

# Functional separation: what we can learn from the British experience

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The objective of functional separation is to create a virtual company within an integrated operator, with responsibility for managing access to certain resources. In the United Kingdom, BT has set up an entity of this type, known as Openreach, to control the British incumbent's access and backhaul networks. These are network elements over which BT is likely to retain its dominant position for some time to come. New investment in fibre access networks (FTTx) will be made through Openreach. This business unit treats other divisions of BT as customers and applies the same conditions to these internal customers as it applies to third party operators. All procedures, including the information systems, production systems and

the employee pay structure, are designed to ensure non discriminatory treatment of the group's external and internal customers. Compliance with the non discrimination obligation is monitored by the Equality of Access Board, which reports to the BT Board of Directors. Openreach will also present separate financial statements.

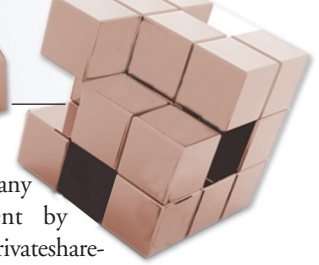
## Separation with a view to reducing the need for regulation

The Openreach system was not imposed by the British regulator Ofcom as part of the remedies established following the market analyses, but rather as a result of bilateral negotiations leading to a series of Undertakings by the incumbent operator. This was in BT's interests,



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because functional separation will, in theory, lead to speedier deregulation of its other operations, allowing it more room for manoeuvre on its retail markets. The British incumbent considers that if the conditions of access to the "built-



ding blocks” of the network are the same for everyone, and this equivalence is both verifiable and verified, then the regulator will be able to concentrate on that part of BT and relax its control over the group’s other operations. By creating a situation where the group’s behaviour in the upstream market is deemed to be irreproachable, BT hopes to be able to gain greater freedom of action in the downstream markets.

This view is not shared by all incumbent operators. France Télécom considers that the Openreach system creates inefficiencies, leading to a general reduction in quality of service for all operators. The French incumbent operator also rejects the idea that it is possible to draw a clear boundary around the infrastructure and services to be managed by the Openreach business unit. Its view is that any demarcation will quickly become outdated because of the rapid development in networks and services. Many of these objections come down to the conclusion that functional separation would not be a proportionate remedy, that the costs of the remedy would exceed the expected benefits.

Even if functional separation were explicitly mentioned in the European Access Directive and the French Post and Electronic Communications Code, the regulator could not impose this solution unless the remedy passed the proportionality test.

In France, the proportionality of a remedy such as this would depend on the market to which it applies. In the residential broadband market, it is possible that the operational procedures already implemented by France Télécom are sufficient to achieve a satisfactory level of non discrimination, whereas in other markets, such as the wholesale bitstream market for instance, the level of non discrimination is still unacceptable. Consequently, functional separation would be appropriate for the bitstream market, but not necessarily for the residential broadband market.

## Encouraging a culture of non-discrimination

One of the lessons from the Openreach experience is that non discrimination is not simply a matter of compliance with a series of detailed non discrimination rules, but involves the creation of a true culture of non discrimination among all the personnel responsible for managing access to shared resources. Without such a culture, any detailed non discrimination rules imposed by the regulator will remain a dead letter and some form of functional separation will become necessary.

In France, a culture of non discrimination is creeping into France Télécom. Alternative operators sometimes say that France Télécom “has understood” non discrimination for

certain services, and that for those services France Télécom is implementing truly non discriminatory procedures with respect to third party operators. In the case of other services or markets, however, alternative operators complain of systematic discrimination, despite the existence of detailed non discrimination rules. In these markets, the non discrimination rules are inadequate because they are not backed by a culture of non discrimination. In such circumstances, functional separation would be a proportionate remedy.

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## Preserving investment incentives

In addition to proportionality, the functional separation remedy would also need to satisfy the criterion of encouraging efficient investment in networks and innovative services. Some people say that functional separation removes incentive for investment, citing the example of French “cable plan” in the 1980’s, generally considered a failed experiment in separating network ownership from operation. This same line of argument has been advanced with respect to all the remedies imposed on France Télécom with regard to its optical fibres or new services. Some feel that any access remedies on new infrastructure will kill investment.

ARCEP’s approach across markets has been to impose remedies which preserve investment incentives. The regulator has, in certain cases, abandoned the concept of cost-oriented pricing in favour of a concept of “non-excessive” pricing, which allows a greater return on investment in order to compensate for the risk incurred. This same pro-investment approach can be transposed to the remedy of functional separation. Some investment banks even go as far as to say that functional separation would encourage investment in new optical fibre networks. The incumbent’s separate business unit is regarded by the financial market as having the characteristics of a utility, allowing a higher gearing ratio and more attractive financing opportunities.

The investment bank J.P. Morgan goes even further. In its view, an incumbent operator which rolls out a major programme of investment in optical fibre within the framework of a functional separation scheme such as Openreach has every chance of receiving the blessing of the authorities, allowing it to become the only FTTx operator on the market

and discouraging any parallel investment by other public or private shareholders. By adopting a functional separation solution for new investment in fibre networks, the incumbent can gain credibility as a “neutral” operator and thus pre-empt this new market. The bank adds that this stratagem would have little chance of succeeding in France, given the active efforts of the regulator and the government to establish shared optical fibre networks outside the ambit of France

Télécom. In other countries, however, the bank sees functional separation as a tool which could facilitate the creation of a new fibre monopoly. This is the “dark side” of structural separation.

## Finding a legal basis

Is it necessary for EC directives to be amended before ARCEP can impose functional separation? The regulator has already imposed several measures that resemble functional separation in the context of non discrimination remedies. Its decision on accounting separation requires France Télécom to establish internal protocols to ensure that the operator uses the same inputs as its competitors when developing its retail services. Unfortunately, the internal protocols that France Télécom is required to put into place are not published, which makes this measure less effective in terms of creating a culture of non discrimination recognised by the market. One of the benefits of functional separation is to create a verifiable culture of non discrimination which can be recognised as such by other players on the market, and will in turn create a certain degree of confidence in, and deregulation of, the incumbent.

Imposing functional separation of the Openreach type in France would probably require a more specific legal basis than that provided by the current provisions of the Access Directive and the French Post and Electronic Communications Code. It was probably in order to remove any ambiguity on this point that the Chair of the European Regulators Group (ERG) called, on 12 October 2006, for a revised Access Directive to specifically mention this remedy. If functional separation were explicitly provided for in the EC Directives and national law, it could be examined in the ERG’s Remedies Paper and thus gain in legitimacy. The regulator would then find it easier to bring this subject up with the incumbent operator, perhaps within the scope of wider dialogue about the deregulation of the operator’s other operations. ■