



TESLTRA'S STRUCTURAL SEPARATION UNDERTAKING AND DRAFT MIGRATION PLAN

SUBMISSION TO THE AUSTRALIAN
COMPETITION AND CONSUMER
COMMISSION

September 2011



Contents

Summary.....	2
Introduction	3
A SSU must be self-enforcing.....	3
Remove corporate arrangements that are contrary to achieving equivalence	4
Provide incentives to achieve and maintain equivalence.....	5
Use transparency to demonstrate progress and provide assurance.....	6
Impose redress mechanisms to address non-compliance	7
The proposed SSU does not deliver.....	8



Summary

Vodafone Hutchison Australia Pty Limited (**VHA**) strongly supports the structural reforms envisaged by the Australian Government as part of the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010*. For too long there has been a lack of effective regulation or oversight to ensure appropriate market behaviour of the integrated incumbent. These circumstances led the Australian Government to embark on far-reaching structural reforms, which include the establishment of the National Broadband Network (**NBN**) and the passage of legislation enabling the structural separation of Telstra.

A Structural Separation Undertaking (**SSU**) by Telstra should be a pivotal part of the structural reforms necessary to promote productivity, competition and innovation in the Australian telecommunications industry. It is therefore crucial to ensure that a SSU will credibly deliver the objective of structural reform rather than implement an imperfect agreement that maintains the status quo and risks locking-in the current industry structure for the future telecommunications landscape.

A SSU must be framed in terms of the conditions required for its acceptance. In addressing these conditions a SSU requires a number of self-enforcing features for it to be credible and effective. These are:

- > commitments to removing corporate arrangements that are contrary to achieving equivalence or structural separation;
- > incentives for Telstra to achieve and maintain equivalence, and to make timely progress toward structural separation;
- > transparency measures to demonstrate progress toward structural separation and provide assurance that equivalence is being achieved; and
- > redress mechanisms to address and remedy non-compliance.

The ACCC must assess the proposed SSU in terms of its ability to credibly and effectively deliver structural separation, transparency and equivalence and sufficient information and remedies for the ACCC to monitor Telstra's compliance with the SSU. VHA's view is that the proposed SSU does not meet these conditions. Specifically, the proposed SSU does not address the ability and the incentive for Telstra to favour its retail business units and discriminate against its competitors. Nor does the proposed SSU provide Telstra's wholesale customers with any assurance that equivalence and transparency will be achieved and maintained throughout its duration. Indeed, some of the key measures on equivalence, such as the Independent Telecommunications Adjudicator (**ITA**), are unlikely to deliver any tangible benefits for wholesale customers.



Introduction

VHA welcomes the opportunity to comment on the Australian Competition and Consumer Commission's *Assessment of Telstra's Structural Separation Undertaking and draft Migration Plan* Discussion Paper.¹ Our submission focuses on the elements required of Telstra Corporation Limited (Telstra) to deliver an effective SSU under Section 577A of the *Telecommunications Act 1997* (Telco Act).

The SSU must be framed in terms of the objectives and conditions required for its acceptance.

The objective of a SSU is to ensure that after the designated date:²

- > Telstra will not supply fixed-line carriage services to retail customers in Australia using a telecommunications network over which Telstra is in a position to exercise control; and
- > Telstra will not be in a position to exercise control of a company that supplies fixed-line carriage services to retail customers in Australia using a telecommunications network over which Telstra is in a position to exercise control.³

In addition, the ACCC must not accept Telstra's SSU unless the following conditions are satisfied:

- > The SSU provides for transparency and equivalence in relation to the supply by Telstra of regulated services to:
 - its wholesale customers; and
 - its retail business units up to the designated day;⁴
- > the SSU provides for:
 - the ACCC to monitor Telstra's compliance with the undertaking; and
 - Telstra to have systems, procedures and processes that promote and facilitate the ACCC's monitoring of Telstra's compliance with the undertaking.⁵

For these conditions to be achieved in an appropriate and effective manner, the SSU must contain measures that give the ACCC and industry confidence that the commitments will be delivered in a sustainable and effective manner. Part of that confidence must stem from a SSU design that gives confidence that Telstra will be motivated to comply with the new arrangements. In other words, if the problems of the past are to be avoided, a SSU must align Telstra's corporate objectives with the conditions required for the SSU's acceptance. That is, it must be self-enforcing.

A SSU must be self-enforcing

The past decade in Australian telecommunications has demonstrated that no amount of regulation or oversight by a regulator can constrain strategic behaviour by a vertically integrated firm whose incentives are not aligned with the intended policy objectives of the broader national

¹ VHA is one of Telstra's wholesale customers.

² Subsection 577A (10) of the Telco Act provides that the designated day will be 1 July 2018 unless the Minister specifies otherwise.

³ Subsection 577A (1)(a) of the Telco Act.

⁴ Subsection 577A (3)(a) of the Telco Act.

⁵ Subsection 577A (5)(a) of the Telco Act.



interest and the promotion of competition. As mentioned above, a key requirement of the SSU is that the design has a range of incentives to deliver self-enforcement of appropriate market behaviour.

A self-enforcing SSU requires two things:

- > the removal of corporate arrangements that are contrary to, or create a potential conflict of interest with, the objective of structural separation by the designated day and the provision of equivalence between Telstra's wholesale customers and its retail business units in relation to the supply of regulated services; and
- > incentives for Telstra to pursue structural separation and to promote equivalence in its day-to-day operations for the supply of regulated services to its wholesale customers and its retail business units (including incentives to immediately remedy discrepancies between Telstra's pricing for wholesale customers and Telstra's internal cost estimates for equivalent services).

Only once there is alignment between the commitments Telstra makes as part of a SSU and the conditions required for the acceptance of a SSU, can the ACCC have confidence that Telstra will adopt internal governance measures that pursue structural separation and promote equivalence in the supply of regulated services.

There will still be a need for externally-focused transparency and redress mechanisms to reinforce any self-enforcing mechanisms that Telstra might adopt in a SSU. Transparency over the treatment of regulated services is essential to reassure the ACCC and wholesale customers that equivalence is maintained. The public disclosure of information is necessary to determine whether structural separation and equivalence are being achieved. It also may assist wholesale customers in determining whether to seek redress because Telstra has failed to deliver or maintain appropriate and effective equivalence arrangements for regulated services.

The external mechanisms required in the SSU to meet the transparency and equivalence conditions are:

- > a commitment to publicly disclose internal retail and wholesale cost estimates for regulated services in aggregate form and to confidentially disclose fully disaggregated internal retail and wholesale cost information to the ACCC;
- > a commitment to publicly disclose non-cost related information on performance and service levels for regulated services, disaggregated between Telstra's wholesale customers and its retail business units, with metrics focused on consumer outcomes;
- > an annual independent audit of cost and non-cost information provided to the ACCC and to the public for the purposes of satisfying the SSU; and
- > redress mechanisms to address any non-compliance by Telstra with an accepted SSU. In the event non-compliance is identified and substantiated, the SSU should outline remedies that include both compensatory and punitive components to ensure there are sufficient incentives for Telstra to avoid non-compliance.

Information should also be publicly disclosed on Telstra's progress toward achieving structural separation.

Remove corporate arrangements that are contrary to achieving equivalence

Equivalence cannot be achieved if Telstra's senior management have responsibility for operational decisions that span its retail, wholesale and network business units and remuneration structures that reward the performance of Telstra as a whole rather than its individual parts. If a SSU is to achieve the condition of equivalence Telstra must take proactive steps to remove arrangements that are contrary to achieving



equivalence. In particular, strong and unequivocal ring fencing arrangements are required to remove or limit operational decision-making by senior managers whose responsibilities straddle different business areas.

The proposed SSU imposes some ring fencing arrangements but it contains far too many exceptions and exclusions. For example, some in Telstra's senior management would still have the power to approve pricing for both the retail and wholesale services. Such scenarios create a clear conflict of interest between the senior manager, whose incentives may be aligned to the performance of Telstra as a whole, and the proposed SSU, which can only be approved if it provides for equivalence between wholesale customers and retail business units. The proposed exceptions critically undermine the effectiveness of the proposed ring-fencing arrangements. A SSU should only be accepted if there are clear ring fencing arrangements, which include measures to remove actual or perceived conflicts of interest.

The proposed continuation of existing pricing approval arrangements means that there will continue to be no separation between the retail and wholesale arms when it comes to pricing strategy and governance – a fundamental gap in Telstra's proposal. It does not ensure equivalence between business units because it creates potential conflicts of interests in the decision making process and maintains the ability for the ability of Telstra to disadvantage one business unit over the other. With the introduction of the Telstra Economic Model (TEM) the current governance arrangements are not necessary because each business unit should have a clear understanding of Telstra's costs and information about their own revenue projections (this will be discussed further below). This means that a business unit can undertake its own business case assessment independent of the corporate centre and is able to determine what is financially responsible for its particular area of activity. In other words, current strategic pricing assessment arrangements need to be updated to ensure that equivalence obligations are met.

Similarly there are no apparent constraints regarding the non-price terms and conditions for regulated services. Differences in non-price terms and conditions, including those relating to quality of service, may impede wholesale customers from achieving equivalence of outcomes. Provisions in a SSU should ensure that such non-price discrepancies are identified and explained.

Equivalence also requires Telstra to make efforts to remove actual or potential bias within its operations. For example, Telstra should ensure service requests for fault repairs do not reveal the name of the retail service provider unless there is a technical reason to do so. Such an approach may avoid inadvertent bias, to the extent any such bias exists, by Telstra's network business units against performing service requests for wholesale customers in a timely manner.

Provide incentives to achieve and maintain equivalence

Equivalence will only be achieved if it becomes part of Telstra's corporate "DNA". This requires a SSU to contain incentives for Telstra's personnel, including its senior management, to achieve 'equivalence of outcomes' between its wholesale customers and its retail business units. The incentives within a SSU must be at least as powerful as Telstra's existing corporate incentives if they are to have any effect.

A SSU must have incentives for equivalence to be delivered in a timely manner. Such incentives may take the form of remuneration structures for senior management that are directly and materially linked to performance indicators based on the level of equivalence achieved or mandatory price discounts for regulated services where Telstra has not achieved specified target levels for price or non-price equivalence.



Telstra has identified that some of its existing Long Term Incentive (LTI) plans will be in place until 30 June 2013.⁶ Senior management who are remunerated under the existing LTI arrangements should not have day-to-day control over operational decisions that span one or more of the wholesale, retail or network business units. Instead, operational decisions should be constrained to personnel employed strictly within the respective business unit.

Price equivalence cannot be achieved in the proposed SSU in a sufficiently timely manner. The proposed SSU suggests that internal pricing structures are based on the Telstra Economic Model (TEM) but reference prices for regulated services are set by the ACCC's Access Determinations. It is likely that significant discrepancies may arise between these two sets of reference prices which means that pricing non-equivalence is likely, at least in the short-term. Under the proposed SSU, where non-equivalence occurs then the mechanism for recalibrating between the TEM and the access prices determined by the ACCC is through Part XIC rather than through the SSU. While this reflects an appropriate legislative approach, it is likely to mean that Telstra's wholesale customers may not be able to realise equivalent pricing for a substantial period of the SSU's duration, putting Telstra at a substantially competitive advantage for certain regulated services.

The lack of equivalence could be overcome when internal TEM prices are below the price of regulated services. In such circumstances, Telstra could elect to set its prices below the regulated prices contained within the ACCC's access determination. However, if the internal TEM prices are above the price of regulated services Telstra does not have the ability to set prices above the regulated price. This asymmetry mutes Telstra's ability to set prices below the regulated price (since to do so is likely to mean its costs are under-recovered). Until this problem can be addressed the SSU cannot provide Telstra's wholesale customers with any comfort that equivalence is achieved.

Wholesale customers should be given an opportunity to revise contracts based on information made available through the SSU process or its subsequent implementation. It is not satisfactory for Telstra to make reference prices available only after the next time a wholesale customer is out of contract if such prices are the basis of Telstra's internal price structure. Such measures will ensure it is possible for equivalence to be achieved in a timely manner, and provide Telstra with appropriate incentives to avoid gaming in any negotiations it has with wholesale customers prior to a SSU being accepted by the ACCC.

Equivalence is not the same as economic efficiency. The proposed retail minus retail cost approach for wholesale ADSL will provide equivalence between Telstra's wholesale customers. The approach will permit wholesale customers whose retail operations are at least as efficient as Telstra to enter or expand their operations. However, it does not provide assurance to end-users that wholesale costs have been, or will continue to be, efficiently incurred. Moreover, Telstra does not have a strong incentive to efficiently lower its wholesale costs in a timely manner. Therefore, while a SSU ought to provide Telstra with incentives to deliver equivalence an access determination may still be required for wholesale ADSL+ services to promote the long-term interests of end-users.

Use transparency to demonstrate progress and provide assurance

Transparency measures within a SSU will be more powerful and more credible if the information is made publicly available. Limited disclosure to the ACCC is not sufficient to ensure the objectives of equivalence and transparency have been achieved. At a minimum, a SSU must require Telstra to publicly disclose:



- > the internal wholesale price (**IWP**) – the “price” faced by Telstra’s retail business units for access to various regulated services;
- > the external wholesale price (**EWP**) – the price faced, on average, by access seekers for access to the same regulated services and the distribution of pricing for wholesale customers; and
- > non-price information disaggregated between wholesale customer and retail business units for service connection times, fault detection, handling and rectification of technical problems and timeliness of resolution mechanisms.

By design, a SSU that is capable of acceptance must be in the national interest. Therefore, public disclosure is essential to assure the general public that Telstra is conforming to its obligations under an accepted SSU and that the national interest is being served.

Transparency is also critical to provide assurance to wholesale customers that Telstra is delivering on its commitments to provide equivalence under an accepted SSU. Wholesale customers require the certainty of a level playing field prior to considering business decisions on the scope of their service offerings or the depth of their investments.

Publicly disclosed price and non-price information will also enable wholesale customers to monitor the performance of Telstra independently of the ACCC. Given the expertise of wholesale customers, such monitoring is likely to be effective at identifying inconsistencies within Telstra’s reporting or identifying areas of emerging concern regarding Telstra’s compliance with the SSU.

Telstra’s proposed 5 per cent margin for price range of the EWP relative to the IWP is too generous and should be tightened. In addition, a SSU should require price and non-price information on both the average and the distribution of data across wholesale customers and Telstra’s various retail business units. Information on the distribution of wholesale prices (or other non-price information) is important to ascertain whether Telstra is providing certain wholesale customers with materially advantageous pricing structures relative to other wholesale customers.

It is Telstra’s incremental retail pricing that is most relevant to assessing equivalence. To help ascertain Telstra’s incremental pricing, a SSU should commit to the provision of price information that is disaggregated between the entire customer base and more recent customer acquisitions (for example, those acquired in the previous reporting period).

As with any performance or financial metrics, the usefulness of the outputs is dependent on the quality of the inputs. Information integrity is critical to meeting the conditions required for transparency. Neither the ACCC nor Telstra’s wholesale customers can assess the integrity of Telstra’s business or accounting systems simply by monitoring the outputs from it. Data integrity is best-assessed by an independent audit of the information derived from Telstra’s business reporting systems. A SSU should contain provisions, including the terms of reference, for an annual audit of financial and non-financial information Telstra’s is required to disclose as part of the SSU.

Impose redress mechanisms to address non-compliance

The SSU must be supported by enforceable commitments that ensure ‘equivalence of outcomes’. The SSU should contain remedies to counteract any evidence of systemic bias, for instance, in circumstances where EWPs are consistently below IWPs. Such measures are required regardless of whether the bias is intended or unintended.

Redress mechanisms are therefore an important element of a SSU. Redress mechanisms provide assurance to wholesale customers that they will be compensated if Telstra fails to deliver equivalence and could impose discipline on Telstra to comply with the terms of the SSU. If redress mechanisms are to be effective they must be impartial, timely, balanced and proportionate to the problem. That said, the remedies derived in a SSU must necessarily be sufficient to provide a deterrent on Telstra from engaging in behaviour that is contrary to the objective



of structural separation or the achievement of equivalence. To that end, the proposed remedies should contain a punitive financial component in addition to a compensation component for the affected wholesale customer(s).

Of course, in the event of an escalated dispute, any redress mechanism administered by Telstra will be subject to perceptions of bias. Therefore, a SSU must ensure there is recourse for wholesale customers to seek resolution through independent third parties. In the case of pricing disputes, this is likely to be the ACCC for regulated services, and in the case of non-price disputes, this is likely to be the proposed ITA. If a SSU is to be effective the ACCC and the ITA must have the power to impose remedies that deter behaviour that is inconsistent with the SSU.

The ACCC requires a strong oversight role. To perform this function, the ACCC will require the provision of detailed and robust information from Telstra in order to monitor compliance with a SSU. However, for the ACCC's monitoring function to be meaningful a SSU must include provisions that permit the ACCC to enforce remedies in the event that Telstra is non-compliant with the SSU.

The credibility of a SSU is enhanced when the punitive aspects of any redress mechanisms provide a strong, self-imposed deterrent for Telstra. If Telstra is genuinely committed to meeting the objectives and conditions required for acceptance of a SSU then it should provide enforceable commitments that impose significant penalties when it is found to breach the terms of an accepted SSU. Such penalties, which are backed by robust and independent adjudication processes, will provide the best incentive for Telstra to deliver on its equivalence and transparency commitments.

The proposed SSU does not deliver

VHA agrees with the ACCC's preliminary view that as it stands, the SSU submitted by Telstra is inadequate. It offers few, if any, measures to suggest the future industry landscape would be any different from the past decade. More importantly, the SSU does not meet the conditions required for its acceptance and therefore, the ACCC must reject it.

VHA strongly supports the structural reforms envisaged by the Australian Government as part of the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010*. VHA is hopeful that Telstra will submit a revised SSU that is capable of acceptance by the ACCC. If Telstra pursues such an option then any revised SSU must effectively address the conditions by which the ACCC is required to assess it, and take account of the matters to which the ACCC must have regard in that assessment.