TELSTRA CARRIER CHARGES—PRICE CONTROL ARRANGEMENTS, NOTIFICATION AND DISALLOWANCE DETERMINATION NO. 1 OF 2002

TELECOMMUNICATIONS (CONSUMER PROTECTION AND SERVICE STANDARDS) ACT 1999

REGULATION IMPACT STATEMENT

BACKGROUND

Current price controls

The following price control arrangements currently apply to Telstra:

(a) a broad price cap on a revenue-weighted basket of Telstra's main services (connections, line rentals, local, STD, international and fixed to mobile calls, mobile services and leased lines) set at the increase in the Consumer Price Index (CPI) over the previous year minus 5.5% (CPI - 5.5%);

(b) a price cap of CPI –0% on a basket of line rentals and local calls and a price cap of CPI–0% on a basket of connection charges;

(c) a CPI – 1% price cap on a basket of fixed line services consumed by residential customers, with revenue weights set at the average for the bottom 50% of Telstra's pre-selected residential customers, by bill size ('B50');

(d) Australian Competition and Consumer Commission (ACCC) approval is required for an increase of more than CPI in a line rental charge affecting customers in the bottom 10% of Telstra's pre-selected residential customers, with approval being contingent on the availability of alternative products and arrangements for these consumers ('B10');

(e) ACCC approval is required for an increase in the standard retail price for untimed local calls;

(f) The untimed local call price is not permitted to exceed 22 cents for calls made from a residential or business phone; or 40 cents for calls made from a public payphone, except that it may be set at up to 25 cents where part of a product or arrangement for the bottom 10% of residential customers, by bill size;

(g) caps apply to certain calls made by customers located in Telstra's 'Extended Zones';

(h) the 'local call pricing parity' (LCPP) measure, which provides that the average untimed local call price in non-metropolitan Australia in one year is not to exceed the average untimed local call price in metropolitan Australia in the previous year by more than 0.4%; and

(i) there is provision for disallowance by the Minister of proposed directory assistance charges.

These arrangements are set out in the *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2001*, made by the Minister under sections 154, 155 and 157 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999*. The current arrangements expire on 30 June 2002.

Review of price controls

The Minister directed the ACCC in 2000 to conduct a review of Telstra's price controls, which were then due to expire on 30 June 2001 and report to the Government by February 2001. The ACCC found that:

(a) competition is still not sufficiently developed in all telecommunications markets to warrant the full removal of price control arrangements;
(b) the welfare of the community as a whole is best improved with a broad price cap applying to all price controlled services and the removal of a number of existing sub-caps from the current price control arrangements;
(c) the long term benefit to consumers will be enhanced by the removal of certain price control arrangements, as current arrangements may be inconsistent with the development of competition, efficient investment and consumer choice;
(d) the appropriate X factor in a price cap needs to consider both Telstra's expected productivity growth as well as its existing productivity level;
(e) revenue weights used to determine whether Telstra complies with a broad CPI-X% price cap should be based on previous period revenue levels;
(f) the current price control arrangements appear to be not well targeted towards protecting low-income consumers;
(g) equity objectives would be better served by more targeted assistance packages and better funded through broad based measures and from services with low responses to changes in price; and
(h) the cost of compensating those residential consumers who do not benefit as a result of changes to the price control arrangements is likely to be small.

The ACCC recommended that:
(a) a broad CPI – X% price cap should be retained for the next price control period;
(b) The level of X for the broad basket of services should be in the order of 5 per cent, and should apply for a period of three years;
(c) All other existing sub-caps in the price control arrangements (other than the 22 cent sub-cap on local calls) and the local call parity requirement should be removed;
(d) The revenue weights used to determine whether Telstra has complied with its price control arrangements should be based on past year revenue levels;
(e) Targeting of low-income groups should be based on measures of income rather than usage levels for telecommunications services;
(f) Targeted assistance or other equity measures recommended by the ACCC should be funded from government or industry-based sources; and
(g) There should be an adjustment period over which rebalancing of the price of line rental is allowed to occur.

The Government extended the existing price controls for twelve months in May 2001, to enable consultation with stakeholders on the ACCC report and to provide an opportunity to further develop the ACCC's ideas, such as its proposal for a scheme to protect low-income consumers from increased line rental charges.

The Department of Communications, Information Technology and the Arts (DCITA) consulted stakeholders in January and February 2002 on the ACCC's recommendations and alternative options.

The Government made commitments at the last election to 'retain a system of price caps on Telstra'; and 'ensure that appropriate arrangements are in place to protect low-income users from the effects of any line rental increases'.

PROBLEMS AND ISSUES

Telstra's market dominance.

While competition is growing, Telstra retains considerable market power in some of the main basic telephony markets. The level of competition is still not sufficient of itself to provide Telstra with incentives to improve its productivity and pass on the benefits of any improvements to consumers.

Lack of effective competition in the market results in other problems:

- Innovation proceeds at a slower rate than it could; and
- Incentives for the firm to align prices with the cost of supply are reduced.

The ACCC assessed the state of competition in all of the currently capped service markets. It concluded that competition is sufficiently developed in the mobiles and leased line markets to enable these services to be excluded from the current broad basket. The ACCC considered that the remainder of the currently capped services were not yet effectively competitive and recommended that these services remain subject to price regulation.

Inefficiency in Telstra's pricing

A number of studies in recent years have concluded that the structure of Telstra's prices is inefficient. The more competitive services, including STD and IDD services, are over-priced, while line charges (connections and line rentals) are under-priced, compared with efficient (Ramsey) prices, based on underlying supply and demand conditions. In 1998, Access Economics found potential annual efficiency gains of from $0.85 billion to $2.2 billion from rebalancing of Telstra's tariffs. In February 2001, the ACCC found potential welfare gains of about $0.38 billion in the first year of the controls it recommended, with additional, though slightly smaller, gains in the following years.

Rebalancing has been restricted by sub-caps on line charges (connections and line rentals) over the period since 1989. There are four separate controls on residential line rentals under the current arrangements (including B10) which constrain Telstra's ability to rebalance. While intended to protect residential consumers, especially low-bill residential consumers, from adverse effects of increased line rental charges, these sub-caps have restricted restructuring of prices to achieve a more efficient pricing structure. The ACCC has assessed the access deficit, ie the amount by which line charges fail to cover line costs, at $1.180 billion in 2000-01. A small amount of this deficit is due to under-recovery of business line costs.

This inefficient pricing structure has caused distortions to arise in various markets. In assessing charges for interconnection to Telstra's network by other carriers, the ACCC adds an access deficit contribution (ADC) to the conveyance cost for calls in order to estimate a reasonable charge for the service. This was determined at 0.69 cents per minute for 2001 which, when combined with an estimate of conveyance costs, led to an overall price of 1.53 cents per minute. Therefore, without an ADC, the appropriate interconnection charge would have been much lower at around 0.84 cents per minute. Removal of the access deficit will therefore mean reductions in the prices of telephone calls.

Allowing Telstra greater scope to correct these market distortions may, however, impact adversely on certain consumers. Increases in line charges towards economically efficient levels would mean an increase in the bills of low-bill consumers, particularly residential consumers, for whom line charges represent a relatively large proportion of their bill. The 'rate shock' caused by a line rental increase is greater for these consumers.

While Telstra has a commercial incentive to rebalance because this would increase pricing efficiency and potentially producer surplus, it has been constrained in its ability to increase line rentals by the price caps imposed by the Government to reduce rate shock; and the need to maintain the goodwill of its customers, particularly low-bill customers.

Higher prices in regional areas

In regional areas the costs of providing telecommunications services are higher than in metropolitan areas, with the result that prices tend to be higher. While Telstra has adopted a policy of charging uniform rates throughout the nation, eg for line charges, discounts are generally not available to the same extent in regional areas. This is explained in part by the slower growth of competition in regional areas.

According to the ACCC's 2000-01 report on telecommunications charges, prices of PSTN services fell, on average, by 25.0% in capital cities between 1996-97 and 1999-2000, compared with only 22.4% outside the capital cities.

OBJECTIVES

Arising from the problems discussed above, there are four main objectives:
(1) to allow Telstra greater freedom to rebalance line rentals while protecting consumers from 'rate shock' caused by excessively rapid rebalancing;
(2) to promote efficiency in markets not yet effectively competitive and the passing on of benefits to consumers;
(3) in accordance with Government policy, to protect low-income consumers from any adverse effects of line rental increases;
(4) to ensure that consumers in rural and remote areas share in the benefits from greater competition in telecommunications; and
(5) to meet other equity objectives.

Options - objective (1) – greater freedom to rebalance, with protection from 'rate shock'

The ACCC found that the standard residential line rental, at $166.20 per annum, was then only approximately 55% of the efficient cost of line provision, being kept low in part by the existing sub-caps on line rentals. With increases since then, the rental stands at about 63% of the cost of the average line.

A reasonable 'glide path' or measured transition to cost-based residential line rentals now appears critical to address market distortions, the efficiency losses of which have been found to be substantial in a number of recent studies by the Productivity Commission (PC), ACCC and Access Economics. In its September 2001 report on telecommunications competition regulation the PC recommended removal of the sub-caps on line rentals preventing increases towards cost.

The ACCC recommended that Telstra be allowed to rebalance residential line rentals to cost within 5 years. It considered that a cap of CPI+10% on the standard residential line rental, ie a 10% increase each year, would allow this. Given the increases in line rentals that have occurred since February 2001, the ACCC now considers full rebalancing of the standard rental could be achieved over 5 years with a cap of CPI+7% or over 4 years with a cap of CPI+9.5%. In practice, CPI+9.5% would mean an increase of about $2.00 per month each year (in 2002 values).

In addition, business line rentals are considered by the ACCC to be slightly below cost. In the ACCC's view, the standard business line rental would need to increase by about 0.5% per year over 5 years to align with costs.

The ACCC considered that a five year rebalancing period was the shortest practicable consistent with avoiding or minimising 'rate shock'. Under the existing price controls, the line rental sub-caps have operated so as to cause a much slower rate of rebalancing (and hence removal of the access deficit) than the ACCC (and the PC} considered desirable.

Telstra has a commercial incentive to take advantage of any scope to increase line rentals that is provided under a line rental sub-cap. This is because the ACCC imputes reductions in the access deficit (and the access deficit contribution from other carriers) each year on the basis that Telstra has taken full advantage of the scope to increase line rentals provided under the cap.

DCITA consulted stakeholders on options for rebalancing over 3, 4 or 5 years. In its submission to the ACCC in November 2000, Telstra considered 7 years was desirable to minimise rate shock, but advised DCITA in January 2002 that it considers that a shorter period of 4 or 5 years would be feasible. Telstra's competitors generally prefer a period of 3 years or less. Consumer organisations preferred a longer period of at least 5 years. There was a general acceptance that some control over the pace of rebalancing to protect against rate shock is required.

For the purposes of this assessment, rebalancing 'glide path' options of 3, 4 and 5 years are examined.

Impact analysis – objective (1) – greater freedom to rebalance with protection from 'rate shock'

Table 1 sets out the amounts by which the standard residential line rental would need to increase over 3, 4 and 5 years to align with costs and so remove the access deficit in respect of the standard residential service. Increases to bring both business and residential line rentals to cost (both standard and non-standard rentals) are also shown in Table 1[1]. The X factors for the business and residential baskets are considerably lower than for residential only because of the much smaller increase required to bring business line rentals to cost and the respective revenue weights for business and residential rentals. The data in Table 1 were provided by the ACCC.

[1] The increases in business and residential line rentals apply to all rentals, not just standard rentals. That is, they show the increases required to bring total line rental revenue to cost, recognising that line rentals above and below the standard line rental may be charged. Most non-standard rentals are above the standard rental. The difference may be considerable for business lines.

Table 1: Line rental increases required to remove the access deficit.

	3 year	4 year	5 year
Residential only	CPI + 13.7% ($2.84)	CPI + 9.5% ($2.00)	CPI + 7% ($1.50)
Business and res.	CPI + 5.7%	CPI + 3.7%	CPI + 2.6%

It is relevant that Australian residential line rentals are comparatively low in international terms. The Productivity Commission found in 1999 that Australia ranked fourth lowest out of nine similar countries.

A 4-year rebalancing period applied to both business and residential line rentals now appears to strike a reasonable balance between actively addressing the problem while providing scope for community adjustment. This could be achieved with a CPI+4.0% cap over the 3-year period of the next controls (see paragraphs 186-188 below for further discussion on this period), with a review of the cap to be undertaken in early 2005. While a CPI+9.5% cap on the standard residential line rental would enable removal of the access deficit in respect of residential lines, it would not address the ongoing deficit in respect of business lines.

It is relevant that some other countries, such as Canada, have rebalanced more quickly than this. In some provinces of Canada, residential line rentals more than doubled between 1995 and 2000.

Options - objective (2) - to promote efficiency and pass benefits on to customers

Alternative general approaches

There are three main approaches towards achieving increased efficiency and price reductions in monopoly service areas: (a) price caps of CPI minus X form; (b) rate-of-return regulation; or (c) promoting competition in markets for services that are not yet effectively competitive.

The Government already has price caps in place and is committed to maintaining them.

Option (b) – rate of return regulation - controls prices through control of profits, and takes the form of a specified rate of return on capital employed for relevant services (a form of cost-plus regulation). The firm is required to earn no more than the specified rate of return in each year, the rate of return being set after assessment of the appropriate level of costs. This could be done for each of the services separately, or for a revenue-weighted basket of services, to enable rebalancing of charges for services within the basket.

In relation to option (c), all restrictions on entry to telecommunications markets have been removed. Parts XIB and XIC of the Trade Practices Act, dealing with anti-competitive conduct and record keeping rules in telecommunications and the telecommunications access regime, respectively, have provided the main instruments and powers to promote competition in the Australian telecommunications market, in conjunction with Part IV of the Act, dealing with general restrictive trade practices.

The telecommunications access regime promotes network competition by encouraging the development of competing, interconnecting networks so that there is a choice of operators providing either retail services to customers or wholesale services to operators. The access regime provides a framework for regulated access rights to be established for specific carriage services and related services, and establishes mechanisms within which the terms and conditions of access can be determined.

The current legislation promotes service competition by removing barriers to entry, encouraging network competition, providing for customer pre-selection of service providers, telephone number portability and a range of other measures to encourage the expansion of the range of retail services offered to customers.

The provisions of Part XIB of the Trade Practices Act promote fair trading by deterring anti-competitive conduct by a firm in markets where it holds substantial market power, and dealing promptly and effectively with anti-competitive conduct where it occurs.

Amendments to make fine-tuning adjustments to Parts XIB and XIC of the Trade Practices Act were passed in September 2001. These amendments strengthened the power of the ACCC to facilitate competition in the industry. Parts XIB and XIC and competition-related parts of other telecommunications legislation have been reviewed by the Productivity Commission, which reported to Government in September 2001. The Government responded to the PC's recommendations in April 2002.

While options (a) and (c) could be, and have been, used in combination to achieve the Government's objectives, the use of price caps in combination with rate of return regulation is more problematic.

Rate of return regulation is inherently more intrusive and bureaucratic than price cap regulation. Unlike rate of return regulation, where there is annual review of profitability and consequent adjustment to price regulation, price caps are set for a period of several years and are not revisited until the end of the period. To use price caps and rate of return regulation together (as has been done in some States of the US) risks losing the advantage that price caps have of providing an incentive to minimise costs. The regulated firm would have less incentive to reduce costs if any increased profitability achieved by productivity improvements were to lead to a requirement for lower prices as a result of an annual rate of return review.

Structure of price caps, service composition and X factors

Structure of price caps: There is a clearly a large number of ways in which services can be grouped for inclusion in price cap baskets. At one extreme, there could be one broad cap that includes all services not yet considered effectively competitive. At the other extreme each of these services could be capped as a separate basket. Between these extremes, a broad cap and individual sub-caps could apply, or services could be grouped together for price capping as parallel baskets, eg the existing line rentals and local calls basket.

The existing price cap structure is complex, with a broad cap and 3 separate sub-caps. Further, the sub-caps can act to prevent rebalancing of prices within the broad basket, as noted by the ACCC.

One structural option, raised by stakeholders with DCITA in recent consultations, is to price cap a basket of calls and a basket of line rentals, with another cap for connection services. This is an alternative to the existing broad basket which includes the full range of line rental, calls and connection services. This option is examined further below.

Service composition: The Government has previously stated at the time of its Telstra 1 and Telstra 2 share offerings that it is committed to the principle that price caps will be removed where there is effective competition in a telecommunications market.

The ACCC assessed competition in all of the currently capped service markets. It concluded that competition is sufficiently developed in the mobiles and leased line markets to enable these services to be excluded from the current broad basket. The PC concluded along similar lines in its September 2001 report on telecommunications competition regulation. The PC noted that 'the mobile services market appears to exhibit characteristics of an effectively competitive market'. In relation to leased lines, the PC concluded that 'there are now many providers in the market and faster growing data areas like frame relay, ATM and managed IP services, which are close substitutes for leased lines'.

The ACCC's 2000-01 report on telecommunications charges indicates that the rate of price reductions in mobile services is increasing. Prices fell by about 12.7% and 10.4% in 1999-00 and 2000-01, respectively, compared with around 3.9% in 1998-99.

In relation to national long distance (STD) and international call (IDD) services, the ACCC concluded in February 2001 that while STD and IDD prices had fallen significantly over recent years, it had information that suggested that prices remained above costs. The ACCC considered that Telstra maintained a relatively high market share in STD and IDD, and facilities-based entry into the long distance and international components of the production chain had been limited, especially on other than major routes. The ACCC was therefore not convinced there was sufficient evidence that the STD and IDD markets were effectively competitive.

The ACCC has confirmed this view in its 2000-01 competitive safeguards report. The ACCC noted that while a small number of new entrants have established independent long-distance transmission facilities on major routes, especially between capitals, there is a 'clear lack of effective competition on non-major routes'. The ACCC also noted that there is no alternative means for suppliers of long-distance and international calls to reach the majority of their potential customers without access to Telstra's PSTN network. The ACCC concluded that despite the access regime allowing Telstra's competitors to access essential upstream originating and terminating infrastructure, a lack of facilities-based competition in the downstream stage of production would appear to be hampering the development of effective competition in retail markets for these services.

The PC concluded in September 2001 that the STD market was highly concentrated, with Telstra accounting for around 75% of the market and the largest three providers for around 97%. In IDD, the PC noted that there have been many new entrants, with providers other than Telstra and Optus now accounting for around a third of the market.

The ACCC concluded that there was not effective competition in fixed to mobile and local calls, and other local access services (line rentals and connections). These areas appeared to the ACCC to be the least competitive of the services currently subject to price control.

The ACCC's 2000-01 competitive safeguards report confirms the ACCC's views on the ineffectiveness of competition in the local and fixed to mobile call markets.

The ACCC notes that while there has been an increase in the number of fixed to mobile service providers, the rate of price reductions in fixed to mobile calls was only 18.1% between 1997-98 and 2000-01, compared with 21.4% for a full basket of telecommunications services. The price fall in 2000-01 was particularly modest. The ACCC also considers that the extent of price reductions has been limited by lack of competition in the supply of the GSM termination service, which is a key component in the provision of fixed to mobile calls.

In relation to local calls, the ACCC states that 'the local telecommunications market is an example of one that appears a long way from being effectively competitive' and that Telstra has the only ubiquitous fixed-line network with the full range of capabilities, including provision of local call services and line rentals.

While prices of local calls have fallen quite rapidly over the last two years (9.6% and 18.6% in 1999-00 and 2000-01, respectively), the ACCC considers the price reductions have in part been driven by the price controls, particularly the CPI cap on the line rentals and local calls basket.

Setting of X factors: Having determined an appropriate structure and composition for the price caps, X factors for the relevant baskets must be determined. X factors are normally based on estimated productivity growth for the relevant services, adjusted as appropriate for economy-wide productivity growth.

The ACCC recommended an X equal to 5% for a broad basket of connections, line rentals, local, STD, IDD and fixed to mobile calls in its February 2001 report. This was based on its estimate of the extent to which Telstra's productivity growth would exceed that of the economy as a whole over the price control period. The ACCC concluded that the PSTN-specific total factor productivity (TFP) growth from 1996-97 to 1999-2000 was 7.1% per annum and considered that this growth would continue over the following three years. It estimated the economy-wide productivity growth at 1.8% per annum, resulting in a 'net' PSTN-specific TFP growth of 5.3% per annum.

The ACCC also argued that its TFP growth projection of 10% for Telstra as a whole was consistent with findings that Telstra's productivity is considerably below that of carriers in other countries. The ACCC updated work previously undertaken by the Bureau of Industry Economics (BIE) and concluded that Canada was about 36% more efficient than Australia, USA 62% more efficient and the UK 98% more efficient.

DCITA requested ACCC to re-examine these findings in the light of market changes since February 2001. The ACCC advised that while Telstra's PSTN-specific TFP growth may have slowed slightly in 2000-01, so too has the economy-wide productivity growth. It therefore considers there is no reason to suggest that X should be set at a lower level for the broad basket than it recommended in its February 2001 report, ie CPI-5.0%.

The **first option** is therefore the ACCC recommended cap of CPI-5.0% on a basket of connections, line rentals, local, STD, IDD and fixed to mobile calls.

Telstra and some of its competitors have strongly disputed the validity of the ACCC's analysis and consider the recommended X is far too high.

Telstra claims that the ACCC analysis ignores the fact that Telstra is subject to wholesale price regulation which sets prices by reference to costs of the most efficient provider, not actual costs, and that the ACCC's benchmarking analysis is not robust. Telstra argues that the substantial differences between Australia and other countries (including US and Canada) in respect of network density explain the differences in labour productivity observed. Telstra claims the ACCC dismisses the effect of subscriber density on costs despite evidence, eg a recent study by the PC, that Telstra is disadvantaged by Australia's lower line densities.

Telstra also claims there is evidence that Telstra's efficiency rates very highly compared with similar countries.

Telstra claims on the basis of its own studies that the true scope for productivity improvements is only in the order of 1 to 2 percent and that it has reached the frontier in terms of its ability to make further cost reductions. It considers that TFP growth in the future will be at a considerably lower rate than has occurred over the last decade.

Optus claims that an X for the broad cap set at the level recommended by the ACCC would result in Telstra being unable to rebalance line rentals to cost without having to reduce the prices of other services, particularly STD and IDD calls, below retail cost levels. Optus claims that this would in turn force its own prices below cost, in order to compete with Telstra. Optus also claims that it does not have the ability to increase productivity at the same rate as Telstra, due to its smaller scale.

AAPT also considers that an X of 5.0% would drive STD and IDD prices to unsustainable levels.

As can be seen in Table 2, mobile services contributed significantly to compliance with the broad cap in both 1999-2000 and 2000-01. It is therefore arguable that exclusion of mobiles from the existing broad basket should reduce the X factor by considerably more than 0.5%.

Table 2: Contribution of capped services to compliance with broad cap, 1999-2000 and 2000-01

Service	**Revenue-weighted price movement***	
	1999-2000	**2000-01**
Connections	0.0	0.0
Line rentals	3.4	3.3
Local calls	-4.5	-1.2
STD and fixed to mobile	-1.3	-1.4
IDD	-0.6	-0.3
Domestic leased lines	-0.2	-0.2
International leased lines	0.2	-0.1
Mobile services	-3.6	-4.0
Overall	-6.6	-3.9
CPI	1.1	3.2
CPI-5.5%	-4.4	-2.3
Carryover from previous year	Nil	2.2
Carryover to next year	2.2	3.8

* Calculated as price movement (percentage increase or decrease) multiplied by the revenue weight of the service in the broad basket.

Further, the telecommunications market has slumped further since the ACCC's report. Revenues have continued to be flat; many entities have yet to show a profit; and access to capital has become difficult. There have been some remarkable market consolidation activities, including the demise of One.Tel, the closure of Dingo Blue, and the proposed pay TV consolidation between Foxtel and Optus.

The **second price cap option** is a broad cap on the same services included in the ACCC recommended basket, but with an X factor of, say, 2.0% to reflect the current depressed state of the telecommunications market and the concerns raised by Telstra and its competitors.

The remaining four options involve a restructuring of the price caps along the lines suggested above, ie to break the existing broad basket up into parallel calls and line rentals baskets, with an additional safeguard cap of CPI on connection charges. For each of these four options a cap of CPI+4.0% on line rentals would apply, as indicated above.

Given the revenue weights of local, STD, IDD and fixed to mobile call services in the ACCC's 2001 recommended basket, applying the ACCC's expected TFP growth of 5.3% implies that a cap of around CPI-8.5% would be appropriate for this basket. This is the **third option**.

Telstra, Optus and AAPT all consider that an X of 8.5% for this calls basket would lead to similarly deep price cuts for STD and IDD calls as a CPI-5.0% cap on the broad basket. In the current telecommunications environment, this would be likely to damage competition and lead to increased dominance of Telstra in the longer-term. Telstra, Optus and AAPT have recommended X factors in the range of 1.0% to 3.0% for this basket. The **fourth option** involves a cap of CPI-4.5% on this basket, representing a compromise between the X factor implicit in the ACCC's analysis and industry recommended X factors.

The **fifth option** involves removing price controls from IDD and STD on the basis of the claims of market participants that these markets are now effectively competitive.

Excluding STD and IDD would mean a reduction in the X factor, irrespective of whether the broad cap/subcap or parallel line rental and calls caps structure is adopted. Adjustment of the ACCC's 2000 TFP analysis to cover local and fixed to mobile call services alone suggests an X of around 8.0% would be appropriate for this basket Telstra and Optus have claimed that a much lower X than 8.0% would be appropriate for this basket, for similar reasons as their objections to X of 8.5% for the broader calls cap. Telstra considers that X for this basket should be 0.0%, while Optus favours 3.6%. An X of 3.0% appears to be a reasonable compromise.

Impact Analysis – objective (2) – to promote efficiency and pass benefits on to customers

Arising from the discussion above, the five options for analysis in this section are therefore:

1. A cap of CPI-5.0% on a broad basket of connections, line rentals, local, STD, IDD and fixed to mobile calls; with a sub-cap of CPI+9.5% on a basket of residential line rentals;
2. A cap of CPI-2.0% on the same broad basket as in option (1); with the same sub-cap;
3. A cap of CPI-8.5% on a basket of local, STD, IDD and fixed to mobile calls, with parallel caps of CPI+4.0% on a basket of business and line rentals, and CPI-0% on a basket of connections;

4. A cap of CPI-4.5% on a basket of local, STD, IDD and fixed to mobile calls, with the same parallel caps on line rentals and connections as in option (3);
5. A cap on a basket of fixed to mobile and local calls, with an X of 3.0%; with the same parallel caps on line rentals and connections as in option (3).

Options (1) and (3) would appear to have significant risks in the current Australian telecommunications environment. If Telstra and its competitors are correct about the scope for future productivity growth, complying with the cap would risk pushing STD and IDD call prices below cost and of damaging competition in these markets. This would adversely affect both Telstra and its competitors, such as Optus and AAPT.

Options (2) and (4) would entail less risk of forcing unsustainable price cuts in STD and IDD services.

Options (3), (4) and (5) have the advantage of making rebalancing more transparent. The parallel basket structure brings into sharper relief the nature of rebalancing of line rentals against call services. The ACCC has acknowledged the transparency advantages of the parallel basket approach.

Option (5) has the advantage of removing from price control services (STD and IDD calls) commonly considered effectively competitive. The rate of price reductions in STD and IDD has exceeded that in most markets, and has been comparable to that in mobiles. In IDD, prices fell by 54.9% from 1997-98 to 2000-01, compared with 24.8% in mobile services. STD prices fell by 22.1%. Market shares in IDD and STD have also fallen to relatively low levels, particularly in IDD where Telstra has only 48% of the market.

Against this, the ACCC has recently expressed concerns about the state of competition in these markets, as discussed above.

Overall, option (4) is the preferred option. It recognises the current slump in the telecommunications market whilst making rebalancing transparent. The state of competition in the STD and IDD markets would, however, need to be assessed as part of the 2005 review of the price controls, to determine the need for continued price controls.

Options - objective (3) – to protect low-income consumers from any adverse effects of line rental increases

Low-bill consumers can be made worse off from rebalancing of line rental and call charges because line rentals are a bigger component of their phone bills. The bill size below which the consumer will generally be worse off depends on the particular price caps in place and the extent of price competition in the relevant access and call markets. The ACCC found that consumers with a bill of lower than $32.27 per month would be worse off from rebalancing, however this relates to the price controls recommended by the ACCC. The relevant bill size would need to be adjusted to the extent that price controls apply that are different from those modelled by the ACCC.

The ACCC estimated that the lowest 35.5% of Telstra's pre-selected customers (about 1.5 million) would have bills of less than $32.27 per month and may therefore be worse off from line rental increases. Of these, ACCC estimated that about half would be worse off by less than $10 in the first year. The remainder—about 800 000—would be worse of by between

$10 and $19.10 in the first year. These consumers would generally have bills of less than $23 per month.

The Government is committed to protecting low-income consumers from the effects of any line rental increases. Low-income, low-bill consumers who would be made worse off from rebalancing should be protected. The Government is no longer committed to protecting from line rental increases higher income, low-usage consumers such as those with a fixed phone in a holiday residence or who rely primarily on a mobile phone provided by their employer, by cross-subsidisation from other services (or direct Government subsidy).

The available evidence does not suggest that there is a strong correlation between household income and fixed line telecommunications expenditure in Australia. This means that low-usage protections such as the existing B50 and B10 controls will unnecessarily give incidental protection to many low-income, high-usage consumers and high-income, low-usage consumers, through cross-subsidies from other services. A more targeted approach to protecting low-income consumers appears justified.

Who are low-income consumers?

Any protection for low-income consumers will in practice need to be based on a surrogate for income, such as the consumer's eligibility for certain welfare payments. It would not be feasible to implement a scheme in which the right to particular services or subsidies was dependent on the level of household or personal income, *per se*, because of concerns about privacy and for administrative reasons associated with changes in household income over time.

Eligibility to hold a Pensioner Concession Card (PCC) is one indicator of income that is already used to establish eligibility for subsidies provided by the Government and Telstra. A Telephone Allowance is paid by Centrelink and Department of Veterans' Affairs to around 2.66 million PCC holders (and about 0.22 million holders of a Commonwealth Seniors Health Card (CSHC)). The Allowance is $18.00 per quarter per service (which can be a fixed line service or a mobile) or $9.00 per month where a service in joint names.

PCC holders are also eligible for concessions made available by Telstra for connection charges (50% of $55 for an in-place connection and 29% of $190.30 for a new service connection); rebates of up to $6 a month for telephone calls, depending on the consumer's rental plan; and the EasyCall Call Control facility.

Eligibility to hold other Commonwealth concession cards, such as the Health Care Card (HCC) and the CSHC, may also be considered as an indicator of low-income. There are around 1.6 million HCC holders, of whom about 40% are recipients of the Newstart Allowance and a further 21% hold the Low-income Concession Card.

The HCC has a more stringent means test than the PCC and is a better indicator of low-income, while the PCC in turn has a more stringent means test than the CSHC.

While HCC holders are the most deserving of protection in terms of income, they are also an unstable group, as cards are generally issued for a relatively short period of 3 to 6 months and eligibility reflects reversible circumstances relating to employment and income. Such instability would complicate administration of any compensation measure as more frequent checking of eligibility for compensation would be required.

There are at least five options for protecting low-income consumers:

(1) Retention of a low-bill protection measure, such as B50 or B10, on the assumption that this will protect low-income, low-bill consumers (while providing incidental benefits to other consumers who do not need protection).

(2) Compensation for low-bill, low-income consumers funded by Government or an industry levy, but administered by Telstra.

(3) A fully commercial solution, involving reliance on Telstra's commercial offerings of low-income consumer products.

(4) A commercial solution, with regulation of certain products.

(5) A requirement for Telstra to obtain the ACCC's consent prior to increasing line rental charges, with ACCC consent being contingent only on Telstra's compliance with a new licence condition requiring Telstra to have an approved low-income package in place, with details notified to the Australian Communications Authority (ACA) in writing.

Impact Analysis – objective (3) – to protect low-income consumers from any adverse effects of line rental increases

<u>Retention of low-bill protection (option (1))</u>.

The problem with low-bill protection measures such as B50 and B10 is that regardless of the incomes of the payers and payees, high users of telecommunications services that more than fully recover costs make transfers to low users of telecommunications services that do not fully recover costs. This means that high users of telephony services with low incomes can subsidise low users of telephony services with high incomes. These measures assist high-income and low-income consumers alike.

The threshold issue is whether or not the Government wishes to protect all low-bill consumers from the 'rate shock' caused by increased line rentals or just low-income, low-bill consumers. The amount of the cross-subsidy and, therefore, the amount of alternative consumption foregone, increases with the numbers of consumers whose services are cross-subsidised.

Further, the amount of the cross-subsidy in measures such as B50 and B10 is commonly not transparent. Consequently, the amount of consumption foregone is also not clear. Telstra advises that rebates are provided to low-bill consumers in order to meet the B10 and B50 requirements, mainly through pensioner concessions. Telstra claims that lower prices required across the broader residential consumer base result in the loss of additional revenue, however there is no estimate available of this amount.

Should the Government wish to retain some assistance for medium or high-income, low-bill consumers, a cap such as the existing B50 cap could be implemented in addition to more targeted protection for low-income consumers. However, the cost of such a cross-subsidy should be made transparent.

Where bill size is a good surrogate for household income, it may be reasonable to focus protection on low-bill consumers. Expenditure-based caps on BT's charges for residential consumers have been widely used in the UK and such caps are used elsewhere, such as in

Ireland and South Africa. In the UK there appears to be quite a strong correlation between fixed line bill size and household income, which may account for the high use of the BT Light User Scheme by pensioners (around three-quarters of users).

There is less evidence of a strong correlation between fixed line bill size and household income in Australia.

Telstra has provided DCITA with details of a study which suggests that at the 95% level of significance there is no correlation between fixed line bill size and household income except at levels of income above $80 000 a year. Households with an annual income greater than $80 000 were found to have only $118 more fixed line expenditure a year than households earning less than $26 000. Total telecommunications expenditure increased quite markedly with household income but this was largely due to increased use of mobiles at higher income levels.

The ABS Household Expenditure Survey 1998-99 also shows increasing total telecommunications expenditure with increases in household income, such that the average expenditure of the highest 20% of incomes is more than double that of the lowest 20%. The ABS does not, however, collect disaggregate data for fixed line expenditure.

Survey data commissioned by DCITA shows a stronger relationship between household income and fixed line call bill size.

In view of the remaining uncertainty about the relationship between household income and fixed line expenditure, there is a strong argument in Australia for targeting low-income consumers directly for protection, that is, to aim to protect only those low-income consumers who may be made worse off from line rental increases because they have a low-bill.

<u>Budget or industry funded compensation (option (2))</u>

The ACCC recommended Government or industry funded compensation as providing less distortionary means of funding low-income consumer protection than through the Telstra price controls. It considered that transparency, efficiency and fairness objectives would be better achieved through Government or industry funded compensation. If industry funding was adopted, the ACCC suggested all carriers could contribute to the fund according to their shares of eligible telecommunications revenue (ie on the same basis as contributions to the universal service levy).

The ACCC envisaged a scheme involving Telstra examining the bills of all consumers deemed by the Government to be low-income because they hold a specified concession card, such as the PCC or HCC. Cardholders with total bills below a specified level would then receive rebates from Telstra through reductions in their bill.

Details of all bills for consumers who use carriers other than Telstra for calls would need to be provided to Telstra by these carriers, with appropriate privacy safeguards. Telstra would then receive reimbursement from the Government or industry fund for rebates paid to consumers.

Government or industry funding would meet fairness and efficiency objectives better because the funds for compensating low-income consumers would come from a broader group than for option (1) (taxpayers in the case of Government funding and customers and shareholders of contributing telecommunications companies in the case of industry funding). Optimal tax principles tend to suggest the narrower the group taxed, the higher the rate of tax necessary and hence the greater the distortion of pricing signals.

However, the ACCC noted that carriers other than Telstra already contribute to the cost of cross-subsidies under the operation of the B10 and B50 arrangements. First, other carriers bear some of the costs explicitly where interconnection charges include a contribution to Telstra's access deficit. Competing carriers also implicitly contribute where they price their services to match Telstra's offerings. Second, all carriers contribute to the net cost of services provided by Telstra in universal service obligation (USO) areas according to their shares of eligible telecommunications revenue. To the extent that the price control arrangements serve to keep line rental and local call prices below cost in USO areas, this adds to the net cost of the USO and all carriers' funding contributions.

The ACCC concluded that while payment of direct subsidies funded from within the industry to achieve equity objectives is an improvement on the cross subsidies implicit in the current B50 and B10 arrangements, this approach has shortcomings compared with the use of the general tax system, particularly in regard to equity in financing.

Industry funding is currently used to fund the universal service obligation and various other expenditures such as consumer representation grants, and the telecommunications related costs of funding the ACA and the ACCC. Industry funding is considered appropriate for these purposes because while it is considered reasonable for the industry rather than the Government to meet the cost, it is considered unfair in an environment of open competition to expect the incumbent former monopolist to meet the entire cost. However, establishing an industry fund to compensate low-income consumers for line rental increases would require an amendment to primary legislation. Such an industry fund would make explicit and transparent the contributions of other carriers to low-income consumer protection, in contrast with the existing B10 and B50 arrangements where the contributions are implicit, non-transparent and not capable of estimation.

Cost of compensation

The ACCC estimated that the cost of compensating all low-income consumers made worse off from rebalancing of line rentals an amount representing the average loss for these consumers would be from \$5.1 million to \$14.5 million in the first year, depending on the numbers of low-bill consumers who are also low-income. The amount of \$5.1 million was based on 35.5% of low-bill consumers (ie with bills of less than \$32.27 per month) also being low-income. The amount of \$14.5 million was based on all low-bill consumers being low-income. The ACCC had no information on the numbers of low-bill consumers who are also low-income.

Given the ongoing lack of detailed evidence on the relationship between household income and fixed line expenditure, as discussed above, an indicative cost of around \$10 million could be assumed for the first year, representing the middle of the range estimated by the ACCC[2]. The cost would rise cumulatively each year with further rebalancing. Assuming further that the additional compensation would rise by only 90% each year because of consumers moving out of the low-bill group, a very imprecise, 'order of magnitude' estimate of total

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[2] This estimate implies that low-income consumers comprise about two-thirds of low-bill consumers.

compensation required over 4 years of rebalancing is $90 million. This is arrived at as explained below.[3]. The issue would then be whether further compensation would be required for the ongoing higher line rentals following the completion of rebalancing and, if so, how much.

This indicates, in very broad terms, the costs over 4 years (excluding administrative costs) that may be incurred by Government (or industry) under option (2) if it funded a compensation package aimed at making low-bill, low-income consumers no worse off, on average, from line rental increases. This compensation package would not protect low-income consumers currently without a telephone service, for whom the affordability of a basic phone service is reduced by line rental increases. Administrative costs of such a Government or industry funded scheme are likely to be substantial given the need for billing details to be transferred among carriers and for bill-by-bill analysis, however these costs were not assessed by the ACCC.

The total cost of a Government or industry funded compensation scheme is therefore highly uncertain. It is likely to exceed $90 million over 4 years, however the magnitude of the excess cannot be estimated. This uncertainty could make such Government funding problematic in the current Budgetary environment.

A fully commercial solution (option (3)).

Telstra advises that it has been working to improve its package of products for low-income consumers for some time. In September 2001 Telstra increased the level of rebates made to pensioners for calls. Telstra has more recently intensified its efforts to develop products and arrangements for low-income consumers and for families and youth.

On 23 April 2002 Telstra announced the initiatives in its 'Access for Everyone' package, which are intended to be phased in from 1 July 2002. The package includes measures to:

- Allow pensioners the option of taking the existing rebate on calls of up to $6 per month in the form of an equivalent concession for Big Pond Internet access; and permit 'bill smoothing' (averaging of the bill over time) for pensioners. Telstra has committed to no real increase in the average bill of a pensioner for their fixed line services;
- Provide a free virtual messaging service to enable the homeless and other itinerant persons, including job seekers, to remain contactable by prospective employers, Centrelink, or family members via a mobile mailbox (with the capacity also to make other calls on a pre-pay basis);
- Provide a 'pre-rebalancing' pricing package with low line rental and high call charges (with prices close to those applying prior to rebalancing and which would not rise in real terms irrespective of increases in other line rentals). Telstra has committed to no real increase in the average bill of these customers;
- Provide emergency relief to Telstra customers facing financial difficulties via a Telstra sponsored voucher system operated through major welfare organisations, supporting up to 100 000 households each year;
- Provide an enhanced InContact service with greater outgoing call capacity. It would also provide a greater range of free outgoing call destinations, ie to some counselling services, and an ability to make other outgoing calls on a pre-pay basis; as well as concessional installation charges for HCC and PCC holders;

[3] Comprising $10m in year 1, $19m in year 2, $27.1m in year 3 and $34.4m in year 4.

- Provide Telstra sponsored access to up to 6000 emergency homes, eg community homes, refuges, which will support Government initiatives;
- Provide an enhancement of the existing Homelink service which will enable 'cashless' calling to the family home or sponsor by simplified access codes, with applications including improved contact in emergency situations, as well as for non-custodial parents and fractured families; and
- Provide other services for families, such as sub-accounts allowing independent youth living at home to use the family phone and meet the cost independently; and free calling number display (CND) for one month where malicious and threatening calls are received (to avoid the need for an unlisted number).

Telstra announced that the package had been developed in consultation with welfare groups, including ACOSS, the Salvation Army, The Smith Family, Jobs Australia and the Australian Federation of Homelessness Organisations. Each of these organisations has written to Telstra or the Government endorsing the low-income package.

Telstra advised the Government prior to the announcements that the above products and arrangements are designed not only to compensate existing low-income customers for any increase of the line rental on their standard telephone service, but also to meet the special needs of low-income consumers for an affordable basic service, perhaps with restricted functionality. They claimed that welfare groups were seeking a multi-faceted solution to the needs of low-income consumers.

The package would build on and enhance a number of existing products for low-income and/or low-bill consumers, such as Homeline Budget, InContact and Pre-paid Home.

Telstra has announced that the package is expected to cost about $150 million per year to implement, although a proportion of this is already being incurred, for example, in the existing Pensioner Concessions for calls and network connections. An estimate of the amount that will be repackaged in this way was provided on a commercial in confidence basis by Telstra and can not be disclosed.

This option has the advantage of giving Telstra greater flexibility in how it meets the needs of low-income consumers. It is Telstra's preferred option for this reason. Telstra would like the freedom to make line rental increases as and when the market permits, subject to maintaining a package of products for low-income consumers. Telstra has also sought minimal regulation of the low-income package.

<u>A commercial solution, with regulation of certain products (option (4))</u>

Telstra indicated its preferred forms of regulation, should regulation of the low-income package be considered necessary. They are:

1. Annual reporting to the Minister by a Low-income Measures Assessment Committee (LIMAC) on: (a) the effectiveness of the low-income package for low-income consumers; (b) the effectiveness of promotion of the package; and (c) the efficiency of allocation of resources within the package. The LIMAC would mainly comprise representatives of low-income consumer advocacy groups.
2. A CPI cap on the average bill of a customer receiving the proposed Homeline Classic 'pre-rebalancing' product; and
3. A CPI cap on the average bill for a person receiving the pensioner concessions.

ACCC consent subject to low-income protection (option (5))

Greater assurance that low-income consumers would be protected from line rental increases could be provided via an ACCC approval process. That is, the price control determination could provide that:

- before increasing a line rental affecting a low-income consumer, Telstra must obtain the ACCC's consent to the increase; and
- ACCC consent is to be contingent only on its being reasonably satisfied that Telstra has complied with a new licence condition.

The new licence condition would require Telstra to:

- have products and arrangements available for low-income consumers which protect these consumers from the effects of line rental increases; and have been endorsed by low-income consumer advocacy groups and notified in writing to the Australian Communications Authority (ACA) ('low-income package');
- maintain and resource a Low Income Measures Assessment Committee (LIMAC), comprising representatives of welfare organisations agreed by the Minister and with appropriate Government representation, responsible for reporting annually to the Minister on the effectiveness of the low-income package and its marketing by Telstra; and assessing proposed changes to the package or Telstra's Marketing Plan for the package;
- have a Marketing Plan in place for the package, approved by the LIMAC; and
- obtain and consider the LIMAC's views on proposed changes to the package.

The ACCC would consult the ACA, which is responsible for enforcing licence conditions, on compliance with the licence condition if and when the ACCC receives a proposal for a line rental increase. It would be expected that the ACA would be in a position to provide timely advice to the ACCC on compliance, to enable line rental increases to be made without significant regulatory delay, where compliance exists.

Under the Telstra price controls legislation, there is no provision for the ACA to have a direct role in price control, except in relation to services supplied under the universal service obligation.

The licence condition and light-handed ACCC certification approach outlined above appears to provide a reasonable compromise between the need to ensure that Telstra has products and arrangements in place that genuinely meet the needs of low-income consumers, while providing Telstra with the flexibility it needs to change the low-income package over time to cater for changes in consumer needs.

It would be important that low-income consumers be adequately informed about the products and arrangements available. The absence of a specific requirement under the current B10 measure for Telstra to inform customers of the availability of products has resulted in a low take-up. A requirement for Telstra to prepare a Marketing Plan for its products and arrangements for low-income consumers and have it approved by the LIMAC would help to ensure that Telstra adequately informs low-income consumers of the products and arrangements available to meet their needs.

Cost of option (5) and impact

The costs to Telstra of option (5) would comprise the costs of its low-income package (and its promotion) as well as the costs of maintaining and resourcing the LIMAC.

As discussed under option (3), the estimated annual cost to Telstra of the new products and arrangements in the package is about $150 million. Telstra has estimated the annual cost of maintaining and resourcing the LIMAC at $31 000 or more annually, based on 4 face-to-face meetings and three audioconferences per annum. This does not include the cost of Telstra officials attending the meetings and the labour cost of the secretariat services, which are to be provided by Telstra.

Telstra has estimated the annual cost of marketing the low-income package at $1 million in the first year. Telstra considers that the level of Telstra's ongoing financial commitment to marketing will depend on what is required to achieve and maintain an acceptable level of awareness of the products, as judged by the LIMAC.

While option (5) appears, at first glance, to be more costly than option (2), it is necessary to take the following factors into account:

- the costs already being incurred by Telstra in the form of pensioner concessions that are included in the $150 million annual cost estimate for the low-income package;
- the substantial administrative costs associated with option (2);
- the additional benefits for low-income consumers and the broader customer base from the low-income package compared with benefits from seeking simply to compensate low-income consumers for line rental increases.

When these factors are taken into account, option (5) is the more cost effective and expedient option.

Telstra's revenue should increase as a result of the removal of the B10 and B50 measures, to the extent that these measures required Telstra to lower prices across the broader residential customer base.

The costs of the low-income package would be likely to be funded largely by cross-subsidy from other Telstra customers. As with the B10 and B50 measures, other industry participants may also contribute a small proportion of the costs through interconnection charges and universal service levy arrangements.

Option (5) would provide greater assurance to low-income consumers of protection against line rental increases than option (4), which would in turn provide greater assurance than option (3). Under option (3) there would be nothing to prevent Telstra from withdrawing the low-income package or removing elements of it incrementally. Option (5) would ensure that any incremental reduction in the scope and benefits of the low-income package is transparent to the public and enable the Government to strengthen requirements if necessary.

All of the options, with the exception of option (2), may mean that compensation for line rental increases would be limited to Telstra-preselected consumers. This raises issues of consumer choice, in that consumers would only be eligible for compensation if they were pre-selected to Telstra. Under option (2), payment of compensation to low-income consumers whose call services are provided by carriers other than Telstra would be made by Telstra, based on billing data provided by the other carriers on the call bills of these consumers.

While the issue of consumer choice was raised by consumer representatives in consultations with stakeholders, Telstra's competitors did not generally consider that Telstra funding of protection for low-income consumers would provide it with an unfair advantage in competing for the custom of these consumers. There was a perception that serving low-income consumers is not highly profitable. AAPT has, for example, recently withdrawn from supplying certain services designed for low-bill consumers. Optus sought an arrangement enabling it and other service providers to have and register with the regulator a low-income package, on a voluntary basis, if Telstra was required to have such a package. There is nothing to prevent other service providers from developing and actively promoting packages in competition with Telstra. Low-income customers of service providers who do not develop such packages have the option of obtaining access to low-income products by pre-selecting Telstra as their preferred service provider for long-distance and fixed-to-mobile calls.

A Regulation Impact Statement (RIS) has been prepared for the carrier licence declaration that will be required to implement this option. That RIS will be tabled in Parliament separately.

Options - objective (4) – to ensure rural and remote area customers share in the benefits of increased competition

This objective can be implied from the Government's decision to introduce the local call pricing parity (LCPP) scheme in June 1997 and subsequent decisions in relation to the pastoral call rebate in January 1998 and untimed local calls in the Telstra Extended Zones in July 1998. These decisions reflect an ongoing concern of the Coalition Government to ensure that consumers in rural and remote areas benefit from falling prices.

In announcing the LCPP scheme in June 1997, the Minister assured regional and remote Australians that they would share in the benefits of increased competition in the fully liberalised telecommunications environment of post 1 July 1997. The Coalition's 1998 election policy statement included a commitment to maintain regional price cap arrangements.

The LCPP has been in place since 1 January 1998 and provides that the weighted average untimed local call price in non-metropolitan Australia in a given year is not to exceed the weighted average untimed local call price in metropolitan Australia in the previous year, for residential/charity and business customers, separately.

Access Economics, which reviewed the price controls in 1998, recommended that the LCPP scheme be removed, as it considered the scheme restrains the changes in prices that Telstra can implement in metropolitan local call charges and is likely to slow the development of competition in rural areas. Access Economics recommended replacing the LCPP scheme with direct and targeted assistance for customers in regional markets where Telstra has no competition.

Similarly, the ACCC recommended the LCPP scheme be removed in February 2001, finding potential welfare gains to the community as a whole from removal of from $9 to $19 million per annum. ACCC considered that there are substantial differences in the wholesale cost of local calls in different geographical areas, particularly between metropolitan and non-metropolitan areas. Requiring retail prices to be comparable could, in the ACCC's view, be expected to affect final consumption and investment decisions. The ACCC considered removal of the scheme could lead to substantial additional benefits for rural consumers in the form of increased competition, investment and consumer choice in rural areas.

Telstra recommended in its submission to the ACCC that other service providers should be subject to the same requirements as Telstra, under the LCPP scheme.

There are four main options:
1. remove the LCPP scheme;
2. remove the scheme and replace with direct Government assistance for regional users;
3. maintain the scheme and extend to all providers of local calls in rural areas;
4. maintain the scheme, but continue to apply to Telstra only.

Impact Analysis - objective (4) – to ensure rural and remote area customers share in the benefits of increased competition

Option (1) has the disadvantage that it could exacerbate the existing differential in rate of price reductions in rural and urban areas. The ACCC's 2000-01 report on telecommunications charges concluded that the price of a basket of PSTN services in areas outside capital cities decreased by 22.4% between 1996-97 and 1999-2000, compared with a decrease of 25.0% in capital cities.

The ACCC did not make an assessment of the time period that would be required for competition in local calls to develop in rural areas should the LCPP be removed. This period would depend in part on the extent to which removal resulted in geographic de-averaging of local call prices by Telstra and the response of potential competitors. The flatness of the current telecommunications market suggests that potential competitors may react slowly to emerging market opportunities.

Option (2), like the Government funding option in relation to low-income consumer protection, has the advantage of greater fairness and a broader funding base, but is likely to have higher administration costs than options (3) and (4). Access Economics acknowledged that direct assistance would be difficult to provide in practice, due to the large number of customers involved.

Option (3) would appear to place all service providers on the same footing. However, other service providers would not have the ability to recover any compliance costs from other carriers. To the extent that the LCPP scheme increases the losses incurred by Telstra in 'net cost' areas, Telstra recovers a proportion of the cost of meeting the LCPP scheme from other carriers through the universal service levy.

Further, smaller service providers may claim that complying with the LCPP scheme would require them to establish systems which comprise a larger proportion of their costs than for Telstra, and so place them at a competitive disadvantage. This was the argument of some smaller service providers in relation to Customer Service Guarantee (CSG) compliance in a recent review of the CSG.

Extending the scheme to other service providers is therefore likely to discourage entry by alternative local call providers into rural markets.

Option (4) would have the advantage that it merely continues existing arrangements, which are not seen by Telstra as a significant impost. This option has the advantage of guaranteeing that non-metropolitan consumers have local call prices that are comparable to those in metropolitan areas, at least in the short to medium term. In the longer-term, option (4) has the disadvantage that it may discourage the development of competition in rural areas, with the associated benefits in terms of price reductions, innovation and greater consumer choice.

On balance, option (4) is preferred at this time. However, the operation of the LCPP scheme will be monitored over the period of the next controls with a view to possible removal in the longer term when the benefits of the measures introduced in response to the Telecommunications Service Inquiry and other reforms have flowed through to rural consumers..

Options – objective (5) – meet other equity objectives

<u>40 cent cap on local calls from payphones</u>

The 40 cent cap on untimed local calls from payphones appears to be intended to ensure that those who rely on these phones as their primary means of communications are protected from price increases on their essential communications, eg to businesses, family and friends, and support groups in their local area. Prior to the imposition of the cap in 1996, alterations to the charge were subject to disallowance by the Minister if not considered in the public interest.

Payphones are primarily used by those who cannot afford or opt not to use either a fixed or mobile phone. About 73 000 households are in this category. Many low-income consumers rely on payphones, particularly remote indigenous communities.

The existing 40 cent charge has been in place since 1 September 1994. The price was effectively reduced by 3.7 cents when Telstra was required to absorb the GST on 1 July 2000. Costs have risen since 1994 and revenues have fallen, with the recent growth of pre-paid mobile services, in particular.

Telstra is seeking removal of the cap or its increase to 50 cents, at least in areas where Telstra competes with other providers. It considers that the cap places it at a competitive disadvantage, claiming its competitors commonly charge 50 cents per call and that some charge up to 70 cents.

The Payphone Industry Association (PIA), which represents smaller payphone providers, has also sought an increase in the cap to 50 cents. It considers the cap effectively constrains the prices charged by Telstra's competitors, and that profit margins are low and declining. The PIA suggests that Telstra has considerable market power due to its control over the network and is able to charge competitors monopoly rates for access.

Options are:
(a) increase the cap to 50 cents per call;
(b) increase the cap to 50 cents in competitive areas;
(c) make the charge subject to notification and disallowance provisions;
(d) maintain the cap of 40 cents.

22 cent cap on untimed local calls from other phones

The ACCC recommended that the 22 cent cap be retained, apparently on equity grounds to protect regional users if the local call pricing parity scheme were removed. Telstra has sought CPI indexation of the 22 cent cap on the local call price and greater flexibility to offer local calls above 22 cents as an option for consumers.

Some other service providers support a relaxation of the cap. For example, Optus suggests the cap be increased to 25 cents.

There are four main options for achieving the Government's objectives of protecting consumers from increases in charges for local calls from residential and business phones:
(a) maintain the 22 cent cap on the standard local call charge;
(b) index to CPI the cap on the standard local call charge, commencing at 22 cents;
(c) provide Telstra with greater flexibility to provide local call options with prices above 22 cents; and
(d) increase the cap above 22 cents.

Directory assistance charges

Options to achieve the Government's objective of ensuring that charges for calls to directory assistance are in the public interest are:
(a) continue to apply the notification and disallowance provisions;
(b) require alterations in charges to be approved by the ACCC; and
(c) include existing charges in a basket subject to a CPI-X price cap.

Impact Analysis - objective (5) – meet other equity objectives

40 cent cap on local calls from payphones

An increase in the cap to 50 cents would benefit Telstra and Telstra's competitors in the payphone market. The increase would appear consistent with general price increases since 1994, when the last increase was made. However, there is little information available to the Government at this time on cost increases in the industry.

Telstra has only recently sought an increase in the cap and provided little information to substantiate its claim for a price increase. Lifting the cap could be seen as inconsistent with the Government's 2001 election commitment to protect low-income consumers against price increases and its commitment to improve payphone services for remote Indigenous communities.

Many low-income consumers appear to rely on public payphones to meet their communications needs. Allowing an increase in the price differential between local calls from payphones and from other phones may be seen as inequitable.

Option (b)—increasing the cap to 50 cents in competitive areas—would be complex to administer. The ACCC could be given responsibility for determining 'competitive areas', however this would create a scheme that is likely to be confusing to consumers and costly to administer. Regular review of the extent of payphone competition would be required.

Option (c)—making charges disallowable—would enable the Government to respond to a specific pricing proposal from Telstra and, in doing so, to have regard to the public interest. It would enable referral of the issue to the ACCC, which could undertake a comprehensive analysis if changes in the payphone market since 1994.

Option (d) – retaining the existing 40 cent cap – could be seen as consistent with the universal service obligation objective of ensuring equitable access by all Australians to payphone services. Further consideration could be given to the case for an increase in the cap over the coming months, when more information, including cost information, is available. If justified, an increase in the cap could be made by amending the price control determination during the period of the controls.

Consideration could also be given to the PIA's claims that the terms of access to Telstra's network by competitors give Telstra a competitive advantage. The Minister could request the ACCC to examine the existing access arrangements, with a view to implementing changes if necessary.

Option (d) is the preferred option.

<u>22 cent cap on local calls from other phones</u>

Option (a) – maintain the 22 cent cap on the standard charge without indexation - represents a continuation of a recently re-affirmed Government policy. Option (b) – index the standard charge with CPI - would make administration of the cap more complex and it is unlikely that the CPI increase will be so high as to substantially affect Telstra's ability to meet an unchanged 22 cent cap.

Option (c) – allow Telstra flexibility to charge above 22 cents as an option - has the advantage that it would continue the scope that Telstra currently has to increase local call prices above 22 cents as an option where provided as part of a product or arrangement for the bottom 10% of residential customers, by bill size. With the proposed removal of B10, Telstra could be allowed to offer a local call priced above 22 cents where offered as an option in combination with a correspondingly lower line rental, below the standard charge. This arrangement would complement the low-income consumer protection proposals.

Option (d) – increase the 22 cent cap - would not appear necessary at this time. The ACCC has not stated publicly its views on whether the cap is causing, or is likely to cause, Telstra to price local calls below the efficient cost.

On balance, a combination of options (a) and (c) is preferred.

<u>Directory assistance charges</u>

Option (b) – giving the ACCC responsibility for assessing proposals to alter directory assistance charges – would reduce the Government's ability to influence these charges, with no clear offsetting benefit. Option (c) – a CPI-X price cap on existing charges – may assist in reducing these prices over time, however it is not clear that the existing prices are cost based. A CPI-X price cap would require an analysis to determine an appropriate level of X.

On balance, option (a) – continue to apply the notification and disallowance provisions – is preferred.

CONSULTATION

The proposed new price control arrangements have been the subject of an extensive public review by the ACCC and public consultation processes undertaken by the ACCC and the Department of Communications, Information Technology and the Arts (DCITA). The ACCC conducted a public inquiry in 2000-01, inviting public submissions on a discussion paper and further submissions in response to its draft report.

The ACCC received fifteen submissions to its discussion paper and seven submissions in response to its draft report. The ACCC also conducted public hearings in twelve locations across Australia, including some regional locations.

DCITA conducted further consultations with stakeholders in January and February 2002, including with organisations which made submissions to the ACCC inquiry. Views were sought from stakeholders on the ACCC's recommendations and some alternative price control arrangements. Sixteen organisations, including representatives from individual service providers, service provider organisations, and consumer and welfare organisations, were consulted. DCITA received written submissions from nine organisations.

Stakeholder views on some issues have been summarised in the above discussion of the options and impacts.

The views of Telstra, Optus and AAPT, in particular, were sought on appropriate X factors for various price cap options. Their views have been incorporated in an earlier section.

Telstra was informally consulted on the specific proposals considered by the Government in April 2002. Telstra expressed broad acceptance of the proposals.

Telstra has also been consulted on the draft price control determination and carrier licence declaration that will together give effect to the Government's decisions. Telstra proposed some minor changes to both the draft licence declaration and price control determination, which were accepted with minor exception.

CONCLUSION AND RECOMMENDED OPTIONS

The most significant change to the existing price controls recommended here is the move to eliminate the access deficit over 4 years. This will lead to considerable improvements in pricing efficiency, remove distortions in pricing signals in a range of telecommunications markets, and encourage rollout of new and more advanced customer access networks.

Another significant change from the existing arrangements is the proposal to narrow the basket of services subject to price control. Mobiles and leased lines are proposed to be excluded from the existing basket, on the basis that markets for these services are now effectively competitive.

For reasons set out above, the following options are recommended as appropriate to achieve objectives (1) to (5):

Objectives (1) and (2)

(a) a calls price cap, where prices for a basket of STD, IDD, fixed to mobile and local call prices must fall in real terms by at least 4.5% (CPI-4.5%) each year;
(b) a line rentals price cap, where prices for a basket of residential and business line rentals must not rise in real terms by more than 4.0% (CPI+4.0%) each year, to achieve removal of the access deficit over 4 years; and
(c) a connections price cap, where prices for a basket of connection services must not rise in real terms each year (CPI-0%).

Objective (3). A requirement for Telstra to obtain the ACCC's consent prior to increasing line rental charges, with ACCC consent being contingent only on its being reasonably satisfied that Telstra has complied with a new licence condition requiring the maintenance of an approved low-income package, appropriate marketing of the package and resourcing of a new advisory committee responsible for reporting on and assessing changes to the package.

Objective (4) Retain the local call pricing parity scheme.

Objective (5) Retain the existing 40 cent cap on untimed local calls from payphones; retain the cap of 22 cents on the standard price of local calls from other phones, with a price of above 22 cents being permitted only where the local call is offered in combination with a corresponding lower line rental; and maintain notification and disallowance for alterations to directory assistance charges.

It is proposed that the new controls continue for 3 years, from 1 July 2002 to 30 June 2005.

The ACCC recommended a 3-year price control regime. The shorter the period of the price controls, the greater is the degree of direct control and uncertainty for the regulated firm, reducing incentive to make efficiency improving changes in tariffs and costs. Price control periods of 4 years are common overseas and the first three price control regimes in Australia were of three years' duration.

Stakeholders were consulted on price control period options of 2, 3 and 4 years. Most considered 3 years to be an appropriate period. Telstra did not express a firm view, noting that its preference would depend on the tightness of the caps. The caps should be set for 3 years with carryover of credits permitted between years within the regime but not into any future price controls.

IMPLEMENTATION AND REVIEW

The proposed arrangements are being implemented by means of a Ministerial determination under Part 9 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* and a licence condition imposed via a Ministerial declaration under section 63 of the *Telecommunications Act 1997*. Regulation Impact Statements are being prepared for each of these disallowable instruments. Administrative guidelines will also need to be developed by the ACCC for the price control determination, in consultation with Telstra.

A review will be conducted in the first quarter of 2005 of the effectiveness of the price control arrangements, the state of competition in markets for price capped services, the status of the access deficit and the need for, and form of, any further price controls after 30 June 2005.