



Maddocks

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**Competitive
Carriers' Coalition**

Supplementary
Submission – Service
Level rebates



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CCC Supplementary Submission – Service Level Rebates

1. Executive Summary

Maddocks has prepared this Supplementary Submission on behalf of the Competitive Carriers' Coalition (**CCC**) in response to the Australian Competition and Consumer Commission's (**ACCC**) *Discussion Paper on the Assessment of Telstra's Structural Separation Undertaking*, dated 30 August 2011 (**Discussion Paper**).

This Supplementary Submission focuses on the discrete issue of Service Level Rebates, in response to the Service Level Rebate regime proposed by Telstra at clause 16 of its proposed Structural Separation Undertaking (**SSU**). It should be read in conjunction with each of the CCC's previous submissions in response to the Discussion Paper dated 31 August 2011, 27 September 2011 and 29 September 2011.

This Supplementary Submission provides an overview of the core principles and functions of Service Level Rebates in commercial contracts, a brief analysis of the weaknesses of the regime proposed by Telstra against industry norms, and an overview of amendments the CCC therefore submits are required as a minimum.

In particular, the CCC submits that, to be effective, any Service Level Rebate regime imposed by Telstra must be benchmarked against related industries in which suppliers face genuine competition, and against regimes which have been imposed in similar circumstances overseas, for example, the functional separation of British Telecommunications plc (**BT**) in Great Britain. Further, as well as compensating wholesale customers for any disadvantage suffered as a result of Telstra's failure to achieve agreed service levels, any effective Service Level Rebate regime must also be sufficiently stringent to counteract Telstra's incentive, as a vertically integrated incumbent, to engage in sabotage behaviour.

Where the supplier is best placed to monitor its own compliance with the agreed service levels, the customer must then consider how the measurement will be reported by the supplier and, if necessary, assessed or audited by the customer.

Although it is essential that the supplier's performance be easily and objectively measurable, there are also inherent risks associated with focussing on service levels that are easy to measure but which have limited relevance to the customer. For example, a service level regime which focuses on response times, but neglects to incorporate any reference to *accuracy* of the response provided, risks incentivising the supplier's delivery of fast, but ineffective, service.⁵

In order to avoid selecting unimportant but easily measured services, parties often devote substantial effort to identifying 'emblematic' measurements: simple measurements that signify that a less tangible (but more important) service has failed.⁶

2.3 Performance Incentives - Financial Rebates

An equally important feature of a service level regime is its function as a tool to incentivise performance of a supplier.⁷ Where a customer is dependent on the service to be provided under the contract over a lengthy term, it is reasonable that it should seek to ensure some certainty regarding the quality of the service to be provided. Ideally, there should be a means available, short of the extreme response of terminating the contract, to address a circumstance where the service provided by the supplier falls short of an agreed service level.

Service credits or rebates are therefore used as an incentive mechanism, and are the second limb of an effective service level regime. These pre-arranged, contractually agreed, financial amounts become payable in circumstances where an agreed service level is not met. To operate as an effective incentive, these amounts should be calculated with reference to the supplier's profit margin under the contract:

... if the service levels and service credits are set too leniently, the supplier may still be able to make a profit on the contract by delivering a service which fails to meet the service levels, meaning it is not properly incentivised to achieve them ... For particularly poor performance, it may well be reasonable for the supplier to lose money through service credits and perhaps also be exposed to other potential remedies, such as termination or a general damages claim.⁸

Service rebates or credits may be calculated in a range of ways. For example, percentage rebates can be calculated on an incremental basis (depending on how far, or for how long, the service provided by the supplier falls below an agreed level) or by the use of service 'credits' points which are determined against a range of service level criteria and regularly credited against amounts otherwise payable by the customer.⁹

To be effective, service rebates should also escalate with the severity or significance of the performance failure, and with the length of time for which (or frequency with which) the failure occurs.

In order to incentivise the rectification of the root causes of problems, service credit regimes frequently include mechanisms which impose multipliers on the service credits that are payable in the event that problems re-occur within particular timescales. This is particularly useful if the problems are trivial but annoying. The intention is to prevent the service

⁵ Parr S., *op. cit.*

⁶ Bickerstaff R. & Cook A., *op. cit.*, at 37.

⁷ Parr S., *op. cit.*

⁸ *ibid.*

⁹ Bickerstaff R. & Cook A., *op. cit.*, at 38. See also Downie D, *How to structure a service agreement that best suits your organization's needs* (2009) at

http://www.cio.com.au/article/321458/it_advocate_negotiating_service_levels_service_credits_it_services_agreements#closeme, accessed 23 September 2011.

provider from behaving as though small lapses in service (and the ensuing service credits) are a part of its overheads.¹⁰

2.4 Financial Rebates or Liquidated Damages?

In general, damages for breach of contract by the supplier as a result of its failure to meet the agreed service levels should apply *in addition* to service level rebates or credits. This is because the rebate amount is intended to represent the price differential between what the customer agreed to pay (for the service which was promised), as compared with the price it *would have* agreed to pay (for the service which was actually provided). The rebate therefore does not take account of the customer's actual losses as a result of the suppliers contractual breach, for example, an inability to fulfil its own supply contracts.

If service credits or rebates are intended to operate as a form of liquidated damages in relation to the supplier's breach of the contract the customer must ensure that the amount of the rebate or credit agreed will adequately compensate for any loss which is likely to be suffered, and that the amount of the credit or rebate is a genuine or reasonable pre-estimate of its likely losses in the event of the breach.¹¹

For this reason, where service credits are intended to operate as a form of liquidated damages the contract must include escalating financial rebates for repeated or more significant failures by a supplier, and will specify that the inclusion of the service credit or rebate regime is not intended to replace any of the customers other contractual rights, such as the option to terminate the contract in relation to the breach.

2.5 Capping Rebates

While it is relatively common to find that the applicable rebates or service credits payable under a service level regime are capped, this will rarely be the case unless the customer also has recourse to additional contractual remedies in relation to the failure.

Otherwise, once the supplier has reached the cap on applicable rebates or credits, there is no ongoing performance incentive available to the customer.

3. Telstra's proposed Service Level Rebate regime

In relation to the Service Level Rebates regime proposed by Telstra, we refer to the earlier submissions of the CCC in response to the Discussion Paper, and in particular the comments made at paragraph 5.7 of the CCC Submission dated 27 September 2011.

We do not propose to repeat those comments here, other than to emphasise the following points:

- There has been no discussion between the parties as to the key service levels which should be incorporated. As outlined above, such discussion and agreement is an essential basis for an effective service level regime.
- Telstra's proposed rebates are subject to significant carve outs and limitations and are qualified by reference to the service Telstra itself receives. In the draft 'Regulated Services SLA Agreement' attached at Schedule 7 to the SSU, Telstra has imposed various restrictions, qualifications and limitations on the application of the regime. In the CCC's submission, the carve outs and limitations which Telstra has incorporated have the effect of weakening the proposed regime to such a degree that it loses all commercial value from the customer's perspective.

¹⁰ Bickerstaff R. & Cook A., *op. cit.* at 38.

¹¹ In this circumstance, unless the service credit will fully compensate the customer there is no advantage of a service credit over a claim for damages: Bickerstaff R. & Cook A., *op. cit.*, at 39.

- There has been no discussion between the parties as to how performance against the proposed service levels will be objectively measured and reported. Once again, such mechanisms are essential to the operation of an effective service level regime.
- In circumstances where the customer has only one choice of supplier, the power of the Service Level Rebates regime to incentivise performance is clearly all important. To be effective it should represent an incentive based model which, at minimum, matches generally accepted market practice. It is an understatement to say that the rebates proposed by Telstra do not adequately incentivise Telstra's performance. The proposed costs to Telstra which will result from a failure to deliver on the limited service levels is negligible. In circumstances where the commercial arrangements in place may be worth several million dollars per month to Telstra, rebates are limited to amounts which are tens or hundreds of dollars at most.¹²

In addition, and as has been recognised by the ACCC in the Discussion Paper, as a vertically integrated incumbent Telstra has an incentive to engage in sabotage. That is, failure to meet agreed service levels is actually likely to provide a benefit to Telstra, by causing damage to its retail competitors (who are also its wholesale customers), potentially boosting the incumbent position of Telstra's own retail arm. Accordingly, an effective Service Level Rebate regime must be sufficiently stringent to counteract Telstra's incentive to engage in sabotage behaviour, as well as compensating wholesale customers for the disadvantage of any service level breaches.

- Telstra has proposed that the regime will be the sole or principal mechanism used to incentivise delivery on key service levels, including non-price equivalence. For the reasons outlined above, the regime proposed is incapable of incentivising performance. Even if it were an adequate incentive, in the CCC's submission the regime should not be the sole mechanism or remedy available to a customer in relation to a failure by Telstra to perform in accordance with agreed service levels.

4. A model Service Level Rebates regime

Clearly, the circumstances in which Telstra's proposed Service Level Rebates regime will be imposed are not typical.

The 'customer' in this situation has no alternative supplier with whom to negotiate. Further, recourse to standard contractual remedies (such as termination) are not available if the customer wishes to continue in business (not only because participation in the scheme is conditional on waiver of such rights, but also because there is no alternative supplier).

In the CCC's submission, these are circumstances which justify a significantly enhanced, 'pro-customer' service level regime. As previously stated, in the CCC's submission, the Service Level Rebates regime proposed by Telstra is deeply flawed. It fails to meet even the basic criteria which would be expected of a standard, commercially negotiated arrangement, let alone its failure to address the unique circumstances of Telstra's current commercial relationships.

In developing an effective Service Level Rebate regime, the CCC submits that Telstra should have regard to the service level regimes which apply in related industries where suppliers face genuine competition. For example, it has been noted that IT supply and outsourcing agreements commonly now impose service levels of in excess of 99.9%.

With the increasing reliability of IT service provision arrangements, the 'uptime' availability commitments that are being offered by IT service providers tend to be getting even closer to

¹² For example total unavailability of the LOLO ordering system for a month for a wholesale customer lodging 1000 orders per month with a consecutive monthly spend of \$1,000,000 per month might result in entitlement to a rebate amounting to approximately 0.0015%, or \$1,500.

the elusive 100% commitment. Uptime commitments of 99.99% availability are now achievable ...¹³

In addition:

- Rebate amounts must be sufficient to incentivise Telstra's performance. To do this, the rebate amounts must scale with the severity of the breach, and must constitute a material portion of the value of the contract with the relevant wholesale customer (for example, 2-5% of total monthly fees increasing with severity of breach up to a cap of, say, 10%-30% of monthly fees).
- Service levels should be comparable with industry best practice (e.g., availability of 99.9+% each month for critical IT systems).
- Any carve outs must be objectively justifiable and narrowly defined, and ideally should be commercially negotiated with the relevant customer.
- Participation in the Service Level Rebates regime must not be predicated on a wholesale customer's agreement to waive all other rights and accept participation in the regime as a sole and exclusive remedy. For example, wholesale customers should be able to take the issue to the ITA or sue for damages in a court of law.

We note the imposition of such a service level regime is not unique globally. Service level regimes have been imposed in similar circumstances overseas and we note in particular the functional separation of British telecommunications provider, BT. The service level regime which has been agreed to by BT provides a useful comparative reference in considering the regime proposed by Telstra.¹⁴

5. Summary

The Service Level Rebate regime proposed by Telstra in its SSU is not commercially appropriate in its current form.

Telstra has proposed an imbalanced and 'supplier friendly' regime, which does not come close to achieving even the minimum standards expected in a commercially negotiated agreement. Such a regime could never seriously be put forward by a supplier which faced genuine competition, and no customer would agree to such a regime.

In the CCC's submission, any applicable service levels and rebates must be benchmarked against related industries in which suppliers face genuine competition, and against regimes imposed in similar circumstances overseas. Further, it must counter Telstra's incentive to engage in sabotage behaviour.

¹³ Bickerstaff R. & Cook A., *op. cit.* at 37.

¹⁴ Chapter VI of the Revised Agreement for Access Network Facilities Services, 'Service Levels and Fixed Compensation' is available for public download at: <http://www.openreach.co.uk/orpg/home/products/llu/contracts/contracts.do#Local Loop Unbundling and Sub-Loop Unbundling Access Network>, accessed 4 October 2011.