BT Separation: The end of a beautiful relationship?

- **Ofcom has proposed that BT's Openreach division should be a separate company within the BT Group**
- **BT has put forward a counter proposal for "Enhanced Functional Separation"**
- **How different are the two proposals in practice and would they affect BT's investment incentives differently?**

In July 2016 Ofcom, the UK's regulator for electronic communications markets, proposed that BT's Openreach division should become a legally separate company within the BT Group, but this has been resisted by the company[i]. In response, Ofcom has announced that it plans to refer its plans to the European Commission[ii] to force through the changes. Its proposal follows from its Strategic Review of Digital Communications (DCR) launched in March 2015[iii]. In that review Ofcom concluded that, although the current "functional separation" model worked well in deterring operational discrimination by BT against retail competitors that relied on its network, BT was still able to make strategic discrimination choices by designing the network to suit its own purposes. Ofcom was also concerned about the lack of fibre based broadband to residential customers. This edition of Hexagon expresses scepticism that Ofcom's approach will achieve anything more than BT's own proposals.

In July 2016 Ofcom set forward its proposal that Openreach, the BT division offering access services to other communications providers (CPs), should become a legally separate company within the BT Group, with various constraints on its behaviour built into its Articles of Association. This is a form of vertical organisation known as 'legal separation". BT set forward its own proposal for what it called Enhanced Functional Separation (EFS): a greater degree of independence for Openreach, but retaining it as division, rather than a subsidiary, of BT.

The two proposals have much in common, but also have some important differences, highlighted in the table overleaf.

The key difference is the organisation form. Ofcom believes that having Openreach as a separate legal entity within the BT Group will enhance its independence and therefore its willingness to treat all customers equally. The second major difference is the level of approval needed by the BT Group Board for Openreach's investment plans and operating budget.

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Features of Enhanced Functional Separation only	Features common to Enhanced Functional Separation and Legal Separation	Features of Legal Separation only
• Openreach a division of BT • Medium Term Plan and Annual Operating Plan approved by BT Group CEO and CFO • Branding linked to BT's	• Equal treatment imposed through Articles of Association • Oversight by Openreach Board • Openreach Board composition • Consultation process with customers	• Openreach a subsidiary of BT • Employees of Openreach Ltd • Openreach Ltd ownership of assets • Financial envelope granted by BT Group • Separate branding

However, there appears to be very little difference in the governance structures. Both proposals envisage a similarly structured Openreach Board and both impose on Openreach an obligation to treat all customers equally. In Ofcom's proposal this is through the Articles of Association of Openreach, whilst in BT's proposal it is through those of the BT Group.

The differences are important, but would legal separation change BT's and Openreach's behaviour to the degree desired by Ofcom, compared with enhanced functional separation?

One of Ofcom's main objectives arising from the DCR is to increase the number of fibre to the premises (FTTP) connections so that more consumers can have access to "ultrafast" broadband. Their expectation is that freedom from BT's control, and an obligation to treat all customers equally, will incentivise Openreach to make such an investment. But would this be the case?

We can assume that any firm would only invest, in this case in a major network upgrade, if it expected to earn an economic profit, i.e. a return greater than the cost of capital. A vertically integrated firm (VIF) with market power upstream and competition downstream may behave slightly differently to conventional firm. It may choose an investment that is likely to deliver a lower return in the short term, but favours its own downstream business sufficiently that its rivals are excluded from the market in the longer term.

However, if that firm is under an obligation to treat all customers equally (as proposed by both BT and Ofcom) its behaviour may change again, as it would be required always to choose an option that does not favour its own downstream business.

An optimistic supporter of such a requirement may expect that the VIF would always comply with the requirement and so not be in breach of the obligation. A more pessimistic view is that the VIF would first and foremost act in the interests of its shareholders. It may, therefore, persuade the regulator to allow it to make an investment that favours itself. Any alternative would breach its obligations to shareholders, many of which are pension funds.

Co-investment would share rewards as well as risks. Would that be necessary for firm with strong access to capital?

Ofcom also believes that its proposals will open up opportunities for new forms of investment in FTTP. This has widely been assumed to include some form of risk sharing or co-investment between Openreach and its wholesale customers.

However, risk sharing also means reward sharing and so is not cost free. As a general rule, investors are willing to share those rewards if they are capital constrained and simply do not have, or cannot get access to, sufficient capital to make the investment by themselves. If the return on a particular investment is likely to be positive and the firm has access to the capital required, it would be rational not to share the rewards. Given the size of BT, and its position as one of the largest UK companies by market capitalisation, it is unlikely to be severely capital constrained. Thus we might expect that BT Openreach would prefer to invest in a commercially viable project by itself. If the project were not commercially viable, there would be no good reason to invest in it either by itself or jointly with others.

In conclusion, would investment be any more likely under Ofcom's than BT's proposal? It is not obvious why that would be the case. The Ofcom model may grant Openreach somewhat more independence than the BT proposal, but it does not affect the fundamental conditions under which any firm would invest. The relationship between Openreach and the rest of BT will not affect market demand, cost conditions or the risk associated with any investment. The return Openreach would achieve on any investment and the cost of capital are likely to be unaffected by the structure of BT. So there are no fundamental changes in the investment incentives. For these reasons we are sceptical that Ofcom's proposals would do any more to incentivise investment in FTTP than BT's own.

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[i] Ofcom (2016) '*Making Communications Work for Everyone: Initial Conclusions from the Strategic Review of Digital Communications*' February 2016

[ii] Ofcom letter to Vice President Andrus Ansip and Commissioner Oettinger, 28 November 2016

[iii] Ofcom (2015) '*Strategic Review of Digital Communications: Discussion Document*' March 2015

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