Operational Separation Framework

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2 May 2005

1. PURPOSE

Despite the reforms of the 1990s, the telecommunications markets in Australia, by and large, are not competitive. Telstra is a vertically and horizontally integrated operator with significant market power across the board. The extent to which there is competition depends heavily on effective regulatory and policy settings that are in place. One of these settings is Government majority ownership of Telstra that moderates, in practice, Telstra behaviour through the prospect of owner-intervention. The purpose of this paper is to propose key elements in the regulatory framework that are needed once Telstra is privatised.

2. 'OPERATIONAL SEPARATION'

Various means have been used to constrain the behaviour of telecommunications operators in markets in which they have significant market power, including -

- structural separation - the formation of fully separate and distinct, commercially arms-length organisations to undertake various functions of the formerly integrated business
- accounting separation - submission to the regulator of financial and accounting returns that aim to show how costs and revenues have been allocated to the various services provided by the organisation, and in particular, costs and revenues at wholesale and retail levels.

The CCC has stated on a number of occasions that its continuing preference is for structural separation - the clear separation of Telstra into two distinct organisations - effectively infrastructure and wholesale, on the one hand, and retail, on the other - that are required to conduct their relationships at commercial arms-length. The CCC believes that this form of separation would ensure that those incentives for anti-competitive behaviour that arise from vertical integration would be eliminated. However, the CCC also understands that this may not be a course of action that the Government wishes to take in all of the circumstances.

Accounting separation is, at best, a means to create a level of transparency in the allocation of costs and revenues between products and services, including wholesale and retail products and services. The inadequacies of accounting separation as a means of influencing the incentives for anti-competitive conduct have been well documented, including by the ACCC. In short, it is expensive to administer, does not reflect the reality of how Telstra actually conducts its business, and does nothing to motivate Telstra to behave in ways consistent with the intention of the telecommunications competition regime. Experience to date has shown that accounting separation is not and cannot be a sufficient guarantee of the behaviour of a vertically and horizontally integrated organisation such as Telstra. This is discussed further in the CCC's response to DCITA's April 2005 issues paper "Telecommunications Competition Regulation"

In saying this, the CCC recognises that some form of regulatory financial reporting by Telstra will need to be part of the solution, but it cannot be the whole solution.

Operational separation is the preferred option, given that the current climate may not permit the Government to proceed with structural separation. Operational separation is an approach that addresses the internal structure and permissible behaviour within the organisation, and is designed to meet the key objectives of

- transparency, and
- non-discriminatory behaviour, including changed internal incentives, whilst allowing the organisation to continue to compete in ways generally considered to be fair and reasonable.

It is important to note that operational separation cannot be expected to replace other elements of the existing regime related to anti-competitive conduct and access to bottleneck infrastructure (particularly the Part XIB and XIC provisions). Rather, it is intended to

1. put in place a framework where reliance on intervention in the market by the regulator based on those provisions is reduced because Telstra's incentives and behaviour should change, and
2. allow those provisions to operate more effectively. For example, where there is evidence of anti-competitive conduct, operational separation should provide greater transparency.

The CCC believes that there is a need to separately consider the effectiveness of the operation of Part XIB and XIC and proposes several amendments. However, these will be addressed in more detail in a separate paper, including DCITA's April 2005 issues paper "Telecommunications Competition Regulation".

3. OPERATIONAL SEPARATION FRAMEWORK - KEY ELEMENTS

There are a number of key elements in the Operational Separation Framework that collectively are both necessary and efficient to ensure that the arrangements will be transparent, non-discriminatory, and effective in sustaining effective competition in the industry.

3.1 Existing Telstra Wholesale Division

The existing Telstra Wholesale Division, that was recently relocated so that it reports to the CEO, does not equate with the proposed Telstra IWS Group in this paper. The existing Division is merely that part of Telstra charged with managing wholesale customers. The retail units within Telstra are not required to access Telstra infrastructure and networks on the same basis nor are they required to source via the Wholesale Division. From the perspective of the Operational Separation Framework described in this paper, the existing Wholesale Division is mere window dressing.

3.2 Internal structure

- Telstra will be required to establish separate groups called, for present purposes, Telstra Infrastructure and Wholesale Services (IWS) Group and Telstra Retail Services Group.
- Telstra IWS Group will be structured to report through its own Chief Executive to its own Board.

- Telstra Retail will still have substantial scale and scope, and therefore will have the potential to act anti-competitively through its dominance of many retail markets (eg. through retail cross subsidies that seek to leverage power in one retail market to gain unfair advantage in another retail market). As a result, Telstra Retail will need to be subject to appropriate continuing regulatory and industry scrutiny.
- No employee or executive director of Telstra Retail Services Group may be employed at the same time by or be on the board of the Telstra IWS Group, and vice versa.
- Telstra IWS and Telstra Retail Groups shall report to the Telstra Corporation main board in terms of corporate metrics and achievements. The main board shall be obliged to ensure that it does not become a means for operating information to flow between Telstra IWS Group and Telstra Retail Services Group. (Specific legislation will likely be required to effect this and to modify the operation of the current obligations of directors in relation to shareholders to that extent.)

3.3 Asset ownership and control

- Telstra IWS Group shall own all of the following assets of Telstra Corporation, and shall use those assets to provide infrastructure services and wholesale services to the industry -

  (a) all transmission, switching, routing and signalling equipment associated with the provision of network services

  (b) all systems for the management, support and supervision of networks

  (c) all billing systems and data bases associated with the billing of carriers and service providers for services provided to them

  (d) all assets associated with the provision of any service declared by the ACCC, or associated with any 'core' service that relies on a declared service

  (e) all facilities (including buildings and parts of buildings) established to support or house equipment described in (a) to (d) above, including, but not limited to, ducts, trenches, towers, masts, poles, exchange buildings, and network equipment rooms

- The HFC assets associated with the provision of services by Foxtel should be separated off entirely from Telstra into a separate company.
- Telstra Retail Services Group may not own or operate assets, facilities and equipment of a kind described in paras (a) to (e) above, or of the kind owned by the new HFC corporation.
- Similar arrangements to those requiring strict separation of the HFC network are a prerequisite to any proposal by Telstra to build new access networks, especially fibre to the home proposals.
- Both Telstra IWS and Telstra Retail Services Groups may own and operate assets, facilities and equipment not of a kind described in paras (a) to (e) above.
- If there is any doubt about whether an asset, facility or equipment falls within the scope of paras (a) to (g) above, or what constitutes the HFC assets appropriate to the new HFC

corporation, the matter shall be determined by the ACCC or an adjudicator appointed by the ACCC having regard to the purposes for which operational separation has been established. In this regard, the ACCC shall be empowered to order Telstra Retail Services Group to divest itself of any asset, facility or equipment that it determines is within the scope of paras (a) to (g) above, or which is deemed to be a HFC asset.

3.4 Relationships between Telstra IWS Group and Telstra Retail Services Group

- Telstra Retail Services Group must source its infrastructure service and wholesale service inputs from Telstra IWS Group, the HFC corporation or from third party wholesale providers - it cannot construct or deploy such services itself.
- Telstra IWS Group must only provide Telstra Retail Services Group with defined services that are available on an equivalent basis to other carriers and service providers. For the avoidance of doubt, Telstra IWS Group may not provide preferential treatment to Telstra Retail Services Group.
- Telstra IWS Group and the HFC Corporation must define services and combinations of services, and publish such services on its websites and in other suitable media. For the purposes of this requirement, a bundle of services is either a service or a combination of services.
- Telstra IWS Group and Telstra Retail Services Group shall not share -

    (a) staff

    (b) consultants and sub-contractors

    (c) systems

    (d) premises

- Telstra IWS Group shall not advertise or market in combination with Telstra Retail Services Group.
- Telstra IWS Group shall not develop or provide services that are intended for the exclusive use of Telstra Retail Services Group.

3.5 Relationships between Telstra IWS Group and third parties

- The Telstra IWS Group shall provide services only to carriers and to service providers licensed under the Act, or to the nominated representatives and associates of those organisations.
- Telstra IWS Group may not operate as a retailer - that is, it may not provide services directly to consumers whether in its own name or in any other way, such as through retail market channel partners acting as agents.
- There shall be nothing to prevent Telstra IWS Group from purchasing or renting capacity, space or other resources from any third party.

3.6 Relationships between Telstra Retail Services Group and third parties

- The Telstra Retail Services Group shall provide services only to end users. However the Group may develop channels to market and provide services to channel partners as agents or intermediate providers.
- Telstra Retail Services Group may source its infrastructure and wholesale service needs from any carrier - it shall not be restricted to Telstra IWS Group in any way, provided that its arrangements are not intended to hide the true nature of services ultimately sourced from Telstra IWS Group.

3.7 Contracts

- All contracts between Telstra IWS Group and any other carrier or service provider, including Telstra Retail Services Group, shall be formal and in writing, and each contract shall be complete in its terms and conditions.
- Telstra IWS Group shall not provide any service or access to any facility until a contract has been formally entered into. (There shall be no service or provision in anticipation of a contract being completed and executed in writing.)
- All transactions between Telstra IWS Group and Telstra Retail Services Group must be in accordance with written contracts or service agreements, which shall have been lodged, prior to coming into effect, with the ACCC. At any time after lodgement the ACCC shall have power to require the parties to amend their agreement to strike out any provision that the ACCC decides has the effect of unfairly favouring Telstra Retail Services Group over other customers of Telstra IWS.

3.8 Equivalence

- Telstra IWS Group shall ensure that all carriers and service providers that it may serve (including Telstra Retail) shall have access to the same products and services on equivalent terms. Failure to do so would be a prima facie breach of the competition rule and consequently initiate action by the regulator under the Part XIB provisions of the TPA.
- For the avoidance of doubt, equivalence means -

  (a) products and services shall have the same features, functionality and quality

  (b) the processes for ordering, provisioning, fault management, service restoration and forecasting shall be the same and shall use the same systems

  (c) prices shall be non-discriminatory across all input elements

  (d) product development consultation arrangements shall allow all potential IWS customers to participate on an equal basis

  (e) Telstra IWS Group shall release new products and product information to all carriers at the same time

(f) Telstra IWS Group shall be equally responsive to proposals for new products and services from all customers and potential customers of the Group.

3.9 Equivalence Treatment with Respect to Discounting and Bundling

The combination of Telstra's continuing market power in retail markets and the increasing use of discounting and retail bundling presents a particularly challenging set of problems. In order to address these issues it will be necessary to implement a combination of measures including operational separation, equivalency and transparency in costs and pricing.

The principles that should apply to product discounting and bundling and associated inputs for the construction of bundled services include:

1. the same discounts and bundles and combinations of products and services shall be available to all
2. each item in any bundle shall be available separately
3. discounts and bundles shall not be structured in a way that is of advantage or use only to Telstra Retail Services Group
4. volume and other discounts (whether explicit or implicit in price structures, and whether or not associated with bundles) shall not be offered unless fully justified on the basis of cost savings, and shall be structured to enable other customers of Telstra IWS Group to gain a proportionate benefit should they wish to avail themselves of the offer

Contracts should be available to the ACCC and other service providers and Telstra should certify that the actual terms of supply are no better than those set out in such contracts.

The issues of retail market power, technological changes, convergence, and how they relate to bundling are discussed in more detail in Attachment 2 of this document.

3.10 Review of the Arrangement

- There will be adequate powers vested in the ACCC to determine issues associated with the arrangement as they arise, and to develop guidelines to better codify permissible conduct and behaviour restrictions. Development of guidelines should be undertaken in consultation with the industry.
- In any case, a review of the adequacy of the arrangements, particularly in the light of overall industry development and trends to convergence within technologies, services, markets and service providers, should be held within 3-5 years. It is important to correct any unintended outcomes that might distort the development of competition in network service markets.

4. ISSUES THAT REQUIRE FURTHER CONSIDERATION, POSSIBLY OUTSIDE THE CONTEXT OF THIS PAPER

4.1 Telstra Retail and Market Power

Operational Separation such as under the model described in this paper will not remove Telstra’s market power. Rather, it has the effect of splitting the sources of that market power. The market power derived from the ownership of the monopoly network assets resides with the wholesale group. It is this source of market power that is the focus of operational separation, as an evolution of the approach to regulation that has been represented by mechanisms such as the Part XIC access provisions. The introduction of operational separation and associated changes to regulation is intended to address the ways in which that market power based on network control has been leveraged in telecommunications markets since deregulation in 1997.

However, Telstra also enjoys market power at the retail level that derives from its historic ownership of all customer relationships, going back to its role as the publicly owned telecommunications monopoly provider. Telstra has shown that it is able and willing to leverage this incumbency to the detriment of competitive entry, exclusively of the market power it derives from its network ownership. It is also apparent that Telstra retail will, without intervention, extend this retail-level market power through the acquisition and use of control over, for example, content. Operational separation as proposed in this paper does not address this source of market power.

The CCC submits that the management of Telstra’s Retail market power will rely on the general provisions of the TPA (e.g Sections 45, 46, 47 and 50) and the telecommunications specific sections of the Act relating to anti-competitive conduct. These provisions in turn require strengthening to be effective. This is considered in a separate paper in more detail.

4.2 Divestiture Power

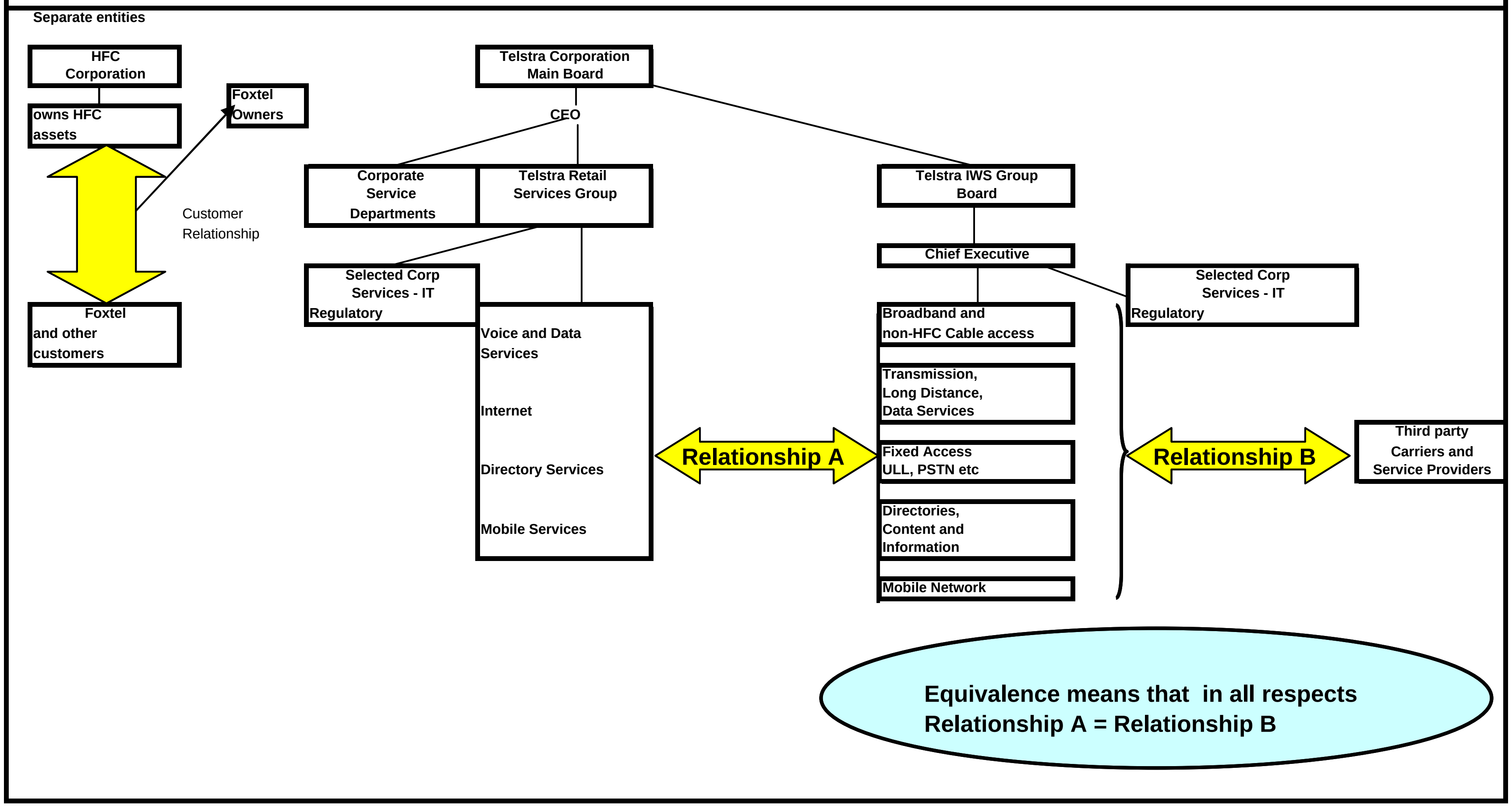
In the absence of structural separation, Telstra's basic incentive to favour its own downstream operations will not change. At best Operational Separation will seek to emulate the outcomes that might be achieved by structural separation, but it will do this by increasing the difficulties, not by removing the incentives. Therefore there is a need to give the ACCC divestiture powers under the Trad Practices Act to be employed in the event of continuing serious breaches of the arrangements underpinning operational separation. The real and continuing threat of divestiture is needed to provide a powerful disincentive for such conduct.

4.3 Organisation chart

The proposed approach to Operational Separation cannot be fully depicted in an organisation chart, since most of the elements in the framework are behavioural not structural. However, with that major caveat, a chart appears at Attachment 1.

Certain corporate functions - such as Regulatory Affairs and Information Technology Departments - will need to be separated for Telstra IWS and Telstra Retail, since the groups have different interests.

Attachment 1: Organisation Arrangements for Operational Separation Framework



ATTACHMENT 2: THE CHALLENGE OF TELSTRA'S RETAIL MARKET POWER AND SERVICE BUNDLING

It is recognised that new regulatory reforms will need to be broadly based on existing competition tests which are already the touchstones for regulatory assessment under the Trade Practices Act. However, those competition tests and the processes for enforcing them must be flexible, responsive and apply readily to emerging regulatory challenges:

- Australia has finally arrived at true convergence for fixed line, fixed wireless and mobile networks. Therefore, the interaction of content and carriage services in a variety of markets has become a reality;
- There is an increasing tendency to bundle services in complex offerings, and as those services are increasingly based on IP transmission, it is more difficult to distinguish between services and to define markets;
- Telstra generally reacts to the introduction of new technologies by allowing innovative operators to incur the significant risks of being a first mover while Telstra is an organised and well resourced follower able to use its existing market power to displace and marginalise, or even eliminate, first movers.

The ACCC has had limited success in targeting its efforts at individual decisions involving particular bottlenecks in the customer access network. It has been less successful in the more complex regulatory task of developing rules that are responsive to emerging markets, the cross market leverage of market power and the interaction of carriage and content. Passive and conservative ex-post regulation of pervasive carriers such as Telstra with significant market power simply does not work. Unwinding anti-competitive structures and activities once they have been allowed to develop is difficult. The rapid and efficient execution of regulatory powers and the ability to source relevant information are key to sustainable competitive markets.

It is beyond question that Telstra has a substantial degree of power in a number of telecommunications markets and that it is allowed to leverage across these markets. Telstra has approximately 90 per cent of the fixed line market with approximately 46 per cent of the mobiles market. One of the key features of Telstra's bundling packages is that the customer must acquire at least the fixed line telephone service component. The bundle may consist of fixed, internet, mobile and cable TV services but fixed is compulsory in order to be eligible for discounts. Telstra's market power across these services provides it with the ability and the incentive, to impede new entrants to emerging markets using leverage from the traditional telephony market.

The fixed-to-mobile service market illustrates how an integrated carrier such as Telstra can leverage market power with fixed and mobile services and is able to avoid the scrutiny of the costs or prices. For example, a vertically integrated carrier can maintain a high fixed-to-mobile cost to its rivals while maintaining lower costs (or even nil costs) when terminating fixed-to-mobile calls between its own fixed and mobile networks. In the case of Telstra, this means that around 46 per cent of its fixed-to-mobile calls can be provided at significantly lower cost than its competitors and there is no visibility of these rates.

The primary guiding principles of the relationship for Telstra's retail and wholesale Divisions should be of "equivalence" and "non-discrimination. Telstra Wholesale should treat all other service providers on the same basis as it treats Telstra Retail. To do so a benchmark is needed to make the relationship between Telstra Wholesale and Telstra Retail transparent. Accordingly, the terms of supply must be reduced to contracts that detail the arrangements between Telstra Wholesale and Telstra Retail in the same manner as external contracts with third parties. In the fixed to mobile example, the Telstra mobile wholesale group would be expected to offer the same Mobile Terminating Access Service (MTAS) rate to other carriers as it offers to its own Retail Services Group.

Prices shall be non-discriminatory across all input elements. Volume and other discounts enjoyed by Telstra Retail (whether explicit or implicit in price structures, and whether or not associated with bundles) would need to be fully justified on the basis of cost savings. Other service providers should be entitled to avail themselves of similar cost savings and related discounts.

The same bundles and combinations of products and services would be available to all service providers. Each item in any bundle would be available separately. Bundles and combinations of products and services shall not be structured in a way that is of advantage or use only to Telstra Retail. Product development consultation arrangements will engage all service providers on an equal basis and on the same time scales.

Imposing operational separation along wholesale\retail lines is a necessary but not sufficient feature of any revised regulatory regime and cannot alone be a panacea for the various problems with the existing regime. In addition to that form of operational separation there must be incorporated features that give the ACCC the necessary regulatory tools to address a range of anti-competitive activities of Telstra that will be relevant more broadly to retail competition, including bundling and exclusive content arrangements.

Operational separation is not an end in itself, it is simply an arrangement that encourages compliance with the regulatory regime and improves the ability of the ACCC to enforce the regulatory regime. For example, ensuring that Telstra Wholesale treats Telstra Retail on an equivalent basis to third parties achieves one aim, but does not prevent Telstra charging excessive prices for wholesale products where it enjoys market power, by which means Telstra will simply trap profits at the wholesale level. While it might be argued that equivalence of treatment for other carriers would ensure that this did not have an anti-competitive outcome, it would create high prices for consumers, constraining innovation through suppressing market growth.

Accordingly, Telstra Wholesale will continue to be regulated under the access regime to ensure that its price and non-price terms to Telstra Retail and to other market participants do not reflect monopoly rents.

Both Telstra Wholesale and Telstra Retail will continue to be regulated under Part XIB to ensure they are complying with the competition rule. The ACCC would develop a decision making framework for dealing with issues such as anti-competitive bundling and exclusive content supply.