Breakup: what Telecom could look like

Telecommunications lawyer MICHAEL WIGLEY looks at ways the telco could be split up to remove monopolistic distortions

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Change in the telecommunications sector will be measured in years rather than months. Of the various initiatives – including local loop unbundling (LLU) and unbundled bitstream (UBS) – the most potent will be the operational separation of Telecom.

If Australian and UK experience is anything to go by, there are powerful arguments for moving to operational separation sooner than later.

Under announced proposals, Ministry of Economic Development officials are to produce a paper on the detail of accounting separation requirements for Telecom. This will be followed by a review of operational and structural separation options.

What is accounting separation?

The new regulatory accounts will be designed to allow greater transparency of business-unit cost components, wholesale prices and relevant internal costs. The aim is to help other carriers get fair, cost-based, transparent and non-discriminating pricing. It's said it will also help disclose anti-competitive behaviour such as predatory pricing.

Telecom could deliver fair pricing yet discriminate in other ways, such as by providing poorer service. Carriers must also report on "non-price" compliance, such as timely provision of service and consistency with the way Telecom provides the service to itself.

This requirement is an illustration of the way accounting (and operational) separation can benefit Telecom as well.

Telstra has been under a form of accounting separation for some time in Australia, where the debate is about moving to operational separation. In at least one year, the required non-price reporting showed Telstra's wholesale customers got better service performance than its retail customers.

The regulatory accounts will build on Telecom's existing accounting treatment, including internal transfer pricing between business units. However, there will be complexity and controversy as to the appropriate accounting treatment for regulatory purposes.

For example, there is the key issue of deciding how to apportion the costs of common infrastructure between individual services, business units, etc. It will also be important to determine which accounting methodologies to use. Fortunately, these are issues that have been heavily canvassed in other countries. As with LLU, New Zealand is running behind the pack.

Does accounting separation work?

One of the problems with accounting separation is that it merely provides information. So it lacks teeth. Telecommunications regulation requires a combination of solutions.

Accounting separation can be a useful adjunct to other solutions. It's significantly better to have it than not have it. It arms the regulator, the government and competitors with better information upon which to take steps.

In Australia and the UK, the relevant regulatory bodies (Australian Competition & Consumer Commission (ACCC) and Ofcom) have concluded that the issues and inadequacies around accounting separation require more robust measures. Both are pursuing operational separation.

What is structural separation?

Other words are bandied around in this area such as "virtual" and "ownership" separation. The latter is the same as structural separation, which is the nuclear weapon. It involves a breakup of Telecom, such as separating out network components into a new and separately owned company, which is not entitled to enter specified lines of business.

Structural separation is unlikely to be implemented in the short term (and perhaps even the long term) in Australia, the UK or New Zealand. It's too hard. The dynamic and complex telecommunications world does not lend itself as readily as the energy sector to separating out the ownership of business components.

Even if structural separation is implemented, it is much more likely to follow operational separation. It would be implemented only if that and other regulatory settings didn't work. The risk of structural separation is an incentive to incumbents to enter more robust operational separation structures.

What is operational separation?

This leaves ownership of the business with the original shareholders. However, there would be dividing lines around business units, and rules under which they operate. Typical candidates for separation in this way are network, wholesale and retail components.

Operational separation can range from relatively low Chinese walls through to hard-edged and clearly separate businesses with minimal cross-over between the two. For operational separation to be effective, there would be clearly delineated and separately run businesses, with a strong audit function.

The solution would be complex. For example, the recent operational separation of BT focuses on an entirely separate network-based business unit called Openreach. This will supply services both to the business unit called BT Wholesale and to third party carriers.

Some carriers will take their service from BT Wholesale, which in turn is supplied by Openreach. Typically a carrier with substantial infrastructure will deal with Openreach and a reseller will deal with BT Wholesale.

Operational separation comes in different shapes and sizes. For example, Australia has opted for an operational separation model reflecting the underlying commercial structure of Telstra so that similar outcomes can be achieved with minimal disruption to Telstra's existing business model.

Why do operational separation?

It is increasingly accepted (including by ACCC and Ofcom) that regulatory measures at the retail level are not working well enough to achieve appropriate regulatory outcomes. These measures include those that are the key focus of the New Zealand regime, such as the services that can be determined by the Commerce Commission (for example, UBS). There is a perception that incumbents will always be one step ahead of the regulatory body.

Operational separation goes back to the next layer (wholesale) and, if successful, can lead to withdrawal of regulation at the retail level.

Operational separation carries cost and disruption. Incumbents maintain this is additional cost and complexity for little or no benefit, with adverse impacts on that key ingredient in the telco world: incentive to invest.

ACCC has budgeted $A25 million over the next six years for implementation and monitoring of the Telstra operational separation. However, such a figure is chicken-feed compared with the billions at stake for the economy.

How will this play out in New Zealand?

The Australian solution was to pass legislation requiring Telstra to submit a separation plan. This is a work-in-progress and it's all jumbled up with T3 and the issues raised by Telstra around wholesaling services and investment in infrastructure.

In the UK, Ofcom agreed to a detailed operational separation plan with BT, after consultation with third parties. This staved off further regulatory action.

In New Zealand, the Commerce Commission (when law is passed) and Telecom will have a number of legislative, regulatory and pragmatic options as well as overseas experience.

Key outlines right path for SOEs

John Bishop

The National Party wants state-owned enterprises to be more exposed to market scrutiny even if it is not yet advocating a major sell off.

Finance spokesman John Key, in a speech yesterday to the Wellington Chamber of Commerce responding to government announcements on widening the role of SOEs, said diversification of their activities into related areas was going in the wrong direction. Opening them up to market scrutiny was a better option, he said.

"Air New Zealand is a better performing company because it is subject to regular reports by analysts and is much more open to market scrutiny," he said.

"So our policy at the last election was to look at selling a minority stake in some enterprises, and Solid Energy was the example we cited.

"If the government believes that continuing state ownership is in the long term interests of the enterprises concerned and of the country, then at least it should ensure that it has competent boards following a well defined commercial strategy."

Economic Development Minister Trevor Mallard said earlier this month that the SOEs were "perfectly placed to play a key role in helping to change New Zealand into an innovative, high-wage and high-value economy."

The government was prepared to be flexible about dividend policies and gearing, and ministers would look at proposals from SOEs "to broaden their scope of business and to extend the time horizon over which they seek to capture a return on investments," Mr Mallard said.

Mr Key said there were too many negatives for the policy to work effectively.

"Too often directors are appointed as political favourites rather than for their business skills. Even small investments can consume large amounts of management time, often disproportionately to the size of the investment.

"Shareholding ministers have little capacity to assess the real risks involved, and anyway, past performance is never a reliable guide to future performance."

Although SOEs are to manage the risks themselves and to finance expansion from their own balance sheets, Mr Key said there was an implied guarantee to lenders and suppliers by virtue of their status as entities owned by the government.

The Treasury had advised "the benefits of expansion are unlikely to be substantial" and the Crown's monitoring unit told ministers "that new initiatives can, and should occur, within the existing operating framework for SOEs."

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