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GENERAL NOTICE

NOTICE 886 OF 2001**INDEPENDENT COMMUNICATIONS AUTHORITY OF SOUTH AFRICA****Independent Communications Authority of South Africa
Findings & Conclusions on the Review of Rate Regime in the
Public Switched Telecommunications Sector****1. Background**

- 1.1. On 7 May 2000 the South Africa Telecommunications Regulatory Authority (SATRA) became responsible for the regulatory regime governing the prices charged by Telkom SA for Public Switched Telecommunication Services in South Africa (the "Rate Regime"). Before that date, the price control rules were set by the government and contained in the license issued to Telkom SA and in the Ministerial Directive on Fees and Charges for Telecommunications Services, (Notice 772 of 1997, 7 May 1997). The regulator was responsible for ensuring compliance with the price control regime.

- 1.2. In terms of s45 and s27 of the Telecommunications Act, the Independent Communications Authority of South Africa (ICASA), as a successor to SATRA, published a notice and consultation document in respect of a Review of Fees and Charges in the Public Switched Telecommunications Sector on 22 December 2000. This document was a first step in reviewing the price control rules for the PSTS. ICASA invited public comment on the proposals contained therein and held hearings on the matter from 22 to 23 February 2001 at ICASA's headquarters in Sandton.
- 1.3. ICASA has now concluded its initial consultation on its review of the Rate Regime for the public switched telecommunications sector. Based on the submissions received, and in terms of s27 (8) of the Act, ICASA hereby publishes its findings and conclusions in respect of the Review of Fees and Charges in the Public Switched Telecommunications Sector.
- 1.4. In terms of s96 and s45 of the Act, ICASA will publish draft regulations on the provisions of the amended Rate Regime. These draft regulations are attached hereto and will be in the public domain for comment for a period of three months, after which ICASA will finalise them and send them to the Minister for promulgation in terms of s96 (6) of the Act.

2. Findings and Conclusions

In the light of the above-mentioned consultation, the Authority has reached the following findings and conclusions.

2.1 *Overall Regime*

Most respondents considered that the existing Rate Regime was generally acceptable and that price cap price control was the best system of price regulation. The Authority accordingly intends to retain the main features of the existing regime.

2.2 *Impact of the Current Regime*

Notwithstanding 2.1 above, most respondents felt that there was considerable scope for improvement in the application of the regime. In particular, strong views were expressed about the urgent need for greater downward pressure on prices to residential users in order to offset the effect of rebalancing. ICASA has duly noted this view.

2.3 *Cost Allocation and the Competitive Pricing of Services*

ICASA notes that according to its licence, Telkom has until May 2002 to develop a COA/CAM. We further note that a number of respondents expressed the view that the timescale for the provision of regulatory accounts by Telkom was unreasonably long and that greater priority should be given to putting these accounts in place as soon as possible. ICASA intends to give urgent attention to this issue.

2.4 *International Price Comparisons*

It was widely felt that, in the absence of reliable information on purchasing power parities, international price comparisons had little relevance because of the wide difference in circumstances with the countries concerned. The Authority is conscious of these shortcomings in the data available. For future reviews we have it in mind to seek advance information from countries more directly comparable to South Africa.

2.5 *Need For and Coverage of Price Control*

Most respondents felt that continued control was needed, especially for residential users, and that the existing coverage was reasonable. The Authority agrees with this view.

2.6 *Maximum Percentage Annual Increases in Individual Prices*

2.6.1 There was widespread concern that the existing maximum increase of 20% in real terms was unreasonably high and should be substantially reduced. Telkom, however, argued for its retention, on the grounds that this would give the company greater certainty that it would be able substantially to complete the necessary rebalancing of prices before the arrival of competition.

2.6.2 We note, on the other hand that Telkom did not expect to increase many of its prices by this amount. It confirmed that such increases would be the exception and would only be made where there were clear grounds for rapid rebalancing. In these circumstances we remain of the view that users should be given the assurance that, in general, increases in individual prices will be strictly limited. And that they will only be allowed to go up at a faster rate where a clear case on cost grounds can be made to the regulator.

2.6.3 ICASA accordingly proposes to reduce the maximum percentage to 5%, subject to a proviso that ICASA will be prepared to consider waiving this rule in exceptional cases where a clear case on cost grounds can be made.

2.7 *Telkom's Efficiency*

2.7.1 ICASA notes that most respondents, while welcoming Telkom's efforts to improve efficiency in recent years, felt that there was still a long way

to go in further efficiency improvements. In contrast, Telkom expressed the view that it had already achieved virtually all efficiency improvements possible, within current employment and other constraints, and saw little if any scope for further significant improvement.

- 2.7.2 ICASA notes the general view and considers that Telkom is being unreasonably pessimistic, particularly in view of the reduction in unit costs that is possible as the telecommunications market grows, leading to important increases in distributional efficiency. The Authority therefore considers it reasonable to expect continuing efficiency improvements comparable to those that other countries in a similar stage of economic development have been achieving in telecommunications.

2.8 *Quality of Service*

Most respondents endorsed the importance to users of quality of service and welcomed the suggestion of more comprehensive publication of quality of service statistics and more extensive service level guarantees. The Authority intends to pursue these suggestions further, in parallel with the revision of the price control regime.

2.9 *Telkom's Profitability and Cost of Capital*

- 2.9.1 There was general recognition by respondents that Telkom's current profits did not appear to be excessive and might well not be meeting its expected cost of capital once it was in the private sector. A final view of this is not possible until the capital basis on which its shares are sold is clear. This is one reason why the Authority has suggested a short initial period of price control on the revised basis, to be followed by a more normal period once the capitalisation and market basis under which Telkom will be operating are known.

2.9.2 Meanwhile, Telkom has stressed that its profitability has been considerably reduced by its overarching obligation to have an additional 2.7m working lines in place by May 2002. Many of these lines are not profitable and the costs of providing and maintaining them without a sufficient return to cover costs is placing the company under considerable financial strain. As Telkom points out, its shouldering of this burden was a key reason for limiting the value of X in the price control formula to - 1.5 %, rather than a more conventionally higher figure.

2.9.3 While accepting these general points, the Authority has concluded that the time has come for greater transparency in the costs of extending the network towards providing universal service. Until these costs can be established on an acceptable basis, telecommunications users are, in effect, being asked to take on trust the extent to which prices need to be kept higher than they would otherwise be in order to finance the required network extension. This situation cannot be regarded as satisfactory.

2.9.4 As COSATU has pointed out, the assets acquired by Telkom in extending the network have a long-term strategic value which also needs to be taken into account. So does the contribution in terms of revenue received from unprofitable customers. What is needed, therefore, is a full analysis of the net cost to Telkom of providing universal service under the current arrangements.

2.9.5 The Authority considers that the burden of proof as to the actual net cost of universal service should lie with Telkom, since it is the company that has the detailed sources of information. At the same time we acknowledge that until there is agreement on the regulatory accounting rules the company will have some difficulty in doing this. ICASA therefore intends to pursue this issue urgently with Telkom at the same time as the accounting rules are established.

2.9.6 Under the arrangements for the future licensing of PSTS operators, we would strongly support a situation where government would make provision for the sharing of the costs of universal service in proportion to revenue from the regulated businesses. The likely effect of this approach would be the formal cross-subsidisation of universal access, in a competitively neutral manner, from the proceeds of profitable long distance and international traffic. In the absence of support from the fiscus, we consider this the best approach.

2.10 *Use and Application of CPI*

The Authority notes that most respondents supported the use of CPI as, on balance, the most appropriate index and also supported its application on a historic basis. We accordingly propose to base the calculation of X on the year-on-year change in CPI recorded at a date as near as possible to the start of the price control year. The most appropriate date appears to be 30 September.

2.11 *Time Period*

There was widespread acceptance that current uncertainties precluded an extended initial revised price control period. The concept was generally advanced that there should be an initial period of at least

eighteen (18) months, the control should be subject to review at the end of that time if appropriate and then there should be a further control period of four years. The Authority concurs with this view.

2.12 *Volume Changes*

There was general agreement that volume related controls should not be included. The Authority agrees.

2.13 *Setting of Price Controls*

2.13.1 There was widespread agreement, except from Telkom, that the current 1.5% level of X is undemanding, despite the acknowledgement that it is linked to the cost of universal service provision. This was associated with concern that residential users, in particular, should continue to be properly protected from potential high prices.

2.13.2 The concept of indexing the value of X against the value of CPI did not attract much support. It was felt that this would only be of potential advantage if inflation rose sharply and that it could have an unintended softening effect on the level of price control if inflation became significantly lower. The Authority is accordingly not inclined to make this change.

2.14 *Level of X*

2.14.1 Telkom proposed that the level of X should be reduced to zero, on the grounds that the company has been under severe financial pressure to meet its universal service obligations and

should not also be expected to reduce its average prices in real terms (i.e. after allowing for inflation).

- 2.14.2 Most respondents, on the other hand, considered that the present level of X at 1.5 % was on the low side and should be substantially increased. A number of respondents stressed the importance, in social and economic terms, of providing residential users with low cost services and felt that Telkom was in a good position to do this.
- 2.14.3 ICASA has much sympathy with the dominant view. While not doubting the level of investment that Telkom has been undertaking, ICASA has concluded that it is not sufficient, in the absence of clear evidence, to make assumptions about the medium to long term profitability of that investment.
- 2.14.4 It would certainly, in the Authority's view, not be right to expect users to pay extra to finance accelerated depreciation of the assets concerned. Much of the investment is likely to turn out to be profitable at current rates of usage and we would also expect reduced prices to stimulate demand, creating extra traffic on the network and so reducing unit costs. Ideally the Authority would like to have been able to model the effects of such influences on Telkom's business. But in the absence of information this has not been possible.
- 2.14.5 ICASA accepts that, until the guidelines for regulatory accounts have been agreed, Telkom is not able to provide cost information in a form that it knows will be acceptable in the longer term. However, ICASA cannot believe that Telkom is running its business and planning the roll out of additional lines with no knowledge of costs. Until the Authority has a clearer idea of such costs it is considered that users should have the

benefit of any doubt about the likely impact of future price controls.

2.14.6 ICASA accordingly proposes to set the general level of annual average price reductions, in those prices that affect all users, at 5% below the level of inflation, measured by CPI. The Authority will, however, be prepared to review this decision at any time in the light of further cost information.

2.15 *Separate Residential Basket*

2.15.1 The concept of a separate basket for residential users raised less enthusiasm among respondents than might have been expected. This was despite the fact that there was clear concern that it was residential users who primarily required protection from price increases. The reason for this disparity may have been a lack of familiarity with the concept of separate baskets, which was not fully spelled out in the consultative document.

2.15.2 In terms of this concept Telkom would be required to reduce the average prices it charged for specified services provided to residential users in a way that ensures that they receive at least as much benefit as users generally. It would be left to Telkom to decide how it priced to business users, within any overall price restraint, taking account of competitive commercial pressures.

2.15.3 Telkom objected to this approach on the grounds that it did not differentiate in its charges to business and residential customers. If required to do so, it saw the prospect of charging business customers more for the same service. This response appeared to ignore the future effects of competition. In a competitive environment Telkom can be expected to come under strong pressure to charge larger business customers prices that reflect

the economic value of their higher usage. In countries introducing competition into telecommunications, business users have been strong and early gainers from this process, as well as from rebalancing (since they are the biggest users of long distance and international services).

2.15.4 It is true that small businesses, using telecommunications in much the same way as residential customers, would also be vulnerable in the same way. But this could be dealt with by requiring Telkom also to offer business users a tariff package at residential rates, as is done, for example, in the UK.

2.15.5 We consider that it would be of major advantage for residential users to be specifically protected in a way that ensures that they receive at least as much benefit as users generally. The danger otherwise is that the benefit of price reductions will in practice be concentrated on business users to meet actual or foreseen competitive pressure. When, in the interests of fairness, the benefits of efficiency improvements should be more widely spread and used to help those most in need of protection.

2.15.6 We accordingly propose to establish a separate residential basket, covering the main services used by residential customers (i.e. call charges, monthly rental and installation charge). Payphone tariffs will be included in this basket. Our proposal is to set this sub-cap at CPI-5%. Though we will be willing to review this figure in response to further cost information.

2.16 *Timing*

Almost all respondents considered that 1 January 2002 would be the right starting date for the revised arrangements. ICASA intends to work to that date.

2.17 *Low Usage Scheme*

Most respondents gave a cautious welcome to the proposal for an improved low usage scheme. ICASA does not consider that Telkom's existing prepaid scheme, useful though it is to many customers, gives low users sufficient protection from the adverse effects of rebalancing. The Authority will accordingly be having further discussions with Telkom on measures to develop an improved scheme.

2.18 *Information for Consumers*

2.18.1 Most respondents strongly supported the proposal to improve the amount of information available to users about tariff proposals. ICASA intends to follow a policy of publication of such proposals in the future.

2.18.2 The Authority believes that customers should have a month's written notice before tariffs become effective. This can be achieved through publication in at least two newspapers that have nation-wide coverage. However, Telkom's licence conditions do not make provision for such notice. An amendment to Telkom's licence will be pursued.

2.18.3 In terms of Telkom's licence the Authority has at least fifteen (15) business days within which to evaluate proposed tariffs and respond thereto. The Authority is of the view that this is not sufficient and thus proposes that it should be increased to at least twenty (20) business days, however, this would necessitate an amendment to Telkom's Licence.

2.19 *Average Residential Bill*

2.19.1 There was a good deal of interest in the proposal that arrangements should be made to calculate and track the

average residential bill, as a means to understanding the actual impact on users of price changes. M-Cell made the interesting suggestion that the average bill (in the form of the median bill) might be a point of reference for future price control.

2.19.2 Telkom raised the objection that it was not able to manipulate the large number of bills it handled in order to make the necessary calculation. As M-Cell pointed out at the public hearings, however, this point ignored the fairly limited and straightforward sampling techniques that are routinely used elsewhere to make such calculations.

2.19.3 ICASA considers that it would be highly advantageous to all concerned to have statistically reliable evidence available on actual usage figures, particularly by residential users. The Authority intends to require that Telkom produce statistical information from which an accurate estimate of the average residential bill can be derived and on which the application of the proposed residential sub-cap will be based.

2.20 *Other Points*

During the consultation respondents raised the following further points, which did not appear in the consultative document.

2.20.1 *Wholesale Discounts*

On behalf of the service providers' sector, in particular, it was pointed out that the provision of economically sound and fair wholesale rates for the bulk usage of network and other facilities was an essential element in the development of an effective competitive environment in telecommunications. The Authority agrees and intends to pursue this

issue at the same time as it carries out work on interconnection prices, which will be an important part of facilitating network competition.

2.20.2 Carryover

Telkom has requested that price reductions in excess of those required should automatically be carried over into the next year. The Authority considers that this refinement of the application of the rules would be beneficial to users. In a period of inflation any postponement of price increases is a net gain to users. The proposed change would encourage the postponement of some price rises for a limited period. The Authority accordingly proposes to incorporate it in the revised rules.

2.20.3 Rollover

Telkom has also suggested that there should be a "rollover" provision to ensure that the price control arrangements carry on after the ending of the price control period if the implementation of new arrangements has not proved possible. The Authority agrees that this is also a useful addition to the rules. Like carryover, it is used in a number of other administrations in order to avoid any unintended lapsing of the arrangements. ICASA therefore intends to adopt a "rollover" provision.

2.20.4 Fixed-to-mobile calls

Telkom has raised the view that fixed-to-mobile call tariff should be taken out of the basket and as such be treated as a service that is not price regulated as its share therein is limited to the portion left after the mobile operators have had their cut. The Authority is of the view that this area should be revisited when the impending Rate Regime is reviewed if an acceptable solution has not been reached under the Interconnection regime.

2.20.5 New Services

Telkom expressed the view that there is little need to price regulate new products or packaged offerings of existing services. The Authority is of the view that a more reasonable approach would be for it to make an assessment of the need to price regulate all new products and packaged offerings on a case by case basis.

3. Summary of findings and conclusions

- 3.1. The main features of the existing price control regime should be retained.
- 3.2. The most immediate need is to protect residential users from having to pay higher prices for services than are absolutely essential.
- 3.3. The programme for finalising regulatory accounting guidelines will be accelerated.
- 3.4. The limitations of international price comparison are recognised. But the process of international comparison is still considered valuable. Efforts will be made to improve the information available in future.
- 3.5. Price control should continue on the basis of the existing coverage.
- 3.6. The maximum permitted annual percentage increase in any individual price should be reduced from 20% to 5%.
- 3.7. Continuing efficiency gains in Telkom's operations and marketing can be expected in line with those in other countries at a similar stage of development.

- 3.8. More comprehensive information on quality of service of the public switched telecommunication network should be published regularly.
- 3.9. Further information is required on the net cost to Telkom of the universal service element of its network extension programme. Pending the availability of such information, price control decisions will have to be made on broader assumptions. Once competing operators are licensed, arrangements should be made for them to share in the cost of meeting universal service obligations in a competitively neutral way.
- 3.10. CPI is the appropriate index to use for price control purposes. The calculation of the value of X each year should be based on the annual change in CPI to the previous 30 September.
- 3.11. The initial period of price control should be at least eighteen months or until such time as a new regime is prescribed.
- 3.12. Volume related controls should not be included in the new arrangements.
- 3.13. The setting of price controls should be based on an assessment of expected efficiency gains and indexed to CPI.
- 3.14. The general level of price control proposed is CPI- 5%, subject to review if further cost information suggests that this is necessary.
- 3.15. A separate basket of services to residential users (call charges, monthly rental and installation charge) is proposed, subject to a sub-cap of 5%, which may also be reviewed as at (14) above.
- 3.16. The next period of price control should commence on 1 January 2002.

- 3.17. A specific scheme to protect low users against the adverse effects of rebalancing should be introduced.
- 3.18. Information should be published about tariff proposals for the public switched network before tariff changes are made.
- 3.19. Arrangements should be made to calculate and publish the average residential bill.
- 3.20. Wholesale discounts for the bulk use of network and other facilities should form part of the tariff structure for business users.
- 3.21. Automatic carryover from one year to the next of price reductions above the level required should be included in the arrangements to facilitate the delay of price increases where administratively or otherwise convenient.
- 3.22. Rollover of the amended price control rules into subsequent years should be included to ensure the continuance of price control if new rules take longer than expected to implement.
- 3.23. Price control of the fixed-to-mobile calls will be reviewed in two years if an acceptable settlement has not been reached under the interconnection regime.
- 3.24. The Authority will assess the need to price regulate new products and packaged tariffs on a case by case basis.

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