

Competitive

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Approaches for Internal Operational Separation of Telstra

March 2005

(Paper 2 in the CCC Revitalising Competition Policy Papers Series)

Background to this paper

This paper is one of several being prepared by the CCC expanding on some of the issues raised in the CCC's January 2005 discussion draft paper *Revitalising Competition in Australian Telecommunications – Proposals for Policy Reform*, Based feedback to that paper.

The CCC does not at this time advocate a single model of internal operational separation, however, effective separation of Telstra's interest in Foxtel and the HFC cable from its telecommunications business and changed Telstra retail/wholesale arrangements are at the core of all options. Further, as a guiding principle, the CCC believes that reforms to create the structure conditions conducive to strong and sustainable competition are preferable to attempting to address points of structural failure through specific regulatory mechanisms.

The latter has been the approach of reforms since 1997, and the CCC believes that it is now beyond argument that this approach has failed. It has created a cycle which sees those with market power in the industry, primarily Telstra, finding ways to avoid or game regulation, followed by tinkering with the regulatory arrangements, followed by a new set of gaming tactics.

The CCC believes that the more a reform package relies on regulation rather than structural reform, the more it will invite gaming.

Like others in this series, this paper seeks to stimulate debate and help focus further discussion on the merits of different policy approaches to achieving effective structural reform. The CCC invites comment and suggestions as to where greater focus or investigation would be useful.

The Goals of Internal Operational Separation

As discussed in the CCC's policy proposals overview paper, the core problem that arises from Telstra's unparalleled vertical and horizontal integration – that it has the incentive and the means to discriminate against those carriers seeking access to its bottleneck and monopoly infrastructure to the detriment of competition – cannot be removed by any measures short of actual structural separation.

The goal driving the design of an internal operational separation model (i.e. a ring fencing model) must therefore be to mitigate the problem as much as possible. Internal operational separation seeks to replicate within Telstra as far as possible the behaviour that could be expected to be observed if Telstra was not structurally integrated, but was a set of independent businesses interacting with other market participants.

It should be emphasized that the CCC believes that competition is the best means of advancing the long term interests of end users, and that this is consistent with the primary goal of telecommunications policy in Australia.

Present Arrangements and Their Limits

The CCC has observed that there is some confusion about the nature of present arrangements relating to Telstra's internal organization and in relation to some of the regulatory mechanisms previously put in place in an attempt to give the ACCC greater insight into Telstra's financial organization. This confusion is caused by the use of the terms Wholesale and Retail by Telstra to describe different parts of its business and the term Accounting Separation to describe an ACCC process. These terms have common sense meaning that leads observers to make certain assumptions. However, these assumptions are often misplaced and it is therefore important to clarify their meaning and operation.

Telstra Wholesale/Retail

Telstra does not supply itself wholesale services, despite having a division called Telstra Wholesale. Telstra Wholesale is in fact simply a sales group that supplies network services to other carriers. Often these services are constructs that are not comparable with the services that Telstra is able to construct for use by its own retail operation.

For example, the recently concluded year-long dispute about the price Telstra charged for Retail ADSL services compared to Wholesale ADSL services could not be resolved by simple reference to the margin Telstra attributed between the wholesale price it offered to competitors and its own retail price because Telstra had no internal wholesale price (i.e. the actual price Telstra wholesale charged Telstra retail). The retail sales group and the wholesale sales group claimed to have no pricing relationship, leaving the ACCC to attempt to impute costs that were in some way comparable to those faced by the rest of the industry. This problem is repeated across the range of wholesale products.

Accounting Separation

A similar problem of artificiality exists in relation to the accounting separation requirements introduced in 2002. The accounting separation regime is extremely limited in that it relates to a narrowly defined set of products and services, and is a completely constructed, artificial set of accounts, not a snapshot of actual accounts against which Telstra actually does business.

The CCC submits that it is important to note that the present accounting separation regime has not been effective in achieving any meaningful outcome, either in identifying breaches of the competition principles in the Trade Practices Act relating to telecommunications, or in creating any real disincentive for Telstra to attempt to abuse its market power.

ACCC Commissioner responsible for telecommunications, Ed Willett, described the weakness of accounting separation to a Senate hearing in February 2005 in the following terms:

“The difficulty we see is that the current accounting separation regime is a virtual accounting separation. It bears no real relationship to what is going on within the organisation. And so, combining that with the problems we have had in imputation analysis—the very large differences we have found between Telstra and ourselves on how you go about applying that imputation—it has meant that those accounting separation arrangements have been of little value in dealing with disputes and complaints about anticompetitive behaviour by Telstra.”

The most powerful example of the failure of accounting separation to provide a useful tool is provided by the investigation of the competition notice that was in place from March 2004 to February 2005 against Telstra in relation to ADSL pricing. The investigation of this matter was the highest priority issue on the ACCC telecommunications group’s enforcement agenda. Yet, according to Ed Willett, the ACCC “has only relied on the existing accounting separation arrangements to a very limited extent in relation to its imputation testing analysis of specific cases”.¹

Commissioner Willett also reflected that the three reports released to date might have served to confuse the public impression of the views of the Commission. He noted that the reports had concluded that the ACCC has “no major concerns with how Telstra is providing the specific services covered by the arrangements”. But he said that this “is far from the clean bill of health that some have interpreted the Commission has provided Telstra in relation to these reports”.

“We noted that the information provided by Telstra is highly aggregated in nature and could mask specific instances of conduct requiring more detailed analysis,” Commissioner Willett said.

The CCC believes it is important that the artificial nature of accounting separation is widely understood. There have been public representations from Telstra to the effect that the accounting separation measures presently in place indicate Telstra has engaged in no anti-competitive conduct. It is clear that they do no such thing and that the present arrangements fall well short of providing an effective mechanism to identify such conduct in any but the most extreme cases.

Guiding Principles in Developing Effective Internal Operational Separation

The CCC submits that two principles should guide the design of effective internal operational separation arrangements

¹ Ed Willett Address to AFR Telecom Summit, Sydney, 15 November 2004

1. Deliver a *transparent and auditable transactional-based relationship* between Telstra wholesale activities and retail activities, and any other activities considered a point of market power leverage, when Telstra acquires the building block inputs for its retail products. This addresses the need for the regulator to be able to gain true insights into Telstra's activities and internal arrangements, a need that has not been met by the existing regulatory regime.

2. Require Telstra to apply a *non-discriminatory* approach to the sale, supply and maintenance of these services or inputs to other carriers. This addresses the need for equivalence in non price terms. That is, Telstra's treatment of its own retail arm viz a viz its wholesale customers.

To deliver against these principles, a number of conditions must be met.

Firstly, the transactional information being recorded must capture price, terms and conditions. The arrangements must reflect an awareness that anything short of structural separation does not remove the incentive to discriminate. Therefore the means by which discrimination does or might occur must be anticipated and prevented as much as possible.

For example, the similar but separate problems of information asymmetry and information leakage must be understood and arrangements must be put in place to address both of them (see below).

Further, in order to maximize the national benefit from an innovative, competitive and dynamic communications sector, the arrangements need to look beyond preventing discrimination in day-to-day transactions and facilitate industry-wide co-operative innovation and product differentiation.

To achieve this, the arrangements must go to behaviour such as providing non-discriminatory access to network design and product and services development. This is important for two reasons: firstly, to prevent Telstra from building new networks that are designed to make wholesale access difficult and secondly to allow equal access for the purpose of new product development and product differentiation.

A related condition of the internal separation arrangements must be that Telstra Retail groups cannot directly own any network infrastructure or hardware. There are serious problems in present arrangements that arise from Telstra's ability to claim that some services that are clearly integrated into the same switches providing wholesale services are "owned" by retail and therefore not available to competitors. Telstra's free message bank service is one such example where, although the functionality for the service clearly resides in the switch, Telstra claims it is a retail developed service and therefore not available as a wholesale service.

A similar example which demonstrates why Telstra retail cannot be permitted to own infrastructure and how it can engage in non price discrimination, relates to broadband services. Telstra offers a wholesale business-grade DSL service from about 90 exchange locations, but Telstra retail offers a business-grade retail service from about 800 exchanges. It claims that the latter is not a wholesale product and therefore does not make it available to competitors. A direct consequence of this arrangement is to reinforce Telstra's incumbency in regional areas where it does not allow competitors access to business grade products it uses itself.

The UK has experienced an extension of this problem post an internal separation process BT embarked on to allay regulatory concerns about discrimination. There, BT retail has overbuilt BT wholesale's DSL network, and claimed that the new network is not subject to access requirements because it post-dates the establishment of the wholesale group.

Clearly, this problem has to be anticipated and avoided by precluding Telstra Retail from owning network infrastructure.

The Depth of Internal Operational Separation

The most consistent complaint from access seekers dealing with Telstra Wholesale is that they are never confident that they are dealing with someone who is genuinely and exclusively in the wholesale business and does not have some relationship with retail – i.e. a competitor. At some point in the organization, whilst ever it is a single company, there will be a convergence between its wholesale and retail concerns and this fundamental conflict of interest will arise.

Telstra itself acknowledged that this is a problem when it announced that it was reorganising its internal reporting so that the most senior executive in Telstra Wholesale reported directly to the CEO. While it is to be welcomed that Telstra has acknowledged the problem, these changes fall far short of what is required to effect real change. This arrangement was previously in place for some time to 2002.

Some commentators have argued that a problem with requiring Telstra to recognise “fair go” principles for competitors is that it could run counter to the legal responsibilities of its directors and senior managers.

This would in part depend upon the form of the requirements – for example, if they were licence conditions (see separate paper on models for effecting internal operational separation) this could create a clear obligation on officers of Telstra to act to maintain the integrity of the Wholesale business.

However, this problem would largely disappear if separate boards were created for each of the operational divisions. Under a model of completely independent boards, there should never be a circumstance where the directors or senior managers feel conflicted,

nor where access seekers can point to a conflicted relationship as providing a cause for concern about improper behaviour.

This approach would be consistent with a recent proposal from BT to address concerns from the UK regulator Ofcom about non-discriminatory access to bottleneck services. BT has offered to create a separate business unit called Access Service, reporting to a separate board containing at least one and possibly two independent directors (i.e. independent from the rest of BT). (see Appendix 1)

If it was not considered appropriate to have separate boards, there is a very powerful argument that there should be separate CEOs reporting to the board. There is a great danger, and arguably unfairness, in vesting the management of the potential conflicting interests of the wholesale and retail divisions with one person, no matter how senior. Having independent CEOs clearly and solely responsible for retail or wholesale activities, each reporting to the board, would at least ensure that a collective decision-making process was taken to resolving conflicts. The question of managing board conflict of interest would remain, however.

Under the three approaches or illustrative models of internal operational separation below, there could opportunities for different management arrangements and points of reporting convergence to co-exist, as long as mechanisms were in place to anticipate and manage conflicts of interest.

The Core Feature of Internal Operational Separation

The first feature of effective internal operational separation would be the development of separate, auditable accounts for the business units, coupled with contracts for the acquisition of core and declared services between the internally operationally separate Telstra groups. These contracts would include all price and non price terms and conditions.

These contracts would be lodged with the ACCC so that the ACCC could immediately refer to them when it received a complaint of anti-competitive conduct from a competitor about a price or service supply issue. Acquisition of services based on those contracts should then be recorded through an auditable invoice and reconciliation process. This could be used to identify and regulate day to day anti-competitive behaviour.

To facilitate equivalency of terms and conditions in particular, the internal divisions would be required to maintain separate information systems for operational matters.² The wholesale information systems that Telstra provided as the interface to its retail business should be the same systems to which other wholesale customers would access. This would be intended to deal with problems such as information asymmetry between Telstra wholesale and retail. This asymmetry can be seen manifesting today in rejections of applications for wholesale ADSL services to a particular customer location on the basis

² Some functions, such as HR, might be able to remain integrated where they did not bear on the attributable costs of providing services in a materially important way.

of a failed line test, indicating an inadequate copper line, followed by that same location being successfully connected to a Telstra retail service. This demonstrates that Telstra Retail is receiving better quality information and perhaps preferential treatment than access seekers.

Another requirement would be separate physical locations for all operational activities that are related to the separated businesses. This would address the information leakage problem. An example of this problem is the apparent passing of information from Telstra Wholesale to Telstra Retail when another carrier passes through a customer connection request to Telstra Wholesale. This is seen in the speed with which retail customers are often targeted by Telstra “win back” offers when they order a service from a competitor.

Drawing the Reporting Lines: Approaches

As identified by the Minister in her speech to ATUG on March 9, 2005, there are many interpretations of what internal operational separation would look like in implementation.

This is not an exhaustive list, nor are the approaches described necessarily mutually exclusive, but they are the most obvious. However, they do illustrate where internal lines might be drawn in Telstra to effect operational separation and the advantages and limitations of different approaches.

The importance of the limitations of the various options would need to be considered in the context of what other possible regulatory tools would be required to address the consequences of those weaknesses.

However, there is a trade-off between the type and number of internal operational divisions created in Telstra and the need for complementary or additional regulation. The CCC believes that structural reform to create a sustainable competitive environment should be the priority in the design of a new regulatory package. The absence of structural reform has been the weakness in the competitive regime to date.

Where there remained a lack of internal transparency in Telstra, the regulator would need to rely on other regulatory tools to prevent, identify and deal with anti-competitive activity that may result. This means a range of second best options to structural reform like those that are in use today, such as record keeping rules, imputation modeling and price controls. These devices have failed to date and the CCC sees no reason for confidence that they will succeed in the future.

The CCC therefore believes the best model is likely to be one that creates both horizontal and vertical transparency between Telstra business divisions.

The CCC is preparing a separate paper on the regulation that could be removed if structural reform was introduced. This paper will further discuss the implications of different models of internal separation for efforts to lift the regulatory burden.

Approach 1. Simple Vertical Division

Possible Lines of Operational Separation:

This involves a straightforward division of Telstra into horizontally integrated Wholesale and horizontally integrated Retail businesses. The wholesale unit would own all hardware and contract with the retail division to supply access to these assets. Contracts, including all terms and conditions, for core and declared services must be registered with the ACCC.

Potential Limitation on effectiveness.

This line of separation does not address the problem of Telstra's horizontal integration, that is, integration across service categories and network infrastructure. This would likely lead to continued sub-optimal competition between potentially competitive network technologies and anti-competitive pricing of wholesale services offered between networks.

The most obvious example of the first problem is the lack of competition between the HFC cable and fixed wire telecommunications networks. Competition between cable owners seeking to deliver high speed Internet access and telecommunication's carriers seeking to sell the same services through DSL technologies have been the drivers of high speed (broadband) Internet penetration in most other countries, notably Canada. Telstra's domination of both network technologies in Australia has repeatedly been identified as causing a key structural source of competition to be absent from this market. A simple wholesale/retail operational separation would not create an incentive for these two network groups to compete vigorously by, for example, trying to differentiate on price or service functionality. As noted earlier, the CCC believes it is necessary that any internal operational separation model include effective operational separation of the Cable and Foxtel.

The second area of likely failure is illustrated by the on going disputes about the appropriate price for terminating calls from fixed networks to mobile networks. There is strong evidence that the major mobile network operators – in particular Telstra and Optus who both own fixed and mobile networks – are providing below wholesale prices to selected corporate customers. Obtaining sufficient evidence of these activities to sustain a competition inquiry is difficult. It is likely that wholesale/retail operational separation of Telstra would not remove all opportunities for below cost termination to be disguised.

Approach 2. Retail and wholesale vertical transparency with additional horizontal wholesale transparency.

Possible Lines of Operational Separation:

Require Telstra to file with the ACCC contractual arrangements for the supply of services between its wholesale groups similar to the wholesale/retail contracts described above.

The logical points of horizontal separation would, in the first instance, be the different networks, i.e. the PSTN, HFC cable and mobile networks. This would be consistent with regulatory requirements in other jurisdictions which prohibit telecommunication's carriers from owning cable networks (e.g. Canada, US and the UK). In the U.K such arrangements have been further supported by equity market pressure to release shareholder value which led to BT voluntarily spinning off its mobile business.

Potential Limitations on Effectiveness:

Arguably, Telstra's integration at a retail level is as problematic as its integration at a wholesale level. Certainly, no other jurisdiction has been willing to tolerate such retail consolidation because of the opportunity for cost shifting.

It could be expected that Telstra would seek to cross-subsidise horizontally at a retail level between product groups in ways that are not available to its competitors, replicating the problems the ACCC has today in determining how vertical costs should be allocated in Telstra.

An example scenario could be imagined in the ADSL markets. It is not difficult to anticipate Telstra arguing that it was legitimate for them to cross-subsidise the marketing cost of the retail ADSL service by spreading total marketing costs across all product lines, including its monopoly fixed line access network for which it faces no competition in most markets and therefore does not have high marketing costs. By this means it could present retail costs to the ACCC that were impossible for others to replicate, by virtue of the continued ability to cross-subsidise from monopoly markets to competitive markets.

The ACCC would be forced to rely on the same flawed modeling and imputation tests in an attempt to penetrate these arrangements.

Approach 3. Vertical and Horizontal Operational Separation of Telstra Wholesale and Retail

This option would add horizontal internal operational separation to the Telstra Retail businesses in addition to the lines of internal separation described above.

Possible Lines of Operational Separation:

Telstra has already created internal business units and brands that suggest there are logical and practical divisions within its retail activities. It would make sense to use these as lines across which Telstra must record transactions for the acquisition of services for the purpose of bundling, or to show what costs are properly apportioned to what activities.

For example, Telstra has BigPond as its retail brand and operational group for higher bandwidth residential data services, the HFC cable content business is operated by a separate joint venture company Foxtel, and its retail mobile business operates as Telstra Mobile. These existing operational divisions could be formalized such that there was a

requirement for transparent transactional relationships to demonstrate how costs were apportioned in retail bundles, for example.

Appendix 1

From the *Financial Times* February 3, 2005

BT responds to Ofcom with equal access proposals

By Ben Hunt

Published: February 3 2005 23:25 | Last updated: February 3 2005 23:25

BT Group has set out proposals for ensuring rivals are offered equal access to its network in an attempt to find a lasting settlement with the telecommunications regulator.

Ofcom, the combined telecoms and media regulator, had demanded cultural and behavioural change from BT, backed by the threat of an investigation by the Competition Commission and possible break up of the company.

The plans announced on Thursday show how BT aims to restructure itself in response. A new business unit, to be called the Access Service, is at the heart of its 130-page proposals.

BT said the unit, which would provide transparent and equal access to its local loop, would offer all the benefits of complete separation without the "pain and cost" of a break-up, which it claimed would affect the entire industry.

The company covered other issues Ofcom has asked to see change on, saying it would offer its operator customers cheaper wholesale line rental prices, a range of faster broadband services and lower prices for "local loop unbundling": allowing competitors access to local exchanges.

Ben Verwaayen, chief executive, said BT's plans represented the most radical change to the sector in the 20 years since liberalisation of the industry and would prompt a new era of fast and innovative services for customers of all telecoms companies.

"We think this addresses all the issues raised in a proactive manner. It's a basis on which to move regulation on to a new start and give companies the certainty they need to invest in their businesses and get on with life," he said.

Mr Verwaayen acknowledged that it was important for BT "to be seen to do the right thing" and said the Access Service unit would be set up in a way that offered reassurance to rivals.

The unit, which will manage the "local loop", the part of BT's network that links the customer to the local exchange, will have a board chaired by Mr Verwaayen that will contain two independent members, one of whom may be an Ofcom board member.

BT said it accepted the unit would be subject to high levels of regulation, but believed that as part of a settlement with Ofcom other parts of its business should be freed from regulation.

This approach, labelled "carrot and stick", has not found favour with BT's rivals.

Francesco Caio, chief executive of Cable and Wireless, said BT should demonstrate it had changed before being freed from the regulatory burdens on the parts of its business that faced significant competition. "They

have already had a huge carrot. They've had carrot, potatoes and aubergines. A very nice meal indeed," he said.

In its submission to Ofcom, C&W said instant action was required from Ofcom, as the industry was moving from narrow-band to broadband very quickly and the window of opportunity for bringing meaningful competition to the market was small. It called on BT to show "good faith" by making immediate changes such as giving all competitors access to its network installation database as it did to BT Retail, before Ofcom forced through real structural change later.

Stephen Carter, chief executive of Ofcom, welcomed BT's proposals. "However, as ever, real delivery will require real detail," he said.

Similarly, David McConnell, chairman of the UK Competitive Telecommunications Association, which represents the alternative carriers, was pleased BT had engaged constructively with Ofcom, but warned that much work remained to be done for a regulatory settlement to be reached.

"There's no reason to celebrate yet. This debate has only just begun and what happens over the next three months will be decisive," he said.

Ofcom must now review all the expected 100 submissions it receives, before publishing its proposals. These are not not expected until summer.

