriers to entry could charge customers prices above the competitive level. However, the telecommunications market has become far more competitive since this time, and the rationale for price controls no longer exists.

Infrastructure Competition

A wide range of technologies is now used to provide local access to end-users, such as copper networks, HFC, fibre optic, fixed wireless and satellite. In its 2004 Telecommunications Competitive Safeguards Report, the ACCC notes that:

Consumers can now choose from a number of alternatives when selecting a supplier of retail local telecommunications services, including Optus, AAPT, Primus, TransACT, Powertel and RSL COM.¹

The range and mix of services offered to consumers continues to grow as new carriers enter the Australian telecommunications industry and as communications infrastructures are further developed. For example, in 2002–03, 20 new carrier licences were issued and seven carrier licences were surrendered, bringing the number of licensed carriers to 94, at 30 June 2003 – see Chart 1.²

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² Licensed carriers are differentiated from CSPs in that they are licensed by the ACA to operate infrastructure known as 'network units'; that is, facilities required to deliver telecommunications services to the public and include copper cable, optical fibre cable and radio-communications facilities, or any combination of these required to provide services.
Chart 1 outlines these trends through time.


It is worth noting that wireless infrastructure solutions are becoming a preferred alternative to the traditional copper-based network platform. As Graeme Samuel, Chairman of the ACCC, recently noted:

> You’ve also got some newer entrants into this market that are putting some challenges up in terms of new infrastructure. I’m thinking of some of the wireless developers that are developing new infrastructure in the area of wireless telecommunications and it may well be that they start to put some pressure on Telstra and others in the fixed wire network. And that competition is all, ultimately, going to lead to benefits for customers.3

An examination of new carriers and the technologies they intend to employ provides an insight into likely industry trends in the near future. Chart 2 shows the carrier licences issued during the years 2000–01 to 2002–03 by the type of infrastructure carriers intend to deploy.

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While some new carriers planned to invest in cable networks, a growing number of new carriers, including 16 out of 20 licensed in 2002–03, planned or used radio-communications facilities, either terrestrial wireless or satellite.

Major investments in satellite broadband infrastructure means that infrastructure-based competition and competition in the customer access markets is not limited to CBDs or metropolitan areas. Satellite communications already provide 100 per cent coverage across the Australian landmass and the newest satellites provide greater capability for advanced two-way broadband services.4

In addition, new wireless technology, such as Wi-Max, is being developed that enables Internet access at greater distances to current telephone exchanges.5 Such solutions may provide an alternative access to telecommunications services, providing not only broadband Internet access, but also access to voice telephony services to all parts of Australia.

It is increasingly difficult to argue that mobile services and existing and potential fixed line alternatives do not operate as an effective constraint on fixed services pricing.

In short, the potential for ubiquitous alternatives to Telstra’s PSTN network is real. Considering these developments, Telstra argues that the continued need for price controls needs to be seriously assessed.

2.2 Access-based competition reduces the need for price caps

Strong access-based competition is another reason why the need for price caps has reduced. Indeed, the long-term benefits associated with infrastructure competition may be at risk if the tensions between wholesale and retail price regulation are not solved.

The Commission has declared many wholesale services provided by Telstra’s network. These include:

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4 For example, New Skies NSS-6 satellite: launched in December 2002; Optus C1 satellite: launched in June 2003. IPSTAR launched in 2004 a $69-million investment program in satellite broadband infrastructure to provide broadband access to regional and rural Australia.

5 Wi-max is an emerging standard for wireless broadband connections, that can offer telecommunications access up to 50 kilometres from the base station.
• domestic PSTN originating and terminating access and service;
• domestic transmission capacity service;
• conditioned and unconditioned local loop service;
• local carriage service;
• line sharing service; and
• mobile termination.

Central to decisions about this wholesale (network access) regulation was the impact on ‘related markets’, including the retail markets in which the services subject to the current price control arrangements are provided.

The declaration of these wholesale services means that Telstra’s competitors can and do, provide retail telecommunications services without sinking large investments in network assets, and hence can readily enter and compete in the fixed voice telephony market. Regulators in various jurisdictions have repeatedly drawn attention to the relative ease with which entry can occur under such arrangements and have drawn attention to the tensions existing between wholesale and retail regulation.

Whilst some elements of the wholesale access regime attempt to account for the effects of regulated retail prices (e.g. cost based PSTN interconnect has included an access deficit contribution, reflecting that calls supplied by Telstra at both wholesale and retail should contribute to access deficit recovery), the same cannot be said for retail price regulation, as it effectively ignores the wholesale access regime. Given the competitive discipline that the wholesale access regime imposes on pricing a continued lack of acknowledgement of the access regime when setting retail controls would be distortionary and wholly inappropriate. Internationally, the view expressed by former US regulator Alfred Kahn, for example, is that network access policies

“have come as close as conceivable to making the provision of telephone services at retail perfectly contestable and therefore regulation of the retail rates simply unnecessary. What these provisions do, at the extreme, is to reduce the sunk costs associated with entry into retailing close to zero […] What it means, specifically, is that the typical requirements in governing statutes or regulations for reclassifying the entire range of retail local telephone services as competitive will, as a matter of economics, be satisfied by these rules. In these circumstances, deregulation of the retail operations of the ILECs becomes not just possible but mandatory. Effective competition demands that they have the identical freedom to compete at that level as is now enjoyed by their competitors.’

If multiple telecommunications service providers can compete for a customer’s business, even if they do so by leasing the incumbent’s facilities, then in the absence of specific social policy objectives it would seem that prompt deregulation of all charges to these providers’ customers is appropriate. This is simply because

• if a carrier tries to charge too much overall to the customer then another will undercut those charges; and
• if a carrier tries to charge a reasonable amount overall but in an inefficient manner, then another carrier can offer a more profitable alternative pricing package that is also better for the customer.

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In other words, in those circumstances, Telstra considers that there should be no need for regulators to resolve the difficult issue of what to charge for and how customers want to pay the cost of service. This is because when wholesale telecommunications markets have been opened to competition through the availability of mandated wholesale elements at cost-based rates, a price cap on retail prices either

- has no impact on competitive outcomes when it is set higher than the prices that competition would produce; or

- distorts competition when the upper limit is too low. In particular, an overly restrictive retail price limit will produce less entry and less investment in network facilities by both incumbents and entrants.

The above discussion demonstrates that it is important that future decisions about the design of any retail price regulation take full account of the prevailing network access regulatory arrangements.

2.3 Future market developments will further reduce the rationale for price caps

Telstra’s view is that, while the next price control period will see a continuing trend towards more competition and more innovation, the specific outcomes are uncertain. The Government needs to be mindful of the high stakes involved in retail price control interventions, especially where competition in telecommunications markets is increasingly about the discovery and commercial development of successful products and services.

Two key disruptive technologies facing existing market structures and hence the regulatory regime are:

- The wide spread roll out of 3G Mobile networks which for the first time make wireless networks an effective substitute for both fixed voice and fixed data services. The extent of take-up, the level of investment and the coverage of these 3G networks remains extremely uncertain and will be impacted by and impact upon the regulatory regime; and

- Voice over Internet Protocol (VOIP) enables calls to be carried either entirely or predominantly over the Internet, bypassing the PSTN altogether. In a VOIP world such core price cap concepts as rebalancing and un-timed local calls are rendered largely irrelevant.

Policy makers need to be very careful to ensure that the price cap regime does not artificially distort the development of mobile telephony and VOIP solutions (nor indeed other potential next generation technologies). Investment and innovation by the telecommunications industry is vital for Australia’s economic development, its international competitiveness, and, ultimately, for the standard of living of all Australians.

The dynamism of the Australian telecommunications industry poses significant challenges for all stakeholders:

- for telecommunications companies, future success will be limited to those who invest efficiently in next generation networks, best manage uncertainties and select the right strategies for developing new services;

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• for Government, there is the challenge of formulating the right approach to regulation (including price control regulation) when markets are very uncertain, and investment requirements substantial.

Telstra and its competitors are all likely to adopt different investment strategies. These strategies in many cases are still uncertain or, at least, likely to evolve with new technological opportunities and changes in consumers’ needs. It is vital that, whatever choices telecommunications carriers and service providers make, the Government ensures that successful investors can expect an appropriate return on risky investments.

The industry is undergoing a process which will effect fundamental change in some areas. Trends in the telecommunications industry are likely to include the following features:

• continuing rapid advances in the technology both of telecommunications networks and of the services provided over those networks leading to the availability of platforms that deliver ever-greater bandwidth. These platforms will be capable of carrying information more quickly and carrying a wider range of applications over a single medium, using common underlying protocols;

• increased consumer expectations for a set of information-based services, with delivery based on their individual identity and location, but regardless of access technology required;

• increased consumer focus on content rather than on the means of conveying services; and

• some voice services becoming low charge (or even bonus) ‘add-ons’ to broadband packages and others becoming high value enhanced services.

While these trends are well accepted among industry analysts and stakeholders, many parameters are less predictable. For example:

• the exact timing of these changes;

• the nature and extent of competitive entry and expansion; and

• the specific form and impact of emerging technologies.

Faced with these uncertainties, the regulatory approach needs to anticipate change, but not seek to determine outcomes. In other words, the regulatory strategy that emerges from this Review of Price Control Arrangements should be designed to let markets – not regulations – fulfil the role of identifying the services and businesses that will succeed.
3 Future price control arrangements

In Telstra's view, the long-term interest of end-users is best promoted by having an efficient price structure for telecommunications services. Telstra therefore recommends that if there are to be any price controls, the aim should be limited to maximising efficiency through telecommunications pricing. Consumers will benefit from facilities-based and service level competition, as well as the emergence of new technologies and new services. If price controls are to continue, a single broad basket, including line rentals, local calls, fixed to mobile calls, STD and IDD should be applied, with a cap that provides industry with sufficient pricing flexibility.

Price controls should focus on targeted measures aimed at ensuring that the pricing-related social policy objectives of Government are achieved. Rather than recommending distortionary sub-caps, the Commission should recommend of continuing cooperative arrangements between LIMAC and Telstra.

If price controls are continued, three particular areas of price control arrangements will need attention: the overall design of any scheme; the selection of appropriate price targets for the chosen basket of services; and the extent of any sub-caps that are to apply.

3.1 The overall design of the scheme

Three important issues need to be taken into account in considering the design of any new scheme.

First, bundling is an increasingly popular feature of the telecommunications landscape. A good example is the bundling rate Optus has achieved with telephony customers on their HFC network - some 63% of Optus telephony customers purchased telephony and at least one other product delivered over the HFC, such as cable internet access, narrowband internet and/or PayTV. There is a clear preference by customers for bundled services. This raises a number of difficult questions for a price control regime. First how the price control arrangements should manage the challenges that arise from selling as a bundle price-regulated and non-regulated services. Additionally, there is the very real problem of how price reductions for the bundle are imputed to the price controlled services for the purpose of assessing compliance. Increasingly only a proportion of what is purchased is regulated. The question of how to measure the movement in prices of the regulated portion of the bundle becomes increasingly difficult.

The second issue is the duration of the regime. Typically price control regimes have run for three years which was appropriate in the past as it provided a level of certainty for Telstra and the industry. However, given the issues raised in section two as to the uncertainty arising from alternative infrastructure platforms and as a consequence of the uncertainty surrounding future market developments, Telstra is of the firm view that the duration of the next price control period should be two years, with a systematic review conducted towards the end of that period.

The third issue is carry over. The provision of carry-over credits within a price control period has been recognised by the Government as promoting Telstra’s incentives to exceed the mandated price reduction at any point in time. Allowing the carry-over of unexercised credits between price control periods would be consistent with this approach. To disallow carry over credits between price control regimes provides a clear incentive to use those credits before the price control period ends to the extent that competitive constraints allow.

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9 Page 42, Singapore Telecommunications Limited and Subsidiary Companies, Management discussion and analysis of unaudited financial condition, results of operations and cash flows for the first quarter ended 30 June 2004.
3.2 Price targets

The establishment of particular price targets for the chosen basket of retail services will need to take three particularly important issues into account.

- Setting an X factor in a CPI regime based on an empirical study of Telstra’s productivity growth is becoming increasingly difficult and arbitrary because of the necessity to allocate common costs to an expanding range of telecommunications services provided over an integrated network.

- A retail-level intervention must take into account all the drivers of consumer welfare gains, be they the pass through of cost reductions, innovations or product differentiation.

- The ACCC should consider the linkages between particular future price targets and the ability for Telstra to meet its social policy objectives and its network enhancement aspirations.

3.2.1 The relevance of Total Factor Productivity (TFP) in setting X has diminished

Telstra believes that future welfare gains will largely be generated by the provision of innovative and differentiated services rather than by the traditional ‘reduction of production costs’. Technology in the telecommunications industry is inherently dynamic, making it an extremely fertile ground for product innovations and consequent welfare improvements to the benefit of consumers. With the emergence of new technologies promising new services to be available for commercialisation, stalling the innovation process would be very costly.

In their current forms, the price control arrangements are implemented as if the main driver of welfare gains was cost reductions that result in a corresponding decline in prices and improvement in allocative efficiency. Earlier price controls, for example, were (at least implicitly) based on rate-of-return regulation aimed at minimising the monopoly rent that Telstra’s predecessors would have otherwise secured. Price caps, or incentive regulations, have since then essentially focused on the pass through of productive efficiency gains in the forms of lower real prices.

This strategy will become increasingly ineffective in delivering future welfare gains to consumers.

First, the delivery of telephony services via new and emerging technologies necessitates significant investments, which in turn would be undertaken only if an appropriate return can be expected. Monopoly rents, which have been an important concern of early price control arrangements, are not at issue here. The expectation of temporary quasi-rents from innovation and investment is very different to the creation of monopoly rents. It is not a danger to be avoided; it is a necessary condition for innovation to occur.

Generally, competitive firms will undertake investments in innovation to the point where the marginal return on such investment equals the marginal cost of innovation. In this case, they would not earn monopoly rents, defined as the ability to earn economic profits by restricting output.10 Enabling firms to appropriate temporary innovation rents is important to the level of innovation. By reducing the availability of financial returns, price controls distort the incentive to innovate and invest.

Second, while reduction of the real price of telephony services should remain an objective, innovation in the combinations of products offered to consumers is an important dimension of competition between suppliers. Consumers can gain significant benefits from this type of competition. The ability to integrate a range of voice, data, Internet and multimedia services will be

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10 If there are economies of scope and/or scale or if different firms have different cost structures, they may secure some (Bertrand or Ricardian) rents but these rents do not arise as a result of a monopolist’s restriction of output. For example, if a firm has a comparative advantage in innovation, it may earn a superior return, without monopolisation.
increasingly valued by end-users. Whether consumers regard those services as being substitutable or complimentary, any forced price reduction of voice services has flow-on effects for, and inevitably will distort the pricing of, other innovative services.

Telstra believes that the traditional approach of establishing price controls, with a focus on the passing through of cost reductions, is no longer consistent with the ultimate source of welfare gains, that is, innovation. The usefulness of using TFP has thus diminished.

3.2.2 With network integration, the chances of serious regulatory errors occurring in setting the level of X have increased markedly

The trend to network integration, which means that network inputs are increasingly common, results in regulatory decisions being increasingly sensitive to cost allocation methodologies. To the extent that retail price regulation decisions result in prices charged and profits retained which are different from efficient levels, such regulation distorts the investment decisions of a regulated firm, as well as those of its competitors.

The current network is essentially an overlay of a myriad of distinct networks that share some common elements. There is, in fact, multiplicity at every layer in the network architecture. For example, Telstra operates a mix of circuit switched networks, most notably the PSTN and the ISDN, and packet switched networks, such as ATM and Frame Relay.

Greater integration of those overlays into a single core network is inevitable. For example:

- video is currently transported largely separately from, and differently from, voice and audio, and computer-to-computer data separately and differently from each of these. In the future these and other uses will share a common means of transport, not only in terms of the physical support over which that transport occurs, but also of the form the information takes in the course of transmission.

- a similar move towards commonality of equipment, processing and protocols will occur in those elements of the network that deal with the management of the flow of communications, that is, those functions that are exercised in the circuit-oriented world by switching and signalling systems.

In this environment it is difficult if not impossible for a government or regulator to determine an efficient pricing structure – that is, pricing levels that would correspond to the investment and operating decisions that would prevail in a competitive market. But this is what is required for a government to implement successfully CPI-X forms of price regulation aimed at forcing Telstra to pass on to consumers its productive efficiency gains through price reductions.

In its traditional form, setting an X is about deciding what productivity gains are available and the share of those gains that should be passed on to consumers. The implementation challenge arises from the fact that this ‘incentive regulation’ should be limited to productivity gains associated with the services that are within the scope of the price controls; that is, the prices for these services should not depend on the success or failure of services not subject to this specific regulation.

There is little doubt that the changed nature of Telstra’s networks makes the allocation of productivity gains between services relevant to the price control arrangement and the other services or products delivered over those networks inherently arbitrary.

The difficulties in deriving appropriate values for parameters such as economic depreciation and cost of capital are well recognised – but in addition it would be necessary to assign fractions of the costs of the network facilities, including shared costs and common overheads, to the regulated services.
The basis for a regulator allocating joint and common costs is typically accounting mechanisms that are, at best, imperfect, and more likely arbitrary. The end-result would almost certainly be a measure of the likely available productivity gains for a particular service that is highly sensitive to underlying assumptions that have little firm basis. The translation of this measure through to price controls therefore runs the risk of severely distorting and hindering operating and investment decisions. Forcing Telstra to set prices at levels that are not justified by economic cost allocation principles, taking demand characteristics into account, would result in inefficient prices and resource misallocation, which inevitably would reduce consumer welfare.

In addition, the Commission has determined access prices based on the TSLRIC necessary to recover efficient forward-looking network costs. In other words, the regulation of Telstra’s wholesale business is based on a model that estimates the costs that would be incurred by an efficient operator. Therefore, all the potential productivity gains that Telstra would secure if it were using the best available technology are accounted for at the wholesale level, which are then passed on to consumers thanks to resale-based competition, obviating the need for retail price caps to achieve the same result.

Telstra’s view is that the risk of price controls distorting outcomes is increasing with increased network integration.

Given that TFP is less relevant to setting X, and that the risk of using TFP to set X has increased so markedly, Telstra recommends that the Commission not take the approach of using TFP in deriving X.

3.3 The extent of sub-caps

The efficiency with which Telstra can achieve an overall price reduction is promoted by the flexibility it has to set the price of individual services (particularly in response to competition). Any restriction on that flexibility (and hence the policy choice to reduce the level of efficiency in the provision of telecommunications services) should be justified by specific policy objectives.

Telstra believes that delegating to telecommunications service providers the responsibility of setting individual prices allows for a more efficient pricing structure, which is beneficial to consumers. As such, if price controls are determined to be required, Telstra would support a broad basket approach, with no sub-caps.

Sub-caps on line charges (connections and line rentals) have restricted Telstra’s ability to rebalance its tariff towards a more efficient price structure that reflects the real cost of providing services and the real preferences of consumers.

While intended to protect residential consumers, especially low-bill residential consumers, from adverse effects of increased line rental charges, these sub-caps have restricted the restructuring of prices to achieve a more efficient pricing structure. They have likely resulted in significant distortions and hence costs to society compared to the efficient pattern of cost recovery that market-based decisions could achieve.

When freed from tight price controls on individual services, competitive service providers have an incentive to discover what approaches to pricing work best in growing the market and maximising benefits to consumers overall.
In the presence of common costs shared by different services and consumers, prices that cover marginal cost only will not be consistent with full-cost recovery\textsuperscript{11}. Therefore, forcing a firm to price at marginal cost is

- neither sustainable (because no firm would invest or re-invest knowing it would not be allowed to recover its investments);
- nor efficient (because efficient investments would not be made and allocative inefficiencies can also arise).

This raises the question of how to most efficiently ensure cost recovery. While any departure from marginal cost pricing will distort market outcomes, prices should, and could, be set so that the aggregate distortion of choice is minimised.

The general principle is that consumers whose decisions would be most affected by departures from marginal cost should be offered prices closest to marginal cost (e.g. those with lower willingness-to-pay and/or more elastic demand), whereas those with high willingness-to-pay and/or inelastic demand should bear the biggest burden of revenue generation in the form of high price-cost margins.

The regulator could reduce the risk of regulatory error and make use of any information held by Telstra by delegating the setting of individual prices, while requiring that the weighted average of the prices set by the regulated firm does not exceed a certain level. Pricing flexibility provides firms with the ability to price at the margin, that is, to set prices for customers with lower willingness/capacity-to-pay at levels closer to marginal cost, while maintaining infra-marginal contributions to fixed costs. In other words, it is in the firm’s interests to increase consumption at the margin (to the point that the marginal price equals marginal cost) while maintaining consumption by customers who are not excluded. This type of pricing behaviour would not only be in the firm’s interest but also be to the benefit of consumers generally.

Therefore, in keeping with economic principles, it is in consumers’ interests that any future price control arrangements only limit Telstra’s flexibility to continually seek to adjust all prices in line with cost movements where there are compelling social policy objectives for doing so. Any reductions in Telstra’s pricing flexibility should be kept to the minimum that is necessary to achieve those objectives.

The Commission has raised the question of the flexibility granted by the current price controls arrangements in relation to (1) fixed-to-mobile services, currently in the broad basket of calls – the ‘first basket’ and (2) business and residential line rentals, currently in the same basket – the ‘second basket’.

\textit{F2M services}

Regarding the fixed-to-mobile services, Telstra notes that the Commission

- determined that a key benefit of declaration of the mobile termination services, with implementation of an accompanying pricing principle yielding a closer association of price with underlying cost, is that the market within which fixed-to-mobile services are provided will become more competitive; and

\textsuperscript{11} Strictly marginal cost pricing would be consistent if marginal costs were sufficiently increasing for intra-marginal rents to cover common costs.
suggested that the pricing principle itself should, over the long-term, work to provide a greater level of fixed-to-mobile 'pass-through'.

While Telstra expressed some concerns over the efficiency of regulating mobile termination services, Telstra agrees with the Commission's view on the rate of pass-through.

The Commission also suggested that improved competition could manifest itself in many forms as well as price reductions. In particular, improved competition may be associated with incomplete pass-through if it is also associated with improvements in the quality of services provided, which may increase the cost of providing fixed-to-mobile call services. Telstra also agrees with this comment.

Further, the Commission argued that lower input costs might be passed-through in the form of reductions in the price of other services provided in the bundle of pre-selected fixed line services. Hence, while fixed-to-mobile call prices may not fall by the same amount as the price of the mobile termination services in the short-term, the long-term interest of end-users can still be promoted if there are reductions in the price of STD and IDD call services as a result of lowering input costs for competitors in the market within which fixed-to-mobile services are provided. Telstra also agrees with this comment.

It is therefore Telstra’s view that the Commission should not recommend the creation of a sub-cap of fixed-to-mobile services. To do otherwise would be inconsistent with the logic of the Commission’s final decision on mobile termination services, and not in the best interests of end users.

**Combined business and residential basket**

Regarding the fact that business and residential lines rentals are included in the same basket, the Commission contends that the burden of increased line rental charges since the current price control arrangements were introduced is likely to have fallen on residential customers. The Commission suggests that this is largely because, prior to the commencement of these arrangements, the price of line rental for business customers was already much closer to efficient/underlying cost compared to the price of line rental for residential customers.

The evidence provided by the Commission is as follows:

Telstra’s residential line rental charges have increased significantly from 1 July 2002 to the present time, with charges under its HomeLine Complete plan increasing 23.1 per cent, to $26.95 and charges under its HomeLine Plus plan increasing 20.28 per cent, to $29.95. In contrast, Telstra’s business line rental charges increased by substantially less over this period, with charges under its BusinessLine Complete Plus plan increasing 2.9 per cent, to $34.95 and charges under its BusinessLine Plus plan increasing 2.5 per cent, to $40.95.

Telstra believes that the Commission should not have undue regard to price changes that occurred in the previous period. Given the level of competition and the emergence of new technologies and services, the historical evidence on residential prices is unlikely to offer a robust insight into what is likely to happen in the next few years.

Such evidence also overlooks the introduction of Telstra’s ‘HomeLine Budget Plan’ on February 2001 for which the monthly line rental is currently $18.50. In other words, some residential customers, and particularly those for whom higher line rentals is likely to be most burdensome, have benefitted from a price reduction rather than price increase. The following chart illustrates the continuing growth in the number of residential customers benefiting from such lower line rentals.
Telstra believes that the Commission’s comment on the distributional impacts of a broad basket ‘business and residential’ is unjustified since it ignores the measures implemented by Telstra to protect the low income residential customers adversely affected by the necessary rebalancing of line rentals.

Telstra also notes that, while the ‘second basket’ contains both business and residential lines rental, Telstra is subject to some constraint on residential operations:

Line rentals charged at residential rates must not be increased without prior consultation with the Commission and it being satisfied that Telstra has complied with clause 22 of the Carrier License Conditions (Telstra Corporation Limited) Declaration 1997 to have in place a low-income package.

In other words, while residential and business access services are in the same basket, the Commission’s concerns are already addressed by the current price control arrangement – with a focus of social policy objectives, which are further analysed in the next section.

It is possible that some submissions to the ACCC’s review may seek to justify the introduction of a sub-cap constraining residential line rental price increases on the basis that: there would be social policy benefits from residential customers being assured of a higher share of Telstra’s overall productivity gains at the expense of business customers; or that there is more competition for business than residential customers.

The first of these arguments assumes that a sub-cap could somehow address a perceived distributional issue between the business and residential customers. However, this would ignore that business telecommunications expenditures eventually flows into the prices charged by businesses for their goods and services. Artificially skewing the flow of productivity gains to residential customers would serve little purpose because at the same time they would be forgoing the benefits of lower telecommunication prices to businesses being translated into reduced prices for other goods and services they consume. Such an arrangement may also be judged as inequitable because of the differential gains received by residential customers with more than one access line.

The second argument overlooks the fact that net revenues received by Telstra from many of its residential customers through access and usage charges are very low already and that a low level of “competition” for these customers simply reflects this fact.

For similar reasons, artificially skewing the distribution of gains from productivity achievements so that they are reflected in residential call charges at the expense of the telecommunications prices paid by business customers cannot be justified. As residential usage demand is highly concentrated, a sub-cap that relates to call services would pass a disproportionate amount of the
benefit to high volume residential users, who may well also have higher incomes. A fairer distribution of the benefits of productivity gains would be achieved through allowing greater price reductions to occur for telecommunications services used by businesses so that these gains can be passed on through lower household outlays for goods and services generally.

Telstra notes that the majority of its residential customers have chosen to take up the higher monthly line rental plans. Customers have demonstrated that they derive utility from being able to choose between more and less rebalanced plans. While the majority of customers have embraced the more re-balanced options, plans such as HomeLine Budget have provided a popular alternative for customers favouring the bundle of low line rental and higher call rates. Future price control arrangements should enable Telstra enough flexibility to construct pricing which meet the demands of diverse customer segments.

### 4 Social policy objectives

Telstra recognises that the government has pursued various social policy objectives through its past price control schemes, and therefore may seek to regulate some of Telstra’s prices to meet similar objectives over the near term. In this regard, social policy objectives would usually be better addressed through direct and transparent mechanisms rather than through controls on the retail prices of only one competitor.

**Telstra submits that the aim of price controls should be restricted to maximising overall efficiency in the provision of telecommunications services and that preference should be given to targeted measures to achieve social policy objectives.**

The Commission suggests that the government could direct subsidies, through the budget, to those individuals who it considered should be granted some form of assistance. Another suggestion is a subsidy to particular consumers funded through some form of industry funding obligation.

Telstra recognises and agrees with the Government’s objective of protecting low-income groups, from significant increases in the price of basic telephony services, including the cost of being on the network (line rental). It is widely recognised that, from an efficiency perspective, this is best done from consolidated revenue, or (less preferably) from an industry fund. Telstra recognises that the budgetary and political realities that constrain this, make it extremely unlikely that there will be a change in the way social policy measures are funded. Telstra also recognises that the current Low Income Measures Assessment Committee (LIMAC) measures as provided for under the price control arrangements have been successful in addressing the Government’s concerns. Given that alternative sources of funding are outside the remit of the Commission, Telstra believes that if the Commission recommends a continuation of a price control regime, it needs to assume that various social policy objectives of government relating to telecommunications will continue to be funded by Telstra.

Telstra contributes to social policy objectives through targeted measures monitored by LIMAC. Telstra estimates that the value of its contribution to social policy obligations was in excess of $160 million for the 2003–04 financial year.

Telstra recognises its role regarding the social policy objectives of government and is funding the Access for Everyone package comprising nine programs covering seven different low-income groups, including:

- HomeLine’ Budget phone plan which offers a lower monthly rental charge but higher than standard per-call costs, targeted to low income earners with low call usage;
• HomeLine' Low Income Health Care Card phone plan, to assist people who have a Low Income Health Care Card from Centrelink;

• Telstra's Pensioner Concession Scheme which provides a monthly call concession and substantial discount on new or in-place telephone connections;

• InContact - a telephone service free of ongoing monthly access charges which allows incoming calls, with restricted outgoing access;

• Telstra Bill Assistance Program (TBAP) providing short-term relief to Telstra customers (including farming families) who have difficulty paying their Telstra home phone bill;

• MessageBox - a free message service for people who do not have access to a working or secure telephone service and who are homeless, experiencing financial hardship or are in a crisis situation;

• Homelink 1800 which is a cashless calling service designed to help families maintain communication via a 1800 phone number linked to a fixed Telstra phone service;

• Sponsored Access offers an InContact telephone service in Crisis Accommodation Program (CAP) properties;

• Multiple Number (Sub-Account) provides the ability to have a split account on the one telephone line service by dialling a short account code. It enables different people in the household to take responsibility for their own calling costs.

In their latest report, LIMAC members concluded that Telstra has responded genuinely and comprehensively to its licence requirement to provide a program assisting low-income Australians to access telecommunications services. Such targeted measures provide an option for people who may be adversely affected by changes in the pricing structure for telecommunications services, such as the line rental rebalancing. Telstra is of the view that, on balance, this type of program is the most effective means of meeting the government's social policy objectives for low-income groups.

If future price control arrangements were to limit Telstra's flexibility to achieve economically efficient pricing outcomes (e.g. a continued calls - line rental price rebalancing), Telstra would be placed in the unfortunate position of having to reassess its ability to continue to fund social policy initiatives. This is because one of the fundamental reasons why targeted measures such as those monitored by the LIMAC exist is to protect disadvantaged groups from the undesirable consequences of a more efficient pricing structure in the telecommunications industry. Furthermore, if the future price controls were to aim at protecting these disadvantaged groups through a series of sub-caps, targeted measures would become less relevant. In this situation, Telstra would also need to consider reducing its social policy commitment.