# COMPETITIVE SAFEGUARDS: THE NEED FOR ACCOUNTING SEPARATION FOR DOMINANT OPERATORS

*Paper to the 3rd OOCUR Conference, November 2-4, 2005,*
*Nassua, Bahamas.*

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**Abstract**

In competitive markets, the absence of market power means that no single competitor can influence the market outcome even if the entity is an integrated firm. However, in relation to telecommunications markets, most regulators are of the view that, since some critical markets are still monopolized, competitive safeguards are necessary to prohibit entities enjoying such monopoly power from using their market power to unfairly favor or promote their own retail services to the detriment of their competitors.

Market distortion by a dominant firm may take various forms including excessive charges for interconnect services, discrimination in pricing, unfair cross-subsidies, and predatory pricing. These practices are usually aimed at stifling competition and may even prevent market entry. Accounting Separation is a common tool used to address these anti-competitive concerns. Under this approach, the operator's activities are split for accounting purposes, into separate businesses or services. In other words accounting separation does not impose on the operator a set of rules about how its activities should be organized, but simply how accounting information is to be collected and reported.

The National Regulatory Agency (NRA) has a critical role to play in a country's telecommunications markets in terms of facilitating competitive outcomes. The OUR proposes to introduce regulatory accounting for Cable and Wireless as a critical competitive safeguard in the local telecommunications markets in order to facilitate competitive outcomes in such markets.

This paper outlines some of the problems that can occur in the absence of appropriate safeguard rules and examines the proposed level of accounting separation for C&WJ and one of the critical requirements of the system of regulatory accounts for the Jamaican telecommunications markets.

**Regulatory Framework**

The Telecommunications Act 2000 (The Act) is the primary legislation governing Jamaica's telecoms sector. Under this Act the Office has been assigned certain regulatory duties. The broad objectives of this Act are:

- to promote and protect the interests of the public;
- to promote universal access to telecommunications services for all persons in Jamaica, to the extent that it is reasonably practicable to provide such access;
- to facilitate competition in a manner consistent with Jamaica's international commitments in relation to the liberalization of telecommunications; and
- to encourage economically efficient investment in the sector.

It is a provision of the Act that the Office discharges its duties and responsibilities in a transparent and accountable manner. Amongst the its duties and functions, the Office should:

- promote the interests of customers while having due regard for the interests of carriers and service providers; and
- promote competition among carriers and service providers.

In an industry that is usually dominated by the incumbent, entrants have to pay large sums of their revenues for interconnection and other wholesale services. This makes them vulnerable to abuses by dominant carriers and service providers.

A dominant firm has the ability to distort competition in a relevant market. This is especially so in telecommunications, in which a dominant firm is typically both:

- a supplier of critical inputs (interconnection and other wholesale services) to downstream service providers; and
- a competitor against these service providers in downstream retail markets.

Given this conflict of interest, regulators are generally of the view that adequate competitive safeguards are critical.

For these reasons, the Act provides some general underlying principles regarding interconnection services supplied by dominant public voice carriers. These are listed below (see Section 30):-

- the terms and conditions under which it [interconnection] is provided shall be
  - "on a non-discriminatory basis;
  - reasonable and transparent, including such terms and conditions as relate to technical specifications and the number of locations of points of interconnection; and
  - charges shall be cost oriented and guided by {certain cost causation}…principles… (Section 33);
- no unfair arrangements for cross-subsidies shall be made; and
- where technically and economically reasonable interconnection services shall be so diversified as to render it unnecessary for an interconnection seeker to pay unreasonably for network components or facilities it does not require."

Notwithstanding the fact that these principles address interconnection among carriers, they are equally applicable in the context of the provision of services to non-carriers from an anti-trust perspective.

In the Jamaican context, under the current legislative framework, where any such action is determined to be of competitive significance, the Act requires that this should be referred to the competition authority, the Fair Trading Commission (FTC). Specifically, Section 5 of the Act states that:

> Where after consultation with the Fair Trading Commission the Office determines that a matter or any aspect thereof relating to the provision of specified services -
>
> (a) is of substantial competitive significance to the provision of specified services; and

(b) falls within the functions of the Fair Trading Commission under the Fair Competition Act, the Office shall refer the matter to the Fair Trading Commission.

However, the reality is that, a 2001 Supreme Court ruling has served to constrain the FTC's adjudication function[2]. Thus, the deficiency in the legislative framework favours firms with market power.

Against this background, the establishment of appropriate competitive safeguard rules, including accounting separation, is of paramount importance.

**Objectives of Separated Accounts**

Accounting separation provides a useful technique for investigating allegations about anti-competitive behavior by dominant firms.

It is a commonly held view that integrated telecommunications firms with market power should be obligated to act in a non-discriminatory manner, additionally, these firms should be subject to a system of separated accounts. These requirements facilitate regulatory control. The obligation of non-discriminatory behaviour is thought to be meaningless without proper accounting separation because separation produces much of the information required to assess claims of discrimination. For example, although integrated telecommunications firms are obligated to provide services based on non-discriminatory pricing, it may choose to sell those services at a higher price to competitors of its own retail service division. Accounting separation will assist in restricting this behaviour by publicly providing information on the prices paid by the integrated firm's retail arm.

Thus, regulators tend to hold the view that the preparation and publication of separated accounts that are audited are essential to the development of truly competitive markets for telecommunications services. Indeed, without such a

[2] See Jamaica Stock Exchange v Fair Trading Commission, January 29, 2001.

tool, the OUR may not be able to properly discharge its duties and functions as provided for in the Act. In the March 2000 consultative document (Regulatory Accounts for a Dominant Carrier or Service Provider) the OUR set out four regulatory objectives that separated accounts are intended to support:

- ensuring non-discrimination,
- identifying unfair cross-subsidies,
- setting or assessing interconnection charges,
- retail price control.

It is important to establish not only that the transfer charges[3] from one of the incumbent's businesses to another are calculated in a non-discriminatory manner, but also that these are treated by the dominant carrier/service provider as 'hard' charges and not simply paper accounting transactions. In other words, when the incumbent sets the prices for the retail business that purchases network services, it must treat the transfer charges as real costs that need to be recovered. Otherwise, a price squeeze may occur if the incumbent does not properly account these charges.

The margin between the interconnection or wholesale charges and the incumbent's retail price, against which the entrant is competing, may be insufficient to allow an equally efficient competitor to make a normal profit. This may constitute a distortion of competition.

More than one Internet Service provider (ISP) have made allegations that C&WJ have used this tactic to limit competition in the retail markets for Internet access services. However, in the context of a vertically integrated firm and consolidated accounts and with the absence of an appropriate system of accounting separation, it is difficult to check the validity of these claims.

[3] Transfer charge is the charge for any service that the carrier and or service provider provides to itself or to any member of that carrier and or service provider's Group for the use or provision of a service.

**Imputation Test**

One of the critical requirements of the system of regulatory accounts for the Jamaican telecommunications markets is the imputation test. The imputation test is designed to indicate if there is sufficient margin between a dominant operator's retail prices and the prices that it charges competing operators for access to its network to enable equally efficient access seekers to compete in the downstream or retail telecommunications markets.

The imputation test is conducted by comparing the retail price charged by the incumbent with the 'stack' of costs incurred to provide each service that is subject to competition. These costs comprise the wholesale charges for that service plus its retail costs (and any other relevant costs). The wholesale charges for the relevant service are calculated using the same charges as paid by an access seeker, and depend on the particular access services that it uses as inputs.

If regulatory accounting requirements have not been set in advance, as is the case in Jamaica, when a problem arises there is the risk that the regulator would lack the necessary information to analyze an allegation of anti-competitive behaviour. Any cost information obtained would be on an ad hoc basis and could consequently lack robustness and credibility.

*Identifying a price squeeze using an imputation test*

As noted, the test is conducted by comparing:

- the retail price charged by the dominant operator for a particular service with
- the wholesale access price charged by the dominant operator for access to its network, plus the additional expenditure needed to transform the essential input into the retail service.

If an imputation test is conducted and the retail price is less than the sum of the wholesale access price and additional costs (including the cost of capital), without additional information to the contrary, a price squeeze exists.

The Australian Competition and Consumer Commission (ACCC) performed several imputation tests pursuant to the existing regime for Telstra (the incumbent telecommunication operator). As per the information in Table 1.0 from ACCC on the imputation test for ADSL service as at March 2005, only the bundled ADSL service offered by Telstra to businesses passed this test.

Table 1.0

| | Unconditioned Local Loop Service | | | |
|---|---|---|---|---|
| | ADSL Service | | ADSL, local calls, line rental, domestic long distance, international and FTM | |
| | Business | Residential | Business - 1 x ADSL Service + 4 x Voice Lines | Residential -1 x ADSL Service +1 x Voice Line |
| Revenues | | | | |
| retail | 19,632,269 | 49,786,880 | 97,097,297 | 110,613,684 |
| other | 0 | 0 | 0 | 0 |
| total | 19,632,269 | 49,786,880 | 97,097,297 | 110,613,684 |
| | | | | |
| Retail Costs | | | | |
| organisation | 5,162,743 | 18,067,870 | 10,498,202 | 22,784,581 |
| product and consumer | 9,906,989 | 34,671,143 | 25,538,440 | 45,450,681 |
| total | 15,069,732 | 52,739,013 | 36,036,642 | 68,235,262 |
| | | | | |
| Other Costs | | | | |
| organisation | 1,395,588 | 4,884,090 | 6,161,982 | 9,056,484 |
| product and consumer | 990,609 | 3,466,799 | 2,328,874 | 4,842,580 |
| network expenses | 4,224,487 | 14,784,290 | 17,041,744 | 27,028,291 |
| total | 6,610,684 | 23,135,180 | 25,532,601 | 40,927,355 |
| | | | | |
| Ancillary Charges (TEBA)* | 1,368,689 | 4,789,952 | 1,390,328 | 4,887,169 |
| Cost of Capital | 4,597,817 | 16,090,818 | 19,786,921 | 29,934,748 |
| | | | | |
| Retail Volume** | 100,863 | 352,987 | 100,863 | 352,987 |
| Retail price | 194.6428 | 141.0445 | 962.6646 | 313.3648 |
| Access price | 68.0065 | 68.0065 | 127.2178 | 92.7780 |
| Unit cost | 274.1035 | 274.1035 | 820.3845 | 407.9033 |
| Imputed margin | -147.4673 | -201.0655 | 15.0623 | -187.3165 |
| Imputed margin % | -75.7630% | -142.5546% | 1.5646% | -59.7759% |

Source: Australian Competition and Consumer Commission

Table 1.1 shows that, with the exception of local calls and line rental (both business and residential) and three ADSL services, all other services passed the imputation test.

Table 1.1

| | | | Imputed margin (by quarter) | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Retail service** | **Core service(s )** | | **Mar 04** | **Jun 04** | **Sep 04** | **Dec 04** | **Mar 05** | **Result** |
| Local calls and line rental | LCS | Business | -16% | -17% | -18% | -15% | -14% | Fail |
| | | Residential | -17% | -13% | -19% | -18% | -16% | Fail |
| Domestic long-distance | PSTN O/T | Business | 65% | 66% | 69% | 69% | 69% | Pass |
| | | Residential | 60% | 61% | 66% | 66% | 66% | Pass |
| International long-distance | PSTN O | Business | 49% | 49% | 48% | 51% | 55% | Pass |
| | | Residential | 36% | 37% | 41% | 39% | 44% | Pass |
| Fixed-to-mobile | PSTN O | Business | 15% | 14% | 17% | 18% | 20% | Pass |
| | | Residential | 32% | 34% | 36% | 36% | 38% | Pass |
| Bundle of fixed voice services# | LCS & PSTN O/T | Business | 5% | 4% | 3% | 5% | 6% | Pass |
| | | Residential | 10% | 12% | 9% | 11% | 13% | Pass |
| | | Total | 8% | 9% | 7% | 9% | 10% | Pass |
| ADSL | ULLS | Business | - | - | -186% | -180% | -76% | Fail |
| | | Residential | - | - | -214% | -224% | -143% | Fail |
| Bundle of ADSL and all fixed voice services | ULLS & PSTN T | Business^ | - | - | -13% | -13% | 2% | Pass |
| | | Residential | - | - | -93%* | -93% | -60% | Fail |

* Telstra revised the margin for the residential bundle of ADSL and fixed line services from -85% to -93% in February 2005.
# The bundle of fixed voice services comprises of locals calls and line rental, domestic and international long-distance and fixed-to-mobile calls.
^ The bundle for business customers contains one ADSL service and four bundles of fixed voice services.

Source: Australian Competition and Consumer Commission

## Proposed Structure of Accounting Separation

*Main Business Areas and Dis-aggregation*

For purposes of accounting separation, the OUR expressed the view that C&WJ should split its activities into the main business areas listed below:

- Fixed Access Business
- Fixed Network Business
- Fixed Retail Services Business
- Mobile Business

It is also proposed that the Fixed Retail Services Business be disaggregated (see Table 1.2) to facilitate the assessment of allegations such as price squeezing.

**Table: 1.2**

**Annex III: Main Businesses & Disaggregated Service Categories**

| ***Main Business Areas*** | ***Disaggregated Service Categories*** |
|---|---|
| Fixed Access Business | - |
| Fixed Network Business | - |
| Fixed Retail Services Business | Intra-Parish Calls<br>Inter-Parish Calls<br>Fixed to Mobile Calls<br>Public Payphones<br>International Outgoing Calls<br>International Incoming Calls<br>Directory Enquiries (DQ)<br>Data Communication Services<br>Internet service provision (dial-up, and ADSL)<br>Supplemental Retail<br>Remaining Services |
| Mobile Business | - |

Source: OUR Jamaica

*Transfer Charges*

The objective of the process of internal transfer charges is to provide transparency for all intra C&WJ activities. As part of its accounting information the Office expressed the view that C&WJ should provide detailed description of the process and methods used for deriving internal transfer charges between its network business (fixed and mobile) and its other Businesses or service categories.

**Table: 1.3**

**Annex X: Statement of Transfer Charges**

| Costs/Services | ***Fixed Retail Services*** | Intra-Parish | Inter-Parish | Calls to Mobile | Public Payphones | Directory Enquiry | International Outgoing Call | International Incoming Call | Data Circuits | Internet Serv. | Supplemental Retail | Remaining Services | ***Mobile Business*** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fixed Access | X | X | X | X | X | X | X | X | X | X | X | X | X |
| Fixed Network | X | X | X | X | X | X | X | X | X | X | X | X | X |
| Fixed Retail Services | X | X | X | X | X | X | X | X | X | X | X | X | X |
| Mobile Business | X | X | X | X | X | X | X | X | X | X | X | X | X |
| **Total** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** | **X** |

Source: OUR Jamaica

**Challenges of Establishing an Appropriate Regulatory Framework for Accounting Separation**

Regulators usually require that separated accounts be audited to give the assurance that they were prepared in accordance with the relevant regulatory framework documents. This requirement usually raises several questions. These include, but are not restricted to:

- *What is the Appropriate Level of Audit Assurance?*
- *Who bears the cost of auditing?*
- *What is the appropriate relationship between the regulator and the Auditors?*
- *What is the cost basis of separation?*

These questions are addressed in turn below.

*(1) What is the Appropriate Level of Audit Assurance?*

As part of the audit report, the auditor is required to provide an opinion on the regulatory accounts. There is a range of opinions that may be used, varying according to the development of the firm's regulatory accounting system and the "confidence" that is required in relation to the accuracy of the regulatory accounts.

A number of audit opinions may be provided, including the following:

- that the regulatory accounts are "fairly presented in accordance with" the relevant prescribed accounting framework ("FPIA");
- that the regulatory accounts are "properly prepared in accordance with" the relevant prescribed accounting framework ("PPIA"); and
- a review opinion on a set of accounts that may involve the performance of an inquiry and analysis that provide the accountant with the basis for expressing limited assurance that no material modifications should be made to the regulatory accounts for them to be in conformity with the accounting framework.

More often than not, the telecommunications operator will opt for the lowest level of audit opinion in an effort to minimize the requirement for regulatory compliance. It is often argued that it is not possible for an audit opinion to be

given in the first year of the accounting separation regime, and that a less stringent review opinion should be required. The incumbent will argue that its existing accounting system was not designed to generate regulatory accounts and that the timely development of a regulatory accounting system to prepare the first set of accounts would place too great a resource and financial burden on the Company. However, the fact is, with the prospect of increased competition, it is in the regulated firm's best interest to have separated accounts. This will enable it to properly assess the performance of each product in terms of contribution to cost, revenue and profitability.

(2) Who bears the cost of auditing?

From an economic perspective, the principle of cost causation is fundamental to the efficient pricing of goods and services. This principle states that the users of a service should only pay for those costs that are caused, or triggered, by the provision of service to them. Therefore, it could be argued that access or interconnection seekers should pay the cost since they require this audit assurance. However, ultimately, it is the retail customers that will pay.

(3) Should the operator's auditor owe a duty of care to the regulator?

Most would argue that the auditor only owes a duty of care to the operator since the operator is its client. However, PwC (as British Telecom's –(BT) regulatory auditors) has recently concluded an agreement with Ofcom and BT where it will in future acknowledge that it owes a duty of care to Ofcom in the auditing of BT's regulatory accounts.[4]

(4) What is the cost basis of separation?

After settling the issues of allocating audit costs and duty of care, the bases on which the accounts should be separated must be addressed. Should costing be on a historical cost[5] or current cost (current cost accounting[6]) basis and should

[4] See http://www.ofcom.org.uk/consult/condocs/fin_reporting/pwc_doc?a=87101.

[5] An accounting technique that values an asset for Balance sheet purposes at the price paid for the asset at the time of its acquisition.

[6] This is a system designed to adjust accounts for changes in prices that affect a company's assets.

this be distributed based on fully distributed costing[7] or incremental costing? It could be argued that if costs are allocated based on causality (Activity Based Costing - ABC[8]) and assets are valued at current prices this would approximate LRIC[9] and the question would be settled.

When these and other questions have been appropriately settled, much is expected from the new regulatory framework. Some new market entrants seem to be of the view that competitive safeguard rules, in particular, accounting separation is a panacea for all competitive problems. However, in some cases, increasing layers of regulation have not been able to facilitate the level of competition expected.

**Accounting Separation vs. Structural Separation**

In 1984, the structural separation of AT&T became effective and facilitated the development of increased competition in the US telecommunications markets. At the same time, the UK telecommunications regulatory authority (now OFCOM) decided to opt for regulatory accounts and other methods of creating and safeguarding competition.

- Just about twenty years later, OFCOM placed structural separation of British Telecom (BT) on its agenda. According to an Ofcom's executive "Twenty years after liberalisation, the market has made good progress. However, its foundations are unstable in parts, overly dependent on intrusive regulation and with limited sustainable competition".[10] These comments were made in Ofcom's *Strategic Review of*

[7] Under this method of cost allocation, the total costs of a firm are allocated to all commercial and non-commercial outputs. All direct costs are allocated to their respective outputs, and indirect and joint costs are averaged across all outputs.
[8] Activity Based Costing in an accounting technique that allows a firm to determine the actual cost associated with each product that the firm produces.
[9] LRIC (Long Run Incremental Cost) methodology calculates the cost of providing a defined increment of output, on the basis of forward-looking costs incurred by an efficient operator.

[10] See http://www.ofcom.org.uk/media/news/2004/11/nr20041118, for Ofcom's *Strategic Review of Telecommunications*.

*Telecommunications* that concluded that the UK telecoms market has two key problems:

- "Firstly, an unstable market structure in fixed telecoms, dominated by BT and with alternative providers that are, in the main, fragmented and of limited scale.
- Secondly, the continuance of a complex regulatory mesh, devised over twenty years of regulation and in many areas dependent upon intrusive micro-management to achieve its purposes, yet which, in aggregate, …has failed effectively to address the core issue of BT's control of the UK-wide access network."

In most cases, less than five years have elapsed since the commencement of liberalization in the Caribbean but we seem to be moving in the same direction as the UK. We are weaving the so-call "complex regulatory mesh" that is intended to increase the level of competition in the telecommunications markets. However, regulators should ask themselves if they should be looking at structural separation instead of increased regulation?

It would appear that, under the threat of structural separation, BT has struck an agreement with Ofcom to create a new access services division. Among other things, this new division: "…will be required, through a set of formal rules on governance and separation, to support all providers' retail activities (including those of BT Retail) on a precisely equivalent basis, which Ofcom terms "Equivalence of Input". Equivalence of Input will mean that all providers will benefit from:

- the same products, with equal opportunity to contribute to the development of new products;
- the same prices, offered to all providers equally; and

- the same processes, to ensure all providers are able to order, install, maintain and migrate connections for their customers on equal terms."[11]

Without the legal trappings, Jamaica also proposed that C&WJ be required to create a similar division (Carrier Services). Although no final decision was taken on this matter, the Division was established. However, the requirements for establishing and monitoring this Division were not strictly enforced.

Additionally, the Office has indicated that it is on the verge of making a decision on its consultation on accounting separation and commencing consultation on general competitive safeguard rules. It is hoped that these changes will serve to enhance the level of competition in the telecommunications markets.

**Conclusion/Recommendation**

To conclude, competitive safeguard rules and accounting separation are likely to enhance the competitive environment in the telecommunications sector. However, we must see this solution for what it is. This is a second best solution that is likely to yield less than the desired results if not crafted with meticulous detail. For the Caribbean regulators that have started the process of implementing competitive safeguards, seeing the process through seems reasonable from the standpoint of all stakeholders. But since these regulations do not always yield the desired results, structural separation should always be kept as an option.

[11] See http://www.ofcom.org.uk/media/news/2005/06/nr_20050623.

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