Strategy & Corporate Services

Executive Director
Regulatory Affairs
Level 11
400 George Street
SYDNEY NSW 2000
Australia

Telephone (02) 8576 2730
Email: jane.vanbeelen@team.telstra.com

25th August 2011

Michael Cosgrave
Group General Manager,
Communication Group
Australian Competition and
Consumer Commission
Level 35, The Tower
360 Elizabeth Street
Melbourne VIC 3000

cc: Caroline Lovell, NBN Co Limited

Dear Mr Cosgrave,

**Re: Organisational arrangements and staff incentives under the draft Structural Separation Undertaking**

I refer to the Structural Separation Undertaking (**SSU**) given by Telstra to the Australian Competition and Consumer Commission (**ACCC**) on 29 July 2011 as well as the submission it provided in support of the SSU and draft Migration Plan on 31 July 2011.

The purpose of this letter is to expand, at the request of the ACCC, on a number of specific matters under the SSU related to Telstra's proposed organisational arrangements. In particular, we set out in this letter more detail on:

- how the restraints on Group level or other cross business incentives for staff in 'separated' business units (i.e. the Wholesale and Network Services business units) will operate under the SSU, including the timeframe over which grandfathered incentives will expire;
- the general approach which Telstra has adopted to developing the modified ring fencing rules, including key areas where Telstra's position in the SSU differs from the current Operational Separation arrangements; and
- the reasons for, and intended scope of, the 'customer excellence' provision (clause 8.9).

Telstra understands that the ACCC will be publishing this letter to assist stakeholders and Telstra intends that it be read alongside Telstra's earlier submission (which also discusses the new organisational arrangements at page 12). Like the supporting submission, this material is for information purposes and does not bind Telstra or otherwise affect the interpretation of either the SSU or the draft Migration Plan.

## 1 Organisational incentives

### 1.1 Background

The SSU requires that remuneration incentives for employees of each of the Wholesale and Network Services business units reflect solely the objectives and performance of those respective business units, or other business units that are not Separated business units. There are limited exceptions to this requirement, including for:

- any senior management for whom responsibilities in relation to a Separated business unit do not comprise a substantial part of their role; and
- those incentive schemes that are in place at the date of the SSU and which are therefore 'grandfathered' until they expire – although those staff will not be eligible for similar future incentives if they are within the Separated business units.

### 1.2 Existing Telstra Incentive plans

At a Group level, Telstra has both Long Term Incentive (LTI) plans, which operate over several years as well as annual or short term incentive (STI) plans. The corporate level Telstra incentive plans that currently operate and that could apply to employees in Wholesale and Network Services business units are the following:

- The Telstra FY2012 STI Plan measures Telstra's financial performance, customer satisfaction and individual key performance indicators. Employees in the Wholesale business unit participate on the same terms but the plan is customised to survey Wholesale customers only to determine the customer satisfaction score. The plan measures performance from 1 June 2011 to 1 July 2012 and will be paid out in September 2012 once the actual results are determined and assessed. Further detail is outlined in the Attachment to this letter.
- The Growshare 2009 and 2010 LTI plans, both of which will expire on 30 June 2012.
- The Growshare 2011 LTI plan, which will expire on 30 June 2013.

### 1.3 Participation in the LTI plans

Further detail on each of the LTI plans is outlined in the Attachment.

Currently, only Group Managing Directors (**GMDs**) and Telstra senior managers participate in the LTI plans. Telstra believes that there are 10 managers within the ring-fenced Wholesale and Network Services business units who participate in still current LTI schemes.

Moving forward, of those senior managers within the Wholesale and Network Services business units, only the Group Managing Director – Chief Operations Officer will be invited to participate in future LTI plans (discussed in more detail in section 1.5 below).

Telstra will develop a suitable long term incentive for the remaining senior managers (and any other eligible employees in the Wholesale or Network Services business units), which will comply with the SSU incentive restrictions.

### 1.4 Participation in the STI plans

The annual or short term incentive scheme is available to a wider set of employees. Telstra estimates that there are approximately 250 staff in the Wholesale business unit and 1153 staff in the Network Services business units that participate in the current STI scheme which runs until 30 June 2012, in addition to the two relevant GMDs and 9 other senior or executive level managers (5 in Wholesale and 4 in Network Services).

With the exception of the COO, discussed below, all of these staff will be moved to business unit-specific short term incentive arrangements from the 2012-13 fiscal year onwards, as required by the SSU.

In addition to the STI scheme, there is also currently a 'customer satisfaction bonus scheme' which is available to all non-STI staff, based on company performance against customer satisfaction results.  This will be grandfathered for the current 2011-12 fiscal year and Telstra is reviewing how this will be modified for the Network Services and Wholesale business units moving forward.

### 1.5 Continued participation of the Chief Operations Officer (COO) in the LTI and STI plans

The Network Services business unit as defined in the SSU comprises those parts of Telstra's broader Operations function which have principal control over and responsibility for:

- fault detection, handling and rectification; and
- service activation and provisioning,

in relation to regulated wholesale products and comparable retail products.

Telstra has identified those teams within its wider Operations group that fall within this business unit.  This includes, for example, field technicians who are responsible for activation and fault rectification of standard copper services and those staff who manage retail and wholesale tickets of work related to the standard copper products in Telstra's OSS (including identifying and responding to any 'dirty' tickets of work, which fail or drop out of the order or provisioning process for any reason and need to be corrected or referred back to customers).

However, there are a number of functions and lines of business that report to the COO, including network activities not related to activation or fault rectification of copper services as well as network or operational functions in support of non-regulated products and services.  In fact, the activities undertaken by the Network Services business unit do not comprise a substantial part of the COO's overall management responsibilities, including in terms of:

- the total lines of business that report to the COO;
- the total revenue of the total Operations group; or
- the total Capital Expenditure (CAPEX) budget for the Operations group (and Telstra's total CAPEX budget).

The Network Services business unit also only accounts for a small portion of the total financial outflows from the overall Operations function which is the responsibility of the COO and, given the non-discretional nature of most expenditure undertaken by the network services business unit (to meet Telstra's Customer Service Guarantees), its performance is not considered a major driver of Telstra's overall free cash flow.

For these various reasons, the COO will continue to participate in future Group level LTI and STI incentive schemes.  At this stage, however, the COO is the only Employee who works for either the Wholesale or Network Services business units who Telstra has identified will be exempted from the operation of the business unit incentive restrictions under clause 8.10 of the SSU.

## 2. Organisational arrangements – intended operation of the ring fence

Telstra is aware that there is particular interest from wholesale customers, and other stakeholders, about the operation of the new ring fencing provisions in clause 8 and Schedule 2 of the SSU.

The three relevant issues which this letter will address are:

- Telstra's general approach to the 'three box model', including explaining why the degree of separation between Retail and Wholesale business units is, in some cases, stricter than between the Network Services business unit and either of the other Separating business units;
- the nature and scope of the relevant functions which are used to define the Network Services business unit; and
- the rationale for, and importance of, the 'customer excellence' provision in clause 8.10 of the SSU.

### 2.1 Telstra's guiding principles when developing its organisational commitments

There were four key principles that guided Telstra's consideration of the organisational 'ring fencing' commitments in the SSU:

- The commitments must comply with the SSU Guidance, including the accompanying explanatory statement which makes clear that while the interim equivalence and transparency measures must be effective and appropriate measures, they are not intended to require Telstra to implement functional separation.
- The commitments must address genuine equivalence issues with specific, transparent and realistic obligations.
- The commitments should not unnecessarily constrain the way that Telstra internally organises itself as it prepares to migrate to the NBN and transform its business to compete in an NBN environment.
- The commitments are an interim measure prior to full structural separation (by the designated day) and therefore the cost of implementation and wider disruption to Telstra's operations should be balanced, appropriate and proportionate.

Telstra's organisational commitments continue the 'three box model' that is currently required under Operation Separation. The three 'boxes' are:

1 Retail business units

2 Wholesale business units

3 Network Services business units

The approach adopted by Telstra in the SSU to implementing the three box model follows the relatively detailed requirements specified in Schedule 1 of the SSU Guidance, issued by the Minister. The approach required by the SSU Guidance may be understood as follows:

- First, each of the boxes is defined by the functions performed by the relevant business unit in relation to Regulated Services and Comparable Retail Services. In the SSU, these are referred to as the 'required functions' of each Separated

business unit. The purpose of the required functions is not to limit the activities that each Separated business unit can do, but to make clear what activities related to the relevant set of products must **not** be performed in one of the other Separating business units (subject to some exceptions).

- Second, Retail business units are prohibited from performing:
  - any function that is a required function of the Wholesale business units or the Network Services business units;
  - certain other functions which, although not required functions of the Wholesale business units or the Network Services business units, are nevertheless likely to be considered unsuitable to be performed by a Retail business unit (such as network planning and pricing of wholesale products); and
  - any other work for a Wholesale business unit or Network Services business unit (unless the work is specifically called out in the SSU or is later approved by the ACCC).
- Third, Network Services business units and Wholesale business units are prohibited from performing:
  - any function that is a required function of the Retail business units; and
  - any other work for a Retail business unit (unless the work is specifically called out in the SSU or is later approved by the ACCC).
- Fourth, specific measures are put in place in relation to the separate location of staff who work for the Wholesale Services business units and staff who work for Retail business units.
- Fifth, specific measures are put in place to ensure that Network Services field staff who attend end user premises are prohibited from marketing or selling Telstra products and services to end users that are not Telstra retail customers, and where the end user is both a Telstra retail customer and a customer of a retail competitor, from attempting to 'win-back' the customer. Subject to these restrictions in respect of a 'dual retail/wholesale' customer', field staff are otherwise not prevented from marketing or selling retail products while attending on site at a retail customer's premises.
- Sixth, specific measures are put in place to ensure that incentive remuneration for staff who work for a Wholesale business unit or a Network Services business unit does not take into account the objectives and performance of another Separated business unit (see discussion above).
- Finally, there are information security rules to protect wholesale customer information.

In addition to implementing these requirements, the SSU also includes a range of other commitments which support the implementation of, and continued compliance with, these commitments. For example, there is a requirement to maintain systems and processes for recording employee physical movement between the Separated Business Units and for recording incentive remuneration practices, as well as a requirement to undertake an annual independent verification that incentive remuneration complies with the commitments that have been given.

## 2.2 Why does the SSU establish stricter separation measures between retail / wholesale than between retail or wholesale / network services?

*Physical separation of staff*

The SSU requires staff of the Wholesale business unit to be physically separated from retail staff because both are performing 'customer facing' functions that involve competing interests and because of the potential for sensitive and confidential information to be shared (whether deliberate or inadvertent) and misused. As this suggests, the primary reason for enforcing physical separation is to ensure protection of wholesale customer confidentiality.

On the other hand, the separation of the functions performed by the Network Services business unit is primarily to ensure that staff in that business unit are not incentivised to give preference to retail customers or orders when performing their technical functions (activation, fault rectification etc). The potential for leakage and misuse of sensitive information through the co-location of retail of Network Services staff has not historically been an area of concern.

The Network Services business unit's activities are largely technical and process-oriented tasks that can (and will be) objectively measured in terms of equivalence. There are a range of measures that have already been adopted in the SSU specifically targeted at these functions, to ensure they are performed in a 'customer agnostic' manner, including equivalence metrics with rebates, incentive restrictions, prohibitions on Network Services staff performing any work for Retail business units that is not in the SSU or otherwise ACCC approved and specific restrictions on Marketing Activities.

It is also a far more difficult exercise for Telstra to implement physical separation between retail and Networks Services staff than between retail and Wholesale staff. Staff of the Wholesale business unit are generally located in capital cities or metropolitan areas, minimising the number of locations at which physical separation needs to be implemented. By contrast, staff of the Retail business units and Network Services business unit are more widely dispersed geographically and therefore the potential need for collocation from time to time is higher – for example in regional Telstra offices.

Given the nature of the risk which physical separation is primarily designed to address (confidentiality rather than operational equivalence) and the range of measures already specifically addressed at performance by the Network Services business unit of its technical functions, any incremental benefit that may be gained by imposing a requirement for physical separation of the Network Services business unit staff from Telstra's Retail business units is outweighed by the potential cost and disruption to Telstra of having to implement such a requirement.

*Other commitments are specific to the Wholesale business unit*

The other commitments that Telstra specifically gives in relation to ring fencing of the Wholesale Business Unit relate to the adequacy of resourcing for the wholesale business unit and the level of seniority given to the person that is responsible for managing this business unit. These commitments respond to specific concerns about the capacity for the Wholesale business units to continue to operate and make business judgements as industry progressively migrates to the NBN - they do not specifically go to the level of separation from the Retail business units.

Telstra does not believe that these concerns should also apply to the Network Services business unit because, whereas poor performance of the Wholesale business unit is likely to have a greater impact for wholesale customers than for Retail business units, this is not

the case for the Network Services business unit where poor performance is likely to have an equal (if not greater) impact on Telstra.

## 2.3 Definition of Network Services business unit

Telstra has defined the "required functions" of the Network Services business unit consistently with the SSU Guidance, which requires the ring fence to cover the functions of service activation and provisioning and fault detection, handling and rectification. It is these core functions which the Minister has recognised as being central to delivering services to wholesale and retail customers on an equivalent basis.

The cost of tackling perceived concerns by broadening the scope of the Network Services business units could be significant and would cut across the principle that, as Telstra prepares to migrate to the NBN and transform its business to compete in an NBN environment, it should not be unnecessarily constrained in the way that it internally organises itself, particularly as the NBN fibre footprint grows and the scope and scale of its copper and HFC networks shrinks.

## 2.4 The customer excellence clause (clause 8.9)

Under Telstra's CEO, David Thodey, Telstra has embarked on a company-wide cultural change program focused around Telstra being a truly customer focused organisation. The program is designed to deliver a customer connected culture across the company for the benefit of all customers – both retail and wholesale.

The "customer excellence" clause (8.9) is intended to ensure that the ring fencing provisions and restrictions in the SSU do not impede Telstra's ability to achieve this cultural shift and the commitment Telstra has made towards improving the customer experience at every level and for all customers.

There are two elements to the customer excellence clause:

- The first is intended to provide guidance about the way that the commitments in Part D are to be applied, to make clear that they are not to be interpreted and applied in a way which has a perverse outcome for customers (both retail and wholesale).

- The second provides an exception to what might otherwise be regarded as a breach of Part D. However, it is important to note that there are checks and balances to ensure that the exception cannot be used by Telstra to commit breaches of the SSU. For example:

    - the conduct must not involve a breach of the information security commitments;

    - any incentive provided to the relevant employee for demonstrating customer excellence must be equally available regardless of whether the customer who is assisted is a retail or wholesale customer;

    - for field staff attending the premises of an end user that is not a retail customer of Telstra, the conduct must not involve marketing or selling Telstra products and services; and

    - for field staff attending the premises of an end user that is both a retail customer of Telstra and of a retail competitor, the conduct must not involve attempting to 'win-back' the customer.

Since the customer excellence clause is intended to benefit both retail and wholesale customers, and given the checks and balances which are explicitly provided for in the clause, Telstra sees it as an important means of ensuring that the interim and equivalence framework remains appropriate and does not have an unintended detrimental effect on consumers and wholesale customers, consistent with the statutory requirements for the SSU set out in section 577A(6) of the Telecommunications Act.

Yours sincerely,

Jane van Beelen
Executive Director – Regulatory Affairs
Strategy & Corporate Services

## ATTACHMENT

## High level description of current LTI and STI Plans

### Table 1. 2011/2012 Short Term Incentive plan.

| Plan | Performance period | Performance Measures |
|---|---|---|
| Telstra STI Plan | Fiscal 2011/12 | EBITDA<br>Total Income<br>Free Cashflow<br>Customer Satisfaction<br>Individual Component |
| Telstra Wholesale STI Plan | Fiscal 2011/12 | EBITDA<br>Total Income<br>Free Cashflow<br>Customer Satisfaction (Wholesale)<br>Individual Component |

### Table 2. Existing Long Term Incentive plans.

| Plan | Type of instrument granted | Performance period | Result | Future financial years in which grants vest |
|---|---|---|---|---|
| Growthshare 2009 | Options<br><br>Restricted Shares | 1/07/2008 – 30/06/2012<br><br>1/07/2009 – 30/06/2012 | 30% of the plan was tested at 30/06/2010 of which 0% vested.<br><br>30% of the plan was tested at 30/06/2011 of which 0% vested. | Options and restricted shares may vest subject to plan performance measures in fiscal 2012. |
| Growthshare 2010 | Restricted Shares | 1/07/2009 – 30/6/2012 | The first and only test point of the plan is 30/06/2012. | Restricted shares that may vest in fiscal 2012 are subject to a one year restriction period that ends on 21 August 2013. |
| Growthshare 2011 | Restricted Shares | 1/07/2010 – 30/6/2013 | The first and only test point of the plan is 30/06/2013. | Restricted shares that may vest in fiscal 2013 are subject to a one year restriction period that ends on 20 August 2014. |