Review of price controls on Telstra

The purpose of this submission is to provide some insights gained from recent Commission studies that are relevant to the assessment of price controls. It is not the intention of the submission to offer policy prescriptions.

The current review of price controls must be conducted in a framework that ensures that all options are rigorously evaluated, with attention given to economic efficiency and equity. This evaluation will involve explicit recognition of each option's interaction with other policies and the impact on objectives such as promoting competition within the Australian industry.

Price regulation involves making a trade-off between social objectives and the desirability or otherwise of encouraging entry into particular markets. For example, if price regulation leads to the incumbent's charges for local services (line rental and calls) being below levels at which a new entrant can attain 'full cost recovery', entry into that market will be deterred, with possible adverse consequences for innovation and efficiency.

A number of issues emerged from our recent study, *International Benchmarking of Australian Telecommunications Services*[1], and other Commission work that are central to any rigorous assessment of price caps.

Of particular relevance is the finding that those overseas countries that have provided the greatest latitude for rebalancing prices, were among the countries with the lowest overall prices. In this submission, rebalancing primarily refers to changes to the prices for each service, such as local and long-distance charges, to more closely reflect their cost of provision. However, it also applies to access and usage charges and to urban, rural and remote areas.

Information on the ratio of long-distance to local service charges across countries support the view that there is scope for rebalancing prices in Australia (Productivity

[1] The chief aim of this study was to compare the price and quality-of-service performance of the Australian telecommunications services industry with those in other countries. Comparisons of the regulatory arrangements in Australia and overseas were also undertaken to assist with the interpretation of price differences. The countries against which Australia was benchmarked were Canada, Finland, France, Japan, New Zealand, Sweden, the United Kingdom and United States.

Commission 1999). Further, the Commission's benchmarking study highlights the importance of the regulatory environment in determining outcomes for consumers.

Framework for reviewing price controls

As government action is not costless, any proposal to impose regulation should demonstrate the need for government involvement. In the first instance, the problem that price controls aim to correct should be clearly specified and the objectives of the regulation determined (Office of Regulation Review 1998). The appropriate framework for evaluating of any regulation — including price controls — should also require the identification of available alternatives for meeting these objectives and an assessment of the benefits and costs of each alternative.

Identifying the problem

If the problem that regulation is intended to address is not clearly identified, under- or over-regulation may result — or the problem may not be solved.

The Department of Communications, Information Technology and the Arts (DoCITA), in its discussion paper, implies an underlying concern about the incumbent's market power. It is argued that some form of price regulation is still required because competition is not fully developed in some markets.

Market power derives from the incumbent's control of bottleneck facilities within the network. Control of this network can enable the incumbent to foreclose or reduce competition by raising the price of access to essential services. Left unchecked, market power can create allocative, productive and dynamic inefficiency. These inefficiencies can be costly in the telecommunications industry if consumers are denied the substantial benefits of investment in new and convergent technologies (see Appendix B, Productivity Commission 1999).

Market power can also be inequitable. Where the degree of market power varies across markets and between consumers, some consumers may have to pay monopoly prices while others may not.

The Department also observes that 'rate shock' may result from Telstra's desire to rebalance its prices, implying that minimising the adverse effects of sudden increases to customer access charges is also one of the problems to be addressed by price controls. The concern is that low-usage customers may disconnect from the network, decreasing its size and value.

In the Commission's view, this potential problem should be explicitly stated rather than implied. Further, the likelihood of rate shock occurring and its impact upon efficiency and social objectives should be assessed. And the benefits of avoiding rate shock should be assessed against the costs of delaying price rebalancing. It is of interest that telephone penetration rates in Finland, which has rebalanced, do not seem to differ greatly from those in Australia.

The Commission's benchmarking study reveals wide disparities in the ratio of local service to long-distance prices among the countries benchmarked (see Figure 8.2, Productivity Commission 1999). This suggests that the prices of some countries, including Australia, may be significantly out of balance. The effectiveness of competition in some markets, such as the long-distance market, can be reduced where the incumbent has to maintain high prices to off-set losses in other markets. This can also lead to 'cream skimming' in the higher priced market.

Staff research in the Commission (Albon, Hardin and Dee, 1997) supports Access Economics' (1998) finding that there are significant pricing efficiency gains from rebalancing. Further, the Commission's recent benchmarking study indicated there could be substantial benefits to consumers from productivity improvements stemming from increased competition and more effective interconnection price supervision. Without rebalancing, the competition needed to generate these benefits may not develop. With rebalancing, the resulting productivity improvements would help alleviate any rate shock.

Objectives

The objective of a regulatory initiative should be clearly defined to ensure that the regulation addresses the underlying problem effectively and efficiently (Office of Regulation Review 1998). DoCITA stated that the 'implicit' objectives of the price controls are:

- technical efficiency — to maintain pressure on Telstra to improve its productivity in the absence of competition;
- allocative efficiency — to prevent monopoly pricing behaviour by Telstra; and
- equity — to ensure that the benefits of reform are spread across all consumer groups and that no consumer will be made worse off as a result of rebalancing (DoCITA 1998, p. 5).

That these objectives are implicit raises a concern that they reflect a desired outcome rather than addressing a specifically defined problem. If this is the case, there is a danger that the implicit objectives pre-determine a particular solution, rather than allow for an appropriate assessment of alternative solutions. For example, if the broad objective is to address market power, a number of options should be considered, including facilitating the development of competition.

The twin 'implicit' objectives given by the Department of ensuring that the benefits of reform are spread across all consumer groups and that no consumer will be made worse off as a result of rebalancing, may be mutually inconsistent. If price caps result in cross-subsidisation, some consumers are benefiting at the expense of others.

Further, using price caps to minimise rate shock potentially conflicts with the objective of achieving allocative efficiency, if subscribers are not meeting the cost of their service in some areas. If this is the case, it is important to recognise that there are trade-offs.

In the Commission's view, a clearer statement of the objectives and the respective weights assigned to them is required if the best option is to be identified and rigorously assessed.

Identifying the policy options

There may be a range of alternatives to retail price regulation to achieve specified objectives. A fundamental issue to be addressed in identifying the best option is the respective roles of price subcaps and cost-based interconnection charges.

As the nature of the problem changes with time, regulation must also be sufficiently flexible to accommodate the change. There may be a case for modifying price regulation, or even abandoning the use of price caps altogether.

Testing the effectiveness and appropriateness of alternative regulatory measures for achieving stated objectives should help in the selection of the most effective and efficient approach.

Control of market power

In using retail price regulation to curb Telstra's market power, it must be recognised that access arrangements are playing an increasingly important role in industry regulation. Access regimes aim to diminish market power that incumbent network owners have by allowing competitors access to network services at cost-based prices. As access rights to network services become well established over time, the need for retail price controls to counteract Telstra's market power could decline.

However, even if access rights are established, the extent of competition may be affected while the subcaps continue to impede rebalancing. This may constrain efficiency-enhancing entry in some markets and reduce the effectiveness of the access arrangements as a measure to address market power.

Access rights take time to become fully established. In the meantime, the need for some form of overall retail price control to prevent monopoly pricing could remain. However, as access arrangements mature and entry occurs in all markets, including the local call market, the need for price caps should be reviewed.

That said, there may remain a need for an overall price control after effective access regimes are in place if Telstra retains some sources of market power, by virtue of economies in billing and the like. In this case, a price cap on a broad basket of services would seem the most appropriate approach.

Achievement of social objectives

Mechanisms other than price controls are available to achieve social objectives. These may include direct funding and cost sharing among service providers. These measures would have the advantage that they mitigate the effect of any rate shock from rebalancing and preserve network externalities as customer access charges are increased. In the United Kingdom, OFTEL required British Telecom to offer a range of pricing options to meet the needs of those consumers with potential to suffer rate shock.

Relying on retail price regulation to achieve social objectives can distort consumer decisions. Low-usage consumers may be less willing to search for lower cost alternatives (from a broader resource use perspective) as long as they pay less than the full cost of their service.

Assessing the impact of price controls

Any rigorous assessment of price controls would need to include an evaluation of all the consequences of the options developed to meet the specified objectives. In particular, it is important that any assessment of the price control regulation takes into account the need for rebalancing. Further, the effect of cross-subsidies arising out of the price controls must be carefully examined.

Consequences of failure to rebalance prices

A Telstra consultant claims that price controls are greatly restricting Telstra's ability to rebalance its prices so that they more accurately reflect costs (NECG 1999). Specifically, it is said that price caps have prevented rebalancing of its charging structure from usage to customer access — resulting in a so called access services deficit. The price controls on local calls may also restrict Telstra's ability to rebalance local and long-distance prices.

The interaction of subcaps with the universal service obligation (USO) may be a barrier to rebalancing if the provision of the USO accounts for a significant proportion of any gap between costs and revenues within a market. In the course of its benchmarking study, the Commission found significant regional variations in Finnish local service prices, reflecting different costs in urban and rural areas.

As argued by Albon, Hardin and Dee (1997), Telstra's inability to rebalance charges is resulting in substantial efficiency costs. Restructuring charges to reflect costs and eliminate any access services deficit would make consumers, as a whole, better off compared with the current situation.

The analysis did not take into account the interaction of the price subcaps with the distortion caused by geographic averaging of prices. Given this interaction, the benefits of allowing price rebalancing between access, local and long distance charges are likely to be even greater.

Access rights cannot play their proper role unless Telstra is allowed to rebalance prices. The current inefficient structure of retail prices may flow through to service provider interconnection charges (Australian Competition and Consumer Commission 1999). If higher than necessary interconnection charges result from an inefficient retail price structure, entry may be deterred.

- Prices that are not reflective of costs might result in delayed competition in some markets and inefficient and uneconomic entry in others. New entrants may not have an incentive to establish alternative local networks if Telstra cannot recover the costs from providing customer access lines. This may serve to entrench Telstra's market power.
- Further, competition in the long-distance and mobile markets may be compromised, as the incumbent must earn higher than normal rates of return to recoup any losses in other market segments. This provides an opportunity for inefficient entry. It could also lead to charges above the level they would be with effective competition.

For the reasons cited above, it is imperative that the review of price caps includes an assessment of the benefits and costs of rebalancing. For example, the Commission found that the prices in better performing countries, which have rebalanced, were 20 to 40 per cent below Australian prices on a purchasing power parity basis in most major market segments (Productivity Commission 1999).

Equity consequences

Another potential outcome of the current price controls is that large business consumers may be receiving most of the benefits of competition. This is beneficial only to the extent that these savings are passed onto consumers of other goods and services.

The subcap on residential services (CPI-1 per cent) may not be allowing Telstra the scope to restructure charges sufficiently to reflect the cost of providing those services (Access Economics 1998). If this is the case, there is an incentive for Telstra to maintain residential prices as close to current levels as the subcap will allow, and to meet the overall price cap (CPI-7.5 per cent) through lower business prices or using spot discounts. Although this may lead to rebalanced prices in the long run, there may be substantial cost in the interim.

The interaction of subcaps and the USO in constraining rebalancing may also give rise to disincentives to maintain service quality and to invest in new technology and services. There is some indication that quality of service may be declining in Australia and that more effective monitoring of service quality is required (Productivity Commission 1999).

Recognising the existence of these incentives, which may arise when prices are set below cost, is necessary in order to set efficient and equitable price controls. These incentives will only be identified with a better understanding of the current relationship between prices and costs.

The Commission acknowledges that the Department's price control review does not encompass the USO. However, using retail price regulations to achieve an affordable standard telephone service has a number of consequences. The cost of providing a USO with implicit subsidies becomes confused with arguments over the size of any access services deficit. This, in turn, distracts attention from the potential regulatory, competitive and productivity advantages of rebalancing.

Pre-requisite information

The Australian Communications Authority (ACA) is currently reviewing the cost of the USO. The results of that review would clearly provide information useful to an assessment of the effectiveness and efficiency of the price controls. In particular, this information would also facilitate an assessment of the cost of any constraints on rebalancing from the imposition of subcaps.

In summary

The Productivity Commission's benchmarking study shows that governments have adopted a wide range of approaches to regulating the telecommunications industry. Those countries with the lowest relative prices have relaxed price controls to allow for rebalancing and have access rights that are fully established.

This suggests the need for a clear formulation of the objectives of price regulation. These objectives should be established on the basis of a thorough understanding of the nature of the problems that might be potentially addressed by price controls.

A better understanding of industry costs and the cost drivers would enable a more thorough assessment of the effectiveness and efficiency of any price controls.

References

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