

ACCOUNTING SEPARATION A MODE TO COMBAT ANTICOMPETITIVE BEHAVIOUR

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ABSTRACT

[189] Despite massive investment by competitors in alternative local telecommunications infrastructures, particularly in cable modem and wireless access technologies, the traditional telephone company copper-wire pair, or 'local loop', remains the means by which most telecom users get connectivity to the public telecommunications network and its vast array of voice, data and internet services. The dominance of local access by incumbent telephone companies has been a concern of regulatory and competition authorities since the liberalisation of telecommunications markets began because of the threat that incumbents may use their dominance of this 'bottleneck' to give themselves unfair advantages over competitors in complementary markets. In other words this leads to anticompetitive behaviour by the incumbent company.

There are typically two approaches to the issue: (1) to seek the physical separation of the business streams, which is known as structural separation; or (2) to separate the business streams only for accounting purposes. This is known as accounting separation.

This paper analyses the different kinds of anticompetitive behaviour, and ways to combat them, with emphasis on Accounting Separation and the costing principals involved therewith. Further it gives a brief outline about the practice in Australia.

[190] ... proper accounting separation is essential to demonstrate the affective working of rules to prevent a vertically-integrated dominant operator from leveraging market power from one market to another.²

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² OfTel, *Submission to the Office of Fair Trading's Review of BskyB's Position in Pay TV Markets* (May 2000) [1.1].

Introduction

Telecommunications operators, typically operate in vertically integrated businesses with the various business streams having relationships between, or dependencies upon, each other.³ Telstra operates in this manner.

When competition is introduced in a market, such as Australia, where the incumbent operator like Telstra, has enjoyed a de-facto monopoly for many years and owns the essential telecommunications network, it becomes necessary to have transparency between the various business streams contained within the overall integrated business of the incumbent. This is to ensure that the incumbent, who has the role both as a network and service provider, does not engage in anticompetitive behaviour and the dealings between the business streams of the incumbent's business are on the same basis as dealings between the incumbent and its competitors.

There are typically two approaches to the issue: (1) to seek the physical separation of the business streams, this is known as structural separation, or (2) to separate the business streams only for accounting purposes. This is known as accounting separation.⁴

In Australia, the system of accounting record keeping established in the early 1990s was a system of 'chart of accounts or cost allocation manual' (COA-CAM). The COA-CAM was replaced in May 2001 with the Australian Competition and Consumer Commission's (ACCC) Regulatory Accounting Framework (RAF).

On 19 June 2003, the Minister released a Ministerial Direction instructing the ACCC under s 151BUAA(1) to use its existing powers under Pt XIB of the of the *Trade Practices Act 1974* (TPA), to ensure that Telstra prepares and provides to the ACCC current (replacement) cost accounts, as well as existing historical cost accounts.

³ Bahrain, *Accounting Separation and Associated Costing Methodologies*, A Consultation issued by the Telecommunications Regulatory Authority on 9 June 2003, 1, [1.1]; see: <<http://www.tra.org.bh/pdf/ERUCN009.pdf>>.

⁴ Ibid.

Anticompetitive Behaviour in Telecommunications

As stated earlier, firms with market power may misuse that power through anticompetitive behaviour. Such behaviour is intended to sustain long-run high profits by deterring entry or by disciplining the prices of the competitors.⁵

Some of the anticompetitive behaviour are described as follows.

Predatory Pricing — This describes situations where a carrier or carriage service provider (CSP) with substantial market power in a telecommunications market takes advantage of that power to sacrifice short-term profit by setting prices below the cost of production with the effect of eliminating or reducing competition. Such pricing practices may increase long-term profit, if the carrier/CSP can price above marginal cost of production once the competition has been removed or substantially reduced.

Retail Margin Squeezing — This describes a situation where an incumbent firm sells a particular product at retail prices that are below the rates at which competing firms can gain access to the existing incumbent's underlying network facilities, which are required by them to offer a similar product(s).

Bundling — Generally refers to the situation where two or more products or services are sold as a single package. The price of the bundled package is usually at a discount to that of acquiring given amounts of [191] the products separately, and a consumer is likely to receive only one bill for all of the services provided in the bundle. Bundling of telecommunication services can lead to increased efficiencies and provide many consumer benefits, such as lower prices and single bills. However there is also the risk that bundling may have anticompetitive effects.

Vertical Cost Shifting — Describes behaviour whereby a vertically integrated firm shifts costs between its wholesale and/or retail businesses in order to damage competitors. In this regard, the ability to identify upstream versus downstream costs is the key to diagnosing vertical cost shifting.

⁵ Productivity Commission, *Telecommunications Competition Regulation*, Inquiry Report No 16 (Canberra, 2001) 32.

Cross subsidisation — Describes a situation where an operator that dominates one market increases or maintains its prices above costs in that market, and use these excess returns from the dominant market to sustain lower prices in other more competitive markets. Consequently, a disproportionately large share of the costs of the operator's entire business can be recovered from the markets the operator dominates. Cross-subsidisation can be a significant barrier to effective competition since without the ability to cross-subsidise its own competitive services, an economically efficient new entrant may be unable to match the incumbent's low prices in competitive markets, and may be forced out of business.⁶

Accounting Separation is a means to combat cross-subsidisation since it informs regulators whether cross-subsidisation may be occurring. Further, it also helps to identify other forms of anticompetitive behaviour.

What is Accounting Separation?

There is no single or universally accepted definition of accounting separation. The Organization for Economic Co-operation and Development (OECD) employs a general definition, considering accounting separation to be 'the preparation of separate accounts, on some pre-defined basis, for some specific functions or services'.⁷

In the UK, Oftel goes further and defines accounting separation as:

the preparation of separate accounts for different businesses and parts of the businesses run by the same company or group of companies, so that the costs and revenues associated with each business and part of a business (and transfers between them) can be separately identified and properly allocated.⁸

The purpose of accounting separation is to provide a financial picture for each part of the integrated business, which reflects as closely as possible how it would have

⁶ Australian Competition and Consumer Commission, *Accounting Separation Regime, Discussion Paper* (July 2003) 11; available at < <http://www.accc.gov.au/telco/rkr/ASD.pdf>>.

⁷ OECD, *Structural Separation in Regulated Industries*, Report by the Secretariat, DAF/CLP (2001) 11.

⁸ Oftel, *Submission to the Office of Fair Trading's Review of BskyB's Position in Pay TV Markets* (May 2000) Glossary.

performed if it had operated as a separate business. In principle, when the accounts of the local business are separated out from the accounts of the other parts of the business, the regulator is able to see that internal transactions are taking place on terms similar to transactions between the company and competitors. The regulator can also ensure that revenues from the local business are not being used to cross-subsidize other more competitive lines of business.⁹ Thus accounting separation is used to promote an effective competitive environment and contribute toward a level playing field for all competitors.

Accounting Separation versus Structural Separation

Accounting separation can exist with or without structural separation of the entity to which accounting separation applies. Structural separation refers to the process by which the wholesale and retail arms of an operator are actually separated such that they operate independently. This means that the wholesale arm will supply all retail operators equally.

[192] In relation to forms of separation other than structural separation, the OECD notes that there are three possible forms of separation that do not amount to full structural separation. These are:

- accounting separation (or accounting unbundling) the preparation of separate accounts, on some pre-defined basis, for some specific functions or services;
- functional separation, which is described as the separation of different services into different divisions of the same firm, possibly under different management; and
- corporate separation, which is described as the separation of different services into different corporate entities, which are owned by the same company.¹⁰

Internationally the OECD has endorsed the use of separation as a deregulatory tool in its report *Regulatory Reform, Privatisation and Competition Policy*:

⁹ Michael H Ryan, *Structural Separation: A Prerequisite For Effective Telecoms Competition?* (June 2003) Arnold and Porter-Publications 15; available at: <<http://aporter.pair.com/articles/structsep.pdf>>.

¹⁰ OECD, *Structural Separation in Regulated Industries*, Report by the Secretariat, DAFFE/CLP (2001) 13; available at: <<http://www.oecd.org/dataoecd/49/15/2474629.pdf>>. See also Angus Henderson, Steven Dounoukos and Madura Wijewardena, 'Implementing Effective Accounting Separation of Telstra (October 2002) 6 *Telemedia* 70.

Competition policy must give a high priority to separation of the ownership of genuine natural monopoly activities from those where competition is possible. This will foster the development of product market competition, for activities this is technically feasible'.¹¹

Commenting on Accounting Separation, Functional Separation and Corporate Separation as tools to combat anticompetitive behaviour OECD stresses that:

these approaches do not promote or protect competition when used on their own, they are often, however, an important supplement to other forms of separation, particularly as a supplement to access regulation. The information made available through accounting separation, for example, is typically used as a basis for determining access prices and for detecting cross-subsidies. These other forms of separation have their primary value as an adjunct to the other approaches.¹²

Further in Australia, Hilmer¹³ noted that there were two alternatives to address bottleneck¹⁴ power. First, the natural monopoly element could be structurally separated from the competitive elements, such as in a separate company. Second, the integrated structure could be left intact, and regulatory controls, such as accounting separation, could be used to guard against misuse of control over access to the natural monopoly element. However, Hilmer concluded that accounting separation was unacceptable because:

While separation of this kind may place some practical constraints on cross-subsidisation, ... it will not be sufficient to remove potential incentives through misuse of control over access to a vertically integrated element.

¹¹ OECD, *Regulatory Reform, Privatisation and Competition Policy* (Paris, 1992) 38.

¹² OECD, *Structural Separation in Regulated Industries*, Report by the Secretariat, DAF/CLP (2001) 11, 13.

¹³ In October 1992, following the agreement of all Australian governments, the Prime Minister established a Committee of Inquiry to investigate and report on a recommended course of action to achieve consistent competition rules across Australia. The Committee was chaired by Professor Fred Hilmer and its final report was released in August 1993.

¹⁴ In this context, bottleneck are refers to a facility where the availability and/or terms of access fall below a benchmark or standard that has been deemed to be in the public interest: Martijn Poel and Richard Hawkins, 'The Evolution of Access Bottlenecks in Europe: Re-locating the Regulatory Issues' (2001) 44(4) *Communications & Strategies* 72.

[193] Hilmer also concluded that full separation at the level of ownership or control is required to address vertical integration issues.¹⁵ Recently, structural separation has received prominent endorsement as a regulatory solution to the perceived failures within the telecommunications market from the Shadow Minister for Communication, Lindsay Tanner MP, in his report of May 2002, *Reforming Telstra*.¹⁶

Further, on 11 December 2002, the House of Representatives Standing Committee on Communications, Information Technology and the Arts announced that it had received a request from the Minister for Communications, Information Technology and the Arts to inquire into the structural separation of Telstra's core network from its other businesses.¹⁷ On 6 February 2003, however, the Minister announced that the inquiry into structural separation would be discontinued, indicating that there appeared to be no valid reason for progressing with this option.

Structural separation differs significantly from accounting separation. Accounting separation usually provides the information necessary to enable a regulatory authority to detect anticompetitive conduct, whereas structural separation removes the incentives for a firm to act in an anticompetitive manner.

Supporters of structural separation argue that the benefits would be that it:

- promotes entry and innovation into the competitive market. Specifically, it would provide consumers with benefits of local phone and high speed Internet competition;
- creates a level playing field by forcing the incumbent's wholesale arm to deal with its retail arm on the same terms that it deals with any other competitor;

¹⁵ Peter Waters, 'The Mystery Of The Missing Ring Fence — Regulation Of Vertically Integrated Telecommunications Operators' (March 1998) 1 *Telemedia* 150; available at <http://www.gtlaw.com.au/templates/employee/list_publications_2.jsp?team_id=174&empname=Peter%20Waters>.

¹⁶ Angus Henderson, 'Structural Separation Of Incumbent Telecommunications Carriers And Divestiture Of The Local Loop' (10 January 2003) *Gilbert + Tobin: Publications* 1; available at <<http://www.gtlaw.com.au/binaries/pdf/publications/structuralseparation.pdf>>.

¹⁷ National Competition Council, *Assessment of Governments' Progress in Implementing the National Competition Policy and Related Reforms: 2003; Volume Two: Legislation Review and Reform* (August 2003) ch 11 ('Communications'), 11.12; available at <<http://www.ncc.gov.au/pdf/AST5LR-012.pdf>>.

- allows regulators to focus on the wholesale network to guarantee service quality, network reliability, and access to essential network facilities at cost-based prices;
- is simple compared to behavioural remedies, such as accounting separation, since by dividing the vertically integrated company it targets the very reason for the incumbent to act in an anticompetitive manner. This compares favourably with the complexity of accounting separation where cost allocation methodologies are far from straightforward because the bulk of costs are joint or common costs. For example, it is difficult to allocate the costs for provision of the local loop, since the local loop is an essential component for not only local, STD and IDD calls, but also for internet access and mobile services.
- brings the incumbent's incentives into alignment with a non-integrated carrier, promoting competitiveness; and
- reduces the need for regulation, as government oversight decreases through the change in incentives.¹⁸

However, forcing an Access Provider to divest itself of any potentially competitive services is not without cost. Vertical Separation may lead to the loss of economies of scope, a reduction in the incentives to invest in infrastructure at the natural monopoly stage, a tendency for lower quality service due free-rider effects and loss of socially desirable price discrimination.¹⁹

[194] Vertical separation may lead to poor product quality. There will always be a tendency for vertically separated producers to blame each other for product or service deficiencies.²⁰ Vertical Separation may also create regulatory difficulties since regulation maybe more difficult if the firms are separate rather than merged.²¹

Restructuring may make it easier for firms to enter the potential competitive sector, but this will not necessarily lead to lower prices. It may have the opposite effect if the regulated price for access exceeds the marginal cost, firms that purchase access to produce a final product will compete on the basis of inflated input prices.²²

¹⁸ Henderson, above n 16, 14–15. Please see this article for a detailed explanation.

¹⁹ Stephen King and Rodney Maddock, *Unlocking the Infrastructure* (1996) 129.

²⁰ *Ibid.*

²¹ *Ibid.*

²² *Ibid* 131.

Structural separation in the telecommunications industry raises issues particular to that industry. Unlike other utility industries, the telecommunications industry is also a highly dynamic industry, which is significantly affected by technological change. There is a constant need to upgrade network and utilise existing network for new services in the telecommunications industry. Structural separation of the local loop and the subsequent regulation may dampen the incentive for innovation in the local loop.²³

Structural separation may be good in theory, but there are significant practical difficulties in implementing full structural separation in the telecommunications industry. The practical difficulties involved were illustrated by the 2003 decision of the Minister for Communications, Information Technology and the Arts, referred to previously, to discontinue the inquiry into structural separation of Telstra's core network from its other businesses.²⁴

This decision followed a statement by the Shadow Minister for Communications on the same day that although there is some significant policy merit in a full separation of Telstra, the cost of doing this, particularly because of the minority private share-holding and all of the legal processes and court actions this would inevitably be involved, outweighs any benefit.²⁵

Thus, there is bipartisan support for the view that accounting separation is the preferred means to combat anticompetitive behaviour. To assess how effective it is, however, one needs to examine the costing methodologies involved.

Costing Methodologies used in Accounting Separation

In telecommunications, there are three fundamentally different approaches to cost analysis, which can be associated with different professions.

1. Accounting is principally concerned with the recording, classification and interpretation of actual, incurred costs. The focus is on historically recorded costs

²³ Henderson, above n 16, 28.

²⁴ See text to n 17 above.

²⁵ ABC Local Radio, 'Telstra inquiry shelved by Government', *PM*, (6.10 pm, 6 February 2003); available at: <<http://www.abc.net.au/pm/s778321.htm>>.

and data sources include corporate financial accounting and more detailed management accounting measures.

2. Engineering is directed to examining the costs of alternative ways of performing specified tasks, such as finding the least cost way of adding a specified amount of capacity to a telecom network. This is primarily concerned with forward-looking management decisions.
3. Economics is concerned with the most efficient way of allocating society's limited economic resources among different possible uses. Economic costing uses a forward-looking approach that emphasizes concepts of cost variability, incremental costs and opportunity costs.²⁶

[195] In a sense these approaches are complementary. Economics can help decide what quantity of output to produce by comparing the cost estimates of producing at different possible output levels. Engineering can provide the estimates of the minimum cost for producing each possible output level being considered in the economic analysis. Accounting can measure what the output that is actually produced really cost.

Top down versus bottom up

Broadly speaking, costing methods and models can be 'top-down' or 'bottom-up'. Top-down approaches are generally associated with historic costs, while bottom-up models are generally associated with forward-looking costs. A pure top-down approach would be based on actual cost, reflecting historical unit costs and the historical roll-out of assets. Actual traffic data and historical accounting data would be used. In contrast, a bottom-up approach involves estimating the cost of replicating the functionality of the network if it had to be built from scratch today.²⁷

There are advantages and disadvantages attached to each approach. The top-down approach has the advantage of an existing data set and consistency with accounting

²⁶ Material taken from William H Melody, *Network Cost Analysis: Concepts and Methods* 208; available at: <<http://www.lirne.net/resources/tr/chapter17.pdf>>; and Hank Inteven (ed), *Telecommunication Regulation Handbook* (2000) B-11; available at: <<http://www.infodev.org/projects/314regulationhandbook/>>.

²⁷ Dr Suella Hansen, 'Telecommunications Cost Modelling Using Engineering-Economic Principles' (15 July 1997) *Network Strategies*; available at <<http://www.strategies.nzl.com/files/engineer.pdf>>.

results is assured. However, this approach has been criticised for the following reasons.

- The actual investments carried on the incumbent's books may represent bad decisions made in the past under monopoly conditions. In a competitive market, the carrier would not have been able to recover these investments — instead, they would at some point have been written off the books of the firm and the undepreciated amount charged against earnings — but as a monopoly, the carrier was able to maintain these excessive and inefficient investments as part of its rate base.²⁸
- Evolution of the costs of assets is not taken into account. The cost of facilities and equipment used in the provision of telecommunications services do not remain constant over time, but may increase or decrease as the cost of materials fluctuates and as technological advances reduce costs and increase capabilities. Moreover, in recent years there has been a decrease in equipment costs.
- Historical accounts cannot incorporate the impact of continuously evolving technologies. Hence this approach cannot ensure that costs are those of an operator employing modern technologies.²⁹
- The allocation of common or joint costs of telecommunications is either arbitrary or are left unassigned, typically as one or more lump sum amounts.

The bottom-up approach, on the other hand, typically involves the development of engineering-economics models that are used to calculate the costs of network elements and, in turn, services provided using those elements. These models estimate the costs of rebuilding specific elements of the network using current technology. Generally, this modelling approach assumes operating and capital costs will be incurred efficiently.³⁰

Thus this approach is not based on actual experience, but instead represents an imaginary network that obtains efficiencies that could not be obtained in the real

²⁸ 'Response to NTT "top-down" cost model'; available at: <http://www.soumu.go.jp/joho_tsusin/policyreports/japanese/telecouncil/iken/990906_11.doc>.

²⁹ Bahrain, above n 3, 14, [7.1].

³⁰ Inteven, above n 26, 5–22.

world. However generally forward-looking costs or 'bottom-up' approach is preferred since they reflect the working of a competitive market in a better manner.

Scorched node versus scorched earth

One important parameter in creating a proxy model methodology is the manner in which the geographic placement of network facilities is modelled. There are two contrasting approaches for network topology in long run incremental cost modelling: 'scorched earth' and 'scorched node'. While scorched node is a model which is optimal when using existing switches and technologies, scorched [196] earth is an ideal model when no pre-existing infrastructure is involved. In practice it is almost unknown to adopt a scorched earth approach.³¹

Current Cost Accounting

Current Cost Accounting (CCA) reporting system is based on forward looking costs and pricing approach. In developing this system two key issues need to be resolved. These are:

- (1) the basis for measurement of assets (and liabilities);³²
- (2) the concept of capital maintenance and the determination of profit.³³

The basis for measurement of assets (and liabilities)

Under CCA reporting, assets and liabilities are valued based on what is referred to as a 'current entry value' methodology. The replacement cost (RC) of an asset is often used as a basis for estimating current entry values. RC is defined as the present day cost of acquiring an identical or substantially similar present day asset that could provide equivalent services and capacity to the existing asset.

The RC is based on current market values, and therefore current technology. Since, as mentioned above, in telecommunications certain classes of assets have been subject to technological change and there has been new technological development also. Therefore, existing assets would not be replaced in an identical form. In such cases

³¹ Please refer to 'Principles of implementation and best practice regarding FL-LRIC cost modelling' (November 2002); available at: <http://www.regtp.de/imperia/md/content/internatio/pib_0211.pdf>.

³² Australian Competition and Consumer Commission, above n 6, 15.

³³ Ibid.

the replacement cost of a particular asset can be based on the cost of a modern equivalent asset (MEA).

Essentially, the MEA is an asset with the same service potential as the existing asset, and as a result, can produce the same stream of services and at the same level of quality. The use of MEA as a measure of RC should be independent of whether or not the operator has plans to replace the existing technology.

For some assets, calculating replacement costs might not be necessary. For assets with low values or short lives calculating the current cost of such assets will be time consuming and is likely to provide little additional information. In such cases historical costs, appropriately indexed, will be appropriate as a proxy for the current cost of these types of assets.

The concept of capital maintenance and the determination of profit

The concept of capital maintenance is central to the operation of any accounting system and refers to the manner in which the capital of a company is viewed when determining profit. There are two basic concepts of capital maintenance; namely, financial capital maintenance (FCM) and operating capability maintenance (OCM).³⁴

FCM is concerned with maintaining the real financial capital of the company and with its ability to continue financing its functions. Capital is assumed to be maintained if shareholders' funds at the end of the period are maintained in real terms at the same level as at the beginning of the period. Under FCM, profit is therefore only measured after provision has been made to maintain the purchasing power of opening financial capital.

OCM is concerned with maintaining the physical output capability of the assets of the company. Capital maintenance under this approach requires the company to have as much operating capability — or productive capacity — at the end of the period as at the beginning. Under OCM, profit is therefore only measured after provision has been made for replacing the output capability of a company's physical assets. Generally,

³⁴ Ibid.

this would require the application of specific inflation indices to the values of the company's assets.³⁵

[197] In July 2002, Andersen Business Consulting, on behalf of the European Union (EU), released a *Study on the implementation of cost accounting methodologies and accounting separation by telecommunications operators with SMP*. In this paper, the EU states that FCM is the superior capital maintenance concept noting that:

The use of the OCM concept may systematically incorporate insufficient or excess returns into the level of allowed revenue (depending, respectively, on whether asset-specific inflation was expected to be lower than or higher than general inflation). This is not a desirable feature of any regulatory regime, as it would not provide appropriate investment incentives. Under FCM however, the returns to the providers of capital would equal the required return (as measured by the cost of capital) irrespective of whether replacement costs were rising or falling relative to general prices. Hence, if current cost accounting information is used as the basis to determine interconnection charges, FCM is the preferred capital maintenance concept.³⁶

Further, the telecommunications regulator in Denmark has outlined three reasons why FCM should be preferred to OCM when undertaking CCA adjustments.

1. OCM becomes of limited value in a world where the mix of assets and the mix of outputs is rapidly changing, as is the case for telecommunications.
2. Accounting data can provide essential information about whether a firm should continue or discontinue an activity and whether, from a regulator's perspective, the firm is making acceptable, excessive or insufficient profits. However, one of the conditions for accounting information to perform this role is that it includes holding gains and losses. In other words any inferences drawn about the firm's performance from OCM measures of profitability, either from a shareholder's perspective or a regulator's perspective, may be incorrect.

³⁵ Telecommunications Regulatory Authority of India, *Accounting Separation and Formats for Accounting/Regulatory Statements*, Consultation Paper (4 May 2000) 33–4; available at: <<http://www.trai.gov.in/inpge.htm>>.

³⁶ Andersen Business Consulting, *Study on the Implementation of Cost Accounting Methodologies and Accounting Separation by Telecommunications Operators with Significant Market Power: Prepared for the European Commission DG Information Society* (3 July 2002) 15.

3. OCM depreciation implies that the firm will not recover the cost of its investment when asset prices are falling and will over-recover its costs when asset prices are rising.³⁷

Problem in Allocation of Common Cost

The term 'common costs' refers to the cost of something that is shared among different activities or services. In telecom networks, there is a very high proportion of common costs, but most of these costs are fungible, ie, highly substitutable, with other services. The core component of all services is communication signals of many different services being transmitted over a common telecom network. Because of the high degree of substitutability of network capacity among the different services, the same unit cost calculations are generally applicable for all the services sharing the common facilities or activities.³⁸

Given the arbitrary nature of some cost allocations, incumbent operators will often have the opportunity to allocate costs to their less competitive service offerings and engage in cross-subsidisation. In order to solve this problem, the regulators have specified rules for allocation of such common costs.

Practice in Australia

In Australia the system of accounting record keeping has existed from the early 1990s, when retail and limited carrier-based competition was introduced to the Australian telecommunications market. Section 80 of the *Telecommunications Act 1991* required AUSTEL to develop chart of accounts (COA) and a cost allocation manual (CAM).

[198] One of the objectives of the COA/CAM was to establish a horizontal accounting separation regime, requiring each carrier to provide financial data for each of its major retail services. This information was primarily intended to assist AUSTEL in identifying cross-subsidisation between services, and to detect

³⁷ Australian Competition and Consumer Commission, *Current Cost Accounting Methodology for Telstra's Subsequent Reports under the Accounting Separation Regime: Framework Document* (January 2004) 20.

³⁸ William H Melody, *Network Cost Analysis: Concepts and Methods* 219; available at: <<http://www.lirne.net/resources/tr/chapter17.pdf>>.

anticompetitive practices by carriers. However COA/CAM suffered from many shortcomings:

- there was inadequate vertical separation between upstream network services and contestable downstream retail services;
- internal costs at the access level were not explicitly identified;
- reported information was historic and not forward-looking; and
- certain definitions of services had become obsolete due to changing technology.³⁹

In May 2001 the COA-CAM model was replaced with the ACCC's Regulatory Accounting Framework (RAF). The ACCC in its *Regulation Impact Statement* stated that:

The primary objective of the RAF is to provide for accounting separation for major vertically integrated carriers. That is, carriers are required to report separately on the retail and wholesale businesses. This information will assist the Commission with investigations of possible anticompetitive conduct, in arbitrations on the terms and conditions of access to declared telecommunications services and in assessing any undertakings offered by an access provider on the terms and conditions of access to a declared service.⁴⁰

Section 151BU of the TPA provides that the ACCC under the RAF to may make record-keeping rules (RKR) under which specified carriers and CSP, or classes of carriers and CSP's, are required to keep and retain records. The RAF consists of financial statements in respect of assets, capital employed and profit and loss relating to lines of business in the retail, internal wholesale and external wholesale categories of the provider.⁴¹

³⁹ Tasman Asia Pacific, 'Accounting Separation Of Local Fixed' (July 1999) 245; available at: <<http://www.ncc.gov.au/pdf/AST2V1Pb-012.pdf>>.

⁴⁰ Australian Competition and Consumer Commission, *The Telecommunications Industry Regulatory Accounting Framework made under section 151BU of the Trade Practices Act 1974: Regulation Impact Statement* (May 2001) 3; available at: <<http://www.accc.gov.au/content/item.phtml?itemId=340638&nodeId=file3f20c97620ec0&fn=Regulation%20Impact%20Statement.pdf>>.

⁴¹ Department of Communications, Information Technology and the Arts, *Explanatory Statement: Accounting Separation — Telstra Corporation Limited Direction (No 1)* (2003) 1–2; available at: <http://www.dcita.gov.au/download/0,6183,4_115419,00.doc>.

Carriers and CSP's can also be required to provide reports to the ACCC consisting of information contained in such records. Subsection 151BU(4) limits the information that can be collected under the RKR. Sections 151BUA, 151BUB, 151BUC give the ACCC the power to disclose, or to require carriers or CSP's to disclose, reports prepared in accordance with the RKR. These provisions contain a number of procedural steps to ensure that information is disclosed where the benefits to the industry outweigh the commercial interests of the carriers and CSP's required to disclose the information, including the requirement that the carrier or the CSP whose information is to be disclosed is given an opportunity to comment on the proposed disclosure.⁴² Decisions by the ACCC on disclosure are subject to review by the Australian Competition Tribunal.⁴³

However, the RAF is based on historical cost accounting. The main drawback with using historical information to determine access prices is that the current cost of a company's assets may bear little relationship to their historic purchase prices because of technological change and general inflation.⁴⁴

[199] There has been criticism in the industry that there is no accounting transparency in Telstra's wholesale and retail costs and discriminatory pricing in these services is resulting in an anticompetitive behaviour.⁴⁵

To address this problem on, 24 September 2002, the Minister for Communications, Information Technology and the Arts (the Minister),⁴⁶ announced measures to encourage a more transparent regulatory market by requiring an augmented system of accounting separation of Telstra's wholesale and retail operations.⁴⁷ To enforce these decisions on 19 December 2002 the *Telecommunications Competition Act 2002* was introduced, which also made certain amendments to the TPA.

⁴² *Ibid.*

⁴³ *Trade Practices Act 1974* (Cth) s 151 CI (Division 10).

⁴⁴ Australian Competition and Consumer Commission, *Accounting Separation Regime: Discussion Paper* (July 2003) 13.

⁴⁵ Department of Communications, Information Technology and the Arts, above n 41.

⁴⁶ Department of Communications, Information Technology and the Arts, 'Government Boost to Telecommunications Competition' (Media Release, 24 September 2002).

⁴⁷ Australian Competition and Consumer Commission, above n 44, 4.

These amendments include the creation of a new mechanism allowing the Government to impose greater transparency with respect to Telstra's wholesale and retail operations. Part 16 of the *Telecommunications Competition Act 2002* amended Div 6 of Pt XIB of the TPA to implement the Government's intention of enhancing the accounting separation regime for Telstra. New subsection 151BUAA(1) enables the Minister to give a written direction to the ACCC in relation to the exercise of its powers under s 151BU and new ss 151BUDA, 151BUDB or 151BUDC.⁴⁸

The Ministerial Direction

On 19 June 2003, the Minister issued a Direction entitled *Australian Competition and Consumer Commission (Accounting Separation — Telstra Corporation Limited) Direction (No 1) 2003* instructing the ACCC under s 151BUAAA of the Act to ensure that:

- Telstra will prepare and provide to the ACCC current (replacement) cost accounts, as well as existing historical cost accounts. This will allow the regulator to better understand the costs Telstra faces as an ongoing sustainable business.
- Telstra will make public current cost and historical cost key financial statements for fixed line network services-core interconnection services-that have already been declared by the ACCC as being subject to the telecommunications access regime. This will improve the quality of information available to the market regarding Telstra's internal supply of the core interconnection services.
- The ACCC will publish an 'imputation' analysis, based on information provided by Telstra, which assumes that Telstra purchases the core interconnect services from itself at the price that it charges external access seekers. This will allow the ACCC and the market to clearly assess whether Telstra is engaging in anticompetitive 'price squeeze' conduct.
- Telstra will publish information comparing its supply of core services internally and to external access seekers in terms of key non-price terms and conditions. This report will provide, for the first time, a transparent comparison of Telstra's actual performance in supplying non-price services internally and to others (non-

⁴⁸ Department of Communications, Information Technology and the Arts, above n 41, 2.

price terms and conditions include matters such as faults/maintenance, ordering and supply, availability and performance).

- The ACCC will prepare and publish a six monthly report on competition in the corporate segment of the market. This qualitative report will assist in identifying any emerging or long-term trends or concerns about possible systemic discrimination in this highly contested sector of the telecommunications market.⁴⁹

The requirement on Telstra to produce current cost statements in relation to all services to which the RAF applies, means that the CCA reports produced by Telstra will also be of similar scope. Like the historic RAF reports currently produced by Telstra, the CCA reports will not include intangible assets, domestic investments, overseas operations and investments, liabilities and equity.⁵⁰

[200] For the purposes of the Direction, core services are those defined in s 152AQB(1) paras (a)–(d) of the TPA. These services are all declared under Pt XIC and their description can be found in the relevant declarations:

- Domestic PSTN Originating Access Service;
- Domestic PSTN Terminating Access Service;
- Unconditioned Local Loop Service (ULLS); and
- Local Carriage Service (LCS).⁵¹

Accounting separation is applicable only to core services because providing detailed commercially sensitive information for all services, (a) will impose significant costs, (b) will be unfair to Telstra's commercial interests and (c) may dampen competition in the market and may reduce industry investment.

Government's Objectives

The Government has stated that proposed the AS framework for Telstra (a key requirement of which is the preparation of CCA reports) is to provide the ACCC,

⁴⁹ Department of Communications, Information Technology and the Arts, *Final Direction Issued to ACCC on Telstra Accounting Separation* (19 June 2003); available at: <http://www.dcita.gov.au/Article/0,,0_1-2_3-3_213-4_115426,00.html>.

⁵⁰ Australian Competition and Consumer Commission, above n 48, 7–8.

⁵¹ *Ibid* 8.

access seekers and the public with greater transparency about Telstra's ongoing and sustainable wholesale and retail costs.⁵² More specifically, the AS framework is intended to promote the following objectives, particularly in relation to 'core' services:

- to ameliorate information asymmetries so as to improve the basis for access negotiations;
- to provide a high-level of systemic confidence that there is no predatory pricing occurring;
- through transparency, to provide incentives for equitable treatment in the supply of core services;
- to ensure there is a consistent and appropriate basis to which the regulator can refer when examining any competition issue involving costs;
- over time, to improve the regulator's systemic capacity to identify, and investigate allegations of anticompetitive behaviour in the supply of 'bundled' services in an increasingly convergent environment.⁵³

In designing the AS framework, the Government has also had the objectives of:

- building on work already done by the Commission and the industry with the RAF rather than 'reinvent the wheel';
- not degrading genuine economies of scale and scope in the supply of retail services; and
- avoiding undue regulatory burdens on industry.

ACCC's Objective

The ACCC under Pt XIB of the TPA is responsible for administering anticompetitive conduct in telecommunications markets and obtaining information to assist it in monitoring competition. The ACCC believes that the requirement on Telstra to produce regulatory financial reports on a CCA basis will assist it to identify instances of predatory pricing, price squeezing, bundling, vertical cost shifting, retail margin squeezing and especially cross-subsidisation conduct.

⁵² Department of Communications, Information Technology and the Arts, 'Draft Direction on Telstra's Accounting Separation Issued for Public Comment' (Media Release, 19 March 2003).

⁵³ Department of Communications, Information Technology and the Arts, above n 41, 3.

In particular, the CCA reports will likely enable the Commission to better identify true economic/replacement costs of particular assets owned and operated by Telstra. The ACCC considers that CCA information is more likely to provide costs that underpin prices in a competitive market, and is likely to enable it, in making a more informed assessment as to whether particular conduct can be deemed anticompetitive.

Recently, in January 2004, the ACCC released a framework document, entitled 'Current Cost Accounting Methodology for Telstra's Subsequent Reports under the Accounting Separation Regime: Framework Document'. The framework document was intended to provide guidance to Telstra on the principles the ACCC will use in preparing the RKR for the preparation of future CCA reports.

[201] In this report the Commission notes that Telstra argued that the OCM approach to capital maintenance is inappropriate in a telecommunications context, and that FCM should be adopted as the basis for its CCA reporting. The main reasons for this approach by Telstra are as follows:

- The telecommunications industry differs from industries such as water, gas and electricity distribution in that it involves the supply not of a single (essentially homogeneous) service, but rather of a very wide range of services. These services are undergoing continuing and rapid change as new technologies alter not only the manner in which existing services are supplied but also lead to the development of entirely new services. Telstra believes that it is widely accepted that the concept of OCM is not well defined when the services being supplied by the reporting entity change substantially over time.
- The use of the FCM basis to capital maintenance leads to market participants and potential entrants receiving correct signals on whether to undertake new investment or enter the market. OCM, on the other hand, provides the wrong signals for both existing and potential market participants.
- Telstra believes that when the nature of the services being supplied is undergoing constant change, the fundamental issue facing regulators and the firm is to ensure that the incentives for efficient investment are preserved. Telstra maintains that an FCM approach will ensure that efficient investment incentives are preserved.

- Telecommunications regulators overseas have considered the issues raised above and developed CCA methodologies that meet regulatory needs in both a principled and cost effective way. These methodologies appear to rely on FCM and hence are consistent with the analytical framework underpinning access pricing. Telstra maintain these methodologies have been tested by the operators themselves, auditors, regulators and users of the information, and hence have a significant degree of credibility.

Commenting on FCM or OCM approach to capital maintenance the Commission considered that there are two key implications, which are: the effect on investment and market entry incentives, and the effect on regulatory analysis. Each of these is discussed below.

Investment incentives

When asset values are increasing the FCM approach to capital maintenance results in higher profitability for the reporting firm, whereas when asset values are decreasing, FCM results in lower profitability. This is because under FCM holding gains and losses and adjustments to maintain equity in real terms are posted to the profit and loss statement.

Increasing asset values and higher profitability signal to new entrants and existing competitors that it is possible to enter the market or undertake new investment and recover the cost of investments in the long run. Thus efficient entry and investment is encouraged. Depreciating asset values and resulting lower profitability under FCM, signal to new entrants or existing competitors that entry or increased investment is not sustainable and efficient because low profitability will make it difficult for investment costs to be recouped in the long run. Therefore, the correct investment and entry signals are again being sent to potential new entrants and existing market participants under FCM.

OCM, on the other hand, shows increasing profitability from depreciating asset values. This is because the only adjustment that is expensed to the profit and loss account is supplementary depreciation, which works to offset the depreciation charge as asset values fall. As a result, the pricing signal being generated through OCM is that additional new investment or new entry is sustainable.

This may not send correct pricing signals since at times of falling prices (which manifest themselves in depreciating asset values) it becomes more difficult to recoup investment costs thus suggesting that at these times new investment or new entry is not warranted.

Similarly, OCM, shows reducing profitability from an appreciating asset value. In this case new entrants are discouraged from competitive entry and new investment, because it appears, based on the information generated by regulatory reports relying on the OCM approach that recovery of new investment will not be possible. Thus again OCM sends the wrong pricing signals to potential and existing market participants.

[202] However, in the Commission's view, there are many reasons why firms decide to enter particular markets or undertake investment in new infrastructure. The signals generated by regulatory accounting information are a relatively minor influence on firms' entry and investment strategies.

Further, the Commission noted that where the CCA reports clearly set out the adjustments made either under FCM or OCM, users of the information can undertake profitability analysis with a clear understanding of the implications of the results of that analysis.

Regulatory analysis

The Commission identified two key areas where the choice of OCM or FCM can potentially impact on regulatory analysis. These are:

- where the CCA information is used for the determination of access prices when the Commission is arbitrating access price disputes, assessing the prices contained in access undertakings or establishing indicative prices. Since under FCM holding loss adjustments (when assets are depreciating) are posted to the profit and loss statement, reported costs and consequently access prices based on these costs will be higher under FCM than OCM; and
- where the CCA information is used to undertake imputation analysis of core services, imputation tests will be harder to pass if the CCA information is

prepared on an FCM basis. This is because wholesale costs will be higher under FCM than under OCM for any given retail price for the core service under consideration.

The Commission concluded that the question of whether it is more appropriate to use an FCM or OCM basis for the preparation of CCA reports is of secondary importance to that of the valuation of assets based on the MEA methodology using the concept of service potential.

The Commission decided that there is little practical difference between the use of FCM or OCM and that since there are international precedents and experience which can be drawn upon in implementing FCM, it has adopted FCM as the basis of capital maintenance for CCA purposes.⁵⁴

Under Pt XIC of the TPA, one of the Commission's key roles is the declaration of specific telecommunications services to ensure that competitors can gain access to bottleneck facilities⁵⁵ at fair and reasonable prices in order to be able to compete effectively where this would promote the long-term interests of end users (LTIE).

The requirement on Telstra to prepare CCA reports will assist to promote the objectives of Pt XIC, and as a consequence the LTIE, by providing economic rather than historical financial information on which to base decisions under this provision.

The ACCC has suggested that CCA be used on the basis of MEA approach for measurement of assets and liabilities and the FCM for capital valuation.

Conclusion

The dominance of 'bottleneck power' has been a concern for regulators since it gives incumbents unfair advantage over competitors in complementary markets. To combat this problem structural separation has been proposed as the ultimate solution since accounting separation enables transparency for regulators to detect anticompetitive

⁵⁴ Australian Competition and Consumer Commission, above n 37, 17–21.

⁵⁵ This refers to facilities, which have high initial investment rate but are essential for economies of scale and for access to customers. Local loop in telecommunications is a perfect example.

conduct, whereas structural separation removes the incentives for a firm to act in an anticompetitive manner.

However regulatory authorities are hesitant to enforce this due to the following reasons:

- (1) the belief that there are considerable economies of scale and scope associated with the integration of local and other services, with the consequence that the welfare losses incurred in implementing structural separation might outweigh any gains flowing from increased competition; and [203]
- (2) the concern that structural separation would leave the local entity with a very limited set of functions that would blunt its incentives to innovate. The principle behind separation would, for example, rule out any collaboration between the separated firms aimed at developing new products and services that leverage off the ability to provide integrated functionality.⁵⁶

Thus regulators around the world have chosen accounting separation to combat anticompetitive behaviour. It allows them to see the carrier through a set of information ‘windows’, as if it were a number of structurally separated firms, while allowing the firm to remain vertically and horizontally integrated. Further implementation of accounting separation various cost methodology issues need to be resolved. As discussed above, regulators have adopted the forward looking approach (that is, CCA) based on MEA approach for measurement of assets (and liabilities), and the FCM concept for capital maintenance and the determination of profit. It is important to note to have a background to work on, regulators have maintained accounting on the basis of historical accounts (such as RAF) and have preferred the scorched node network topology. However, irrespective of what form of separation is used or what costing model, the issue of ‘common cost’ brings us back to square one — that is, the problem of cross-subsidisation, which can only be solved by effective regulation.

⁵⁶ Ryan, above n 9, 3.