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Telstra's price control arrangements

Submission to the Australian Competition and Consumer Commission review, March 2010

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Submission

Introduction

Senator Stephen Conroy, the Minister for Broadband, Communications and the Digital Economy, has asked the Australian Competition and Consumer Commission (ACCC) to review Telstra Corporation Limited's (Telstra) price control arrangements and has called for public submissions.[1] The ACCC is to report by 12 March 2010 and the ACCC has asked for written submissions by 12 February 2010.

This submission responds to the Minister's call and its principal rationale is to put a view based on the perspective that Telstra is an extremely profitable organisation, whose profits derive from its exploitation of monopoly power. These profit results are reviewed in the next section and what they mean in principle for regulating Telstra's prices is discussed. The following section examines the implications for consumers, especially for consumers on different income levels. In a subsequent section, responses are given to some of the questions to which the ACCC is seeking answers in its reviews. This submission then concludes with observations on Telstra and the telecommunications market.

Telstra's profit

Telstra operates in a mature market in which the growth of sales is roughly in line with the size of the economy. Yet the striking thing about Telstra's financial position is its very high profitability.

Table 1: Measures of Telstra's profitability

	2009	2008	2007	2006	2005
Profit ($m)	4076	3711	3275	3183	4309
Earnings before interest and tax ($m)	6558	6226	5779	5497	6935
Equity ($m)	12 681	12 245	12 580	12 834	13 659
Return on equity (%)	32.1	30.3	26.0	24.8	31.5
Return on equity before interest and tax (%)	51.7	50.8	45.9	42.8	50.8

Source: Telstra Corporation Limited, *Annual Report 2009,* Melbourne, August 2009.

Table 1 shows that Telstra is very profitable. In 2009, its after tax profit was $4076 million and its rate of return on equity was 32.1 per cent, which is extraordinarily high. Note that before tax the rate of return was even higher at 44.6 per cent,[2] and before tax and interest the return on equity was an astonishing 51.7 per cent. Table 1 indicates that profits in 2005 were higher still although the return-on-equity figures show 2009 to have been the most profitable of the years displayed in the table. Nevertheless, the figures suggest that the orders of magnitude are much the same in earlier years, implying Telstra is very profitable now and has been for some time.

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1 See ACCC, *Review of Telstra Price Control Arrangements—Discussion Paper*, Canberra, January 2010. Available at: http://www.accc.gov.au/content/item.phtml?itemId=909684&nodeId=4d2ab200af9801255d678b21f45fd73c&fn=Retail%20price%20controls%20-%20Discussion%20paper%20-%20January%202010.pdf. The discussion paper includes the Ministerial direction as an appendix.

2 The figure is based on the reported income tax expense of $1582 million in 2009. See Telstra Corporation Limited, *Annual report 2009*.

The rate of return earned by Telstra can be compared with other rates of return earned elsewhere in the economy, which are likely to be approximately six to seven per cent.[3] The average increase in the Australian Stock Exchange accumulation index since December 1979 gives a figure of 12.3 per cent.[4] It must be remembered, however, that because they include Telstra itself as well as the very profitable big banks, these figures are higher than they would otherwise be.

Another interesting comparison can be made with the alternative uses of their capital that investors have to consider. The risk free alternative use of capital can be represented by the 10-year government bond rate which was 5.23 per cent in November 2009 and has averaged 5.65 per cent since January 2000.[5] Adding a reasonable margin for risk implies a target rate of return around the eight to nine per cent level.

These figures suggest the underlying rate of return on equity (pre-tax) in Telstra is at least 35 per cent higher than it would be in a truly competitive market, which amounts to concluding that the monopoly profit for Telstra is around $4.4 billion pre-tax. Note that the pre-tax figure is important here because the amount consumers pay Telstra includes Telstra's income tax expense.

Overall, the above considerations suggest that Telstra's revenue is around 20 per cent too high and should be reduced accordingly, but even these figures overstate the revenue that Telstra can justify. The figures in Table 1 are based on the historic values of Telstra's capital.[6] Technological progress means that over time it becomes cheaper to install new telecommunications equipment such as cable networks, switching gear and billings systems so that in a competitive industry, companies with old equipment would expect to earn lower rates of return than companies with up-to-date and best-practice technology. Only the latter would expect to earn normal rates of return in a competitive market.

Telecommunications should be cheaper than they are. A decade ago, it cost less than $100 to add an additional line between Sydney and Melbourne. A 10 per cent rate of return on that outlay implies that the cost of a 10-minute call between Sydney and Melbourne would be four cents greater than the cost of a local call.[7] However, technological change since then probably means that the costs are now trivial.

We understand that a good deal of Telstra's assets and its workforce are tied up in its billing arrangements; indeed, it has been said that Telstra's biggest asset is its billing system. All of this is 'curiouser and curiouser' as Lewis Carroll once said and implies that part of the reason for the high charges we pay for telecommunications is itself the very high cost of charging us for them.

In the meantime, the phone is now viewed as something of a relic in that it is often the most expensive means of sending messages per megabyte of information—sometimes by a factor

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3 There are arguments that suggest the average rate of return should equal the growth in GDP. The budget projections beyond the forecast period have GDP growth at 6.75 per cent for 2012–13. See Australian Government (2009). *Budget Strategy and Outlook, Budget Paper No 1, 2009-10*, Canberra. Available at: http://www.budget.gov.au/2009-10/content/bp1/html/index.htm.

4 The figure is the geometric mean of the increase between December 1979 and October 2009. See Reserve Bank of Australia, *Reserve Bank of Australia Bulletin*, (various editions), Sydney (various dates).

5 Reserve Bank of Australia, *Reserve Bank of Australia Bulletin.*

6 The value of shareholders' equity in Telstra is equal to Telstra's total assets of $39.96 billion less total liabilities of $27.28 billion. The value of those assets is (roughly) their historic cost less depreciation.

7 These calculations are based on earning a 10 per cent return, and assume that the line is at full capacity for 50 per cent of the time.

of thousands. For example, one blog site claims that 'sending an SMS is nearly 12000 times more expensive than sending an email message using your broadband connection'.[8] In a second comparison, the difference between one gigabyte of cable versus text under some SMS charges is a factor of over a million to one.[9] Similarly, in Australia text messages are expensive and emails are cheap, yet most of this information is transmitted over the same Telstra network.

The ACCC needs to examine world best practice and derive a figure for Telstra's revenue that would give it a normal return on best-practice technology. At a bare minimum, the ACCC should undertake an accounting exercise and establish price caps that allow Telstra a reasonable rate of return and no more. The precedent is the Reserve Bank of Australia's exercise in setting interchange fees[10] for the Australian banking system.

The ACCC discussion paper suggests that 'where [Telstra] operates in an effectively competitive market there is no need on efficiency grounds to maintain price controls'.[11] It is not clear what effective competition is supposed to mean because in this industry there is no possibility of anything approaching the textbook ideal of perfect competition. A few competitors in an industry cannot be said to equate to effective competition. There remains a strong case for price caps when dealing with the largest supplier within an oligopoly context. Moreover, the fact that Telstra is earning excessively high profits is itself strong evidence, if not proof, that it possesses monopoly power and is using that power.

Mobile phones and the large business segment of fixed-line services have been freed from controls. The report by Analysys Mason suggests that Telstra continues to retain strong pricing power in mobile phones and that regulation would have a 'positive impact on overall social surplus'.[12] Given the wide take-up of mobile phones, it would seem important to bring them back under the price controls.

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8 G Bird, 'The scurge of the SMS', *The Ape—Glynn Bird's blog*, 27 June 2006. Available at: http://glynnbird.blogspot.com/2006/06/scurge-of-sms.html

9 The cost of sending a text without a 'plan' is quoted as $1,533,742/GB at $0.20 per message versus $0.75/GB for cable internet. See The Weakonomist, 'Text messaging is the biggest scam of the 21st century', *Weakonomi¢s*, 7 May 2009. Available at: http://weakonomics.com/2009/05/07/text-messaging-is-the-biggest-scam-of-the-21st-century.

10 'Interchange fees' are the fees the banks charge each other when a customer uses a credit card to make a transaction with a merchant. Of course, those fees are then passed on to the banks' customers.

11 ACCC, *Review of Telstra Price Control Arrangements,*. p. 13.

12 Cited in ACCC, *Review of Telstra Price Control Arrangements*, p. 15.

Implications for consumers

The previous section suggested that Telstra is taking something of the order of $4.4 billion more from consumers than would be possible if it were operating in a competitive market in telephones. As if that figure were not bad enough, as it happens the impact on consumers is also very regressive since, on average, low-income groups spend proportionately more on phones than high-income groups. The following table is based on the ABS household income and expenditure survey in 2003–04. Those figures are now very out-of-date and so are more important for the qualitative information they convey than for the actual numbers.

Table 2: Spending on telephones etc: 2003–04 Household expenditure survey

	GROSS HOUSEHOLD INCOME QUINTILE					
	Lowest	Second	Third	Fourth	Highest	All households
Telephone and facsimile charges	15.71	21.04	28.09	30.91	39.66	27.07
Fixed telephone account	12.41	14.44	16.99	17.63	20.63	16.42
Mobile telephone account	2.58	5.26	9.36	11.17	16.20	8.91
Public telephone call (not account)	*0.11	*0.17	*0.16	*0.13	*0.39	0.19
Mobile phone charges (not account)	0.61	1.16	1.58	1.98	2.45	1.55
Other telephone and facsimile charges	-	**0.01	-	-	-	-
Mean gross household income per week	**263**	**555**	**930**	**1,385**	**2,512**	**1,128**
Telephone etc charges as share of income (%)	5.97	3.79	3.02	2.23	1.58	2.40

Source: ABS, *Household Expenditure Survey, Australia: Detailed Expenditure Items, 2003-04*, Cat. No. 6535.0.55.001, 15 February 2006.

All households spend 2.4 per cent of their income on phones, but the poorest 20 per cent spend just under six per cent. The implication is that Telstra's exploitation of its monopoly power is very regressive and hits the poor much harder in relative terms. The figures in the table suggest that fixed telephone charges are the more important target if the regressive impact of Telstra's profit is to be countered since they constitute a larger proportion of low-income earners' total spending on telephones. However, because the figures are so out-of-date it is possible that that conclusion would no longer hold and, therefore, the ACCC should inform itself about the current pattern of expenditure on fixed and other telephone services. Ideally, if there is scope to shift profits around between services, Telstra should be required to avoid pricing patterns that collect excessive profits on services where the impacts are more regressive.

There is other evidence to indicate that the caps imposed on Telstra's pricing have been too loose. For example, Telstra has consistently held most of its prices below the levels permitted by the regulator and, according to one observer; it has voluntarily forgone billions in lost profit as a result.[13] The fact that the caps have not bitten is a concern. If Telstra is content to charge below cap limits, we have to question whether these limits have been too generous. Telstra's enormous profit suggests that is the case.

Milton Friedman believed that in the case of a monopoly like telecommunications, 'there is only a choice among three evils: private unregulated monopoly, private monopoly regulated by the state, and government operation'.[14] For Friedman, the evil in a private unregulated monopoly is that the community pays much more than the cost of providing the service and delivers excess profit to someone who is in a position to exercise economic power. In addition, the figures above show that the excess profit of the monopolist is disproportionately at the expense of the poor.

The ACCC's own questions

- In its discussion paper, the ACCC states that the CPI minus X controls over baskets of fixed-line services 'allow Telstra to 'rebalance' its prices for greater efficiency'. It goes on to suggest that it can efficiently recover common costs.

  The ACCC must be aware of the discriminating monopolist literature. Giving Telstra **freedom to rebalance prices** can mean allowing it to discriminate against those consumers and/or products that are least responsive to any change in prices. In practice, that can mean the most essential services. That is no doubt why governments have also set the rate for items such as the standard untimed local call.

  The ACCC needs to monitor the possibility of any rebalancing of charges that exploit the inelastic demand of especially low-income earners.

- The ACCC asks whether there are any sub-markets '**sufficiently competitive to warrant the removal of price controls**'. Given the excessive profits Telstra is earning, there would have to be compelling evidence to remove any price controls. There has to be a strong presumption that Telstra is charging well above cost in all its sub-markets.
- The ACCC asks whether price controls might discourage potential entry into some markets. Any new entrant is going to have to rely on purchasing wholesale services from Telstra itself and it is likely that Telstra is charging well above the cost of supplying these services at world best-practice standards.

  Suppose it were true that some competitors were deterred because they could not match Telstra's prices. The ACCC needs to ask whether a lack of diversity in supply is a problem. Telecom services are fairly homogenous; nobody really cares about the identity or variety of suppliers of commodities such as wheat and much the same is likely to be true of many of the utilities, including power, banking and, of course, phone services.

- The ACCC asks about investments in the industry. The incentive to invest in a mature industry, such as telecommunications, where the industry is a monopoly or structured as a near monopoly, is perverse. Investment in best-practice technology is unlikely to increase revenue for Telstra, simply because

[13] S Bartholomeusz, 'The cap doesn't fit Telstra', *Business Spectator*, 20 January 2010. Available at: http://www.businessspectator.com.au/bs.nsf/Article/Tesltra-Conroy-ACCC-NBN-pd20100118-ZT4SN?opendocument&src=rss

[14] M Friedman, *Capitalism and Freedom*, Chicago University Press, 1962.

> the market is mature and saturated. Costs will fall but against that there will be large write-downs on previous investment. On top of that, any substantial cost reductions are bound to lead to community pressure to reduce prices. To a large extent, Telstra knows that its total profit is likely to be threatened by investment in best-practice technology. The ACCC would be aware of studies showing how monopoly and oligopoly industries have strong incentives to resist investment in modern facilities unless they are forced to by disruptive developments.[15] A company like Telstra can continue to earn monopoly profits without keeping its plant and equipment up to date.
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> Industries such as telecommunications are characterised by very high investment costs but very small marginal costs and are therefore highly motivated to avoid any competitive pressures that involve battles over prices, especially battles that involve pushing prices down to marginal costs. In that scenario, there would be insufficient revenue to meet capital servicing costs; depreciation, amortisation as well as any borrowing costs.
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> In practice, the implication is that countries wanting best-practice telecommunications are going to have to intervene strenuously in the decision-making of their telecommunications companies or supplement them altogether. That presumably will be one of the results of the National Broadband Network (NBN). Of course, the NBN should change the whole economics of telecommunications in Australia, but in the meantime it seems futile to think price incentives will deliver best-practice telecommunications to Australia.

In contrast to the perspective drawn here, the ACCC's perception of competition in telecommunications is quaint. It suggests that allocative efficiency would be achieved with a competitive market in which the price of telecommunications services would just equal the marginal cost of producing them.[16] However, Telstra would go broke if it charged marginal cost. Earlier, the ACCC itself put the view that in the telecommunications industry 'marginal costs are likely to be low and in some cases close to zero'.[17]

The government should be intervening heavily in Telstra's business plans and investment program to ensure that Australia gains the telecommunications industry it deserves. Given the pattern of incentives in this country, anything less on the part of the government will mean an inferior service. In the context of a monopoly with perverse incentives, leaving such an initiative to the market would be a complete abrogation of the government's responsibilities.

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15 An example of a disruptive element is the cheep steel coming from modern and efficient Japanese and Korean plant that threatened US producers with obsolete technology. See M Perelman, *Railroading Economics: The Creation of the Free Market Mythology*, Monthly Review Press, N Y, 2006.

16 The marginal cost is the cost of supplying the additional unit of a service. That is distinct from the total cost of supplying the service

17 ACCC, *Bundling in Telecommunications Markets: An ACCC Information Paper*, Melbourne, 2003. Available at: http://www.accc.gov.au/content/item.phtml?itemId=397875&nodeId=13d48b86f18b2ee76ad4d5a5f82a7ce2&fn=Final+info+paper_Bundling_Aug03.pdf. To be fair, the ACCC refers to long-run marginal costs but, for technical reasons, marginal costs will be lower than average costs in industries such as telecommunications which are characterised by economies of scale. A company that cannot put its price at or above its average cost will go broke.

Conclusions

The conclusions from this submission can be easily stated.

1) Telstra is a monopolist that exploits its monopoly power to make huge profits at the expense of ordinary Australians and, disproportionately, at the expense of lower-income groups.

2) A fairly conservative estimate is that Telstra's pre-tax profit is at least $4.4 billion greater than it should be, constituting a massive transfer of income from Telstra's customers to Telstra.

3) This excessive profit is evidence that to the extent there is competition in telecommunications it is not working to prevent the exercise of monopoly power on the part of Telstra. The ACCC needs to impose price controls that seriously address Telstra's power to exploit its position.

4) The Australian Government needs to intervene in Telstra's decision-making to ensure Australia has best-practice telecommunications and to counter the corporation's perverse investment incentives.

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