



Regulating Retail Prices

Before competition, price regulation was needed to correct monopolistic tendencies (i.e. restricting output and holding up prices) by the incumbent. This was usually done with rate of return regulation or with **price cap regulation** ^{*}.

In the transition to competition, many countries kept some retail price controls to manage the price rebalancing that comes with the transition from monopoly to competition.

With competition, the regulatory focus shifts from regulating retail prices to access prices and maybe neither (e.g. if there is effective infrastructure competition); but not both. To protect competition, the regulator may still need to act to prevent anti-competitive conduct ^{*}. And, there may be cases where access price regulation alone is not effective (e.g. **mobile termination** in CPNP countries).

This section reviews,

- **Policy Issues**
- **Key Concepts**
- **Price Caps**

2.7.1 POLICY ISSUES

Before the development of effective competition (e.g. state owned monopoly operators) the regulatory concern is that prices will be set substantially above cost so that the operator earns a monopoly level of profit. Wholesale prices are not relevant because there is no competition. With monopoly, the regulatory focus is on regulating retail prices to get the outcome one would expect if the market was competitive.

When regulating either access or retail prices (or both), regulators observe the principles of **economic efficiency** because that leads to the outcomes we expect in a competitive market.

But regulators are expected to target not only economic efficiency objectives but also politically determined social equity objectives which may include:

- Managing **tariff rebalancing**: An important outcome in the transition from monopoly to competition is the elimination of **cross-subsidies** through tariff rebalancing. Competition erodes cross-subsidies and incumbents would like to expedite this process by increasing unprofitable (subsidised) retail access prices in order to lower profitable long-distance call prices. But sudden tariff rebalancing is politically unacceptable. So, price caps, geographical averaging or other similar schemes may be introduced to manage the impact of the necessary rebalancing and to ensure that rebalancing does not undermine the affordability of telephone services.

Whatever the benefits from subsidizing access prices, economists agree that rebalancing tariffs can produce significant economic gains. Tariff rebalancing meets economic efficiency objectives and can improve social welfare by stimulating demand for services such as long distance calling. Rebalanced prices provide improved signals to actual and potential service providers to invest in network access technologies and improve incentives for competitors to compete for a broad range of customers.

- **Maintaining geographically uniform prices**: It costs more to provide services in rural areas than in urban areas but for political reasons it may be necessary to insist that customers pay the same in any area. This social policy presents a clear conflict with economic efficiency principles. Retail price regulations may require this policy to be observed by the incumbent. Regulators setting cost-based prices may be tempted to set de-average wholesale prices which would pose problems for the incumbent (see **Box 4.1**);
- **Affordability**: the traditional monopoly policy of cross-subsidising access from calls helped increase take-up of fixed services ^{*}. The fear that fixed services might become less affordable after tariff rebalancing has been mitigated by the rapid adoption of mobile services. Now the fear is that fixed broadband services may not be affordable after

spending millions of dollars replacing copper with fibre.

Since cross-subsidy is no longer viable, policy-makers need to find other instruments to ensure affordability. These could include direct subsidies to disadvantaged users or to operators (after competitive tenders) to fund roll-out*.

Where there is competition, the regulatory focus is on **access pricing** leaving to market forces driving retail prices – with two exceptions.

- First, there may be some politically mandated pricing constraints, for the reasons just mentioned. The regulator should be given directions by policy-makers for pricing that supports social objectives. Otherwise, the regulator should be guided by economic efficiency principles.
- Second, the incumbent may seek to use its market position to frustrate competition. The ways in which this may occur and how the regulator can remedy such behaviour are discussed in the section on controlling anti-competitive conduct*.

Any other interventions to regulate retail specific prices are likely to distort markets.

In markets with large fixed networks, there is sometime pressure on regulators to ensure that reductions in mobile termination rates are passed through to reductions in the retail prices paid by fixed customers to call mobile networks. This pressure is resisted.

For example, the Australian regulator was asked to mandate such pass-through in its 'access determination' for mobile termination. It has refused because it limits how fixed operators use the savings to pass on benefits.

Worse, in the Australian context where the 'access determination' is only used to avoid disputes, the existence of a mandatory pass-through requirement may incent fixed and mobile operators to settle on mobile termination rates that are higher than the access determination because a commercial agreement means the pass-through mechanism is not triggered.

And, even if there is a pass-through requirement is triggered, it could be circumvented by fixed line operators raising the pricing of other fixed line bundled services.

◀ Box 7.1: Australia Forbears Regulating Pass-Through

Source: ACCC Inquiry to make a final access determination for the Domestic Mobile Terminating Access Service (MTAS) - Access Determination Explanatory Statement, 7 December 2011

Practice Notes

- **European Union: International Roaming in Member Countries**
- **Hong Kong: Price Regulation**
- **Tariff Structures and Rebalancing: ITU-D Study Group 1**

Reference Documents

- **ACCC Inquiry to make a final access determination for the Domestic Mobile Terminating Access Service (MTAS), 7 December 2011**

2.7.2 KEY CONCEPTS

Key concepts include:

Rate of return regulation: this involves the regulator agreeing an allowed rate of return on capital. This allowed profit is then added to agreed operating and capital cost projections to establish the revenue needs of the regulated business.

Given a forecast for the volume of sales in the regulated period, it is then possible to establish the permitted prices.*

Price cap regulation: the regulated business is given a price cap regime (with or without consideration of the rate of return), which provides some level of incentives for operators to function efficiently and reduce costs.

Sliding-scale regulation: Commonly under this method a price cap is set but if a firm's profits exceed a given level then the firm is expected to cut prices to consumers with immediate effect.

Tariff rebalancing seeks to increase access prices, and reduce prices for services that have traditionally subsidized low access prices. The objective is to ensure that the price for each service reflects the underlying cost of providing that

service.

2.7.3 PRICE CAPS

Many approaches have been developed to regulate prices. Price cap is one of the most widely accepted ways of price regulation. It was designed as an answer to weaknesses in the rate of return regulation.

The UK was the first country to introduce price-cap retail price regulation and the first country to remove them. In narrowband (voice telephony), the introduction of suitable wholesale products, such as wholesale line rental (WLR), allowed Ofcom to abolish retail price controls in 2006 and remove ex ante retail price regulation altogether in 2009.

Price cap regulation is sometimes called RPI-x regulation. It allows the operator to change its weighted average price level by the change in the retail price index (RPI) less a productivity factor (x). Sometimes, a price cap regime allows for exogenous price shocks (z) to be passed-on so the formula for the change in the price of the basket (P) is then,

$P = RPI - x + z$ where these are all per cent changes

This is also known as incentive regulation because if the operator achieves greater efficiencies than required by x, it can retain the difference as increased profits. If it makes greater price cuts than are necessary to meet the formula in any year, it may be allowed to credit the surplus against changes required in the next period. This has been the case in Australia where retail price controls were first introduced in 1989.

The details of the price cap change have changed between the many price control periods in Australia. But, the basic system with its control over the level of tariffs and the amount of tariff rebalancing is still intact until June 2012.

There is no overall basket but four separate baskets of services. The first basket of services consists of local calls, trunk (national long-distance and fixed-to-mobile) calls, international calls and line rentals. The second basket consists of Telstra's most basic line rental product offered to residential customers. The third basket consists of Telstra's most basic line rental product supplied to business customers and charity customers. The fourth basket consists of connection services.

The services in the first basket are subject to competitive pressure and x is set at the change in the RPI (CPI in Australia) so the weighted average of all services in the basket must not increase in nominal terms. In fact, in the year to June 2010 they fell 0.9 per cent overall (and just over 10 per cent for international calls). Together with an unused credit from the previous year of 2.9 the carry forward credit was 3.7 per cent. Carry-forward credits have been abolished but this has been off-set by reducing x from RP to zero.

The remaining three baskets remain subject to a zero x and all saw actual price changes larger than RPI funded by unused credits brought forward from the previous year. However, the remaining carry-out credits have been abolished.

The current regime will expire in June 2012.

◀ Box 7.2: RPI-x in Australia

Sources: [ACCC Telstra's compliance with the price control arrangements: 1 July 2009 to 30 June 2010](#)

Price caps can be complicated to administer and simpler variants such as revenue caps are worth considering.

Practice Notes

- [Barbados: Price Cap Decision](#)
- [Hong Kong: Price Regulation](#)

Reference Documents

- [ACCC Methodology for administration of the Telstra carrier charges price control arrangements, October 2010](#)
- [ACCC Review of Telstra's price control arrangements, March 2010](#)
- [ACCC Telstra's compliance with the price control arrangements: 1 July 2009 to 30 June 2010](#)

Next: 3 Authorization of Services →

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