

Organisational Separation and Structural Separation - key issues

Final report for the MED, 11 April 2006

Network Strategies Report Number 25050

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1 Executive summary

Network Strategies has been requested by the MED to prepare a report on the key issues regarding operational separation (OS) and structural separation (SS). This report addresses the MED's request.

OS and SS both refer to models of splitting organisations into separate functionally independent business units. However, the difference between OS and SS is that under the former the new business units remain under the ownership of the un-separated organisation, whereas under SS the new business units are sold to new owners.

Arguments for OS and SS are that they remove behavioural obstacles to competition, resulting in increased competition and innovation. Arguments against OS and SS include cost and possible reduced opportunities for infrastructure based competition. During the investigation into SS of Telstra in 2003, Telstra estimated a one-off cost of approximately GBP 1 billion. This is very high relative to BT's stated actual minimum OS cost¹ of GBP 70 million, especially when considering its relatively low staff and subscriber numbers versus those of BT.

Network Strategies believes that OS and SS will discourage investment in alternative access technologies such as WiMax and Ethernet in the short-term because:

- OS and SS will encourage telecommunications service providers (TSPs) to take up the incumbent TO's wholesale access network services, particularly LLU
- OS and SS will result in increased competition in the wholesale telecommunications market due to TSPs repackaging the incumbent's wholesale access network services.

¹ BT (2005). *Second quarter and half year results to September 30, 2005*. 10 November 2005.

2 What are organisational separation (OS) and structural separation (SS)?

Organisational separation (OS) and structural separation (SS) both refer to models of splitting organisations into separate functionally independent business units. However, the difference between OS and SS is that under the former the new business units remain under the ownership of the un-separated organisation, whereas under SS the new business units are sold to new owners.

OS and SS require that new business units:

- have their own management, location and information systems, and operate as independent profit centres with specific objectives and remuneration incentives
- deal with all upstream customers on a non-discriminatory and arms-length basis, including transparent pricing arrangements as well as separate invoicing and billing
- maintain fully separate accounts and reporting systems, capable of capturing all transactions between the businesses.

3 What is the purpose of OS and SS?

The main purpose of OS and SS is to structure an organisation so as to remove behavioural obstacles to competition. For example, where the incumbent's access network is determined to be a scarce resource and a barrier to competition in upstream markets OS and SS would result in the creation of a new access network business unit. This business unit would ensure that access network services (such as LLU) are provided to all upstream telecommunications services providers (TSPs) on an equal basis.

4 Arguments for and against OS and SS

The arguments for OS and SS are that they remove behavioural obstacles to competition, resulting in increased competition and innovation. Arguments against OS and SS include:

- cost

- complexity
- loss of efficiency and therefore the possibility of increased prices
- difficult to determine where the split should be made in a vertically integrated firm
- time-consuming
- the possibility of losing shareholder value
- possible reduced opportunities for innovation in the separated companies
- possible reduced opportunities for infrastructure based competition.

5 Costs of implementing OS and SS

Implementation costs are incurred in areas including:

- branding (stationary, vehicles etc)
- buildings
- communications (advertising, PR/media relations, website etc)
- financial and management reporting systems
- hardware and software
- information systems
- legal
- office equipment
- recruitment
- transition planning.

During the investigation into SS of Telstra in 2003, Telstra estimated a one-off cost of SS in ‘the order of \$2 billion’, including the development of duplicate back end operating systems to enable SS costing “in the order of \$400 to \$500 million”². In addition Telstra estimated that there would be additional operating costs of \$80 million per annum. These sums are similar to those estimated by incumbents in the US for structural separation of components of their businesses.

² Telstra Submission no. 59 to the Telstra Inquiry, Jan 2003.

Telstra's SS cost estimate of approximately GBP 1 billion is very high relative to BT's stated actual minimum OS cost³ of GBP 70 million, especially when considering its relatively low staff and subscriber numbers versus those of BT:

A provision of £70 million has been recognised in the quarter relating to the incremental and directly attributable costs to create a new line of business, called Openreach, required under the legal undertakings agreed with Ofcom. There will also be capital expenditure required to deliver equivalent systems and processes, a significant element of which will be absorbed within existing capital programmes.

The Telstra estimate probably assumes a worst case scenario, but costs for duplicate operating systems, systems integration and additional operating costs in New Zealand are likely to be significant.

6 How could OS and SS affect competition?

OS and SS affect the incentive structure of incumbent TOs so as to ensure that access seekers are treated no differently from the incumbent TO's upstream business units, resulting in increased sales of local loop services to all TSPs. As such Network Strategies believes that in the short term OS and SS would encourage TSPs to take up the incumbent TO's wholesale access network services, particularly LLU, discouraging investment in alternative access technologies such as WiMax and Ethernet. This situation would be exacerbated if all TSPs were offered access to fibre loops on an equal basis. In the absence of fibre loop unbundling we would expect TSPs to construct their own high bandwidth access networks to compete with the incumbent's NGN.

Network Strategies also believes that OS and SS will result in increased competition in the wholesale telecommunications market due to TSPs repackaging the incumbent's wholesale access network services. This situation would act as a further disincentive for TSPs to build their own access networks.

³ BT (2005). *Second quarter and half year results to September 30, 2005*. 10 November 2005.

7 Overseas experience – Australia and the UK

7.1 Australia – Telstra⁴

The Australian Government is currently developing an OS model for Telstra's internal structure. The OS plan has the following key objectives:

- To provide separate retail, wholesale and key network business units, in separate premises and staff incentive programs to ensure equivalence.
- Equivalence between the internal wholesale price faced by Telstra's retail business units and the wholesale prices paid by Telstra's competitors for designated services.
- Equivalent standards of service to be provided by Telstra to its retail business units and its wholesale customers, with published internal contracts to set out the conditions upon which Telstra support units provide services to its wholesale and retail business units.
- Sensitive wholesale customer information to be kept confidential and inaccessible to Telstra's retail business units.
- Improved service quality and information to Telstra's wholesale customers, including regular reviews, information on network deployment, a wholesale service improvement plan and reporting on access to Telstra's exchanges.
- Establishment of a Director of Equivalence within Telstra to monitor and report to the Board on Telstra's performance against its operational separation obligations. This monitoring will be backed by an external audit of Telstra's compliance.
- An annual compliance report will be presented by Telstra to Government setting out details of its compliance. This report will include the external auditor's report.

OS is being implemented through an amendment to Telstra's existing licence condition. Compliance with OS will be enforceable by the ACCC and the Minister for Communications, Information Technology and the Arts.

⁴ DCITA (2006). *Operational separation*. Available at www.dcita.gov.au.

7.2 UK – BT⁵

Rather than risk enforced SS in the future BT went through a process of OS, creating an Access Services Division (ASD) branded Openreach which commenced operations on 1 January 2006. It also created:

an ‘Equality of Access Board [EAB]... to monitor, report and advise on BT’s compliance with the undertakings with a special focus on equivalence of input and the operation of Openreach.

Openreach’s and EAB’s places within BT’s new organisational structure are illustrated in Exhibit 1 below.

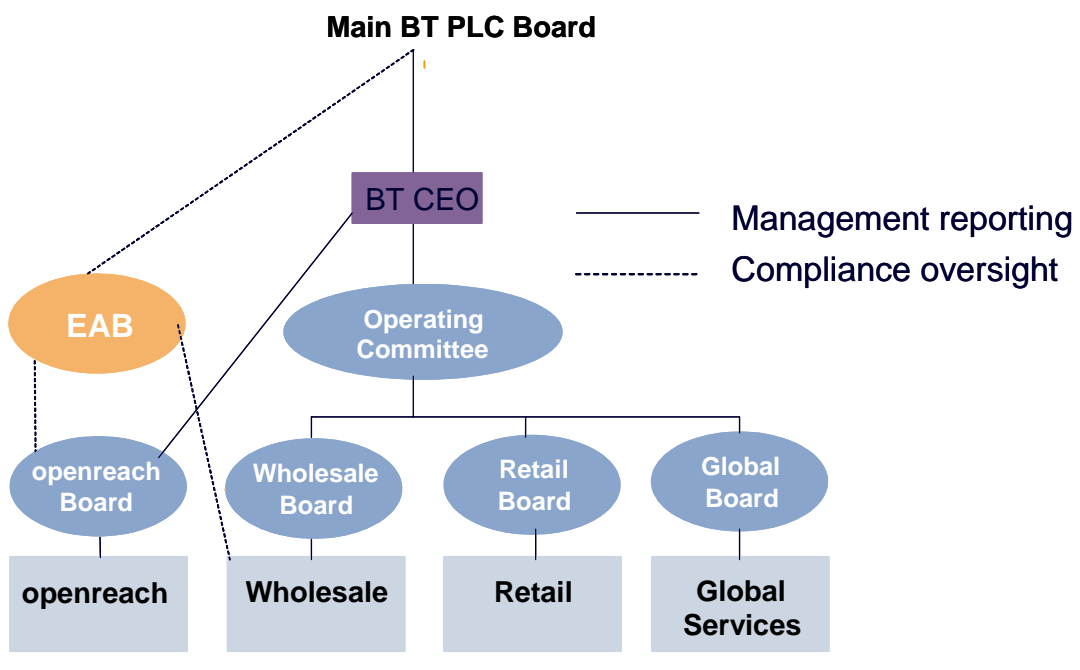


Exhibit 1: BT’s new organisational structure [Source: BT]

Openreach is subject to a high degree of OS with:

⁵ Openreach (2005). *A new era of regulation*. 22 September 2005. Available at www.btplc.com.

- delegation of authority
- separate disclosure of results
- no group element to pay plans
- HQ team in separate accommodation
- separate operational support systems (logical end 2007, physical end 2010)
- code of practice specific guidance for Openreach
- rules about sharing information with all Communications Providers
- its own identity.

Openreach currently offers the following products:

- Wholesale Line Rental – analogue, ISDN2 and ISDN30
- Local Loop Unbundling – full and shared
- Number Portability
- Wholesale Extension Service
- Backhaul Extension Service.

The products are provided to all upstream TSPs on the basis of the same:

- timescales, terms and conditions (including price)
- systems and processes
- reliability and performance
- commercial information.

Openreach operates a ‘Chinese Walls’ policy as illustrated in Exhibit 2 below.

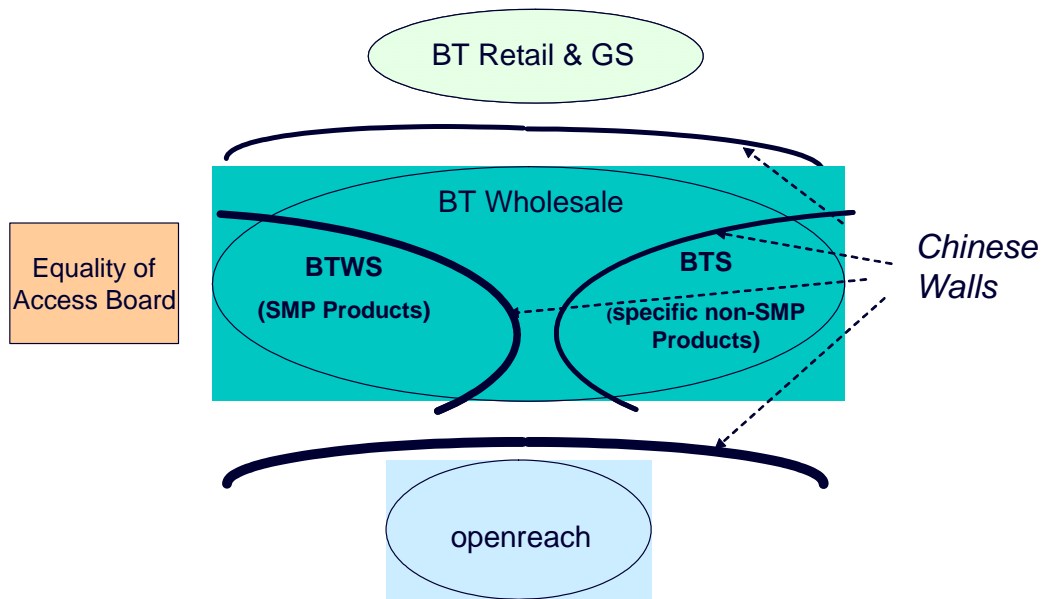


Exhibit 2: 'Chinese walls' within BT [Source: BT]

The 'Chinese Walls' policy requires that:

- no-one in BT outside Openreach influence Openreach Commercial Policy
- no-one in BT outside Openreach have access to Openreach Commercial Information
- Openreach not disclose its Customer Confidential Information to other BT businesses
- no-one employed in Openreach at the same time work for another BT business.