



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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Working Party No. 2 on Competition and Regulation

FUNCTIONAL SEPARATION: THE UK EXPERIENCE

-- Presentation by Andrea Coscelli --

14 June 2010

The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its meeting on 14 June 2010.

Please contact Mr. Sean Ennis if you have any questions regarding this document [phone number: +33 1 45 24 96 55 -- E-mail address: sean.ennis@oecd.org].

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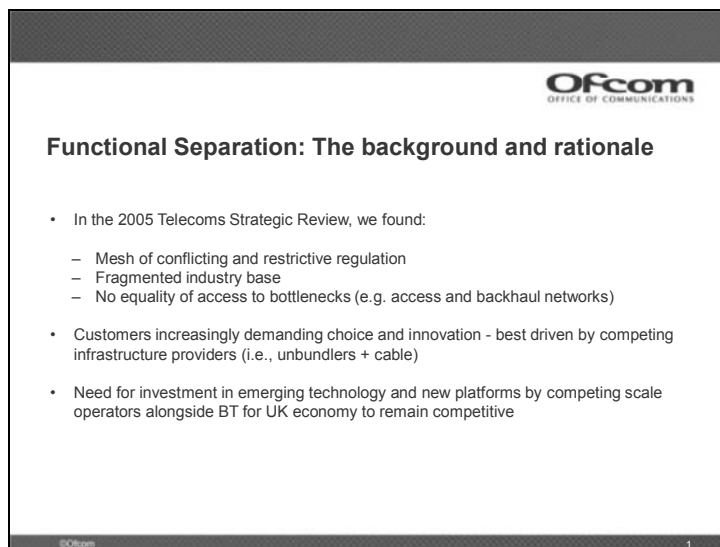
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Functional separation: the UK experience

Andrea Coscelli,
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14 June 2010

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Functional Separation: The background and rationale

- In the 2005 Telecoms Strategic Review, we found:
 - Mesh of conflicting and restrictive regulation
 - Fragmented industry base
 - No equality of access to bottlenecks (e.g. access and backhaul networks)
- Customers increasingly demanding choice and innovation - best driven by competing infrastructure providers (i.e., unbundlers + cable)
- Need for investment in emerging technology and new platforms by competing scale operators alongside BT for UK economy to remain competitive

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Decision to go down the functional separation route

Options consulted on

- **1. Full deregulation**
 - Reliance on EC/UK competition law to resolve issues
 - Option considered unviable by most given BT's market power
- **2. Enterprise Act investigation**
 - Investigation under UK antitrust law that may lead to a referral to the Competition Commission, and could subsequently result in the structural separation of BT
- **3. Real equality of access**
 - Product level equivalence and behavioural and organisational change by BT

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Why Option 3?

- **Support** from **most** stakeholders
- **Flexibility** – enables boundary issues to be revisited even over the medium to long term when significant changes occur
- Process for Option 2 would be **long, fraught** and **uncertain**
- Option 2 carries more **inefficiencies** associated with the loss of vertical integration

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Equality of access

Product-level equivalence

- Equivalence of inputs – BT use same product in its downstream division, price, systems, product development as others
- **Applied to:**
 - certain existing products (Wholesale Line Rental (WLR), Local Loop Unbundling (LLU), Backhaul Ethernet Service (BES), IPStream)
 - certain future access/backhaul products
 - Significant Market Power (SMP) products in 21CN
- **Key dates:**
 - Ready For Service (RFS): available to Altnets; BT use for new customers, start migration
 - Installed Base Migration Complete (IBM)

Organisational change by BT

- Operational separation of unit providing bottleneck products so that incentives to treat all operators including BT equally
- **Openreach**
 - local access and backhaul
 - separate accounts, location, systems, Long Term Incentive Plan (LTIP)
 - brand
 - Chinese Walls
 - independence
- Boundary around product management groups in BT Wholesale reflecting other bottlenecks

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The legal basis of UK functional separation: Undertakings in lieu of market investigation reference to the Competition Commission

Section 131 (1) Enterprise Act 2002
"[Ofcom] may, subject to subsection (4), make a reference to the Commission if it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom."

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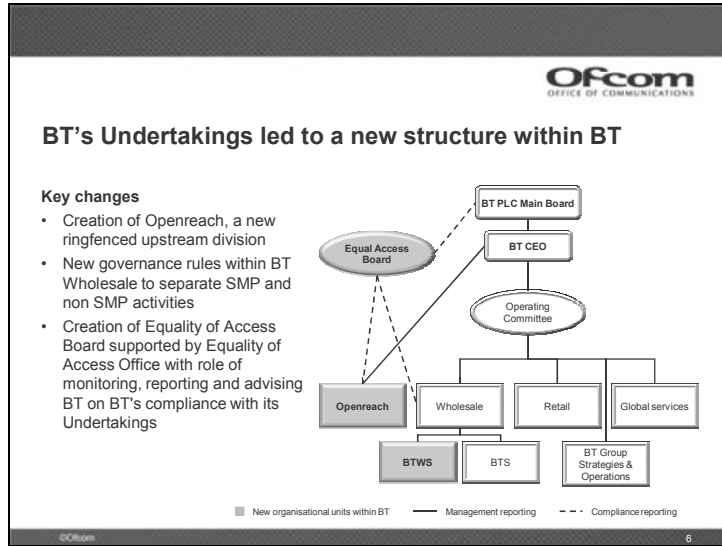
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Operationally compatible with EU Electronic Communications Framework

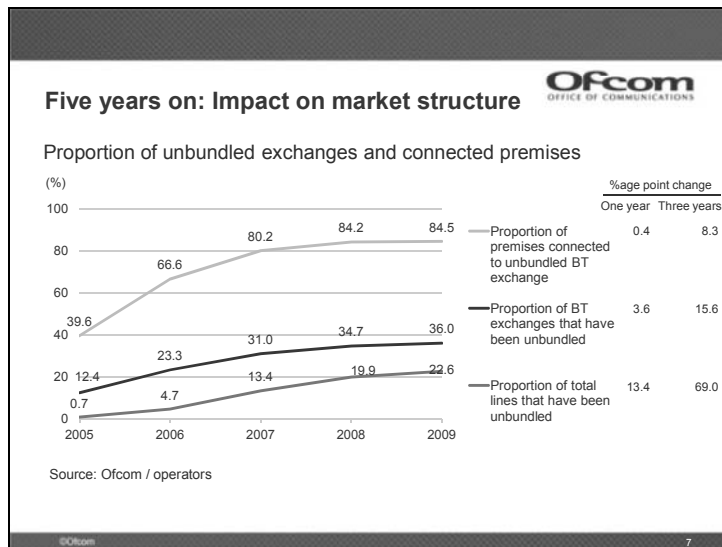
- Doesn't replace market reviews
- Obligations attach to SMP products and
- BT still has to comply with SMP conditions and Article 101 and 102 TFEU

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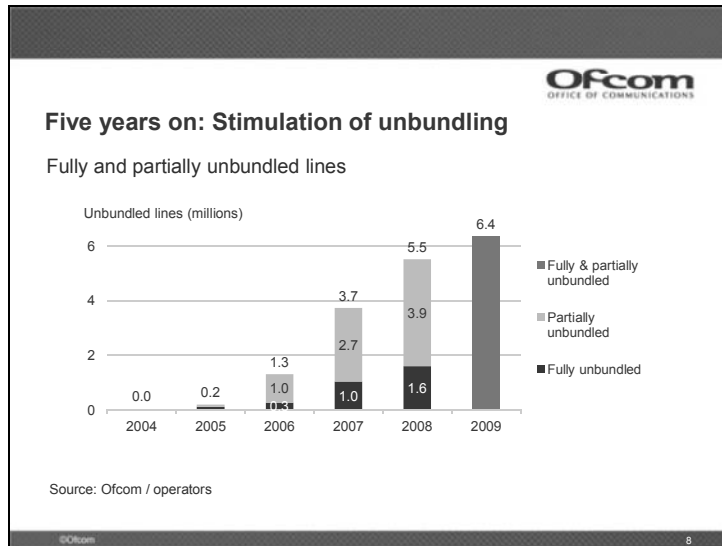
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Five years on: Consumer benefits

A selection of the lowest cost broadband options from major suppliers: May 2010


Provider	Fixed broadband	Mobile broadband	Fixed broadband and fixed phone	Fixed broadband, fixed phone and TV	Fixed broadband, fixed phone, TV & mobile phone
AOL	£14.99	-	£12.99	-	-
Be	£13.79	-	-	-	-
BSkyB	-	-	-	£23.00	-
BT	£15.99	-	£14.49	£28.99	-
O2	£12.50	£10.00	£22.00	-	-
Orange	£12.00	£10.00	£10.00	-	-
Plus.net	£6.49	-	£6.49	-	-
TalkTalk	-	-	£6.99	-	-
Tesco	-	-	£8.00	-	-
Virgin Media	£20.00	£10.00	£12.50	£14.00	£28.00

Source: Pure Pricing, UK Broadband Pricing Factbook May 2010
 Notes: The lowest cost option that provides speeds of 8mb and above is reported, all prices **exclude** line rental (for BT lines this is £11.54 per month). Also excluded are activation charges and promotional discounts. Alongside this, allowances for fixed-line and mobile calls, download limits, plus availability of TV channels included within packages may differ by operator and option

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Changes have allowed significant deregulation in downstream markets




- No SMP for BT in fixed retail voice hence retail deregulation (September 2009)
- Proposal of no SMP for BT in retail ISDN 30 (April 2010)
- Replicability review for retail leased lines (ongoing consultation to allow BT to offer bespoke prices above an agreed floor at the retail level)
- In 2008, significant wholesale deregulation:
 - in wholesale broadband access within certain sub-national geographic markets (i.e. those areas covered by BT exchanges where there are four or more operators thanks to LLU take-up), i.e. ~70% of the UK
 - wholesale Ethernet terminating segments above 1 Gbit/s; and
 - some geographies (the newly defined Central and East London Area) for 34/45 Mbit/s and 155 Mbit/s Partial Private Circuits (PPCs).

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The evolution of 'The Undertakings' – early years



Key challenges in the implementation of the Undertakings since inception

- Concerns about service quality in some areas
- Some products delivered late or to a lower specification than originally anticipated
- Openreach's approach to consultation needed improvement
- Criticism by industry of OR being insufficiently commercial and too compliance focused
- Industry uncertainty over BT's NGN products / plans causing concern
- Information systems separation has proven extremely challenging
- Issues of flexibility

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As a result Ofcom has had to intervene to secure additional commitments from BT and several variations to the undertakings have been consulted on

- Ofcom outlined a new approach for Openreach service level agreements and compensation [in 2007]
- New commitments from BT on:
 - process for space and power allocation
 - NGN consultation and advance notification
 - Product development process
- Re-prioritising BT's remaining Undertakings commitments on information systems separation

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Current issues - UK functional separation and NGA

Focus of 2005 Undertakings was on copper-based consumer market products and on business fibre products – reflecting then market demands

- UK market now moving rapidly to deploy fibre access products for consumers and SMEs:
 - Virgin Media has just completed super-fast broadband rollout throughout its network footprint;
 - BT has announced plans for NGA rollout to 66% of UK premises by 2015;
 - Strong expressions of interest from competing CPs in wholesale NGA products to be supplied by Openreach.
- The Undertakings made no explicit provision for next generation access (NGA). We are varying Undertakings to allow Openreach to provide wholesale FTTC and FTTH products.
- We are currently discussing potential wholesale access remedies in the context of our Wholesale Local Access Market Review (see next slide)

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WLA – specific access remedies proposed for BT

	FTTC	FTTP
↓ Less cost ↑ More innovation	Allows competitors to independently deploy SLU ¹	PIA ²
	Deployment depends on BT investing first/also Sharing BT's FTTC infrastructure is also an option, if possible/reasonable	Fibre access could be requested under the general remedies
	Common remedy (technology neutral) Active remedy: VULA	

- For current generation, exchange based deployments, LLU will continue to be the primary remedy

¹ BT has been required to offer SLU since Jan 2001
² Could also be used for SLU backhaul

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Lessons from UK experience to date (I)

- Functional separation – along with other important regulatory changes – has secured substantial improvements in the overall performance of the UK fixed telecoms market for consumers
- Equivalence of Inputs (“EOI”) is key – no need for functional separation for it
- It has also allowed significant deregulation of markets
- The belief that FS has held back investment in the UK market is misconceived (early days, strong satellite and DTT in UK market, geography, more limited role of the state)
- In other areas, the Undertakings have required modification and revision, but the basic principles remain sound (e.g., poor quality products in early years because of organisational change)
- FS complements rather than replaces SMP regulation under the Framework. Properly applied it can make Framework remedies work much more effectively.

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Lessons from UK experience to date (II)

- Technological change in telecoms means it is difficult to compare telecoms with other vertically-integrated industries (where you draw the line changes as the technology evolves)
- The Undertakings now need to evolve as the wholesale market gravitates to NGA products
- Functional separation, internal governance, effective monitoring and enforcement – complex mix of ingredients
- There is a continuum of market power in telecoms – SMP access remedies on parts of BT that sit outside Openreach
- Litmus test is investor confidence to support competing providers with significant sunk investments – this is the reason why Talk Talk, Sky, Orange, O2, Tiscali and others have spent significant sums in recent years and significantly contributed to competition in the industry

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Lessons from UK experience to date (III)

- Significant cost and complexity of system separation was probably underestimated at the outset (cost minimised though by linking it to product upgrade cycles). Need for Ofcom to intervene to increase contract penalties to increase incentive on Openreach to deliver higher quality products.
- Parallel equivalence vs. EOI (e.g., shared LLU vs. full LLU)
- System separation for business products still quite low compared to residential products
- For new products trade-off between share of the value chain open to competitors vs. loss of vertical synergies for Openreach (empirical issue)
- Regulatory regime obviously has an impact on the costs (and benefits) of new product design and this obviously has an effect on incentives to invest. This is the main issue we are focussing on at the moment.

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