Competitive
Carriers'
Coalition Inc

A Framework for the Assessment of Operational Separation Models

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Credible, Durable and Enforceable Reform

The CCC submits that the benchmark that any proposed model of Operational Separation has to achieve to be acceptable is that it can be said to be Credible, Durable and Enforceable.

Credible in order to convince stakeholders that these reforms can work where previous efforts have not, and to convince the equity markets that there will be some regulatory stability in the environment into which Telstra is sold.

Durable enough to withstand both: attempts by Telstra in the future to wind back the arrangements or to subvert their intention, and; to accommodate changes in technology.

Enforceable so that Telstra is required to make the necessary changes, and to allow the regulator to enforce competition regulation where needed in future.

The elements of a credible, sustainable, enforceable model

Submissions to the DCITA review of telecommunications policy have presented a wide range of views on operational separation, but a number of common themes have emerged from most contributors.

The Australian Consumers' Association has listed the requisite elements of an operational Separation model as:

- Maintenance of separate legal entities for internal business units;
- Allocation of costs in a reasonable manner;
- Transparent pricing arrangements between wholesale and retail arms;
- Separate invoicing and billing systems;
- Fully separate accounts and reporting systems;
- Limitations on common staff and sharing confidential customer information
- Staff incentives linked exclusively to the relevant business unit

The ACCC has said that operational separation should deliver changed incentives, transparency, and non-discrimination, and has identified the need for:

- Separate wholesale and retail business entities
- Fully separate accounts and reporting systems capable of capturing all transactions between the businesses
- Separate management and staff
- Commercial, arm's length dealings with explicit transfer pricing, invoicing and billing

The CCC has also identified the above elements as underpinning requirements. It has said that any model of operational separation needs to deliver:

- Changed or effectively managed incentives within Telstra through clear operational division between wholesale and retail groups.

- Equivalency of treatment for access seekers, both in price and non-price terms.

- Transparency to allow regulatory oversight.

Testing Proposed Models

The CCC suggested the following questions as providing a basis for testing proposed models be tested against the elements described above by contributors to the DCITA review.

- *Does the proposed model create a structure that will emulate market signals between wholesale and retail businesses?*

The fundamental problem the ACCC has identified as undermining competition in telecommunications markets is that that Telstra has the incentive and ability to discriminate against access seekers. Only the creation of a ring-fenced wholesale business will change these fundamental incentives driving Telstra to seek to avoid the intention of telecommunications policy to create a competitive market on the basis of fair access to bottleneck infrastructure.

- *Does it create genuine businesses, or artificial regulatory constructs?*

The ring fencing of selected assets, rather than ring fencing between activities that together represent a meaningful set of business actions, cannot be regarded as a durable arrangement. Trying to separate selected assets is most likely to be motivated by a desire to quarantine regulation rather than emulating market behaviour. The resulting operating division would not have the features of a "natural", self-sustaining wholesale business. A self-sustaining wholesale business, however, would continue to evolve and develop as a market participant in its own right, stimulating general market growth and innovation.

The ACCC comments:

> "Most importantly, this (wholesale/retail businesses) model would increase the competitive discipline around the internal businesses, and reduce the need for regulatory intervention. With genuine arms-length dealing with all retail customers (including Telstra Retail) the network business will have stronger incentives to drive a hard bargain in maximizing returns from all its activities, rather than favoring its own retail activities. In like fashion, the Telstra Retail

unit will face the same commercial pressures in negotiating with the network business over terms and conditions for wholesale services."

- *Does the proposed model simplify the structures and points of regulatory intervention, or multiply them? For example, does the proposal under consideration require a wholesale group and a network group, both supplying services that will therefore both require regulation?*

- *Do they provide effective transparency, only partial transparency, or make matters more complicated?*

The present Telstra Wholesale business has no business relationship with the retail activities of Telstra. Its purpose is purely to supply services to third party carriers. Telstra retail does not acquire services from it. Some proposals for operational separation suggest the creation of a new entity providing access only to the local loop. These models, however, envisage that the wholesale business would be separately retained in its present form. Such an arrangement would in effect create two entities supplying regulated access services, with consequent confusion about the allocation of costs and activities and new opportunities for gaming.

- *Does the proposed model create arm's length commercial relationships between the retail business and the wholesale business?*

- *Is there clear cost allocation between ring-fenced groups?*

- *Is there separation of asset ownership?*

It must be clear what activities reside with which entity and where the costs are generated. These must be passed on to the downstream operations in Telstra on the same basis as they are passed on to other access seekers.

- *Will the pricing of transactions be real transactions, subject to the TPA, or notional transfers?*

- *Are there separate, auditable accounts that reflect real business activity?*

The ACCC has described "the primary limitation of accounting separation arrangements is that they require only a notional allocation of costs across the wholesale and retail businesses". To ensure that these arrangements are enforceable, there must be arrangements that require genuine transactions to be conducted and recorded between the wholesale and retail groups in Telstra. These must represent the same accounts against which the business is actually run, not a special set of "regulator's books". That is, a genuine and transparent internal transfer pricing regime.

- *Will the ring-fenced entities have separate boards?*

- *Will the ring fenced entities have separate management structures?*

Is there clear staff separation, and how are separate incentives for all staff created? How are staff prevented from favoring Telstra over others?
The activities of the employees of the separate entities must be strictly directed toward the interests of the entity for which they work. This should be through a combination of linking management responsibilities and staff remuneration to the activities of the business entities, and through creating a means of identifying and punishing instances where there is a breach of ring-fencing arrangements.

- *Do the proposals deliver non-discrimination?*

Does the model remove and/or manage the incentives to discriminate in favor of Telstra Retail and allow instances of discrimination to be identified and resolved?

Contact

David Forman
Executive Director
Competitive Carriers' Coalition
02 62625821
david@ccc.asn.au