

Functional Separation: Why BT Welcomes Functional Separation in the UK



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Agenda

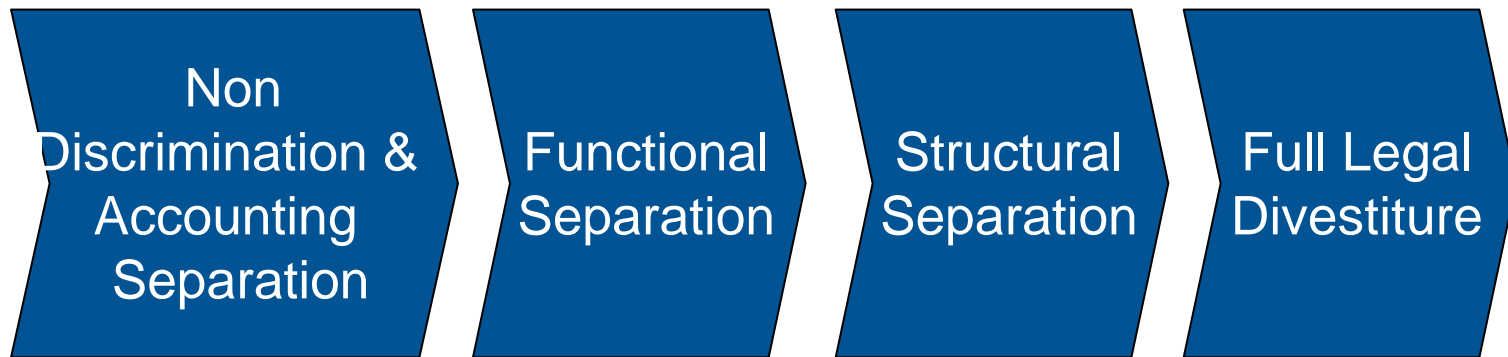
- Why regulate?
- Functional Separation
- BT's Experience

Why regulate?

Why should access be made available ?

- Competition for provision of services will reduce prices and drive up quality
- Innovation and investment will only flourish where markets have been opened to competition
 - ICT is good for jobs and national economies
- The solution needs to be forward looking
 - Monopolists will not innovate as there is no incentive to take risk
 - Appropriate return for investment is the key issue
- NRAs need to consider all markets
 - Residential and business are not the same
- Ex-post competition law vs e-ante regulation
 - Courts can tell you what is wrong, not what is right
 - Certainty, speed of resolution,

Options



Accounting Separation

The separation of a vertically integrated company's financial position into upstream (wholesale) and downstream (retail) reported divisions

- Can be used to demonstrate:
 - cost orientation of wholesale and retail prices
 - non discrimination in the internal sales of wholesale products
 - retail prices set so as to avoid margin squeeze / exclusionary pricing
- Requires transparency of:
 - results of up and downstream divisions
 - internal transfer prices and products used
 - methodologies used for costing
- Provided to NRA and preferably all parties through publication with independent audit for greater confidence
- Linked to cost accounting for:
 - pricing of products
 - cost causality
 - margin squeeze type tests : actuals inform forecasts
- Operators with market power still have the incentive and opportunity to discriminate on services, processes and Information.

Functional Separation

- The separation of a vertically integrated company into upstream and downstream units:
 - separation of unit that controls enduring bottleneck
 - arm's length relationships with downstream units
 - separate incentives for staff on unit not group performance
 - non discrimination in the internal use of wholesale products
 - internal trading at same price
 - use same processes as third parties
 - requires transparency of:
 - results of up and downstream divisions
 - internal transfer prices and products used
 - rules and enforcement processes
- Does not require legal separation:
 - reinforced with strong supervision
 - legal remedies for significant breaches

Structural separation

- If functional separation is a good idea why not remove all temptation to discriminate and separate the bottleneck assets from the vertically integrated entity?
 - separation into a separate legal entity?
 - change ownership?
- Does not address the problem of SMP as it recreates a monopoly with
 - Fewer incentives to invest and / or innovate
 - An enduring need for regulation
- Practical issues
 - Disruptive at time of technology change?
 - Shared assets lower costs?
 - Boundaries may evolve over time, with emerging competition or through technological change?
 - Incentive for companies to “creep” into other space?

Ofcom's view in the UK

- Competition is restricted in wholesale markets for access and backhaul services
- BT has substantial wholesale market power
- and is a vertically integrated provider with a presence in the directly related retail markets

*“This combination gives BT the **ability and the incentive to discriminate** against its downstream competitors who are also wholesale customers.”*

Equivalence of input

- All services falling within the scope of Openreach will be offered to all on equal terms – *Equality of Input (EoI)*.
 - EoI is the key concept of Openreach
 - EoI is more than *non discrimination*.
 - EoI means: *same* ordering system, *same* ability to influence, *same* prices, terms & conditions, *same* services and *same* access to commercial information.
 - It will guarantee *equal access* to the ‘economic bottleneck’ and drive further downstream competition in the UK.
 - It will focus the regulation where it is needed

Openreach

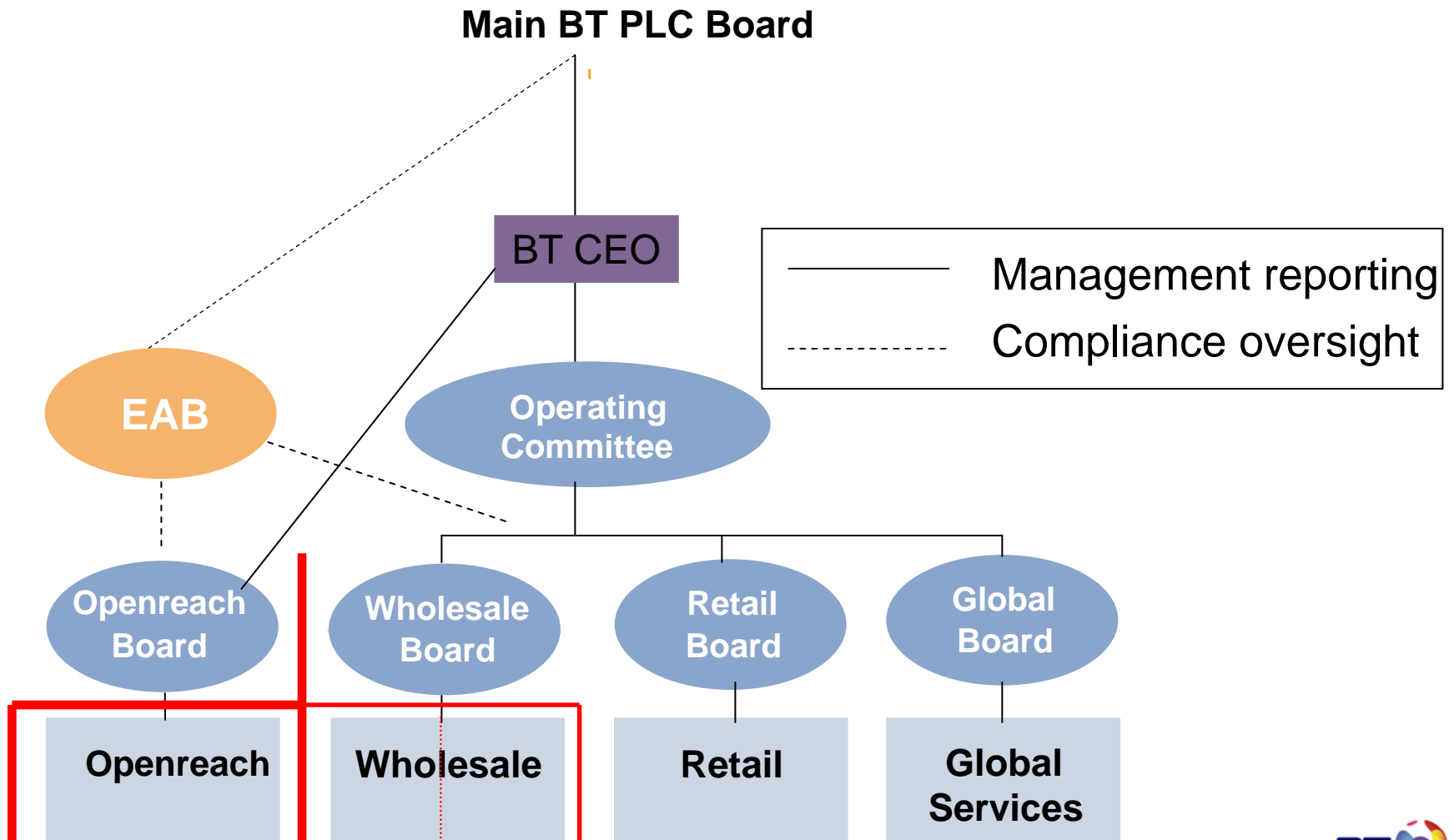


- Openreach controls and operates the duct, fibre, copper and other non-electronic assets in BT's access and backhaul networks
- It has had its own headquarters, distinct brand and around 30,000 people, from January 2006
- It provides product management, sales and service management for significant market power (SMP) products delivered over BT's access and/or backhaul networks - bottleneck products
- Any performance-related pay for Openreach staff is based only on Openreach's own objectives and performance; not BT Group's
- BT publishes separate financial accounts for Openreach

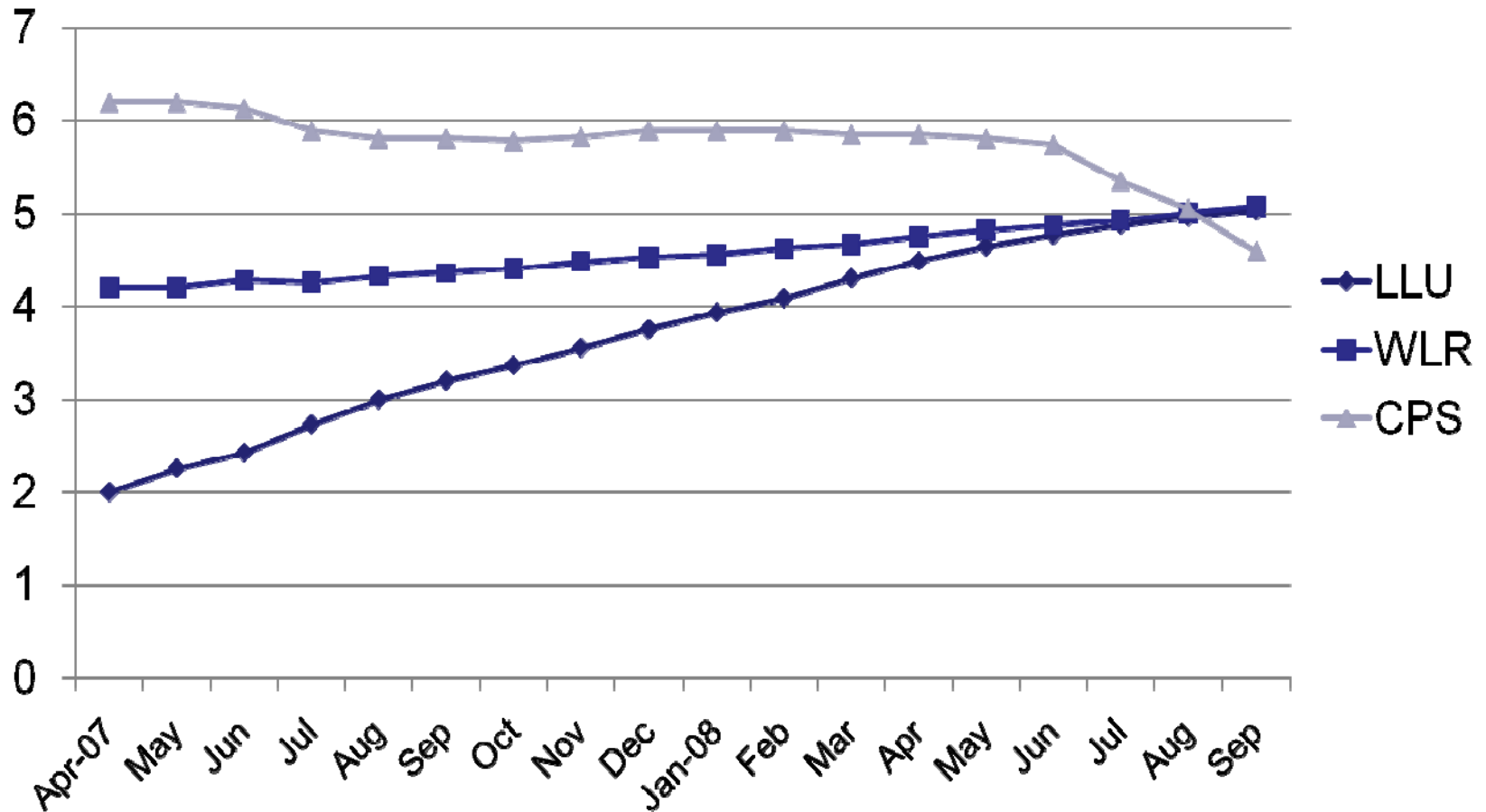
Independent monitoring and oversight

- Equality of Access Board
 - Monitors, reports and advises on BT's compliance with the Undertakings
 - Chaired by BT Group non-exec director, with three independent members plus one senior BT manager
 - reports directly to BT Group plc Board
 - reports annually to Ofcom and publishes a summary report as part of BT's annual compliance report
- Ofcom
 - Publishes quarterly Undertakings implementation reports
 - Publishes annual report on impact of TSR
 - Tracks measures on delivering letter and spirit of Undertakings, product KPIs, etc
- Breaches of the Undertakings can lead to:
 - Directions from Ofcom and/or court enforcement
 - Reference to the Competition Commission
 - Third party action for damages

Governance Structure



Impact on competition



LLU Lines (m), WLR Lines (m), phone numbers using CPS (m)

Source: OTA2 update



Driving Growth in UK Telecoms

- 15M BB connections in the UK
- 5M LLU lines (most since creation of Openreach)
- Over 4.67M WLR lines
- 5.8M CPS Lines
- Openreach handles 55k LLU external orders per week
- More than 20+ LLU operators
- Unbundled services provided from nearly 1,900 local exchanges
- 99.6% of population connected to exchange with up to 8Mb/s BB
- Average BB speed is over 3Mb/s
- ADSL 2+ deployment in 2008, up to 24 Mb/s with average of 8 Mb/s (part of £10 bn investment)

Openreach performance

Full Years to
March 31

External Revenue

Internal revenue

Total revenue

Operating Costs

EBITDA

Amortisation and Depreciation

Operating Profit

Capital Expenditure

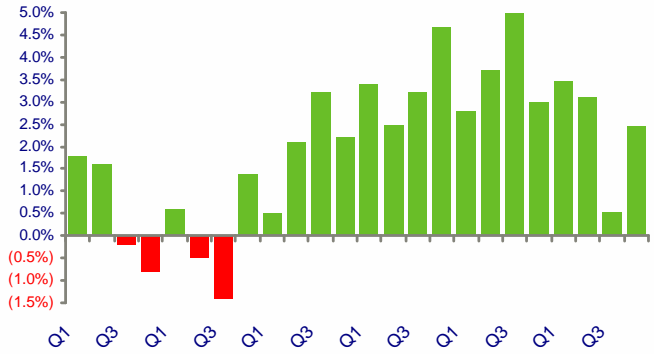
2008	2007	2006
£M	£M	£M
886	685	318
4380	4,538	4,824
5266	5,223	5,142
3328	3,292	3,156
1938	1931	1,983
689	707	800
1249	1,224	1,183
1,073	1,108	1,038



BT - Consistent delivery

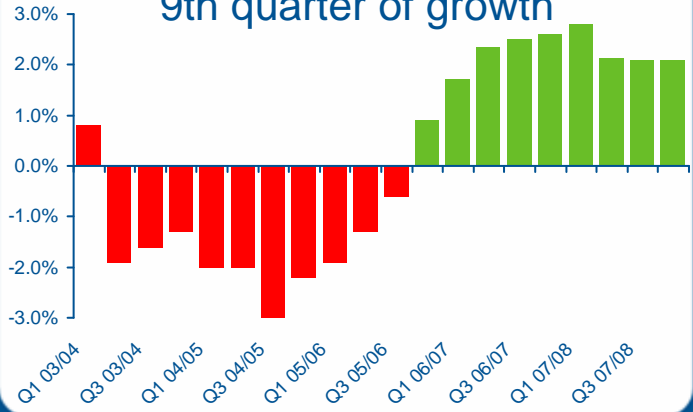
Revenue

17th quarter of growth



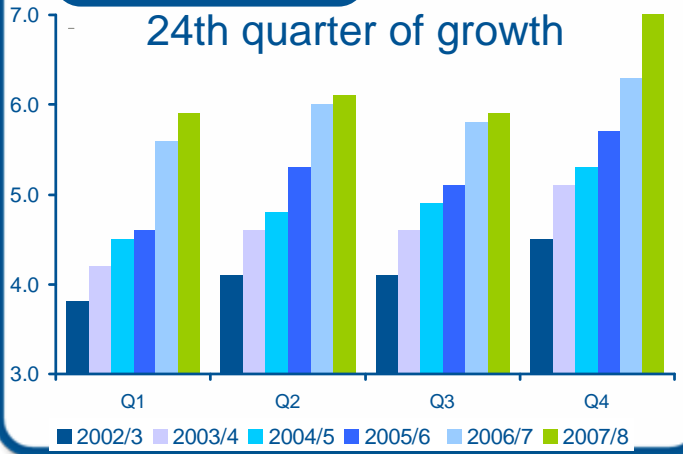
EBITDA*

9th quarter of growth

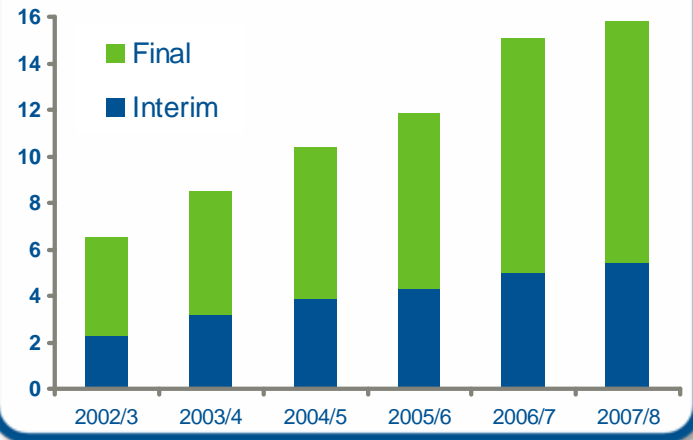


EPS*

24th quarter of growth



Dividends



* Before specific items and leavers



UK: A New Era of Regulation?

- Increased clarity
- Openreach forced to think about all processes with most being redesigned leading to improved quality
- Regulation focused on bottlenecks
- Provided foundation for reduced retail regulation
- Incentive to invest and innovate
- Infrastructure-based competition: benefiting the UK consumer and UK economy

Creating a climate of confidence for infrastructure competition, investment and innovation

Super-fast broadband



15 July 2008

BT plans UK's largest ever investment in super-fast broadband

- £1.5 billion programme
- 10 million homes access to fibre by 2012
- committed to wholesaling its new services

Openreach in other countries?

- Openreach is the **UK's** answer to the access bottleneck.
- The same regulatory, competition law and economic issues concerning creating a competitive environment for Communication Providers need to be resolved everywhere but tools may differ.
- The following may be considered as a minimum:
 - Equality of outcome for access and other SMP services:
 - same services, prices, terms and conditions, treatment
 - Effective non discrimination
 - Published transparency between upstream & downstream
 - Comprehensive and published separated accounts
 - Published Key Performance Indicators
 - Upstream prices set at non margin squeeze level
 - Chinese walls in a vertically integrated company
 - Consider business and residential customer needs separately.

Thank you

For more information:

- **About BT's Undertakings to Ofcom**

<http://www.undertakingsbulletin.com>

- **Ofcom**

<http://www.ofcom.org.uk/telecoms/btundertakings/>

- **About the EAB**

<http://www.btplc.com/Thegroup/Theboard/Boardcommittees/EqualityofAccessBoard/EqualityofAccessBoard.htm>

- **Office of the Telecoms Adjudicator**

<http://www.offta.org.uk/>

- **Report: "The Economic Benefits from Providing Business with Competitive Electronic Communications Services"**

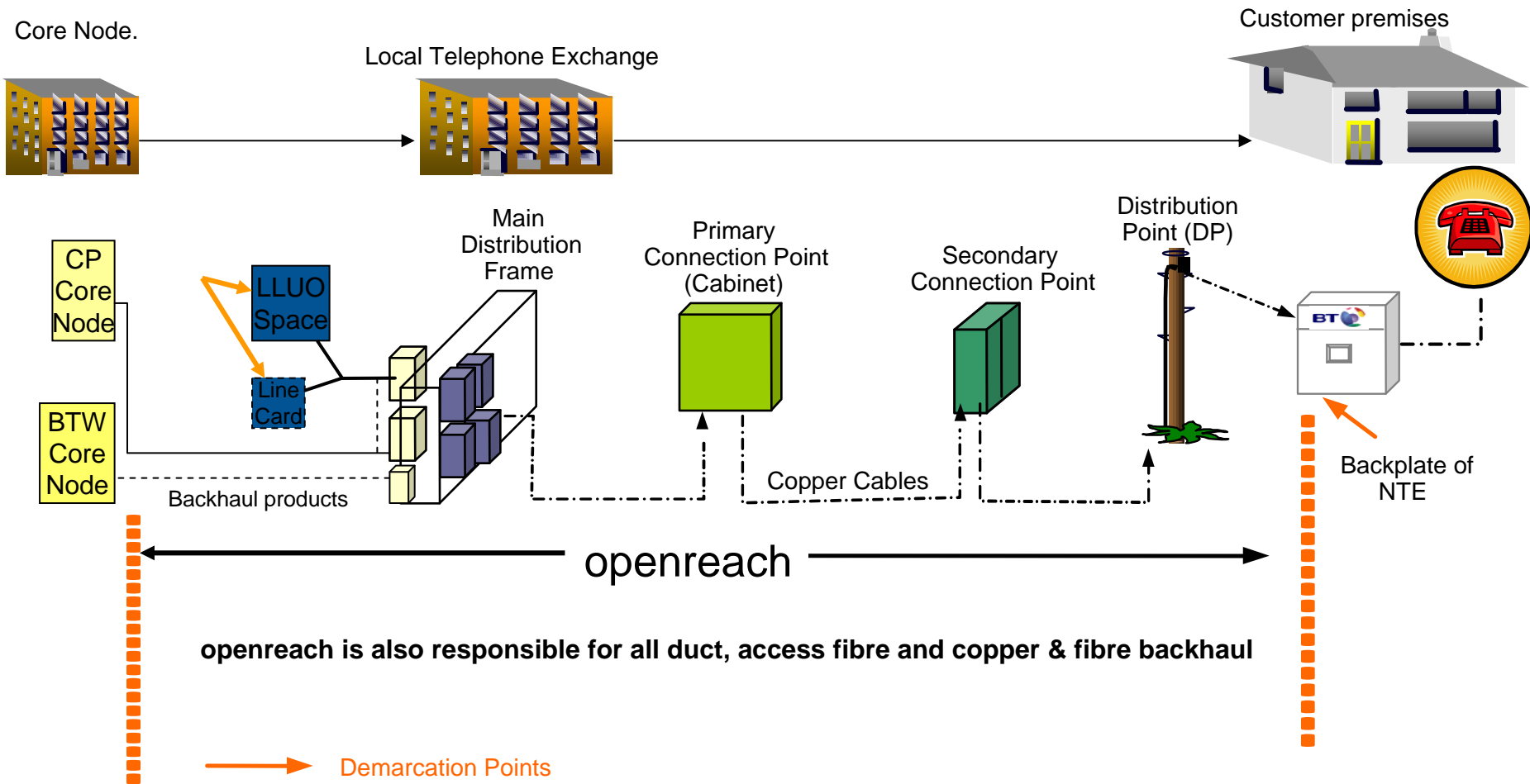
<http://www.btplc.com/Thegroup/Regulatoryinformation/Consultativeresponses/BTdiscussionpapers/Electronic/index.htm>

- **Report: "Productivity, Growth and Jobs: How Telecoms Regulation Can Support European Business"**

<http://btplc.btested.com/Thegroup/Regulatoryinformation/Consultativeresponses/BTdiscussionpapers/index.htm>

Openreach - assets

PSTN & ADSL Service

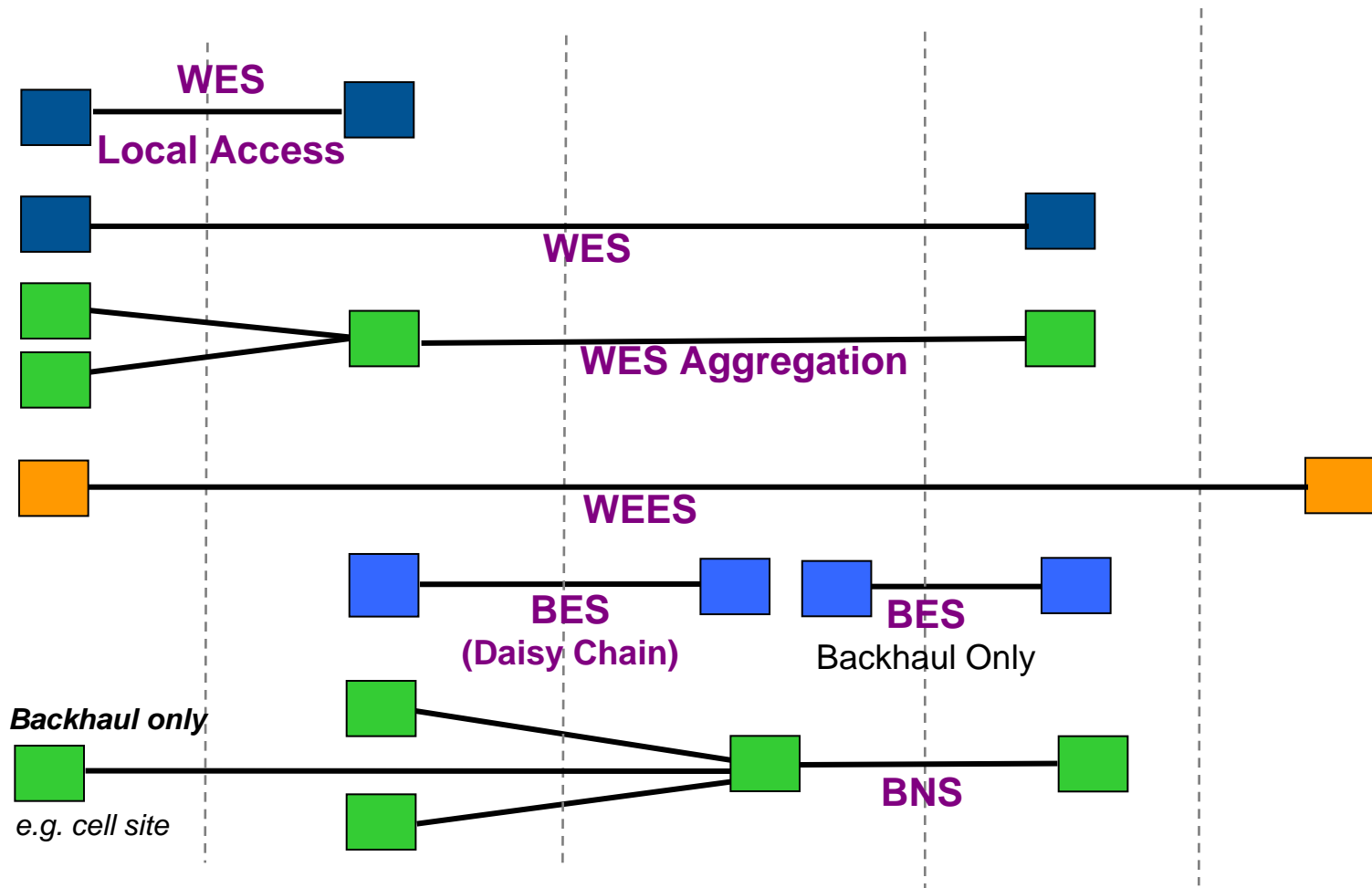


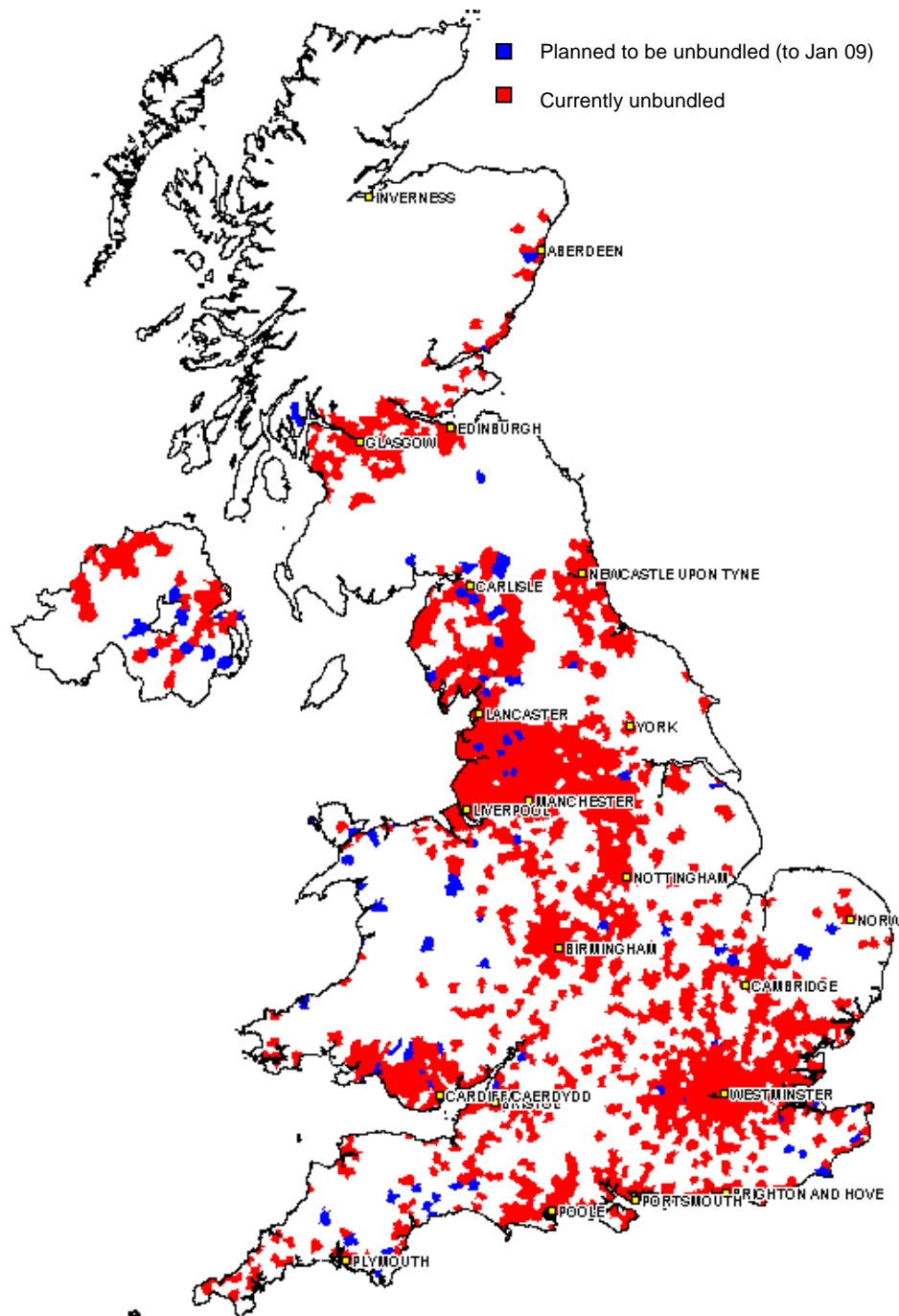
Openreach- Portfolio

1. Wholesale Analogue Line Rental
 - Customer access for analogue voice services
2. Wholesale ISDN2 and ISDN 30 Line Rental
 - Customer access for digital voice services
3. Local Loop Unbundling (LLU) (full and shared)
 - Copper pairs
4. Wholesale Extension Service
 - Ethernet partial private circuits from customer to first exchange
5. Backhaul Extension Service
 - Ethernet partial private circuits from first exchange to POP or second exchange
6. and facility to co-locate specified equipment at exchanges
 - Aggregation equipment, video servers, access network termination
7. Plus specified future access and backhaul services if requested by a CP

Ethernet Products

End User Site BT Access Node BT Access Node Ext. CP PoP Site End User Site





Take-up of LLU

Nationally there are:

- 1915 unbundled exchanges in service (31st Aug 2008)
- This represents 82.9% of Households
- 765 have six or over operators present
- 739 have two to five operators present
- 411 of these have one operator present
- Overall on 5 Oct 2008 there were 5,123,766 unbundled lines

UK Telecommunications market

- Liberalisation began over 20 years ago
 - Oftel formed in 1984; Ofcom took over in 2003
 - Tradition of independent, powerful regulatory authority
 - Extensive use of public consultation, and transparent decision-making
- A highly competitive market
 - Major fixed operators e.g. Cable & Wireless, COLT, Easynet Ltd, Global Crossing UK, Gamma Telecommunications, Geo, Kingston Communications, NTL-Telewest, Thus, Your Communications
 - 370 WLR operators
 - LLU operators : 12 major operators including Carphone Warehouse/ AOL UK, Pipex, Orange UK, Tiscali UK, Cable & Wireless, NTL-Telewest, Easynet .
 - 1 million lines in total
 - Retailers e.g. Argos, Sainsbury's, Tesco
 - CPS operators: 4.5m customers use CPS (25% of UK households).