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Report to the Minister for Communications, Information Technology and the Arts

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1. Background and summary

Under paragraph 151CM(1)(b) of the *Trade Practices Act 1974*, the Australian Competition and Consumer Commission (ACCC) must report to the Minister for Communications, Information Technology and the Arts on the adequacy of Telstra's compliance with the price control arrangements that apply to it.

This report is on the price control arrangements applying to Telstra for the first half of the 2005–06 financial year and which are specified in the minister's *Telstra Carrier Charge—Price Control Arrangements, Notification and Disallowance Determination No.1 of 2002 (as amended)* (the determination). Compliance with these arrangements is a condition of Telstra's carrier licence.

Under the determination, Telstra submitted its price control compliance report for July–December 2005 to the ACCC on 30 March 2006, that is, within three months of the end of the price cap period. The ACCC's report to the minister is based on an assessment of the information that is contained in Telstra's compliance report.

The ACCC considers Telstra has adequately complied with these price control arrangements.

1.1 Summary of the price control arrangements

The central framework of the price control arrangements comprises price caps that apply to three separate baskets of services as discussed below.

The first basket of services consists of local calls, trunk calls and international calls. The second basket contains line rentals and the third basket connection services.

The first basket is subject to a price cap, in annual terms, of consumer price index (CPI)–4.5 per cent. This means that Telstra is entitled to change the individual prices of the services within the basket as it wishes, but the aggregate price of all services in the basket has to decline by 4.5 per cent annually in real terms (that is, net of inflation). If, for example, the CPI increases by 3.0 per cent, the nominal price of the basket has to decline by 1.5 per cent. This means, over six months, which is the period of the current price cap, the average price of the first basket must decline by 0.75 per cent.

The second basket, comprising line rentals, is subject to a price cap in annual terms of CPI +4.0 per cent. That is, any increase in average line rental charges above the CPI will have to be limited to 4.0 per cent. For example, if CPI increases by 3.0 per cent, Telstra is entitled to increase line rentals by 7.0 per cent over a 12-month period. Over a six-month period this allowance will be 3.5 per cent.

The third basket comprising connection services is subject to a price cap of CPI –0 per cent. This means that the overall revenue-weighted price for these services must not rise in real terms.

The determination provides that each price cap is an independent one and not subject to any overall price cap. That is, price movements for each basket will be reported separately and are not required to be averaged to an overall price movement for all services. Any amounts that are unused under these price control arrangements will not carry forward into the following price cap period.

The determination also provides several other price controls that apply to a range of services.

- The revenue-weighted average untimed local call price for residential and charity customers in non-metropolitan Australia in the first half of the 2005–06 financial year—this is not to exceed the revenue-weighted average untimed local call price for residential and charity customers in metropolitan Australia in the 2004–05 financial year by more than 0.4 per cent.
- The revenue-weighted average untimed local call price for business customers in non-metropolitan Australia in the first half of the 2005–06 financial year—this is not to exceed the revenue-weighted average untimed local call price for business customers in metropolitan Australia in the 2004–05 financial year by more than 0.4 per cent.
- The price for untimed local calls—not to increase above 22 cents for calls made from a residential or business phone, and 40 cents for calls made from a public phone, except for discount plans when a customer may be required to pay more than 22 cents per local call.
- Line rentals charged at residential rates—not to be increased without the ACCC being consulted and satisfied that Telstra has complied with clause 22 of the Carrier Licence Conditions (Telstra Corporation Limited) Declaration 1997. This clause states that Telstra must have in place a low-income package and that it must consult with a low-income measures assessment committee before making changes to the low-income package.
- Telstra must notify the minister if it intends to alter charges for directory assistance services, with the minister able to disallow the proposed changes if they are considered not to be in the public interest.
- Telstra must offer a line rental service to schools at a price at or below the standard line rental offered to residential customers.

Telstra is required to report to the ACCC on its compliance with the price control arrangements, before the end of three months after the end of the price cap period.

2. Methodology for determining revenue-weighted price movements

Under subclause 10(2) of the determination, price movements are to be calculated according to a methodology the ACCC establishes in consultation with Telstra. Following consultations, the *Methodology for administration of the Telstra carrier charges price control arrangements* (the methodology) was established for July–December 2005.

The methodology defines the price movement for a component service within a basket of services as a percentage change between the yield calculated from post-discounted revenue and:

- usage (demand) for the price cap period
- demand for the financial year immediately preceding the price cap period.

The methodology provides a robust and transparent way to measure price movements for a single service. These can be aggregated with price movements of other services in the basket using revenue weights for each of the component services in a basket. The price movement for each component service in the baskets is weighted by post-discounted revenue for the service in the preceding financial year.

2.1 Use of GL revenue data and MIS demand data

The methodology requires Telstra to calculate yield on the basis of revenue data from its general ledger (GL) and demand data from its management information system (MIS). However, for some types of calls, data can be obtained from a sample drawn from Telstra's billing systems, if revenue data cannot be obtained from Telstra's GL, or number of calls data from Telstra's MIS. These calls are untimed local calls in metropolitan areas, or untimed local calls supplied to residential/charity, or business customers, in metropolitan areas. The size and structure of the sample must represent demand patterns and conform to statistical principles.

3. Auditing of Telstra's price control report

Audit process and requirements

The methodology requires Telstra to provide a final, independently audited, report to the ACCC, providing full details of its compliance with the price cap requirements, within three months after the end of the price cap period.

The aim of the audit is to determine whether Telstra has:

- complied with the price cap requirements as specified in the determination and the methodology
- complied with the procedural requirements specified in the determination and methodology
- exercised consistency in applying the methodology specifications to its data capture systems
- established internal procedures and information management systems that allow it to efficiently monitor and report on its compliance with its obligations under the determination and the methodology—including any change to these procedures or systems that may have a material effect on its monitoring and reporting.

The methodology states that the independent auditor will be appointed by the ACCC, so that it may be directly involved in the plan and approach to the audit as well as having direct access to the auditor's independent advice. In consultation with Telstra, HLB Mann Judd was appointed as auditor for the first half of the 2005–06 price control compliance report.

Audit opinion

The auditor has expressed the opinion that nothing had come to his attention to suggest that Telstra had not:

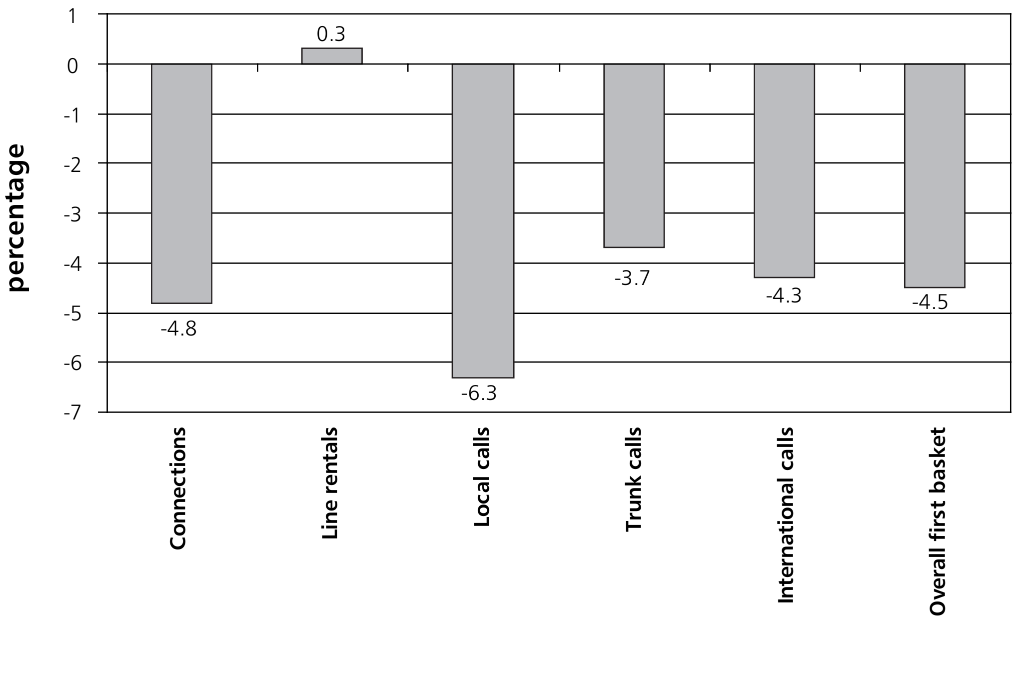
- complied with the price caps or procedural requirements imposed under the determination and methodology
- exercised consistency in applying the methodology to its data capture systems
- implemented internal procedures and information management systems that allow it to efficiently monitor and report on compliance with its obligations under the determination and the methodology

4. Telstra's compliance with the price control arrangements in the 1H 2005–06 financial year

4.1 An overview of the revenue-weighted price movements for Telstra's services

Figure 1 shows the size of the revenue-weighted price movements for each of the Telstra services subject to the price control arrangements. From July–December 2005 the overall revenue-weighted price for the first basket declined by 4.5 per cent compared with a 0.3 per cent increase for the second basket and a 4.8 per cent decline for the third basket. Price movements for individual services within the first basket were a 6.3 per cent decline for local calls, a 3.7 per cent decline for trunk calls and a 4.3 per cent decline for international calls.

Figure 1. Telstra's revenue-weighted price movements in the first half of the 2005–06 financial year



4.2 Telstra's compliance with the price cap for the first basket

4.2.1 Cap on price movement

The first basket of services consists of local calls, trunk calls and international calls. Trunk calls consist of national long-distance calls and fixed-to-mobile calls.

The determination provides that the revenue-weighted price movement of the first basket (containing local calls, trunk calls and international calls) must not exceed CPI –4.5 per cent. The specified CPI measure represents the aggregate price movement in the all-groups basket for the weighted average of the eight Australian capital cities, as published by the Australian Bureau of Statistics, for the financial year immediately preceding the price cap period, that is, 2004–05.

In the 2004–05 financial year, the CPI increase was 2.4 per cent. As the current price cap period is for six months only, Telstra would have been required to reduce its overall revenue-weighted prices by 1.05 per cent [(2.4 per cent – 4.5 per cent)*0.5] in the first half of the 2005–06 financial year.

4.2.2 Reported price movement

As indicated in table 1 the weighed-average price has actually decreased by 4.5 per cent. Accordingly, Telstra could have charged a weighted-average price for the first basket that was 3.4 per cent greater than it actually charged and met this price cap.

Table 1. Telstra's compliance with the price cap for the first basket

Service	Price movements (%)	Revenue weights	Weighted price movement (%)
Local calls	–6.3	0.271	–1.68
Trunk calls	–3.7	0.667	–2.27
International calls	–4.3	0.061	–0.27
Overall		**1.000**	**–4.44**
CPI			+2.40
(CPI–X)*0.5			–1.05
Carry-in from 2004–05			0.0
Surplus (%)			**+3.39**

The largest contribution to the decrease in the price of the first basket for the period, July–December 2005, was made by trunk call services followed by local calls. The price of trunk calls decreased by 3.7 per cent which, after weighting, contributed a reduction of 2.27 percentage points in the price index for the overall first basket.

Local call prices contributed a reduction of 1.68 percentage points in the price index for the overall first basket. Although the price of local calls declined by more than the price of trunk calls, the lesser importance of local calls within the overall first basket meant that local calls did not contribute as many percentage points as did trunk calls.

The decrease in the price of international calls of 4.3 per cent contributed only little more than one quarter of one percentage point to the total decline in the overall first basket price because of its lesser importance in the basket.

4.3 Telstra's compliance with the price cap for the second basket

4.3.1 Cap on price movement

The second basket comprises line rentals. For the first half of the financial year 2005–06 the price movement for line rentals must not exceed half of the full year's price cap, CPI + 4.0 per cent, although this can be adjusted to reflect deemed price reductions as a consequence of an improvement in quality.

As noted previously, the CPI applicable to the reporting period was 2.4 per cent. As a result, Telstra could have increased the weighted-average price of line rentals in the first half of the 2005–06 financial year by 3.2 per cent[1] without breaching the applicable price control arrangement.

4.3.2 Deemed price reduction for quality improvement

Telstra did not claim any credit for quality improvements in the first half of the 2005–06 financial year.

4.3.3 Reported price movement

Telstra's compliance with the second basket is summarised in table 2. The table shows that the weighed-average price has increased by 0.3 per cent. Accordingly, Telstra could have charged a weighted-average price for the second basket that was 2.9 per cent greater than it actually charged and met this price cap.

Table 2. Telstra's compliance with the price cap for the second basket

Service	Price movements (%)	Revenue weights	Weighted price movement (%)
Line rentals	+0.3	1.000	+0.3
Value claim for quality	—	—	—
Overall	**+1.0**	**1.000**	**+0.3**
CPI			+2.4
(CPI+X)*0.5			+3.2
Carry-in from 2004–05			+0.0
Surplus (%)			**+2.9**

1 i.e. (2.4 + 4.0)*0.5 = 3.2

4.4 Telstra's compliance with the price cap for the third basket

4.4.1 Cap on price movement

The third basket comprises connections. Telstra supplies connections that require new cabling and in-place connections.

The overall revenue-weighted price movement for this service (comprising new and in-place connections) must not, on an annual basis, exceed CPI–0 per cent.

The CPI applicable to the reporting period was 2.4 per cent. Consequently, Telstra could have increased the weighted-average price for the third basket during the six-month price cap period by 1.2 per cent[2] without breaching the applicable price control arrangement.

4.4.2 Reported price movement

Table 3 illustrates that the revenue-weighted price for connections decreased by 4.8 per cent. This result was driven by discounts offered to customers connecting additional lines. Accordingly, Telstra could have charged a weighted-average price for the third basket that was 6.0 per cent greater than it actually charged and met this price cap.

Table 3. Telstra's compliance with the price cap for the third basket

Service	Price movements (%)	Revenue weights	Weighted price movement (%)
New connections	–10.7	0.488	–5.2
In-place connections	+0.8	0.512	+0.4
Overall		**1.000**	**–4.8**
CPI			+2.4
(CPI–X)*0.5			+1.2
Carry-in from 2004–05			+0.0
Maximum permitted			**+6.0**

2 i.e. 2.4 * 0.5 = 1.2

4.5 Telstra’s compliance with the metropolitan/non-metropolitan ‘pricing parity’

The determination requires that price reductions in Telstra’s untimed local calls in metropolitan areas flow on to prices charged for those calls in non-metropolitan areas.

More specifically, the revenue-weighted average untimed local call prices that Telstra charged residential/charity and business customers in non-metropolitan areas in the first half of the 2005–06 financial year must not exceed by more than 0.4 per cent the revenue-weighted average untimed local call prices that Telstra charged the respective customer segments in metropolitan areas in the 2004–05 financial year.

The rationale for this price control arrangement is to better ensure that price reductions that occur where competition has developed to a greater extent also become available to customers in areas where competition may not yet have developed.

The revenue-weighted average untimed local call prices that Telstra reports are set out in table 4.

Table 4. Metropolitan/non-metropolitan pricing parity: untimed local calls

Market segment	Metropolitan average price 2004–05 ($)	Non-metropolitan average price 1H 2005–06 ($)
Business	0.1518	0.1462
Residential/charity	0.1604	0.1451

In deriving these average prices, there was no accurate data available for calculating the value of local call discounts—including free local call entitlements under Telstra’s current rewards programs—provided in metropolitan and non-metropolitan areas respectively. Accordingly, the distribution of local call discounts has been estimated from higher level data.

While the unavailability of this data will have affected the accuracy of the average price measures that Telstra has been able to report (and which are set out in the above table), it is unlikely that Telstra has not in fact met this price control requirement in the first half of 2005–06.

4.6 Telstra's compliance with maximum prices for untimed local calls and calls in relation to extended zones

The determination requires that Telstra charge a price of not more than 22 cents for each untimed local call (other than a local call made from a public payphone) and not more than 40 cents for each untimed local call made from a public payphone.

It also requires that Telstra charge for calls between customers within an extended zone and between a customer in an extended zone and a customer in an adjacent extended zone at an untimed local call rate. Moreover, Telstra must not charge for preferential calls at a rate of more than 27.5 cents per 12 minute block of time (or part thereof).

The maximum prices charged for each of these calls as reported by Telstra are set out in table 5.

Table 5. Maximum prices for untimed local calls and calls in relation to extended zones

Call type	Maximum charged ($ including GST)
Payphone	$0.40
Not payphone or 14(3) bundled products	$0.22
STD preferential call	untimed local rate introduced
Call to Telstra's Big Pond internet service	$0.22
Payphone	$0.40
Not payphone or 14(3) bundled products	$0.22

4.7 Telstra's compliance with requirements to offer standard line rental for residential/charity customers and schools

Under clauses 14 and 15 of the determination, Telstra is required to offer a standard line rental for residential/charity customers.

The standard line rental is the most popular line rental charged at residential rates. During the price cap period, July 2005–06, the standard line rental was HomeLine Plus.

Should Telstra supply a residential/charity customer with line rental at a price below that charged for a standard line rental, Telstra is allowed to charge that customer for untimed local calls above the maximum untimed local call price set out in the determination, that is, above $0.22 per call.

Telstra offered two such arrangements to residential customers during the year:

- HomeLine Budget—on which Telstra charged $0.30 per local call
- HomeLine Low Income Health Care Card—on which Telstra charged $0.24 per local call.

Telstra is required to offer to schools a line rental that is at or below the standard line rental.

Telstra reports that it has satisfied this obligation by noting within its standard customer terms that schools are eligible to receive the line rental prices that Telstra offers to non-profit organisations.

The applicable line rental products reported by Telstra for each month are identified in table 6.

Table 6. Line rental prices for standard residential/charity, school and bundled products in the first half of the 2005–06 financial year

Month	Standard product	School product	Higher local call bundled product
July	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine Low Income Health Care Card (LIHCC)
August	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine LIHCC
September	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine LIHCC
October	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine LIHCC
November	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine LIHCC
December	HomeLine Plus	BusinessLine Complete (non-profit organisation)	HomeLine Budget, HomeLine LIHCC

4.8 Telstra's compliance with the requirement to notify the ACCC of increases in line rental charged at residential rates

Under the determination, line rentals charged at residential rates must not be increased unless the ACCC is satisfied that Telstra has complied with clause 22 of the Carrier Licence Conditions (Telstra Corporation Limited) Declaration 1997 (the declaration). The ACCC cannot refuse to consent to a proposed line rental increase on any other basis.

Clause 22 of the declaration requires Telstra to have measures in place to ensure that low-income customers have access to basic telephony services. Specifically, clause 22 of the declaration requires that Telstra must:

- have a low-income package in place which has been endorsed by low-income consumer advocacy groups and specified in writing to the Australian Communications Authority (ACA)
- have a marketing plan in place for the package, approved by the Low-income Measures Assessment Committee (LIMAC)
- obtain and consider the LIMAC's views on proposed changes to the package.

The ACCC is satisfied that Telstra complied with these requirements in the first half of the 2005–06 financial year.

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