

## Enhancing Competition in Telecommunications: Accounting Separation of Telstra's Operations

### Accounting Separation

Accounting separation provides separate accounts for wholesale and retail operations. In June 2003, the Government directed the Australian Competition and Consumer Commission (ACCC) to implement an enhanced form of accounting separation of Telstra. As a result, the cost-basis for the charges which Telstra imposes on its competitors for access to its telecommunications network is to be made more transparent. This is a potentially significant development in enhancing competition in telecommunications as the bulk of the Australian network is in Telstra ownership.

### Background

The accounting separation regime has evolved into its current form over a number of years.<sup>1</sup> Its legislative basis is section 151BU of the *Trade Practices Act 1974* (TPA) which enables the ACCC to make record keeping rules (RKR) that require Telstra (and other telecommunications carriers) to provide the ACCC with information to carry out its regulatory responsibilities.<sup>2</sup>

Towards this end, in May 2001, the ACCC introduced the telecommunications industry Regulatory Accounting Framework (RAF).<sup>3</sup> The RAF requires carriers<sup>4</sup> to provide basic regulatory accounting separation, including a set of core reports covering financial information and network usage.

The Government introduced additional measures in December 2002 with the *Telecommunications Competition Act 2002* which provides for full

accounting separation of Telstra's wholesale and retail operations.<sup>5</sup> The objective of the measures is to further competition by better informing both the regulator and the market of Telstra's costs and revenues (on a current cost basis) and its comparative treatment of its retail arm and its wholesale customers.

The accounting separation direction [Australian Competition and Consumer Commission \(Accounting Separation—Telstra Corporation Limited\) Direction \(No. 1\) 2003](#) requires Telstra to produce reports consistent with the RAF that provide:

- regulatory accounting records for core services based on *current costs* as well as an historical cost basis;
- an *imputation analysis* comparing Telstra's retail prices with the costs (to competitors) of Telstra's core wholesale services; and
- key performance indicators on *non-price terms and conditions* that compare Telstra's service performance between its retail and wholesale customers.

The reports are required to be compiled on both a six-monthly and yearly basis. As well, the ACCC is required to report on the accuracy of the reports and the extent to which the reports comply with the RAF. The ACCC is also required to make its report, and the financial statements, available to the public. In December 2003, the ACCC released its report, [Initial Reports Relating to Accounting Separation of Telstra](#).

### Why Use Current Costs?

Historical costs have been criticised as providing a poor guide to resource allocation and investment decisions.<sup>6</sup> This is considered particularly so in the case of telecommunications where technological change is rapid. Hence, economic decisions regarding allocation and investment in telecommunications services or infrastructure are most often forward looking.

Current cost reporting requires Telstra to produce accounting records that reflect current costs (i.e., the costs Telstra would incur if its network was built today) as well as historical costs (costs incurred when the network asset was purchased or built).

In general, current costs are considered to better reflect the price of access to a network, as measured by the costs that would be faced by a hypothetical new entrant (i.e., an efficient competitor). Current cost accounting measures are currently the preferred method in the UK, the European Union and are gaining broader use in North America.

### Current Cost Report

The ACCC report noted that the timeframe imposed for submission of the initial reports allowed little time for Telstra to change its internal accounting procedures to generate current cost information. As such, the initial reports are somewhat a 'work in progress'.

Both the ACCC and Telstra note that the initial current cost report is limited in that current cost adjustments have only been made to fixed assets, and no profit and loss and capital employed statements have been provided. As well, only 60 per cent of reported asset classes were able to be valued using

the modified current replacement cost (MRC) approach. The remaining assets have been valued using an indexation method.<sup>7</sup> The ACCC expects the methodologies used and content of the reports to be developed further for the next set of reports.<sup>8</sup>

The current cost report shows that, while current cost valuations for individual assets vary, the *total* value of all fixed assets reported is higher under current cost valuation (\$2925m) than under historical cost (\$2105m). This is particularly so for local carriage services and the unconditioned local loop. However, the full impact of the current cost valuations will not be known until the subsequent (and more detailed) current cost reports are published.

### What is an Imputation Analysis?

An imputation test is used to detect anti-competitive behaviour through the existence of a vertical price squeeze in a retail market.<sup>9</sup> A price squeeze can occur where an operator with market power controls services that are key inputs for competitors in downstream markets. The imputation test required of Telstra under the framework involves comparison of:

- the retail price charged by Telstra for a particular service; and
- the wholesale price charged by Telstra for an essential input to that service plus any retail costs incurred to deliver that service.

If the retail price is less than the sum of the wholesale access price and the retail costs (i.e. a negative margin) a price squeeze may exist.

### The Imputation Report

The imputation report shows that Telstra passes the imputation tests for domestic long distance, international long distance and fixed-to-mobile calls but fails for local calls and line rental. However, this failure may not be indicative of anti-competitive behaviour for two reasons. First, it is common for telecommunications carriers (either network owners or resellers) to discount local calls in order to promote long distance

carriage. Second, line rental and local call prices are regulated under the Telstra price control arrangements.

The imputation analysis shows that the imputed margin (available to Telstra's competitors) varies between 21 and 64 per cent for non-local call services and between 12 and 15 per cent for bundled services. For local calls and line rentals it is minus 5 and minus 7 per cent for business and residential services respectively. This suggests sufficient margins are available across a range of services for competition to occur.

### Why a Report on Non-price Terms and Conditions of Access?

A key competition concern has been that Telstra does not provide the same level of service (e.g., provision of new service installations, fault repair and maintenance) to its wholesale customers that it provides to itself. Key performance indicators (KPIs) on non-price terms and conditions of access measure the difference between the percentage of Telstra wholesale and retail customers that meet a required performance standard (set out in the Customer Service Guarantee).

### Non-price Terms and Conditions Report

KPIs for basic access are provided for ordering and provisioning, and faults and maintenance. The report shows that for *business* customers, Telstra's relative service performance is better for its wholesale customers than for its retail customers. In contrast, for its *residential* customers, Telstra's relative service performance is better for its retail than its wholesale customers. The ACCC concluded that while there were some variances requiring further investigation there is no evidence to suggest that there is any bias by Telstra in favour of its own retail customers.

### Conclusions

The ACCC noted that the accounting separation reports comply with the RAF (as required for the initial reports) and that there is no sign of any systemic discrimination against Telstra's

wholesale customers for the services reported. There also appears sufficient margin for competition to occur across most core services (including bundled services).

The accounting separation reports will undergo further refinement and improvement. The subsequent reports should provide a greater level of transparency of Telstra's operations.

1. The notion of network or structural separation of Telstra has been strongly advocated in recent times. Accounting separation is often seen as a 'half-way' measure.
2. The ACCC's specific regulatory responsibilities under Parts XIB and XIC of the TPA and other relevant Acts are designed to maintain and enhance competition and deal with network access and anti-competitive conduct in telecommunications.
3. Regulatory accounting differs from the normal concept of accounting in that its objective is to provide information to enhance the regulatory function rather than provide a statement of financial position.
4. Telstra, Optus, Vodafone, Primus and AAPT are required to report under the RAF.
5. Telstra is considered a dominant firm, particularly in the supply of local call services.
6. See Henry Ergas, (1998) *Valuation and Costing Issues in the ACCC's Guidelines for Telecommunications Access Pricing*.
7. Indexation is not the ACCC's preferred approach as it tends to overvalue assets and overstate depreciation charges. However, its use has been accepted for the initial reports.
8. The subsequent accounting separation reports for the six months ending 31 December 2003 are due in April 2004.
9. For more information see S. King, and R. Maddock., (2002) Imputation rules and a vertical price squeeze, *Australian Business Law Review*, 30(1), pp. 43--60.

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