Three forms of BT Separation: Objectives, solutions and effects

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KEYWORDS: Vertical integration, separation, telecoms, investment, discrimination.

BACKGROUND

- In 2015, the UK telecoms regulator, Ofcom, launched a Strategic Review of Digital Communications (DCR).
- Ofcom concluded that the vertically integrated structure of BT (a British telecoms company) gives it the incentive and ability to discriminate against its retail (downstream) rivals who are dependent on BT's access network.
- Ofcom regards the current remedy of "functional separation" as sufficient to prevent discrimination at an operational level, but it also sees BT as having the power to make key investment decisions in its own interests only.
- To help deter this, Ofcom has proposed that BT's Openreach (its access services division) should be established as a separate subsidiary under BT, with an obligation to 'treat all customers equally' written into its Articles of Association (legal separation).
- BT has responded with a counter-proposal for what it calls "enhanced functional separation".
- Ofcom also believes that BT's current structure does not afford it the incentive to invest in super-fast broadband provided by fibre to the home (FttH). It considers that its proposal will give Openreach more freedom to invest in FttH and so ensure more UK consumers have higher speed broadband access.

METHODOLOGY

- This paper compares and contrasts the three remedies: functional separation, enhanced functional separation and legal separation across a number of key parameters. The objective of this comparison is to determine how different they are in practice.
- The paper then looks at whether further separation of Openreach would affect its incentives to invest in pushing fibre closer to consumer premises, assuming that any firm seeking to invest will only do so if it expects to make a return in excess of its cost of capital. Where the firm has a choice of products, it will choose the one that it expects to deliver the higher profit.
- However, where a firm is vertically integrated with market power upstream, it may act strategically and choose an investment that might result in a lower profit but also harms its downstream rivals.

KEY FINDINGS

- The paper finds that whilst differences exist between legal and enhanced functional separation, in particular the status of Openreach as a legal entity, these are mostly differences of style rather than substance.
- Under both proposals, Openreach would be required to (i) treat all customers equally, (ii) have a similar governance system, and (iii) have a significant degree of financial autonomy.

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- The paper also finds that the structure of BT is unlikely to affect investment incentives and so is sceptical that either form of separation would necessarily increase investment in fibre broadband.

POLICY ISSUES

- When considering the structure of a vertically integrated firm with upstream market power facing downstream competition, the substance of the separation is more important than the method.
- The degree of separation of a vertically integrated firm is unlikely to affect investment decisions if the basic incentive for investment (an expected return greater than the cost of capital) is not present.
- An obligation to treat all customers equally may change the vertically integrated firm's choice of investment project, but only if the basic condition for investment is present.
- There is no reason to expect a separated Openreach to seek new models of investment unless it has unconstrained access to capital.

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