Functional Separation – The UK ‘Openreach’ model

ANACOM 10th Seminar

Lisbon, 9 November 2007

Alex Blowers
International Director, Ofcom
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:

- Accounting Separation
- Functional Separation
- Structural Separation
- Full Legal Divestiture
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

**Structural Features**
- Market Power
- Vertical Integration

**Incentives to Behave in a non-compliant manner**
- Evidence of factors that make this incentive strong
- Evidence on consultation document, 5 Case Studies (June 2005)

**Conduct**
- Evidence on attempts to use our existing powers (5 Case Studies)
- Evidence on potential harm that might result

**Existing Remedies Ineffective or Inappropriate**
- Evidence on attempts to use our existing powers (5 Case Studies)

**Harm**
- Evidence on potential harm that might result

**Appropriate Remedies**
- 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.

• 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

The next 12 months will be critical – with delivery of major new systems and services (e.g., 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)