



RETAIL PRICE CONTROLS REVIEW

SUBMISSION TO THE DEPARTMENT OF
BROADBAND, COMMUNICATIONS
AND THE DIGITAL ECONOMY

November 2011



Contents

1. Summary	2
2. Retail price controls and the fixed line market	4
2.1 Competition from substitutes has delivered benefits	4
2.2 Falling input costs have reduced the effectiveness of price controls	6
2.3 Competition within the fixed line market has not met expectations.....	8
3. A stronger price control is required for FTM calls	10
3.1 The benefits of price controls outweigh the costs for FTM calls	10
3.2 An option to address the lack of FTM pass-through	12
4. Conclusion	13
A The economics of retail price controls	14



1. Summary

Vodafone Hutchison Australia Pty Limited (**VHA**) welcomes the opportunity to participate in the Australian Government's review of retail price controls for fixed-line telecommunications services.

Retail price controls were introduced in 1989, when Telstra was the only provider of telephony services. Retail price controls were designed to restrain Telstra's significant pricing power, encourage efficiency in service pricing and deliver social equity objectives.

In general, VHA does not support the use of retail price controls as the primary mechanism for overcoming market failures and believes they should be used as a last resort. The economics of retail price controls are explored further in **Appendix A**.

Despite the well-known limitations of retail price controls, the critical determinant in whether they should continue to be applied to Telstra's fixed line retail services is whether the benefits outweigh the disadvantages, and whether they provide the only effective way to deal with a significant market failure.

Retail price controls could provide a pragmatic approach to curbing Telstra's pricing power in areas where competition has not, and will not, deliver meaningful benefits to consumers. Retail price controls may promote allocative efficiency in markets that are not yet effectively competitive. This will ensure the benefits of cost reductions or improvements in productive efficiency are passed on to consumers.¹ However, to do so, retail price controls must be targeted and set with reference to the underlying costs of providing the service. If used in this manner, retail price controls can provide a short-term measure to correct market imbalances while longer-term reforms are implemented to target the underlying causes of market failure.

In the absence of alternate regulatory options, fixed-to-mobile (**FTM**) calls provide a clear example of a call type where the benefits of retail price controls outweigh the costs. The average revenue Telstra generates from residential FTM calls is 35 cents per minute, substantially higher than the other standard domestic call types such as local or national long distance calls.² This is despite Telstra facing substantial input cost reductions for the provision of FTM calls. The major wholesale input into the provision of FTM calls is the Mobile Terminating Access Service (**MTAS**). The price of the MTAS is regulated by the ACCC. Since 2004, the regulated price of the MTAS has been reduced by 57% whereas the price of FTM calls has only fallen by 15%. In that time, according to publicly available information, Telstra's FTM margins have increased from 31.7% to 52.2% - a perverse and unacceptable outcome.

The ACCC now appears set to implement further reductions to the regulated MTAS rate, with its draft access determination proposing a 60% reduction in the rate to 3.6 cents per minute (**cpm**) by 2014 without introducing mechanisms to ensure that Telstra passes wholesale price reductions on to its retail customers.

Telstra has had ample opportunity to deliver a more appropriate pricing structure for FTM calls, but prices have not fallen and consumers have missed out on significant benefits. In such circumstances, a specific and targeted retail price control for FTM calls is appropriate to restrain Telstra's pricing power and promote efficient pricing for a service which has not yet benefitted from effective competition.

¹ Allocative efficiency is the market condition whereby resources are allocated in a way that maximises the net benefit attained through their use. Productive efficiency is defined as using the least amount of resources to produce a good or service.

² ACCC (2011) *Imputation and non-price terms and conditions report*, June quarter.



In the absence of other regulatory protections, a specific retail price control should be established for FTM calls. The purpose of the FTM price cap is to directly link reductions in the retail price of FTM calls with the ACCC's reductions in the MTAS rate. That is, the price cap for FTM calls should be determined based on the change in costs of providing a FTM call.

The focus of VHA's submission is on the application of the VHA retail price controls to FTM calls. The submission does not comment extensively on the other matters raised in the Government's Discussion Paper at this time.



2. Retail price controls and the fixed line market

Retail price controls, in their current form, are not an effective constraint on Telstra. Falling input costs have provided Telstra with the ability to easily comply with retail price controls. They have also enabled Telstra to respond selectively to competition from substitute services, while still making very high margins on call types that are less exposed to competition (for example, FTM calls). As a consequence, consumers have not benefited as fully as they should from the efficiencies realised by Telstra in the provision of fixed voice services.

2.1 Competition from substitutes has delivered benefits

For the most part, competition has worked to lower the price of fixed line voice services for consumers but it has not worked in the manner that might be expected. It has been competition from substitutes rather than competition from within the fixed line voice services that has brought benefits to fixed line consumers.

The main competition to Telstra's fixed line provision of telephony services has come from the mobile services industry, calling card companies (for international voice calling) and increasingly, Voice-over-Internet Protocol (VoIP) providers (including companies like Skype and fring). Competition from direct retail competitors to Telstra in the provision of fixed line voice services has, for the most part, been disappointing. Telstra remains the dominant supplier of fixed line voice services, with a market share hovering at 70% and an EBITDA margin across the basket of PSTN services at 60%, despite more than a decade of competition.³

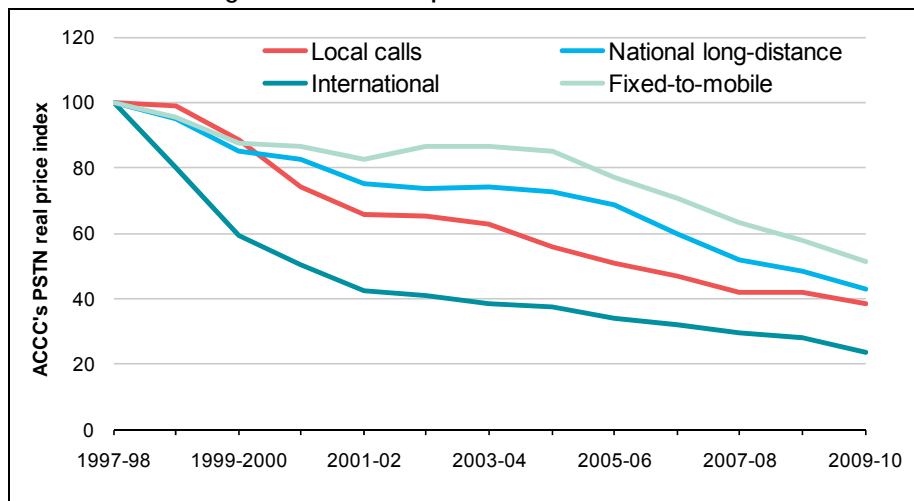
VHA recognises the important reforms the Government has introduced, such as structural separation and the NBN. However these benefits, while welcome, will only deliver significant competitive benefits 3-4 years from now – structural reform takes time. In the short term, without effective regulatory oversight, Telstra's fixed line dominance will continue.

Competition from substitute products has seen the price of many fixed line voice services fall in real terms (see **Figure 1**). The largest fall has occurred in the real price index for international calls, which has been the component of the PSTN voice service bundle most exposed to competition from substitute products.

³ ACCC, *Telecommunications competitive safeguards*, various years; and Telstra (2011), *Annual report 2011*, p9.



Figure 1: ACCC's real price index for PSTN services



Note: Data includes Telstra, Optus, AAPT and Primus.
Source: ACCC, *Telecommunications competitive safeguards*, various years.

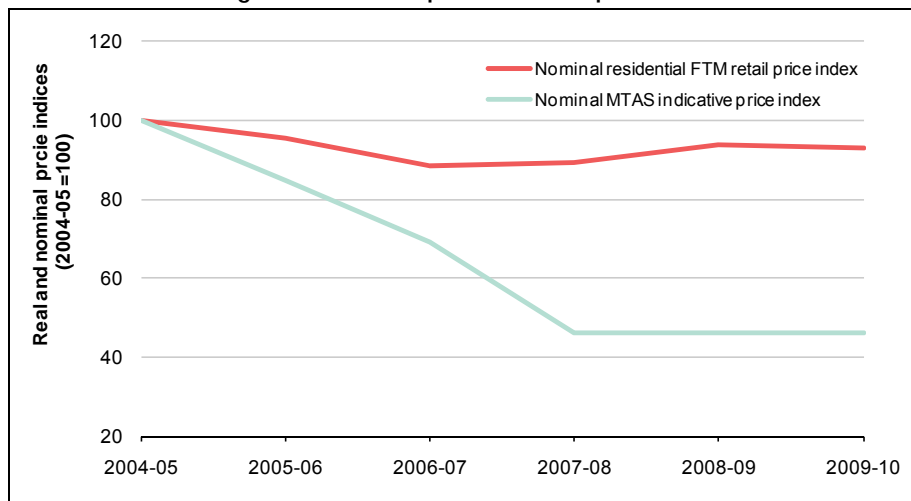
Competition from substitutes has caused Telstra to comfortably exceed its retail price control targets for several years, particularly with regard to the provision of services under baskets 1 and 4.⁴ However, while competition provides an explanation for why Telstra has reduced its prices by more than the retail price control target, it does not explain how Telstra has been able to provide real price declines while maintaining both its market share and its high profit margins in the provision of fixed line voice calls.

While there have been real declines in Telstra's FTM pricing, when one takes into account the substantial cost reductions to terminate a fixed to mobile call, particularly on non-Telstra mobile networks, retail prices should have fallen much further. This is most starkly revealed when one compares nominal retail and wholesale prices as shown in Figure 2. This has led to FTM prices remaining unnecessarily high despite them constituting a growing part of consumer's expenditure on telecommunications services.

⁴ Basket 1 comprises local calls, national long-distance calls, fixed-to-mobile calls, international calls and line rental. Basket 4 includes connection services.



Figure 2: Retail FTM price and MTAS price trends



Note: Data includes Telstra, Optus, AAPT and Primus.
Source: VHA based on information from the ACCC and ABS.

2.2 Falling input costs have reduced the effectiveness of price controls

Telstra can deliver price reductions while maintaining high profit margins only if volumes are increasing or if input costs are falling. Given the high fixed costs involved in providing fixed line voice services, it is worth noting that an increase in volumes is generally also likely to be associated with a decline cost per unit. In these circumstances, retail price controls (in their current form) have not been effective because they are set to cap retail prices at 2005 levels (in aggregate) without regard to changes in the underlying cost of providing fixed voice services. If Telstra's costs have been falling in real terms then the nominal price freeze adopted in past retail price controls will not restrain Telstra's pricing power or encourage efficiency in service pricing.

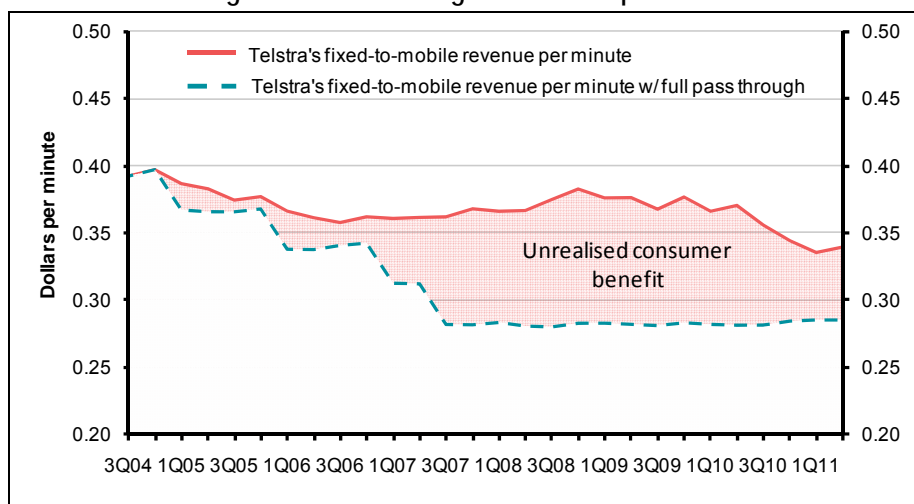
The problem of real cost reductions undermining the effectiveness of retail price controls is illustrated in the provision of FTM calls. The major wholesale input to the provision of FTM calls is the MTAS. The price of the MTAS is regulated by the ACCC. Since 2004, the ACCC has reduced the price of the MTAS by 57% from 21 cpm to 9 cpm in 2011. By comparison, the average revenue per minute (as a proxy for price) of FTM calls was 40 cpm at the end of 2004⁵ and, six years later, Telstra's average FTM revenue had only fallen by 6 cpm,⁶ a reduction of just 15%. The impact is illustrated in Figure 3.

⁵ VHA estimate of the weighted average FTM revenue per minute based on ACCC (2005), *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra for the December quarter 2004*.

⁶ VHA estimate of the weighted average FTM revenue per minute based on ACCC (2011), *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra for the December quarter 2010*.



Figure 3: Telstra's average FTM revenue per minute



Note: Data is based on a volume-weighted average between residential and business segments.

Source: VHA estimates based on the ACCC's *Imputation and non-price terms and conditions report*, various quarters.

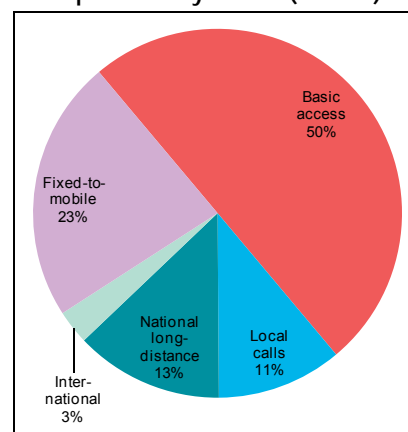
Telstra has not passed on the benefits of regulated reductions in the price of the MTAS to consumers of FTM calls. VHA will refer to this as 'lack of FTM pass-through'. VHA estimates that \$1.1 billion in unrealised consumer benefits have accrued to Telstra due to lack of FTM pass-through between 1 July 2004 and 31 December 2010 (based on Figure 4). In practical terms, the result is that a Telstra fixed line customer making a call to a fixed phone will pay 20 cents for a call from Newtown to a fixed phone in Parramatta but \$1.17 for a call from the same fixed phone to a mobile phone in Parramatta.

Telstra claims that reductions in the MTAS have been passed through to consumers of the PSTN bundle as whole. In a submission to the ACCC, Telstra stated: "reductions in the price of MTAS have been more than passed through to consumers in price reductions for the bundle as a whole".⁷ However the evidence for this is equivocal at best. While it is true that the price of fixed line services has fallen in real terms, it is not clear that retail prices for fixed voice services reflect their economically efficient levels.

Expenditure on FTM calls comprised 23% of consumer's total expenditure on PSTN services in 2009-10 (see Figure 4).⁸ Therefore, it might be expected that sizable reductions in one of the major FTM cost inputs (that is, the MTAS) would translate into a significant reduction in the price of other PSTN services if, as Telstra claim, the reduction in the price of the MTAS was not directly passed through to consumers in the form retail FTM price reductions.

To estimate the size of the reduction in the PSTN basket of services that might have been expected from reductions in the MTAS rate in the absence of FTM pass through, VHA has

Figure 4: Share of consumer PSTN expenditure by service (2009-10)



Source: ACCC.

⁷ Telstra Corporation Limited (2011), *Response to the Commission Discussion Paper on Domestic Mobile Terminating Access Service (MTAS)*, p41.

⁸ ACCC, *Changes in the prices paid for telecommunications services in Australia 2009-10*, (Report 2 in ACCC Telecommunications reports 2009-10), May 2011, p98.



multiplied the reduction in FTM input costs by the FTM share of total consumer expenditure and compared it with ACCC's PSTN price index (adjusted into nominal terms) (see Table 1).

Table 1: The potential for MTAS-rate reductions to have led to reductions in the price of PSTN services

	2004-05	2005-06	2006-07	2007-08	2008-09
Weighted average indicative MTAS price (cpm)	0.195	0.165	0.135	0.090	0.090
Non-MTAS FTM costs (cpm) [^]	0.050	0.050	0.050	0.050	0.050
Total FTM costs (cpm)	0.245	0.215	0.185	0.140	0.140
A: Change in FTM input costs		-12.2%	-14.0%	-24.3%	0.0%
B: FTM share of total consumer PSTN expenditure	24%	25%	26%	27%	23%
A x B: Implied percentage change required for PSTN services from MTAS reductions assuming no retail FTM pass through		-3.1%	-3.6%	-6.6%	0.0%

Notes: [^] As per Analysys Mason (2009), *Regulatory treatment of fixed-to-mobile pass through*, Public version, Report to the ACCC, October, 38.
Source: Analysys Mason, VHA based on data published by the ACCC and the ABS.

Table 1 suggests that if Telstra has not passed on reductions in the price of the MTAS directly to consumers of FTM calls in the form of lower prices, reductions in the price of the MTAS by themselves could have permitted Telstra to meet its requirements under the retail price control for basket 1. If, as seems reasonable, Telstra made further improvements in its cost efficiency during this period, retail price controls are likely to have had little effect in restraining Telstra's pricing power or in encouraging efficient service pricing.

2.3 Competition within the fixed line market has not met expectations

Despite real price reductions, there is little evidence to suggest a strengthening of competition within the fixed voice services market in recent years. Various investigations by the ACCC into the fixed voice market have consistently pointed to the absence of robust competition. For example, Telstra continues to supply around 70 per cent of all fixed voice services and the HHI for the market is 5287.⁹ These figures have hardly changed over the past five or six years.

The ACCC recently observed that:

... the lack of FTM pass-through demonstrates inherent structural issues in the fixed line services market where integrated operators remain dominant with their full suite of services. ... The lack of competitive pressure means that integrated operators have little incentive to pass through savings from reductions in the MTAS directly to consumers in the FTM price. Integrated providers also have the ability to use their savings from the regulated reductions in the MTAS rate to subsidise price reductions in services or geographic areas where competition does exist.¹⁰

VHA agrees. As outlined in section 2.2, FTM consumers have missed out on over \$1.1 billion of lower prices that should have been passed on following substantial MTAS price reductions. Seven years of substantial reductions in the price of the MTAS have not coincided with any improvement in the state of competition in fixed-line markets – in our view it is the single greatest market failure in telecommunications.

⁹ ACCC, *Telecommunications competitive safeguards for 2009–10* (Report 1 in ACCC Telecommunications reports 2009–10), May 2011, pp. 11–20.

¹⁰ ACCC, *Domestic mobile terminating access service – Public inquiry to make an access determination*, Discussion paper, June 2011, p. 8.



VHA made submissions to the ACCC outlining its view that the most efficient approach to resolving the lack of pass through of MTAS price reductions was appropriate wholesale price regulation. As outlined below, if the ACCC has passed responsibility for overcoming the FTM market failure to the Minister then, given the ACCC's lack of preparedness to tackle the problem, VHA agrees with the ACCC that a FTM sub cap in the price control regime is a suitable alternative.



3. A stronger price control is required for FTM calls

3.1 The benefits of price controls outweigh the costs for FTM calls

The ACCC is proposing to embark on another round of substantial reductions to the regulated price of the MTAS, proposing to reduce the rate by 60% from 9 cpm to 3.6cpm in 2014. In a properly functioning fixed line market, this should slash the cost of FTM calls and lead to substantial consumer benefits. This was certainly the ACCC's expectation in its 2004 decision to lower the regulated price of the MTAS:

...the Commission expects that increased competition in the market within which FTM services are provided would create pressures on all providers of this service to pass-through reductions in the price of the MTAS to end-users. If a provider of FTM services chooses not to pass-through reductions in the price of the MTAS, it runs the risk of losing market share to competitors who do.¹¹

However, past experience suggests that reductions in the price of the MTAS will not lead to significant reductions in the retail price of FTM calls. This led the ACCC to state in 2009: "FTM pass through does not appear to have been as strong as expected given the significant reductions in the MTAS since 2004".¹²

Telstra has retained much of the benefits from past reductions in the price of the MTAS and, in the absence of appropriate retail price controls, it is likely to do so again with future reductions in the price of the MTAS. If the ACCC's draft MTAS access determination were implemented VHA estimates an additional \$605 million in unrealised consumer benefits could accrue to Telstra due to lack of FTM pass-through by June 2014, with 44% of that figure directly due to the proposed reductions in the MTAS price.¹³

Past evidence strongly suggests that reductions in the MTAS price have not been fully passed through to consumers.¹⁴ In fact, Telstra's margin on residential FTM calls has increased from 31.7% in 1Q04 to 51.8% in 2Q11.¹⁵

In international comparisons, Telstra's retention of benefits from reductions in the regulated price for the MTAS is unprecedented. Despite having lower MTAS rates than any of the selected countries in a report on the regulatory treatment of FTM pass through undertaken for the ACCC in 2009, Telstra's weighted average FTM revenue per minute and its retention margin were significantly higher than any of the countries selected for the study (see **Figure 5**). Australian consumers of FTM calls have received the lowest pass through rates of MTAS reductions in any comparable jurisdiction in the selection of benchmark countries.

¹¹ ACCC (2004), *Mobile services review: Mobile Terminating Access Service*, Final decision, June, p. x.

¹² ACCC (2009), *Domestic mobile terminating access service pricing principles determination and indicative prices for the period 1 January 2009 to 31 December 2011*, March, p28.

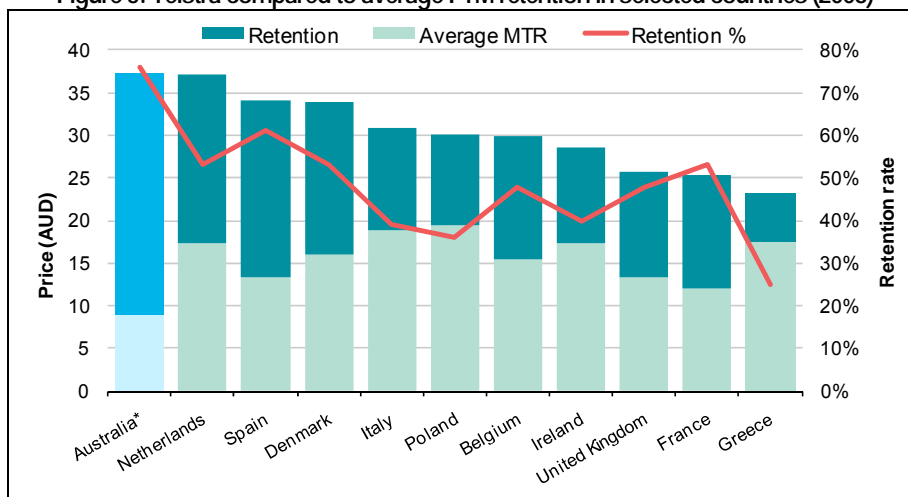
¹³ The volume of residential FTM minutes is assumed to decline by 0.4% year-on-year and the volume of business is assumed to decline by 5.1% year-on-year. The residential and business average FTM revenue per minute is assumed to stay constant at the level indicated by ACCC (2011), *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra for the March quarter 2011*. See VHA's submission to the ACCC on the draft MTAS access determination for further details.

¹⁴ For example, the ACCC's quarterly reports on the *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra* or the ACCC's annual reports on *Changes in prices paid for telecommunications services in Australia*.

¹⁵ ACCC, *Imputation testing and non-price terms and conditions report relating to the accounting separation of Telstra*, for the respective quarters.



Figure 5: Telstra compared to average FTM retention in selected countries (2008)



Notes: *For Australia, only Telstra's average retail FTM revenue per minute has been used. Telstra had 72% of PSTN voice customers in 2008.

Source: VHA based on the ACCC's *Imputation and non-price terms and conditions report*, various quarters; and Analysys Mason (2009), *Regulatory treatment of fixed-to-mobile pass through*, Report for the ACCC, Public version, October.

Persistent distortions to allocative efficiency in the market in which FTM calls are supplied should be a cause for significant concern. Telstra has a large installed customer base. Excessive returns earned from this customer base due to the high price of FTM calls may be channelled into providing price reductions for other call types, line rental or product bundles in a manner that cannot be replicated by Telstra's competitors. Such an outcome is not the result of Telstra's responsiveness to competition – it is the product of Telstra's pricing power.

In the case of FTM calls, the fixed line market has had ample opportunity for competition to deliver a more appropriate pricing structure for FTM calls. It has failed to do so despite a 57% reduction in the regulated price of the MTAS. In such circumstances, a specific and targeted retail price control for FTM calls is appropriate to restrain Telstra's pricing power and encourage efficient service pricing.

In the absence of effective competition within the fixed line services market, the economy-wide benefits from specific retail price controls for FTM calls are significant. In 2009, the ACCC engaged Analysys Mason, a consultancy, to assess the economic impacts from lack of FTM pass-through. Analysys Mason found that consumer welfare could increase by \$1.4 billion, and that the net economic benefits to society could increase by \$1.2 billion if the retail price of FTM calls was set at a price that better reflected the underlying cost of providing the service.¹⁶

¹⁶ Based on Analysys Mason's assessment of the economic impacts from FTM pass-through regulation in 2007/08. Source: Analysys Mason (2009), *Regulatory treatment of fixed-to-mobile pass-through*, Report for the ACCC, Public Version, October, p46.



3.2 An option to address the lack of FTM pass-through

As mentioned above, VHA made submissions to the ACCC requesting it to implement measures to address the lack of FTM pass-through as part of the MTAS Final Access Determination (FAD). However, the ACCC stated in its explanatory statement to the draft MTAS access determination that the “MTAS FAD may not be the most effective way to address high retail prices”.¹⁷

If the ACCC does not endeavour to tackle the problem created by lack of FTM pass-through in its MTAS FAD then a new Price Control regime, with a specific focus on FTM calls, may be necessary. It would be a fundamentally poor policy outcome to allow the monopolistic pricing of FTM to continue particularly in the face of the MTAS price reductions that have been proposed by the ACCC. Specifically, the Government should implement a specific FTM price cap as part of, or in addition to, Telstra’s Retail Price Controls. The price cap for FTM calls should aim to ensure reductions in the regulated MTAS rate are passed through in full to consumers of FTM calls.

The object of implementing a retail price controls with a specific FTM price cap will be to:

- > limit Telstra’s ability to price FTM calls above costs, thus ensuring more of the benefits from wholesale price regulation of the MTAS flow through to consumers; and
- > provide better incentives for Telstra to seek cost efficiencies to meet its future price control obligations.

The FTM price cap should directly link the retail price of FTM calls with the ACCC’s reductions in the MTAS rate. For example, if the ACCC were to reduce MTAS rates, then the reduction in the price of FTM calls would be determined by the impact the reduction in the MTAS rate has on the total costs of providing FTM calls. This will require a bottom-up approach to determining Telstra’s forward-looking costs of providing FTM calls. The percentage change in the cost per minute of providing a FTM call is used to set the FTM price cap. Table 2 illustrates how the percentage figure would be calculated.

Table 2: The determination of an appropriate percentage change figure to apply as a price cap for FTM calls

	Base year	Year 1	Year 2
Non-MTAS cost (cents per minute) [^]	5.0	5.0	5.0
MTAS rate (cents per minute) [*]	9.0	6.0	4.8
Margin (@15%) (cents per minute)	2.5	1.9	1.7
Cost of a FTM call (cents per minute)	16.5	12.9	11.5
Change			
Cents per minute		-3.6	-1.4
Percentage change		-21.8%	-10.9%

Notes: [^] As per Analysys Mason (2009), *Regulatory treatment of fixed-to-mobile pass through*, Public version, Report to the ACCC, October, p38. ^{*}Based on the ACCC’s draft MTAS access determination.

Source: Analysys Mason, VHA based on data published by the ACCC.

¹⁷ ACCC (2011), *Inquiry to make a final access determination for the Domestic Mobile Terminating Access Service (MTAS)*, Draft Access Determination Explanatory Statement, September 23, p17.



4. Conclusion

Retail fixed line customers spend nearly twice as much on FTM calls as they do on any other call type. For Telstra's Homeline Complete customers FTM calls are 5.85 times more expensive than a local call. This differential is, in many circumstances, worse for Telstra's higher end plans such as Homeline Plus, Reach and Ultimate. This is despite the price of the main wholesale input, the MTAS, falling by 57% since 2004.

Telstra's enduring ability to fail to pass through MTAS rate reductions constitutes the most significant market failure in telecommunications. So far fixed line consumers have missed out on over \$1.1 billion in price reductions that would have occurred in a more competitive telecommunications market. Over the next three years fixed line consumers could miss out on an additional \$600 million.¹⁸ There is no reason for Australian consumers to pay the highest retail prices for FTM calls compared to selected international jurisdictions when it has the lowest wholesale input costs for mobile termination.

In the absence of suitable arrangements under the ACCC's MTAS Final Access Determination, VHA believes that a new FTM price cap should be implemented to ensure that Telstra passes on any MTAS rate reduction to consumers of FTM calls. The price cap for FTM calls should be directly linked to reductions in the regulated price of the MTAS to ensure the benefits of wholesale price reductions are not lost to consumers of FTM services. A specific, well-targeted price cap for FTM calls is the only way to restrain Telstra's pricing power and to encourage efficient service pricing across the bundle of fixed voice services.

¹⁸ Assuming the ACCC implements its draft MTAS Final Access Determination and no action is taken under the Price Control regime.



A The economics of retail price controls

Retail price controls are sometimes used to promote efficient pricing outcomes where competition is not yet fully developed. Retail price controls may be appropriate where structural issues (for example, barriers to entry, vertical integration and/or a natural monopoly) inhibit the development of effective competition. In these circumstances retail price controls may provide an appropriate instrument to restrain the pricing power of a monopoly service provider and encourage efficiency in service pricing.

Price controls are seldom the most effective instrument for achieving pro-competitive regulatory outcomes because:

- > retail price controls seek to replicate outcomes in a competitive market but do not directly address the underlying reasons for the market failure;
- > it is inherently difficult to arrive at retail price controls which do not in fact hinder the development of sustainable competition in relevant markets.

The specific economic problems associated with the use of retail price controls are that:

- > **Price controls distort price signals that would otherwise encourage new entry**
New entrants are attracted to a market by the prospect of financial return that is commensurate with the risks involved in their investment. In the absence of price controls, supra-competitive prices charged by an incumbent attract new entrants to the market. Following successful entry competitive forces then have the opportunity to drive prices towards their efficient level without the need for regulation. Price controls may deter entry by restraining or removing signals that entry is efficient.
- > **Price controls entrench a lack of competitive discipline**
Price controls mask the price signals that would attract new entrants and entrench the current market structure. The dependence on regulation to force prices towards their competitive levels is self-perpetuating and real competition is unlikely to develop unless appropriate market incentives exist.
- > **Price controls create incentives for inefficient entry**
Price controls can create incentives for inefficient investment by new entrants in low cost areas where the incumbent is effectively prevented from competing on price by the requirement to offer uniform prices across high and low cost areas.¹⁹
- > **Price controls are invariably set above or below the efficient level**
In practice, price controls seldom reflect the economically efficient level due to:
 - information asymmetries (regulators will never be in a position to know with precision the cost structure of an incumbent);
 - the fact that price controls tend to be set in advance for a period of several years; and
 - a conflict between the goals of achieving allocative efficiency and creating incentives to pursue cost efficiencies (which may involve allowing the incumbent to retain some of the benefit of cost efficiencies by reducing the regulated price by less than the amount of the cost saving).

¹⁹ Discussion Paper, p 18.



For these reasons, many economists (and regulators) consider the use of price controls a remedy of last resort. Retail price controls should only be implemented where the incumbent enjoys significant market power and effective market outcomes are not otherwise achievable. These circumstances hold in the case of Telstra's fixed voice services.

Traditional price control theory suggests that broad based baskets are economically efficient but 'sub-caps' are inefficient as they do not allow competitive forces to maximise consumer welfare. However, this is only true when the basis for the price cap is determined with reference to the underlying cost of providing the basket of services. This has not been the case with the application of retail price controls to Telstra's fixed voice services.

Telstra's retail price controls have been set with reference to costs in the broader economy. In some circumstances, Telstra has been required to implement a nominal price freeze. Since retail price controls have not been set with reference to underlying costs any nominal decline in Telstra's costs will mean that Telstra is able to exert price power or that inefficient service pricing can emerge despite the existence of the retail price control.

The carry-forward mechanism currently used in the retail price controls is not appropriate and should be removed. The carry-forward mechanism enables Telstra to carry forward the unused portion of its permitted price increase into the next year, now means the price cap for basket 1 (and several other baskets) is no longer binding. The carry-forward mechanism may be useful for cost-based price setting because it helps to elicit genuine cost information from the regulated firm. However, it is not appropriate for price control measures that are set based on economy-wide variables such as the Consumer Price Index (CPI) because such variables do not reflect input cost trends for the regulated firm. The application of a carry-forward mechanism in such circumstances can lead to price controls that are damaging to the regulated firm (because they bind an economically efficient price) or too lax on the regulated firm (because, over time, they cease to act as a restraint on pricing power).

Retail price controls generally do not provide an effective approach for the delivery of social equity objectives. The problem with the use of retail price controls to achieve such objectives is that there is no direct link between how retail price controls are set and the achievement of the Government's desired social equity objectives. Retail price controls provide a blanket approach to ensuring equity, rather than providing targeted assistance to those who are most in need. However, it is difficult to be precise about such matters, in the absence of specific information on the Government's social equity objectives.