

Functional Separation – The UK 'Openreach' model

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Our Strategic Review asked five fundamental questions:

1. In relation to the interests of citizen-consumers, what are the key attributes of a **well-functioning** telecoms market?
2. Where can effective and **sustainable competition** be achieved in the UK telecoms market?
3. Is there scope for a significant **reduction in regulation**, or is the market power of incumbents too entrenched?
4. How can OFCOM incentivise efficient and timely **investment in next generation networks**?
5. At various times since 1984, the case has been made for structural or operational separation of BT, or the delivery of full functional equivalence. Are these still relevant questions?

Conclusion: Sustainable and effective competition in fixed telecoms requires infrastructure-based operators with scale

- In the Telecoms Strategic Review, we found:
 - Mesh of conflicting and restrictive regulation
 - Fragmented industry base
 - No equality of access to bottlenecks (e.g. access & backhaul networks)
- Customers increasingly demanding choice and innovation - best driven by competing infrastructures extending as close to customers as is economically sustainable.
- Need for investment in emerging technology and new platforms by competing scale operators alongside BT for UK economy to remain competitive

Degrees of separation:



Structural separation?

- It was a **viable option** that Ofcom considered and had support from some stakeholders
- **Fixes the basic problem** in that it removes the incentive to discriminate in favour of one's own businesses
- It is **inflexible** – doesn't enable boundary issues to be revisited even over the medium to long term when significant changes occur
- The process may be long, fraught and **uncertain**, with a referral to the Competition Commission triggering a 2+ year process.
- Undoubtedly carries some **inefficiencies** associated with the loss of vertical integration

The chain of logic that lead to functional separation in the UK

- Evidence of enduring market power in access and backhaul
- Continued vertical integration provides the **ability** and **incentive** to discriminate against competitors who are also wholesale customers and leverage its upstream market power
- Little incentive on management to provide services to wholesale customers who are downstream competitors led to resistance to regulation and ‘walking slowly backwards’
- In the UK, we observed discriminatory conduct across a range of upstream markets (LLU, PPCs, CPS, bitstream access – case studies contained in Ofcom undertakings consultation document of June 2005)
- However non-price discrimination remains difficult to detect and punish.
- Therefore we sought a remedy that preserves the positive virtues of vertical integration whilst removing ability to engage in anti-competitive discrimination.

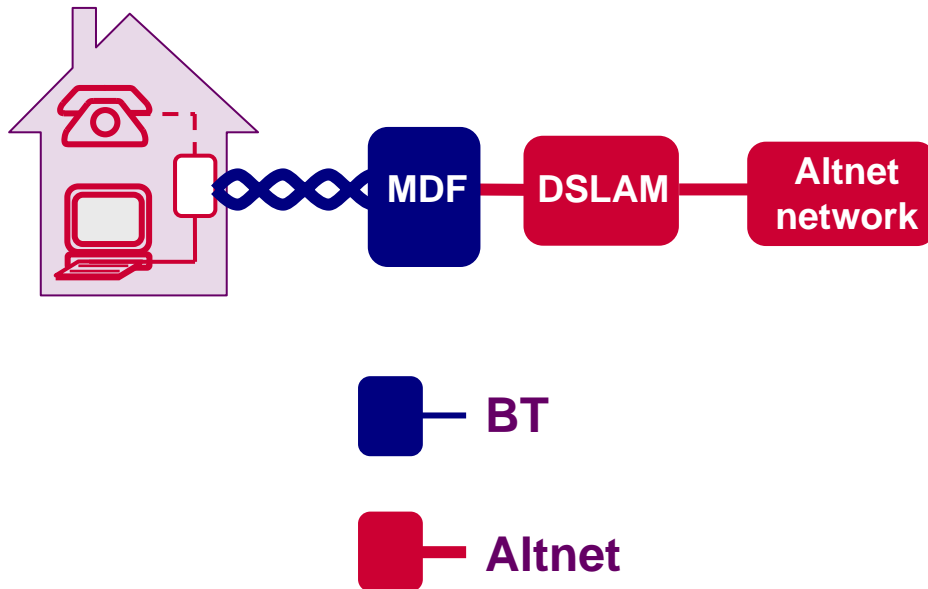
Problems and solutions identified in the UK



- Evidence of enduring market power is enduring in access and backhaul
- Continued vertical integration
- Evidence of factors that make this incentive strong
- Evidence on consultation document, 5 Case Studies (June 2005)
- Evidence on attempts to use our existing powers (5 Case Studies)
- Evidence on potential harm that might result
- Final Agreed Undertakings (September 2005)

In many areas, the deepest level at which competition is effective and sustainable will be the local loop

Local loop unbundling



Results

- >1,670 unbundled exchanges
- Price competition ('free' broadband offers)
- Service innovation

**Real equality of
access**

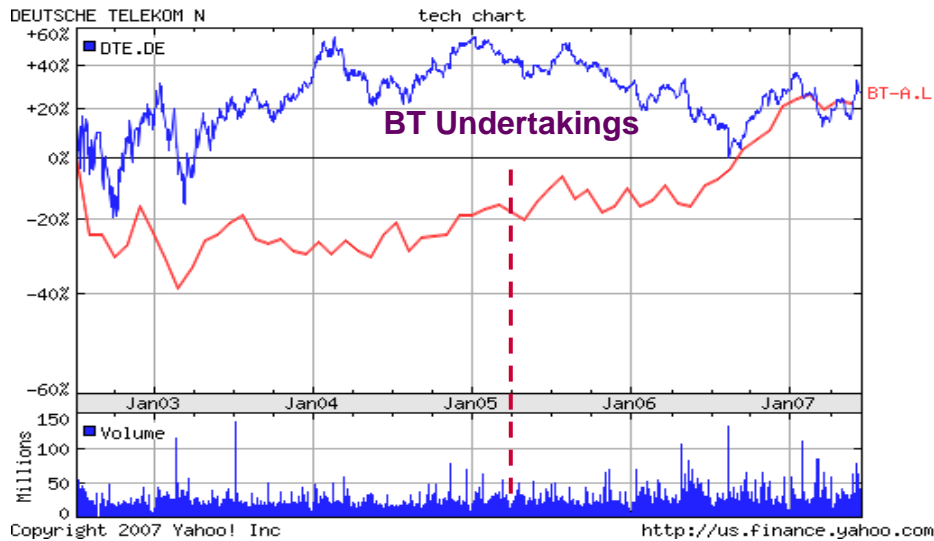
**Equivalence at product level
(‘equivalence of inputs’)**

- Access to same or similar set of regulated wholesale products as BT
- Same product, price, systems, product development processes
- “You build the service. Then we both use it.”

**Functional/operational
separation**

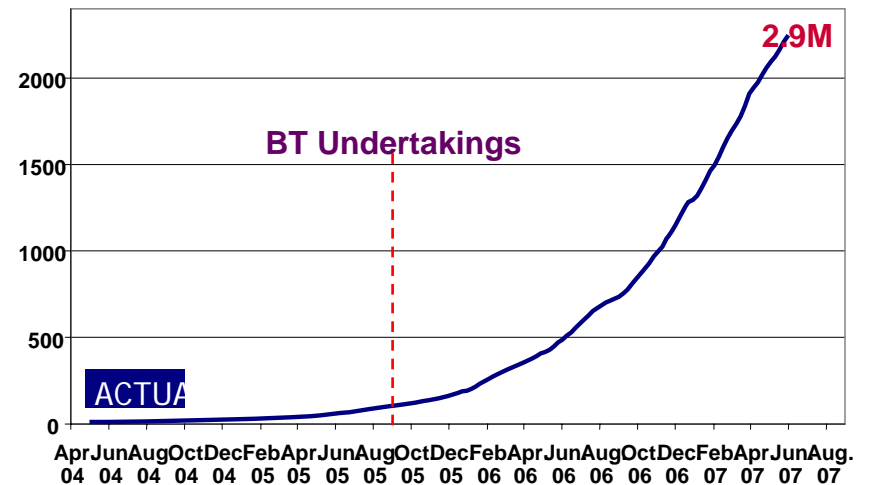
- Functional/operational separation of unit providing bottleneck products
- To address (part of) the incentives and (almost all of) the ability for unfair treatment

Market reactions and investment in new platforms have been encouraging ...



- BT shares stable during TSR and undertakings negotiations
- BT outward-focused strategy seen as successful by markets, after separation
- Creation of Openreach has clarified perceptions but not spooked markets.

Unbundled lines in the UK: actual installed base ('000)



- 30k LLU orders per week from 20+ LLU operators
- New broadband/bundled offers including market entry by pay TV and mobile operators into fixed markets and vice versa
- Process issues (Telecoms Adjudicator)
- Creates a new set of issues about migration

... but ultimately, evaluating success needs to lead back to the customer



Examples

- | | | | |
|--|---|--|---|
| <ul style="list-style-type: none">• Openreach• Equivalence• Governance• Systems• Proven breaches | <ul style="list-style-type: none">• Wholesale product delivery• SORs• BT behaviour• Customer satisfaction• Trust in BT• Openreach branding | <ul style="list-style-type: none">• Numbers of lines (LLU, WLR, etc.)• Investment• NGN interoperability• Merit-based deregulation | <ul style="list-style-type: none">• Retail prices• Quality• Choice and churn• Innovation• Customer satisfaction |
|--|---|--|---|

The **next 12 months will be critical** – with delivery of major new systems and services (eg wholesale line rental III – 30 June 2007)

Functional Separation under a revised EU Framework

- Widespread recognition that such a remedy could be a useful tool to address discriminatory behaviour ...
 - by a dominant vertically integrated operator ...
 - across a range of markets ...
- ... but that such a remedy is currently beyond the scope of NRAs' powers
- FS should only be introduced where appropriate and proportionate
 - details best designed by NRAs (but second pair of eyes in one form or another almost inevitable)
- For effectiveness, need a minimum set of provisions to achieve **real** non-discrimination by a vertically integrated operator who has the incentive and means to favour its own downstream operations, specifically ...

Some of the possible components of Functional Separation

- **Separation of functions:**
 - Creation of separate business unit responsible for the supply of products in question
 - Obligation to supply all operators under non-discrimination conditions (equivalence)
 - Separation of operational support systems (OSS)
- **Separation of the brand of new business unit from rest of the company**
- **Separation of Employees:**
 - Separate Management board, independent of the group (but still able to report to group CEO)
 - Employees are permitted to work for separate business unit only and not in conjunction with any of the company's other affiliates
 - Physically separate offices and places of work
 - Pay incentives: bonuses based on the performance of the business unit and not on overall company performance
 - Code of conduct, notice boards, training
- **Separation of Information:**
 - Limits to the flow of information between of the business unit and the other divisions (firewalls, Chinese walls)
 - Implementation of separate access systems (information specific to the needs of the employee)
 - Separation of management information systems
- **Financial Separation:**
 - Accounting Separation
 - Separate Budgets
 - Financial Autonomy (although strategic financial decisions including major investment programmes still determine on a group basis)
- **Transparency requirements:**
 - Monitoring of compliance with obligations/performance
 - System for reporting breaches (integrated/independent)
 - Independent compliance handing committee
 - Publication of performance indicators (by independent/third party body)
 - Publication of compliance reports (by the regulator or third party)