

Policies of separation for telecom regulators



Introduction and Background

Vertically integrated companies have the tendency of using their leverage to bully other operators in the industry, thus hindering competition and creating a monopolistic situation.

A provider of retail and wholesale services that is a vertically integrated incumbent operator has the urge to consider its own retail division to the disadvantage of new entrants or other operators. Such discriminating behaviours create an anti-competitive environment for other operators who depend on the incumbent operator's wholesale infrastructures to provide their own retail products and services.

Monopolies mostly lead to price and non-price discrimination which is a detriment to the consumer. Competition is a key instrument in bringing consumer satisfaction in the sense that the consumer has several options to choose which keep operators on their toes and thus benefit the consumer ultimately.

The liberalization of the telecom industry has encouraged competition and aimed at bringing enormous benefit to the consumer. To achieve this vision, regulation is critical.

Regulators are set to provide a fair playing field and thus when operators act to the detriment of competition which may lead to the penalizations of consumers the onus is on the regulator to encourage fair competition through sound regulatory practices.

Within the scope of the European Regulatory Framework, National Regulatory Authority (NRAs), are endowed with a broad set of remedies in order to provide a competitive environment and eventually to enhance the end-user benefits. However, according to some NRAs, these measures have proved ineffective or incapable of preventing discrimination of alternative operators by the incumbent operator in the long term.

A popular measure being adopted by many regulatory bodies is separation. This comprises, accounting separation, virtual separation, functional separation, structural separation etc.

Accounting separation requires separate financial reporting for each of the operator's lines of business in its regulatory accounts. Because of different customer groups, operators may separate their business into a key accounting and an end-user segment. This separation does not necessarily entail anything about an independent management of the wholesale area and the prevention of discrimination.

Virtual separation requires a consistent structuring of the interface within the wholesale department, which comprise ordering, processing and billing for internal and external customers, but may not assume the physical separation of networks.

Functional separation involves the creation of a separate business unit along with operational rules to establish what is known as Chinese walls in literature between these new business units. This leads to a complete change of business practices with the intention to allocate assets and inputs

to a particular unit, which then by using identical processes takes care of internal and external customers.

Structural separation is achieved either as a legal entity of its own or with a separated ownership structure. It involves making the new business unit into a separate subsidiary. Generally, it is assumed that adequate separation reduces regulation. The reduction of regulation, particularly refers to the so-called retail segment (end-user), because efficient regulation should prevent the end-user segment of the historical operator (on the wholesale level) from acting in a discriminatory manner, or be able to exploit benefits, which give way to leverage market power. A regulation of the wholesale part remains necessary especially during the transition period.

All in all separation creates a rather diverse brand. Incumbents, which have gone through a separation process, and also the responsible regulatory authorities report about positive effects, while competitors emphasize the problems which arise along with separation, especially in cases where a regulated operator has gained regulatory freedom in other areas (e.g. end-user market).

Each form of separation requires the demarcation of processes and assets. As the reason for discrimination is the potential of combining bottleneck services and competitive areas, separation has to be stimulated at this boundary.

Separation can either be voluntary or obligatory, in obligatory separation the NRA defines how the separation is to be implemented. It can be assumed that separation against the operator's resistance is very difficult if not

impossible and correspondingly implies a severe intervention concerning property rights. Therefore, a form of quasi-voluntary separation has evolved where the UK has an example of OpenReach which was set up through the collaboration of BT and Ofcom.

This paper focuses on functional separation and outline the benefits and some key challenges to be dealt with in order to reap the full benefit of this emerging policy direction for telecom regulators.

Concept of Functional Separation

Functional separation involves making a separate business of the occupant's division responsible for the sale of access to the infrastructures to which the non-discrimination obligation relates, and applying to this new business unit a certain number of operational rules to create a ' wall' between it and the other services offered by the incumbent operator. The functionally separate business is indulged to maintain stern equivalence of efforts between all its various carrier customers and also, therefore, between the company of which it is part and competing companies.

The operational rules established seeks to control the flow of information between the newly created business unit and the other units of the incumbent operator, as well as the management processes within this new business unit, the behaviour of its employees and its style of corporate governance.

Functional separation appears to be a theoretically effective way of dealing with the problem of asymmetric information flows between the incumbent

operator and the regulator and, in more general terms, with the issue of guaranteeing non-discrimination. Indeed, it has several advantages.

The crux of the issue is that by reducing the incentive for and the ability of the employees managing these parts of the network to grant preferential treatment to the incumbent's own retail divisions to the detriment of alternative operators, functional separation makes such behaviour far less likely. It also allows responsibility for non-discrimination to be devolved from the regulator to the management of the newly created business.

This means that, whereas in the absence of functional separation the regulator has to take steps on a case-by-case basis to re-establish equivalence of inputs, with functional separation uniformity of inputs is the rule, and it is up to the separated business unit to justify any departure from this rule which might be necessary for the efficient operation of the integrated company and to obtain the regulator's approval for any such change.

Functional separation indeed involves the separation of some key areas as follows

The Separation of functions that is the creation of a separate business unit, responsible for the production and supply of the products in question; an obligation to supply all operators under non-discriminatory conditions (equivalence/equality); the separation of operational support systems; and the separation of the brand.

The Separation of employees is very keen in functional separation, which is, Employees are not permitted to work partly in the new unit and other times for another department of the operator; there is also the need to restrict the alternation or movement of managers of the other new units; it is also critical to physically separate offices and work places, pay incentives, provide a code of conduct, and other amenities separately.

Separation of information is also very important. This can be achieved by putting limits on the flow of information between the new unit and the other divisions. The implementation of separate access systems and separation of information management systems is also keen.

Financial separation will entail accounting separation, separate budgets and financial autonomy for the new unit.

Separation of strategies, separate management, the separate management board and strategic investment decisions, should all be solely be done without interference from the incumbent.

Another crucial area to be separated are monitoring of compliance with the obligations/performance, which involves independent systems for reporting breaches, independent complaint handling section, Publication of performance indicators and submission to the regulator, contracts signed between the new unit and the incumbent and essentially with other providers.

Pros and Cons of Functional Separation

Functional separation comes with a number of benefits which make which has raised its popularity. But notwithstanding the benefits, there are some key open questions to be addressed. This section discusses some of the pros and cons of functional separation.

Functional Separation increases the transparency of the relationship between the divisions managing the parts of the network subject to the non-discrimination responsibility and the other services offered by the wholesale operator, making discriminatory behaviour easier to detect. It also allows responsibility for non-discrimination to be transferred from the regulator to the management of the newly created business. Separate reports provide a clearer picture of the financial performance of different parts of the business. The increased transparency is likely to lead to having greater analyst coverage and greater access to capital funding in the financial markets.

Functional separation, offers the necessary flexibility to adapt to technological and competitive changes in the marketplace. It avoids the need for complex, costly and, to a certain extent, ineffective regulations. It stimulates innovation and efficiency in the competing services.

It is an effective means of encouraging the incumbent operator to behave honourably. Though the incumbent may want to refrain, functional separation does not mean “over” regulation. On the contrary, it is a straightforward means of implementing the non-discrimination principle and is an effective way of introducing progressive deregulation, while targeting only relevant bottlenecks at any given time.

Competitors can have greater confidence in the industry through a level playing field which will result in increased innovation, leading to more options and lower prices to benefit the consumer. This gives the Customer larger set of options in choosing a service provider. More so, investor confidence has not been dampened.

It indeed helps create a climate of confidence for sustainable infrastructure competition, investment and innovation.

As can be inferred, accounting separation doesn't necessarily solve the problem of non-price discriminating behaviours of the vertically integrated incumbent operator; it constitutes anti-competitive effects upon the alternative operators and the competitiveness of the market.

But in functional separation, the split is subjected to a stronger non-discrimination obligation which indulges it to supply a range of upstream inputs of alternative operators and its own retail division of the same non-discriminating manner.

Though there are several benefits of functional separation, it comes with some key open questions which needs to be dealt with in order to reap the full benefit of functional separation.

The quality of the services provided by the operator requires the deep and lasting involvement with the network owner to ensure good interlinking between the customer process and the network process. Functional separation is likely to remove the incentive to ensure the operational quality

and economic performance of access activities since the incumbent operator may lose interest in the new units.

This loss in quality can be largely attributed to lack of incentive to invest. One of the reasons could be due to the compulsory focus of the incumbent operator in the separation process that may have strict deadlines, meet, instead of concentrating on the upgrade processes which could take time to change the network and requires substantial resources.

Within the scope of functional separation, due to the equivalence principle to deliver exactly the same services in the same manner to all operators, quality levels can end up in the degradation of service quality for all operators including the incumbent operator's own retail unit.

Realising functional separation is not direct, and is costly in terms of time and resources and thus a complex venture to undertake. Besides its complexity, functional separation involves an increase in costs directly or indirectly related to the introduction and maintenance of its key components. The implementation costs can be grouped in three portions. These include costs of introducing and implementing separate systems, the costs of managing and maintaining the separated systems and the costs of paying audit companies that check the compliance of the operator with regulatory standards.

Due to the cost and complexity of functional separation, undertaking it makes it highly irreversible, thus it should be a last mile decision and a critical and a careful thinking should be put into it before its implementation.

Conclusion

Separation and for that matter functional separation is a very important policy to help improve competition and help curb discrimination of monopolistic operators who may have the leverage of vertical integration to other alternative operators coming into the market and may have to rely on the incumbent's wholesale division.

De Bijl argues that separation shall only be taken into account, if access can be regarded as enduring bottleneck. If economic replication is possible or technological alternatives exist, separation can be counterproductive because it might foreclose infrastructure competition.

Currently, the market is in transition to a massive technological change of unknown dimensions. This technological transformation will critically influence the market and its regulation. Especially, there is evidence, that the bottleneck characteristics of the access network might be overcome by the technological development – but on the other hand there is also doubt as in some observers' opinion e. g. new fibre deployment can lead to increased economy of scale and new access monopolies. The applicability of the tool “separation” depends upon whether the access to communications networks may be regarded as an enduring bottleneck

Many NRAs consider the functional separation as having more potential to strengthen competition since it introduces a more drastic non-discrimination principle. This is the fundamental reason why functional separation is being introduced in telecommunications as an alternative remedy. Consequently, its implementation should, in principle, create a level playing field for all

service providers, promote competition in service provision and lead to better services at lower costs for consumers.

Separation as a regulatory instrument can be useful, firstly to influence the operator's incentives, secondly to avoid discrimination effectively and, last but not least, to separate monopolistic areas from those segments competing with each other.

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