9 November 1998

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Productivity Commission
Impact of Competition Policy Reforms Inquiry
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Dear Mr Cosgrove

Impact of Competition Policy Reforms on Rural and Regional Australia

Telstra is pleased to make a submission to the Productivity Commission Inquiry examining the effects of competition policy reforms on regional Australia.

Telstra's submission outlines a range of benefits that have accrued to the Australia economy as a result of liberalisation of the telecommunications sector. In Telstra's view, the benefits of competitive reforms have not been evenly distributed across all geographic markets or all customer groups, partly as a result of the distributional impacts of regulatory reform that have occurred under the current telecommunications regulatory framework.

In Telstra's view, there is scope within the current telecommunications regulatory arrangements to give a greater focus to the trade offs and costs of meeting social policy obligations when regulators make decisions to intervene in the market on competition policy grounds. These issues are outlined in detail in Telstra's submission. Telstra has also made a separate submission to the Senate Select Committee inquiry on the Socioeconomic Consequences on the National Competition Policy.

I would be pleased to discuss aspects of the submission with you at a later date.

Yours sincerely

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Telstra

Community Service Obligations: Background paper Final Report

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Executive Summary

This paper details the community service obligations (CSOs) delivered by selected Federal, State and privatised utilities in Australia, the costs of these CSOs and how they are funded. It also considers government directions and regulations that constrain utilities from acting commercially. The paper reveals the similarities between Telstra's universal service obligation (USO) and the CSOs delivered by other utilities, and the difference in how Telstra's USO is funded. The paper also shows how regulatory constraints on price rebalancing may disadvantage Telstra and some other utilities in competing against new entrants.

Funding of the telecommunications USO

The approach to funding the telecommunications USO is unique among the utilities surveyed in this paper. The telecommunications USO is funded by service providers in the industry according to their share of total telecommunications revenue. In other utility industries, CSOs are either directly funded by government, or funded by a single corporation through cross-subsidies between customers maintained through restrictions on competition. The telecommunications USO is unusual in that it is associated with an industry levy supported by cross-subsidies, but this co-exists with a competitive market structure.

This survey of CSOs in the utility industries has revealed a clear trend towards direct funding of CSOs. For example in NSW, over 96 per cent of CSOs are funded from the government budget. However, the Commonwealth Government has been slow to move to direct funding, and directly funds less than 50 per cent of the CSOs delivered by Commonwealth GTEs.

There are a number of implications of the Commonwealth Government's decision to fund the telecommunications USO through cross-subsidies rather than direct funding. First, this approach inflates the average price of telecommunications services, as higher prices on some services are used to fund losses on others. Under direct funding, there would be no need to inflate the prices of telecommunications services to fund the USO. To the extent that demand for telecommunications services is price responsive (which clearly it is), this practice reduces the size of the Australian telecommunications industry, leading to a loss in economic efficiency and welfare.[1]

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1 Budget funding also involves welfare losses as there is a cost of raising government revenue. However we would expect the welfare loss associated with collecting general taxation to be less than that associated with raising revenue through higher prices for selected services.

Second, funding the USO through cross-subsidies means that the incidence of this tax falls unequally on some parts of the community. In general, service providers will seek to collect the extra revenue to fund their contribution to the USO from the least competitive segments of the market, and/or where demand is less price responsive. There is no reason to believe that the customers in these segments are those who, from a taxation perspective, we would consider should bear the cost of funding the CSO. In the unlikely event that this customer profile was optimal from a taxation perspective, there is no reason to believe it would remain so in the future, given that market entry could change the competitiveness of sectors, and therefore the sectors where companies might seek the largest contributions to fund the USO.

Third, funding the USO through cross-subsidies is more administratively complex than funding it through direct subsidies. Both approaches require estimation of the cost of delivering the USO. However, funding through cross-subsidies also requires estimation of each telecommunication company's share of industry revenue, to determine contributions from each company. This second stage will become more complex in the future, as the number of telecommunications companies in the market increases following deregulation. Accurate estimation of companies' revenue share will be crucial in ensuring that companies bear their share of funding the USO, and ensuring a level playing field in the telecommunications market.

There is evidence that State governments have seen direct funding of CSOs as a precursor to the introduction of competition and privatisation. For example, the Victorian Government signed contracts with electricity distribution businesses to deliver pensioner concessions prior to the businesses being privatised. The NSW Government has announced that pensioner concessions for gas will be budget funded when the gas market becomes contestable. In contrast, full deregulation of the telecommunications industry occurred on 1 July 1997, without any government commitments to directly fund the USO.

The size of Telstra's USO compared to total revenue is in line with other utility sectors. Telstra's USO accounts for about 2 per cent of total revenue, which is similar to the share of revenue accounted for by Australia Post's USO. CSOs constitute a much larger share of revenue for some State utilities. For example, CSOs account for 10 per cent of the NT Power and Water Authority's total revenue.

State Governments have been willing to directly fund even large CSOs. For example, the Queensland Government provided Queensland Rail with $659.3 million in CSO funding in 1996–97, and the South Australian Government provided funding of $70.8 million to the South Australian Water Corporation in the same year to support the provision of water and sewerage services to country areas under the uniform State-wide tariff. By comparison, Telstra's USO was estimated to cost $246.6 million in 1995–96.

The Commonwealth Government's recent decision (July 1998) in relation to the funding of Australia Post's USO indicates ongoing support for funding CSOs internally through cross-subsidies. The National Competition Council recommended that Australia Post's USO be budget funded, but this recommendation was rejected by the Government in favour of ongoing internal funding.

Uniform tariffs in the utility sector

The policy objective underlying the telecommunications USO — that services should be accessible to all Australians on an equitable basis — is also an objective underlying CSOs in other utility industries. For example, uniform (or nearly uniform) State-wide tariffs apply to electricity in Queensland, Victoria, Western Australia and Northern Territory, and to water and sewerage in South Australia, despite large differences in the cost of supply between country and metropolitan regions.

Uniform tariffs are the most costly of the CSOs delivered by utilities. For example, the cost of the SA Water Corporation's CSO to deliver water and sewerage services to country areas at uniform State-wide tariffs is equivalent to 15 per cent of the Corporation's total revenue.

Governments and their utilities have adopted a range of approaches to maintaining country services and uniform State-wide tariffs while commercialising their government trading enterprises. Three broad approaches can be identified:

- the most common approach is through CSOs directly funded from the budget;
- another approach is through internal cross-subsidies as occurs for Australia Post and Telstra. In some cases, governments have not recognised a CSO, but utilities have maintained a uniform State-wide tariff through cross-subsidies. Western Power's uniform price for electricity throughout WA, and AGL's uniform gas tariff for residential customers throughout NSW are cases in point; and
- finally, in some cases governments or utilities have revalued rural assets downwards, to reduce rural costs so that rural prices can be in line with metropolitan prices. This approach has been adopted in Victoria in relation to electricity distribution, and has been applied (implicitly) to the rail track network in NSW by the Rail Access Corporation.

Methods of costing CSOs

Avoidable cost is the most common methodology for costing CSOs. The principal exception being pensioner concessions which are costed according to forgone revenue (akin to fully distributed costs). The *Telecommunications Act 1997* requires that the

telecommunications USO be estimated using the avoidable cost methodology, although in practice the cost has been negotiated between carriers.

Telstra's net universal service cost (NUSC) is measured on the basis of if particular groups of customers were not serviced. This approach measures the cross-subsidy between *areas* rather than *services*. It masks the full extent of cross-subsidies within the telecommunications market, as some services offered within areas not incurring a NUSC, may be loss making. Untimed local calls in urban areas are a case in point.

Governments have given some consideration to reimbursing utilities for efficient rather than actual costs. However, published figures on the cost of CSOs and government funding of CSOs provided in Annual Reports and other public documents do not identify whether amounts reflect actual or efficient costs.

Regulatory constraints on price rebalancing

In addition to its obligations as the universal service provider, Telstra's commercial activities are constrained by pricing determinations made by the Minister under the *Telstra Corporation Act 1991*. Telstra is subject to an overall price cap, reducing prices on a basket of services, and also to individual sub-caps which apply to certain residential services.

In addition to their equity impacts, the sub-caps have two main economic effects. First, they maintain economic inefficiency and welfare losses by restricting the extent to which Telstra can restructure prices to remove cross-subsidies. Secondly, they may disadvantage Telstra in competing with other telecommunication carriers which will be attracted to the market segments in which Telstra is over-charging. While the price caps do not prevent Telstra from responding to such a competitive threat, Telstra relies on the revenue from these markets to make up for the losses incurred in servicing underpriced market segments. The price cap regulation does not apply to Telstra's competitors.

Regulatory constraints on price rebalancing also apply to Victorian electricity distribution businesses. At the time of privatisation, the government set a uniform network tariff to apply within each distribution area. Under the price regulation set by the Victorian Regulator-General, businesses can restructure prices within their area subject to the constraint that the tariff for any individual class of customers may not rise more than CPI+2%. As in the telecommunications market, this restricts the speed with which the businesses can move to setting efficient prices and may lead to excessive prices for some services, potentially encouraging inefficient entry.

Regulated, uniform prices within service areas also apply in other utility industries. For example, Sydney Water Corporation has uniform water and sewerage prices for residential customers, and AGL's residential gas prices are uniform throughout NSW (excluding Yass). To the extent that the cost of servicing customers differs, these

uniform tariffs would lead to economic inefficiency. The Independent Pricing and Regulatory Tribunal of NSW has announced that it will be reviewing uniform tariffs for water and gas. However, uniform tariffs do not have competition consequences in these two sectors because neither sector is open to competition at this stage.

The Rail Access Corporation is free to rebalance prices for access to rail infrastructure, subject to complying with its access pricing policy, which embodies efficient pricing principles. Therefore the Corporation's pricing structure does not raise efficiency issues, and as a natural monopoly, it does not raise competition issues. The one exception is the transitional principles applying to the haulage of coal. These principles allow RAC to maintain excessive charges on some coal routes until July 2000, as part of phasing out the collection of mineral royalties through the rail system.

While there has been recognition in academic and regulatory circles of the potential for inefficient pricing to lead to inefficient by-pass of networks, we are not aware of any instances where this has occurred in Australian utility industries. There was a threat that this would occur in the Victorian electricity industry, where a large industrial user (Kemcor) considered generating its own electricity, in part to avoid high distribution tariffs. However this by-pass was averted after the distributor introduced locationally differentiated tariffs for large customers.

The possibility that tariff distortions may encourage inefficient by-pass is also being considered by the Victorian Regulator-General in assessing Powercor's application to supply electricity to the Docklands, an inset area within Citipower's distribution area. One of the issues here is whether the upward revaluation of Citipower's assets that occurred prior to privatisation so that electricity prices could be nearly uniform throughout the State, has disadvantaged Citipower in competing with Powercor for the right to build and operate trunk infrastructure within the Docklands.

The lack of instances of inefficient by-pass despite the persistence of inefficient pricing is likely to reflect a number of factors including that:

- deregulation of utility industries is a relatively recent phenomenon;
- new investments in these industries have long lead times and long lives;
- in some sectors, the regulatory constraints to price rebalancing are either subject to sunset provisions, or are due for review in the near future; and
- price regulation does not prevent incumbents from reducing prices in response to competitive entry (the exception is the Rail Access Corporation, which is required to maintain excessive charges on some routes until 2000).

Prospective entrants may have decided that it is not prudent to undertake long term investments on the basis of regulatory constraints that the incumbent may not be subject

to over the longer term. In addition, incumbents can respond to competitive entry by reducing prices — they just can't make up revenue shortfalls on underpriced services.

1 Introduction

In July 1998 the Australian Senate established a new select committee to examine the socio-economic consequences of national competition policy. The terms of reference require the committee to examine the impact of national competition policy on unemployment, changed working conditions, social welfare, equity, social dislocation, and the environment. The Committee is also required to examine the relative effect and variation in impact of the National Competition Policy on urban and rural and regional communities and to clarify the definition of public interest and its role in the national competition process. The Committee has called for written submissions from the public.

As part of the preparation for its submission, Telstra has asked KPMG Management Consulting to prepare a background paper on the costs incurred by utility industries in performing social obligations. Telstra has asked KPMG to set out:

- the terms of those obligations;
- how they impact upon costs; and
- the actual costs incurred by utilities as a result of the obligations.

Telstra has asked KPMG to give particular consideration to the costs of meeting obligations in country and regional areas, and where possible to include material relating to national industries.

In meeting this brief, KPMG has drawn on a range of sources including:

- the Steering Committee on National Performance Monitoring of Government Trading Enterprises (SCNPMGTE), which reports on performance indicators for GTEs;
- the Annual Reports of GTEs; and
- reports on utilities by government agencies including the Independent Pricing and Regulatory Tribunal of NSW (IPART), the National Competition Council (NCC), the Productivity Commission, the Victorian Department of Treasury and Finance and the SA Department of Premier and Cabinet.

The outline of this paper is as follows:

- Chapter two outlines the key issues in the funding and costing of CSOs, and Commonwealth, State and Territory Governments' policies on these issues;
- Chapter three provides information on the CSOs delivered by selected Commonwealth GTEs; and

- Chapter four provides information on the CSOs delivered by selected State and Territory GTEs, and recently privatised utilities.

In undertaking this assignment we have reviewed relevant documents listed in our reference list. Please note that, in accordance with our Company's policy, we are obliged to advise that neither the Company nor any member nor employee undertakes responsibility in any way whatsoever to any person or organisation (other than Telstra) in respect of information set out in this report, including any errors or omissions therein, arising through negligence or otherwise however caused.

2 Key issues in CSOs

Key issues in CSO policy are:

- defining CSOs;
- costing CSOs; and
- funding CSOs.

All Australian Governments have issued guidelines and policy statements that outline their preferred approach to each of these issues (see reference list). These policies are discussed in the sections below.

Of course underlying these issues is the question of the purpose of individual CSOs, who benefits from them, and how effective they are as a tool of social policy compared to alternative policy instruments. These questions are beyond the scope of this paper.

2.1 Defining CSOs

The Steering Committee on National Performance Monitoring of GTEs, which includes representatives from Commonwealth, State and Territory jurisdictions has defined CSOs as:

> *A Community Service Obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices (SCNPMGTE 1994, p. xi)*

Key aspects of this definition are that:

- governments must specifically require the enterprise to conduct the activity;
- the activity must be non-commercial, that is, the GTE would not have undertaken the activity if assessed on purely commercial grounds; and
- the activity must not be a general requirement imposed on all business (eg to meet environmental standards or standards of occupational health and safety).

An interesting consequence of this definition is that when governments call for tenders for the delivery of services, such as the delivery of bus passenger services in regional areas, and GTEs successfully tender to provide these services, these services cease to be a CSO. This is because the GTE is choosing to undertake the service on commercial grounds. Similarly, promotional funding, such as sponsoring women's hockey, is not

considered a CSO if it is being undertaken for the commercial benefits it delivers (eg marketing and good corporate citizenship benefits).

This definition also focuses on public enterprises. Where governments fund private agencies to deliver deliver services on their behalf (eg employment case management services), these are not defined as CSOs because private firms have elected to deliver the services on commercial grounds. For example, the Victorian Government has entered into contracts with privatised electricity distribution businesses to deliver pensioner concessions on its behalf.

The definition of CSOs provided by the Steering Group has been generally accepted by all governments with minor variations.

2.2 Costing CSOs

The Steering Committee on National Performance Monitoring of GTEs recommended that CSOs be costed at their avoidable cost. Avoidable cost measures the extra cost (net of revenue) incurred by a GTE as a result of providing a service. Avoidable costs include incremental fixed costs specific to that activity (eg the capital cost of buses for a particular route) but exclude fixed costs that would be incurred even if the service was not provided (eg common costs such as head office expenses).

The Steering Committee acknowledged that in the case of decreasing cost industries and where CSOs constitute a large share of total services, there may be a case to cost CSOs on the basis of average costs or avoidable cost plus a mark-up, to ensure the GTE is financially viable.

Other approaches to costing services include:

- fully distributed costs; and
- stand-alone costs.

Both these methods lead to higher measures of the cost of providing services. Fully distributed cost is the avoidable cost of providing the service *plus* a contribution to common costs which are not directly attributable to the activity. Stand alone costs are even larger, as they include the avoidable cost of the particular activity plus the common costs that would be incurred if this was the only service offered by the GTE. To the extent that there are economies of scale and scope in an organisation providing a range of services, stand alone costs will be greater than fully distributed costs or avoidable costs.

While governments have accepted that avoidable costs are the preferable means of costing CSOs (see Table 1), in practice they use a range of methods for costing CSOs (see sections 3 and 4 below). In some cases this reflects the difficulties in calculating the

cost of services on an avoidable cost basis. It may also reflect that some GTEs have sought to have CSOs funded on fully distributed costs.

Table 1 Method of costing CSOs advocated by Australian governments

Jurisdiction	Method advocated
NSW	avoidable cost fully distributed cost or forgone revenue[1]
Victoria	avoidable cost (inclusive of capital costs)
Queensland	long-run avoidable costs
South Australia	avoidable cost
Western Australia	long run avoidable cost[2]
Tasmania	avoidable cost
ACT	avoidable cost[1] fully distributed cost or forgone revenue[1]
Northern Territory	avoidable cost[1] fully distributed cost or forgone revenue[1]
Commonwealth	avoidable cost[3]

1 *While most CSO services are costed according to avoidable costs, price concessions (eg for pensioners on public transport) are costed according to forgone revenue or fully distributed costs..*

2 *The exception is pensioner concessions which are funded according to forgone revenue.*

3 *The Commonwealth Government has directed that the CSOs performed by Australia Post and Telstra be costed at avoidable cost. However there is no published information on the basis on which other Commonwealth CSOs are costed.*

Source: Industry Commission (1997)

2.3 Funding CSOs

There are three main approaches to funding CSOs:

- cross-subsidies between different customers and services provided by a GBE;
- direct funding from government budgets; and
- acceptance of lower rates of return from a GBE.[2]

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[2] In addition, some implicit CSOs are funded through asset revaluations. See the discussion in Chapter 4 in relation to uniform State-wide tariffs levied by Victorian electricity distribution businesses.

Funding CSOs through cross-subsidies means that some users or services pay more than their cost of delivery, and these excess returns are used to fund services that do not recover costs. This approach to funding CSOs can only be sustained if there are barriers to entry preventing other competitors from undercutting prices on the over-priced services or if all competitors are obliged to share in the cost of providing CSOs (as is the case in the telecommunications industry). The disadvantage of this approach is that it distorts market prices and may require the maintenance of an uncompetitive market structure.

Direct funding from government budgets is the preferred method of funding CSOs as it has the advantages of:

- being transparent;
- being compatible with competitive market structures;
- enabling prices to be set at efficient levels; and
- allowing competition in the provision of CSOs through contracting out.

In NSW, 96 per cent of CSOs were budget funded in 1995-96 (IC 1997).

Funding CSOs through a lower rate of return has some similar advantages and in addition does not require government budget outlays. However, it is less transparent as implicit expenditure on CSOs (through forgone profits) is not reviewed annually through the budget process, in contrast to other government outlays.

The CSO policy statements of all State and Territory Governments state that direct funding is the preferred method of funding CSOs, however budget constraints have prevented some jurisdictions from adopting this policy immediately for all their CSOs. This is discussed further in the case-by-case analysis in Chapters 3 and 4.

The Commonwealth has been the slowest jurisdiction to move to direct funding. The Department of Finance estimated that more than 50 per cent of the total cost of Commonwealth CSOs and uncommercial activities provided in 1994–95 was funded through cross-subsidies (IC 1997). This reflects that the CSOs delivered by Telstra and Australia Post are funded through cross subsidies.

While direct funding is the preferred method of policy makers for funding CSOs, some community groups have opposed direct funding on the basis that greater transparency increases the likelihood that CSO funding will be eroded over time. For example, in relation to the telecommunications USO, the Senate Environment, Recreation, Communications and the Arts References Committee stated:

> *The Committee is concerned that if funding of the Universal Service Obligation was drawn from consolidated revenue, over time budgetary pressures will see the value of the Universal Service Obligation eroded. (SERCARC 1996, p. 136)*

Another issue in CSO policy is whether CSOs should be funded according to the actual costs of delivery, or the efficient costs of delivery. Some governments are seeking to provide GTEs with greater incentives to deliver CSOs efficiently, by funding them at levels below current actual costs. For example, the Queensland Government has stated that it intends to fund Queensland Rail's CSOs on the basis of efficient, long run avoidable costs (IC 1997).

3 CSOs provided by Commonwealth Government Trading Enterprises

3.1 Telstra

Telstra is the largest provider of telecommunications services in the Australian market. The *Telecommunications Act 1997* defines the universal service obligation as the obligation to ensure that standard telephone services, payphones and prescribed carriage services are reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business (section 149).

The Act specifies a number of requirements applying to the standard telephone service including continued access to untimed local calls, emergency calls, directory assistance and operator services. The Act also states that the standard telephone service should be available for voice telephony, equivalent services for users with disabilities, and new purposes prescribed by the Minister. Currently, Telstra has been declared by the Minister as the universal service provider.

The Act states that the USO is to be costed according to a formula of avoidable costs less revenue forgone (section 186). This formula calculates the costs that would be avoided and the revenues that would be lost if a particular group of customers were not serviced. This measure is referred to as the net universal service cost (NUSC) and measures the cross-subsidy between areas rather than services (Ergas 1994 cited in IC 1997). In practice, the cost of supplying the NUSC has been negotiated by participating carriers. In 1995–96, the cost of providing the universal service obligation agreed by the three carriers was $246.6 million, equivalent to 1.6 per cent of Telstra's total revenue (Communications Law Centre 1997).

In contrast to many other CSOs, the telecommunications USO is funded by an industry levy, supported by cross-subsidies on other telecommunication customers, rather than direct funding from the Commonwealth budget. Each telecommunications carrier competing in the telecommunications market is required to cover the loss made on the CSO in proportion to its share of total revenue generated by domestic telecommunications businesses.

Telstra's commercial activities are also constrained by pricing determinations made by the Minister under the *Telstra Corporation Act 1991*. The current price control arrangements took effect from 1 January 1996 and will continue until 31 December 1998. The Department of Communications and the Arts is reviewing these price arrangements to determine whether they are appropriate for the period 1 January 1999 to 31 December 2000. The current arrangements:

- require Telstra to reduce the price of a basket of its main services by 7.5 per cent in real terms ("overall price cap")
  - services covered are telephone service connections and rentals; local, long distance and international calls; certain leased line services; and mobile services;
- require Telstra to reduce real prices by one per cent for each of the following residential services: connections, line rentals, long distance calls and international calls ("individual sub-caps");
- require Telstra to obtain the consent of the ACCC to change prices by more than the CPI ("individual sub-caps"); and
- prohibit the price of untimed local calls from rising above 25 cents for business and residential customers, and 40 cents from a public pay phone ("individual sub-caps").

The Industry Commission (1997) found that the structure of Telstra's prices was inefficient and in need of substantial rebalancing. It found that there was:

- a broad imbalance between use and non-use charges, with use charges being generally too high;
- the structure of use prices was inefficient, with any deviations of prices from long run marginal costs not reflecting elasticities of demand; and
- peak-load pricing principles have not been employed in the pricing of the local network.

While one of the advantages of price capping is that it allows price rebalancing, the scope of this rebalancing is constrained by individual sub-caps. The Commission estimated that the total efficiency gain from moving from Telstra's 1995–96 pricing structure to an efficient pricing structure that yielded the same level of profits would be $402 million. However, the scope for efficiency gains was substantially reduced once the sub-caps were taken into account. The Commission estimated that the efficiency gains from moving from Telstra's 1995–96 pricing structure to the most efficient price structure which was consistent with the sub-caps was $140 million. These different estimates illustrate the potential efficiency costs of the sub-cap regulation.

The sub-cap regulation may also disadvantage Telstra in competing with other telecommunication carriers. This is because they constrain the rate at which Telstra can lift the price of under-priced services, which reduces its scope for reducing the price of over-priced services (given Telstra's revenue and rate of return objectives). Like CSOs, this regulatory constraint on Telstra's commercial behaviour stems from a Ministerial determination.

3.2 Australia Post

The principal function of Australia Post is to supply postal services within Australia and between Australia and overseas. Australia Post's main operations are letter delivery, parcel delivery and third party agency services (ie receiving bill payments on behalf of other companies).

Under the *Australian Postal Corporation Act 1989*, the Commonwealth Government requires Australia Post to provide letter delivery services Australia wide at a uniform price. This requirement is known as Australia Post's Universal Service Obligation (USO). The USO consists of three elements:

- Australia Post must provide a letter service to all parts of Australia at a single uniform price (price element);
- it must make the letter service reasonably accessible to all Australians (access element); and
- it must meet reasonable performance standards in the delivery of letters (performance standards). (NCC 1998)

The USO does not apply in relation to non-standard sized letters, parcels, express post letters or courier services.

Australia Post calculates the net cost of the USO using the avoidable cost method. Using this method, the USO cost $67 million in 1996–97, equivalent to 4.2 per cent of revenue from letter delivery, and 2.1% of total revenue (NCC 1998). The breakdown of this cost by service and region is:

- metropolitan delivery (letters posted from a metropolitan area to a metropolitan address) — $20 million;
- rural and remote delivery (letters either posted from or delivered to a rural or remote address) — $25 million; and
- international (where Australia Post is inadequately compensated by other countries for the cost of delivering letters coming into Australia) — $22 million. (NCC 1998)

Australia Post claims to lose an average of seven cents per letter on household letter mail (Australia Post 1998).

Like Telstra's USO, Australia Post's USO is funded from the profits made on more profitable routes and services (ie cross-subsidies from other customers). However, in contrast to Telstra's USO, other providers of postal services (eg courier companies) are not required to contribute to the cost of Australia Post's USO. Unlike Telstra, Australia Post still has a statutory monopoly over a significant component of its services.

Australia Post is able to fund the USO because it is protected from competition in some services. Under the *Australian Postal Corporation Act 1989,* Australia Post has exclusive rights to deliver standard letters within Australia, and exclusive rights to issue postage stamps. The main exception to this is if companies offer services at a rate four times the standard postage rate (ie services above $1.80). This enables competitors such as courier companies to enter the 'premium' postal market.

Apart from the letter USO, Australia Post also provides two other CSO-type services on behalf of Commonwealth Government departments for which it is fully reimbursed. These services are:

- Freepost — a service which delivers braille literature free of charge to visually impaired and blind people. This service is funded by the Department of Social Security; and
- concessional postal services to Australian Navy and Army Forces stationed at sea or overseas, which is funded by the Department of Defence.

The Commonwealth Government has also directed Australia Post to provide mail redirection for pensioners free of charge for the first month after a pensioner moves address. Australia Post estimated that this Ministerial direction cost $1.8 million in 1996–97, the cost of which had to be funded internally (NCC 1998).

The National Competition Council has recently reviewed the *Australian Postal Corporation Act 1989,* in accordance with the Commonwealth Government's Legislation Review Schedule. The NCC recommended:

- the retention of the letter delivery CSO;
- Australia Post's CSOs be funded by direct budgetary payments;
- the Commonwealth Government negotiate Australia Post's CSO funding in advance for five years;
- the Commonwealth Government should not seek to contract out Australia Post's CSO activities at this stage, but this policy should be reviewed in 2005;
- business mail should be opened to competition completely;
- household mail should be exposed to more competition by reducing the threshold for competition from four to two times the standard letter rate; and
- inward international mail should be opened to competition.

In response to the NCC's review, the Government decided:

- to open all international mail to competition;

- to continue funding the USO internally through cross subsidies between customers;
- to reduce the scope of Australia Post's monopoly or reserved services.

In relation to the Government's decision about the funding of CSOs, Australia Post stated:

> *The total value of the business reserved to us will be around $450 million a year — or about 25 per cent of total letter revenue — and will be sufficient to absorb the cost of our Community Service Obligations without requiring cash payments from the nation's annual budget. (Australia Post 1998, p. 3)*

In relation to reducing Australia Post's monopoly, the Government is allowing private companies to compete in the delivery of:

- all domestic letters weighing more than 50 grams (previously 250 grams); and
- all domestic letters up to 50 grams, provided they charge at least 45 cents (previously $1.80).

4 State and Territory Utility Industries and CSOs

4.1 Electricity

4.1.1 Queensland Transmission and Supply Corporation

The Queensland electricity industry is currently in the process of being restructured. In 1996–97, the Queensland Transmission and Supply Corporation (now called the Queensland Transitional Power Trading Corporation) was the holding company for eight subsidiary corporations responsible for major transmission and electricity distribution in Queensland.[3] In 1996-97, the CSOs delivered by QTSC were:

- the Statewide uniform retail electricity tariff ($89.9m);
- electrical installation inspections and other regulatory functions on behalf of the Government ($6.5m); and
- pensioner/senior citizens electricity rebate ($27.8m). (SCNPMGTE 1998)

The cost of these CSOs was measured using the avoidable cost methodology and is given in parentheses. The Queensland Government directly funded these CSOs. In total, revenue from CSOs accounted for 5 per cent of QTSC's total revenue.

4.1.2 Western Power (WA)

Western Power is a vertically integrated utility undertaking generation, transmission and distribution of electricity throughout WA. It operates two major grids (in the South West and North West of the State), and also operates 29 isolated power systems throughout the State for communities too remote to be served economically by interconnected systems.

In 1998–99, Western Power will deliver three CSOs:

- rebates — rebates are available to eligible customers such as pensioners, veterans, seniors and health card holders. Rebates can be claimed on the energy charge, the daily supply charge and the account establishment fee. Rebates are currently paid to around 242,000 customers, representing 33 per cent of Western Power's domestic customer base;
- isolated supply systems — Western Power is required to provide power at uniform rates across the State. In the isolated areas of the State, relatively high

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3 Electricity generation was the responsibility of AUSTA Electric.

generation costs result in Western Power incurring substantial losses in making supply available;

- community service concession — in response to government policy, Western Power provides concessions to eligible voluntary and charitable organisations (Western Power 1998).

The total cost of CSOs to be performed by Western Power during 1998–99 is estimated to be $41.1 million, equivalent to about 3 per cent of total revenue. The State Government reimburses Western Power for the cost of delivering rebates ($32.8 million), but does not reimburse the cost of administering rebates ($0.8 million).

In 1998–99, the cost of supplying isolated areas at the uniform, state-wide tariff is expected to exceed revenue by $8.0 million. However, the State Government does not currently recognise this cost as a CSO, and no reimbursement is provided.

The community service concession is expected to cost $0.27 million in 1998–99. The State Government currently does not pay Western Power for performing this CSO.

4.1.3 Power and Water Authority (NT)

The Power and Water Authority is the sole provider of public electricity, water and sewerage services throughout the Northern Territory. In 1996–97, the CSOs delivered by the Authority were:

- the uniform tariff policy ($3.3 million, valued on the basis of the previous year's accrual loss);
- services to aboriginal communities ($19.8 million, valued at cash deficit); and
- air conditioner rebates ($0.09 million, valued at lost revenue) (SCNPMGTE 1998).

The cost of providing these services and the method for calculating these costs is provided in parentheses. The uniform tariff policy and services to Aboriginal communities were directly funded by the Northern Territory Government, and air conditioner rebates were funded internally.

4.1.4 Victorian electricity distribution businesses

The Victorian electricity industry has undergone substantial restructuring and reform over the last five years. In 1993 the Government announced that it would be unbundling the former SECV, and since then the generation, transmission, distribution and retail businesses have been privatised.

Prior to privatisation, the Victorian Department of Community Services contracted the five distribution businesses to deliver concessions and assistance schemes to pensioners,

veterans and health care card holders on its behalf. A total of $67 million in concessions is available each year for all utilities (electricity, gas and water) and is administered to 650,000 households (30 per cent of all Victorian householders). The Department fully funds these concessions and also funds the distribution businesses for the administration costs they incur in delivering them.

The concessions available for electricity are:

- the winter energy concession — a 17.5 per cent discount on the two winter electricity bills;
- service to property charge concession — concessions to customers who consume small quantities of electricity;
- energy relief grant scheme — special assistance to customers who are unable to pay their electricity bills due to a temporary financial crisis;
- life support machines — a concession for electricity used in powering life support schemes;
- summer multiple sclerosis concession — a discount on the last quarterly electricity account;
- transfer fee waiver — a waiver of the connection fee charged when customers move house;
- non-mains winter energy concession — a rebate to people living in caravan parks; and
- group homes concession — a discount on the winter electricity bills for eligible residents of group homes (Department of Treasury and Finance 1997).

In addition, where Government supports the relocation of existing power lines underground, this is recognised as a CSO and funded by Government. In 1995–96, $4 million was allocated to this activity.

Significantly, the Government did not recognise the uniform electricity tariff as a CSO. However government policy has been:

> *... to ensure minimal differentials in delivered electricity prices between similar customers in metropolitan areas (for example, United Energy customers) and rural and farm customers (for example, Powercor customers). This variation was no more than 1.25 cents per kWH. (Department of Treasury and Finance 1997a, p. 57)*

The former SECV estimated that in 1989–90, the cost of the uniform tariff CSO was $208 million (Economic and Budget Review Committee 1991).

To achieve the policy objective of nearly uniform electricity tariffs, while not making CSO payments, two regulatory adjustments were made. First, the regulatory asset value

for rural distribution businesses was set below the assets' real value. This effectively reduced the cost of capital that needed to be recouped from prices. Some of the discount in asset values for rural businesses was offset by an increase in the regulatory asset value of the urban distribution businesses. Second, adjustments were made to the transmission charges payable by each distribution business. This in-built cross-subsidy between metropolitan and regional businesses will be phased out over the next 25 years (ORG 1998). The Industry Commission commented:

> *... the asset write down is an alternative means of funding the CSO to rural consumers. As such, it amounts to a cross-subsidy. It is, in a sense, akin to charging urban consumers prices above marginal costs to subsidise rural consumers (who pay prices below marginal costs), except in this instance the means of transferring finances to the rural sector is by adjusting asset values. (IC 1997, p. 25)*

At the time of privatisation, the government set a uniform network tariff to apply within each distribution business, although it allowed small differences in network tariffs between distribution businesses.[4] Network tariffs cover transmission and distribution costs. The uniform tariff within distribution areas meant that charges were invariant of a customer's location within a distribution area, even though costs of supplying customers varied significantly within areas.

Network tariffs are regulated by the Victorian Regulator General through the Tariff Order. Distribution charges are subject to an overall price cap. Under the Tariff Order, distribution businesses can rebalance network tariffs between various customer classes but the average tariff for any individual class of customers may not rise by more than CPI+2% from one year to the next. That is, the Tariff Order slows the rate of tariff rebalancing, in much the same way as the sub-caps in the *Telstra Corporation Act 1991* slow tariff rebalancing in the telecommunications industry.

Powercor, a distribution business servicing the western area of Melbourne and western Victoria, estimated that eliminating cross subsidies within its service area would require network tariffs to rise by as much as 200–240 per cent for some remote, rural customers. In the Victorian electricity industry, it is recognised that the constraints on tariff rebalancing may encourage competitive entry or inset development that would not be justified on efficiency grounds.

Since privatisation, distribution businesses have generally been slow to rebalance tariffs within their areas. The exception is contestable customers (ie large electricity consumers), where distribution businesses have generally rebalanced tariffs to the full extent allowable subject to the CPI+2% constraint. For example, in 1997–98, Powercor

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[4] Differences in network tariffs between distribution businesses were constrained by the requirement that delivered electricity prices could not vary by more than 1.25 cents per kWH between similar classes of customers in city and rural areas.

introduced for the first time locationally differentiated tariffs for large customers. This appears to have been in response to a threat by a large industrial user (Kemcor) to produce its own electricity.

4.2 Gas

4.2.1 Victorian Gas Industry

In 1994, the Victorian Government commenced reform of the gas by disaggregating the former Gas and Fuel Corporation of Victoria. The industry has now been restructured into three gas distributors and retailers, a gas services company and a gas transmission company, and the Government has been considering privatising these companies. The Government has stated that it will continue to provide and fund existing CSOs following privatisation (Department of Treasury and Finance 1997b). The Government has approved CSO status for the following activities:

- the administrative cost of delivering the 17.5 per cent winter energy concession; and
- the administrative cost of delivering the energy relief grant scheme.

These services have been costed at avoidable cost, and are fully funded by the Government.

4.2.2 AGL (NSW)

AGL Gas Networks Ltd supplies around 96 per cent of the NSW natural gas market. Currently maximum prices are determined by a price control formula set by the Minister for Energy. However, a review being conducted by the Independent Pricing and Regulatory Tribunal of NSW (IPART) is investigating whether gas prices should continue to be regulated, and if so how (IPART 1998a).

At present, residential prices are uniform throughout NSW (with the exception of Yass), however costs vary between regions, mainly due to differences in distribution costs. This leads to cross-subsidies between customers in different regions. IPART is proposing to review access prices to AGL's distribution network for residential customers in December 1998. Depending on the outcome of the review, this may lead to differential access prices and differential residential prices.

The *NSW Gas Supply Act 1996* permits the Minister to require gas suppliers to deliver the Government's CSOs. The Government has required AGL to provide discounts to pensioners holding pensioner concession cards. The amount of this concession is approximately $3.50 per quarter. The Act requires the Government to fund these CSOs, however an amendment in 1997 deferred this obligation until the tariff market became

contestable. Once the gas market becomes fully contestable in 1999, the Government will need to resume funding gas CSOs (IPART 1998a).

4.3 Water

4.3.1 Water Corporation (WA)

The Water Corporation provides public water supply, sewerage, drainage and irrigation services to cities and communities throughout WA. The CSOs delivered by the Corporation in 1996–97 were:

- country water services ($107.9 million);
- country waste water services ($17.9 million);
- country drainage services ($7.1 million);
- irrigation services ($11.7 million);
- pensioner and seniors rebates ($26.4 million);
- services to non-rated properties such as charities, religious and sporting bodies and homes for the aged ($7.5 million);
- infill sewerage ($3.2 million); and
- Aboriginal Reserves ($0.6 million).

The total cost of CSOs delivered by the Water Corporation was $182.3 million, equivalent to 23 per cent of total revenue (SCNPMGTE 1998). This cost was met through explicit payments from the State Government.

The costs of individual CSOs is given in parentheses. Pensioner rebates and services to non-rated properties were valued on the basis of forgone revenue. Infill sewerage was valued on the basis of actual cost, and the CSO cost of all other services was based on the loss incurred in providing the service.

4.3.2 South Australian Water Corporation

The SA Water Corporation provides water and sewerage services to the metropolitan and country areas of South Australia. The CSOs provided by the Corporation in 1996–97 were:

- provision of country water and wastewater services under the uniform State-wide tariff ($70.84 million);
- rate concessions for the Adelaide Festival Centre Trust ($0.26 million);

- wastewater to exempt properties for charities ($2.09 million); and
- provision of water and wastewater services to emergency services ($0.05 million).

The total cost of providing CSOs in 1996–97 was $73.24 million, equivalent to 15 per cent of total revenue (SCNPMGTE 1998). The cost of individual CSOs is given in parentheses, and was valued using the avoidable cost methodology. All of the Corporation's CSOs are funded by the relevant government department.

4.3.3 *Yarra Valley Water (Vic)*

Yarra Valley Water is one of three water retailers providing water and sewerage services in metropolitan Melbourne. In 1996–97, it provided the following CSOs:

- water used in fire fighting, street cleaning and parks ($2.73 million);
- unmetered gratuitous supply ($0.026 million);
- administration of pensioner rebates ($0.016 million);
- remission of developer contribution ($0.2 million);
- other minor CSOs ($0.23 million).

In total, Yarra Valley's CSOs cost $3.2 million in 1996–97, equivalent to less than 1 per cent of total revenue (SCNPMGTE 1998). The cost of individual CSOs is given in parentheses. Unmetered gratuitous supply and water used in fire fighting, street cleaning and parks were costed at forgone revenue. The other CSOs were valued using internal costing (method unspecified). All of these CSOs were internally funded and did not attract direct government payments.

4.3.4 *South East Water (Victoria)*

South East Water is one of the other water retailers providing water and sewerage services in metropolitan Melbourne. The CSOs delivered by the Corporation in 1996–97 were:

- gratuitous supply ($1.95 million);
- services to non-rated properties ($0.54 million);
- pensioner concessions administration ($0.2 million);
- water used in fire fighting and street cleaning, and education materials for schools ($1.03 million).

In total these CSOs cost $3.72 million, or less than 1 per cent of total revenue (SCNPMGTE 1998). All of these CSOs were costed at forgone revenue, and internally funded.

4.3.5 Sydney Water Corporation

Sydney Water Corporation provides water and wastewater services to over 3.75 million residential customers and 73 000 businesses within the Sydney, Illawarra and Blue Mountains areas. The CSOs delivered by the Corporation in 1995–96 were:

- pensioner rate rebates ($43.77 million);
- transitional rate rebates ($14.54 million);
- water and wastewater services to exempt properties ($9.04 million);
- contributions to environmental trusts ($10.94 million); and
- sewer backlog projects ($3.68 million).

In total these CSOs cost $81.97 million, or 7 per cent of total revenue (SCNPMGTE 1998). All of these CSOs were funded by the NSW Government and were costed on the basis of foregone revenue, except the sewer backlog projects which was costed at avoidable cost.

While the Corporation's charges vary between residential and non-residential customers, charges are the same for all residential customers, and are the same for all non-residential customers. That is, the Corporation's charges are the same throughout its service area (ie postage stamp pricing). The Independent Pricing and Regulatory Tribunal of NSW has stated that the next major review of Sydney Water Corporation's prices will investigate whether postage stamp pricing is appropriate or whether differential pricing should be introduced (IPART 1998b).

4.4 Rail

4.4.1 Queensland Rail

Queensland Rail operates Australia's largest rail network and provides freight services and city and country passenger services. The CSOs provided by Queensland Rail are:

- unprofitable passenger and freight services;
- the provision of uneconomic branch lines; and
- the staffing requirement that Queensland Rail not retrench or forcibly remove staff.

In 1996-97, the cost of providing CSOs was $659.3 million, equivalent to 33 per cent of operating revenue. These costs were calculated on the basis of long run avoidable costs, and were fully funded by the Queensland Government (Queensland Rail 1997).

4.4.2 Westrail (WA)

Westrail provides freight services, country rail passenger services, country inter-town coach services, and Perth's metropolitan rail service. In 1996–97, the CSOs provided by Westrail were:

- rail and bus country passenger services within WA (Australind, Prospector/Avonlink) ($18.7 million); and
- other services (eg Indian Pacific, maintenance workshops) ($1.2 million).

Westrail's CSOs accounted for 5 per cent of total revenue, were valued according to long run avoidable cost and were funded by the State Government (SCNPMGTE 1998). Westrail's Perth metropolitan rail service is operated under contract to the Department of Transport and is not considered as a CSO.

4.4.3 Rail Access Corporation (NSW)

The Rail Access Corporation (RAC) owns and manages the rail track network in NSW, and its principal source of revenue is fees paid by rail operators for access to the network.

RAC's network ranges from the busy coal routes in the Hunter Valley to light density rural branchlines. RAC's access pricing policy and CSO payments made by the Government enable it to keep underutilised rural lines open, while observing its commercial charter.

RAC's access pricing policy allows for different rates of return across different parts of the rail track network, and also allows different parts of the network to make different contributions to common costs. This is through the application of floor and ceiling tests to prices. The ceiling test states that no operator (or group of operators) will pay more than the stand-alone cost of servicing its operation. The floor test states that no operator (or group of operators) will pay less than the incremental cost of its operation, and the full incremental costs (including fixed costs) of any line section will be met by revenues from operators traversing that section.

As a result of these tests, low density rural routes can be priced so as not to make any contribution to the Corporation's common costs, and the return on assets on these lines can be close to zero, reflecting that investment in these lines is sunk. However, the cost of any new capital expenditure (incremental fixed costs) such as essential maintenance, would have to be fully recovered from revenue from these routes. This was elaborated

upon in the second reading speech of the *Transport Administration Amendment Bill 1996:*

> *... in some areas, the cost of maintaining the system will be more than the users of rail services can be expected to pay, so if rail services are essential in these areas, they will continue to be supported from public funds. In such cases, there is little merit in increasing the Government's outlays to rail operators so that the Rail Access Corporation can make an artificial profit in order to pay an artificial dividend back to the Government. Clearly the Government will only expect Rail Access Corporation to break even on the non-commercial lines...*

RAC's pricing approach reflects a Baumol floor/ceiling band approach to pricing, and is fully consistent with efficient pricing. The National Competition Council has found that it meets the Competition Principles Agreement criteria, after including changes proposed by the NSW Government (NCC 1998b).

Under Section 93 of the *NSW Transport Administration Act 1988*, RAC cannot close a line section without the approval of .Parliament. In cases where the Government wants to keep a line open, but the revenue from that line is insufficient to cover full incremental costs, the Government pays CSOs to RAC. In 1996–97, the Government agreed to pay RAC $177 million in CSO payments to maintain certain lines. The Government also made a commitment to fund CSOs for the next seven years. The level of funding was maintained at $177 million in 1997–98 (NSW Government 1997).

To clarify the relationship between the floor test and CSO payments, the NSW Government proposed that RAC's access regime be amended to read:

> *Revenue from every Rail Operator must at least meet the Direct Cost imposed by that Rail Operator. In addition, for any line section or group of line sections, the full incremental costs, including Incremental Fixed Costs, but excluding that part of Full Incremental Costs met by line section CSOs should, as an objective, at least be met by revenue from the Rail Operators of those sections ('floor test'). (NCC 1998b)*

In addition, the NSW Government pays CSOs to Freightcorp to enable it to continue carrying freight that would otherwise not be viable. In 1997–98, the Government budgeted to provide Freightcorp with CSO funding of $90 million (NSW Government 1997).

RAC's access pricing policy is also subject to additional, transitional principles applying to the haulage of coal. These transitional arrangements expire in July 2000, and are designed to phase out monopoly rail charges paid by the coal industry. Their effect is that in the period to July 2000, some groups of rail operators may pay more than the stand alone cost of providing them with rail access, but this excess is to be fully phased out by July 2000. These arrangements reflect that in the past, governments have used rail charges as a means of collecting mineral royalties from the coal industry.

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