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# Vertical separation in telecoms and other network industries

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Understanding  
the  
Digital World

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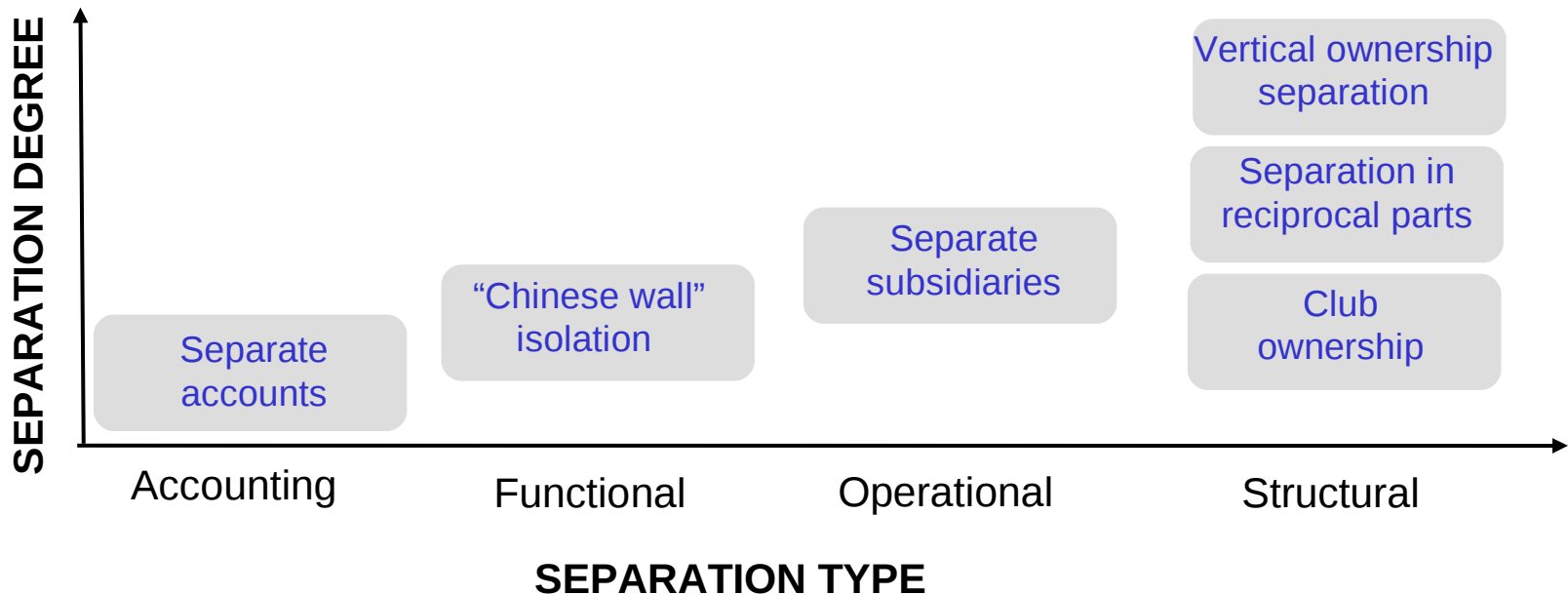
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## Which vertical separation ?

- ▶ Historically, vertical separation in a network industry aims to isolate an asset or activity which does not allow for sustained competition in order to facilitate 3rd party access to it.
- ▶ More recently, it has been considered as a tool to eliminate non-pricing discrimination
- ▶ Three major underlying questions to vertical separation
  - **Which non competitive activity ?** Usually a part of a physical distribution or transport network but can also be a generation asset (e.g. electricity) or services (airport services, take-off and landing time slots...)
  - **Which type of separation ?** Accounting, functional, operational ou structural (ownership)
  - **Which ownership form for the non competitive activity ?** Separation in reciprocal parts , club ownership or vertical ownership separation.



# Vertical separation: not an entirely new concept

	Telecoms	Gas and electricity	Railroad
USA		Several states (California...)	Amtrack
Japan			
South Korea	KT	KEPCO	
Australia	Telstra	Several states (Victoria, New South Wales...)	ARTC
France	<i>France Télécom</i>	RTE, GRT Gaz	RFF
United Kingdom	BT/Openreach	British Gas, NGC	British Rail
Italy	Telecom Italia	Enel/TSO	FS Infrastrutture
Germany			Deutsche Bahn
Spain		REE	RENFE/GIF
Netherlands		Gasunie	NS
Sweden	<i>TeliaSonera</i>		SJ
Portugal		TSO/EDP	REFER EP

Accounting separation    
  Operational/functional separation    
  Ownership separation

*Vertical separation projects in italics*

## The multiple and sometimes conflicting objectives pursued with vertical separation as a remedy...

Most often stated objectives	Railroad		Electricity		# of occurrences
	France	UK	France	UK	
Promote competition	✓	✓	✓	✓	4
Increase sector economic efficiency	✓	✓		✓	3
Stimulate infrastructure investment		✓	✓	✓	3
Create shareholder value		✓		✓	2
Improve quality of service		✓	✓		2
Reduce public subsidies to sector		✓		✓	2
Reduce / refocus regulation		✓		✓	2
Conform to European directives	✓		✓		2

- ▶ Vertical separation has served many other purposes than promoting competition with strong specificities related to national contexts.

**...have for the most part not been met in previous experiences**

Most often stated objectives	Railroad		Electricity	
	France	UK	France	UK
Promote competition	X	X	✓	✓
Increase sector economic efficiency	X	X		✓
Stimulate infrastructure investment		X	X	X
Create shareholder value		X		✓
Improve quality of service		X	X	
Reduce public subsidies to sector		X		✓
Reduce / refocus regulation		X		X
Conform to European directives	✓		✓	

Legend  
 ✓ Objective reached  
 X Objective not met

# The results of vertical separation as a remedy have been highly mitigated...

Impacts	Railroad		Electricity		Total
	France	UK	France	UK	
Regulation	0	-3	-1	-3	-7
Investment	-1	-1	-2	-1	-5
Quality of service	-1	-3	-1	NA	-5
R&D	-2	-1	NA	NA	-3
Pricing	-2	+1	0	+2	1
End user demand	0	+2	0	0	2
Competition	0	0	+2	+2	4
Economic performance	+3	-2	+2	+1	4
Headcount & productivity	+1	+2	+1	+2	6
Total	-2	-5	1	3	-3

**Major negative impacts on most industry level items**

**No meaningful impact on pricing or end-user demand despite competition development**

**Vertical separation may produce economic benefits for separated entity**

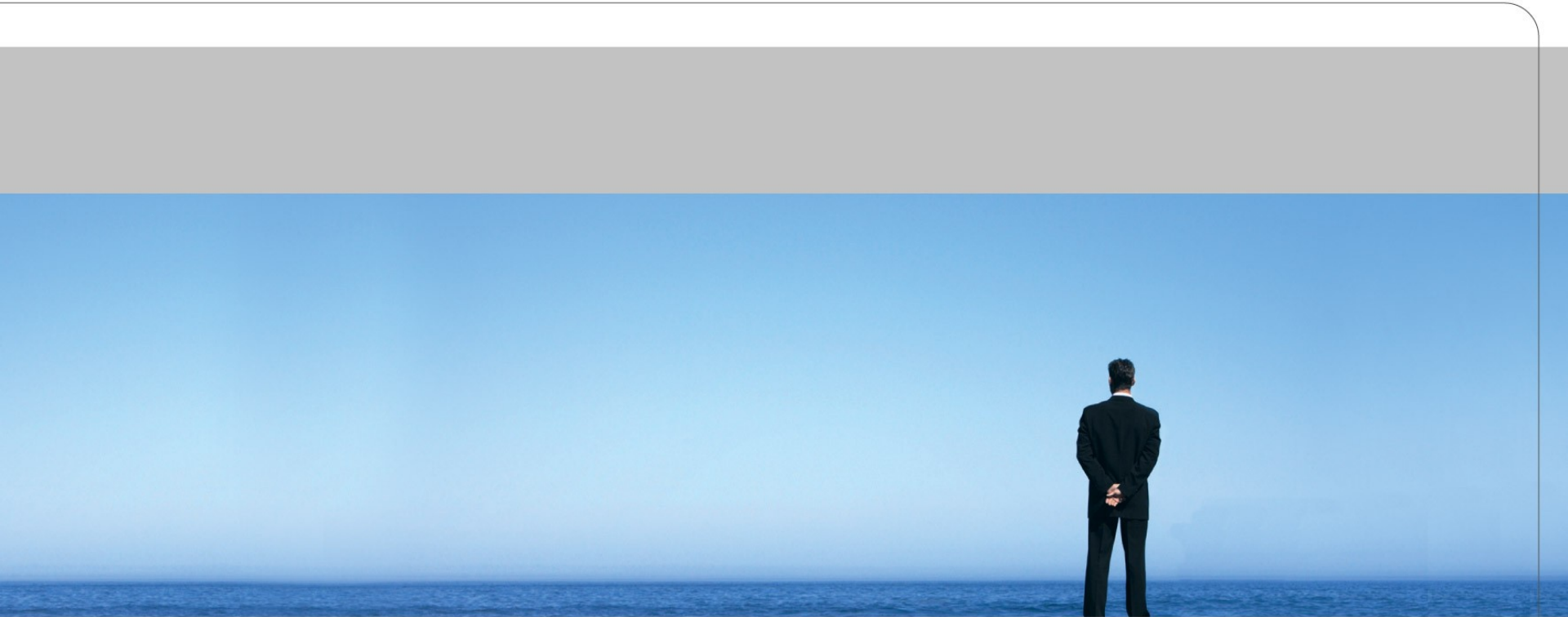
**...with negative impacts leading to a repositioning of vertical separation in the regulation debate.**

**Some negative impacts observed at the industry level...**

<p>Infrastructure investment</p>	<ul style="list-style-type: none"> <li>• Average infrastructure investment decrease of 10% in railways in 5 years post separation in France</li> <li>• Chronic underinvestment in UK railways further accelerated post separation</li> </ul>
<p>Regulation</p>	<ul style="list-style-type: none"> <li>• Apocalyptic regulatory framework for the UK railways industry that resulted in the creation of several regulatory agencies</li> <li>• Multiple ex post regulatory interventions on electricity retail and wholesale prices in the UK and France</li> </ul>
<p>Quality of service</p>	<ul style="list-style-type: none"> <li>• 70% of train lines have seen sustainably degraded punctuality in the UK while 40% more suburban trains and 16% more long distance trains have punctuality problems in France</li> </ul>

**...have led to a repositioning of the vertical separation issue**

- ▶ Facilities-based competition considered as ideal option whenever possible (for freight in particular).
- ▶ Vertical separation has not generated a superior development of retail competition compared to other regulatory tools (e.g. 3rd party access)
- ▶ 3rd party access and functional or operational separations perceived easier to implement and more efficient than structural separation which should only be seen as a last resort option.
- ▶ Non competitive infrastructure can hardly be strictly privatized because of security, investment and public subsidies issues



**What does this mean for telecoms ?**



# Troubled times for European telecoms

**Usage challenge**

Communications usage profoundly changing, particularly with the younger generation

**Growth challenge**

Market saturation and shift in revenue models impact industry growth prospects

**Competition challenge**

Technology disruptions blur boundaries between fixed and mobile and create new “over the top” competitors

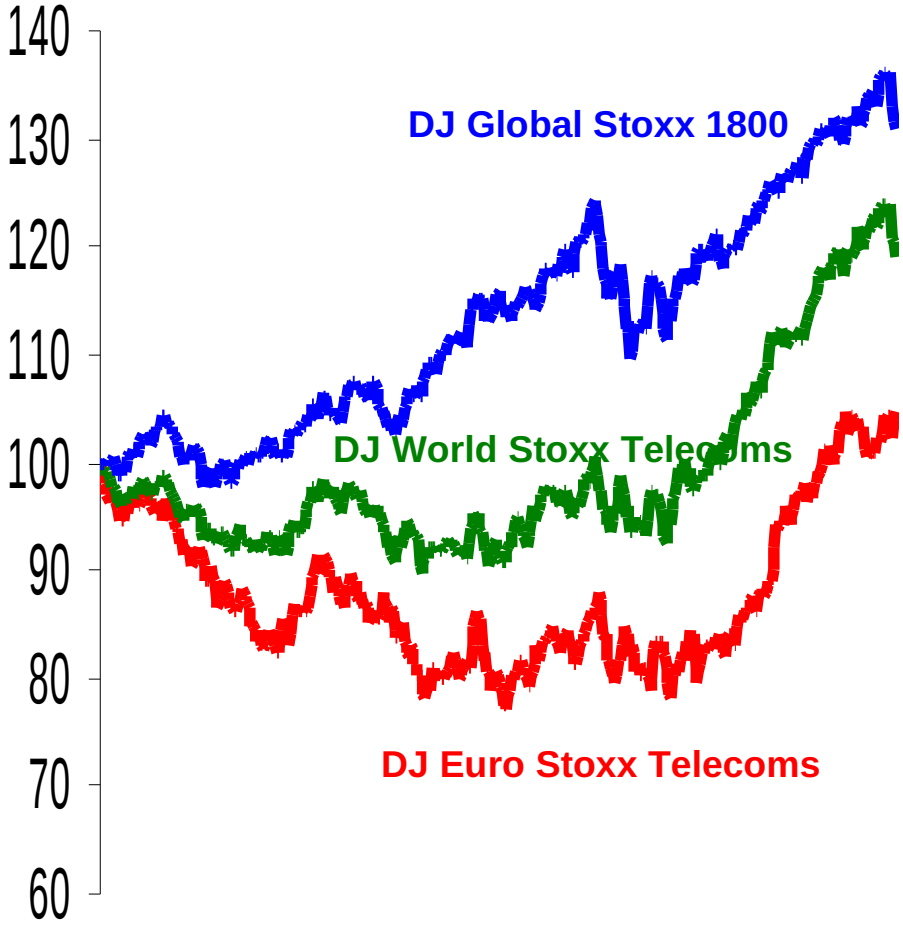
**Globalisation challenge**

Other regions are more attractive to investors for telecoms and are creating new industry giants

**Regulatory challenge**

Fierce debates on fiber infrastructure unbundling, structural separation are further contributing to uncertainty

Compared stock index performance since Jan '05



# Fluctuating and tactical positions on the topic

## Multiple stakeholders involved...

Operators

National governments

European Commission

National regulation authorities

## ...leading to fluctuating tactical views

BT

BT CEO announces plan to float 25% a separated company comprising all BT's fixed network assets called NetCo (March 2001)

"Market evidence shows that separation is unnecessary for the development of competition, whilst such a step would be hugely costly and disruptive to the industry, and is unlikely to reduce the need for regulatory intervention" (June 2004)

BT proposes operational separation in exchange for deregulation (February 2005)

Ofcom/Ofcom

"Ofcom believes an all-encompassing prevention of vertical integration would be unjustified, since it may hamper innovation in new services, damage competition across different platforms and hinder UK firms competing in world markets (April 2001)

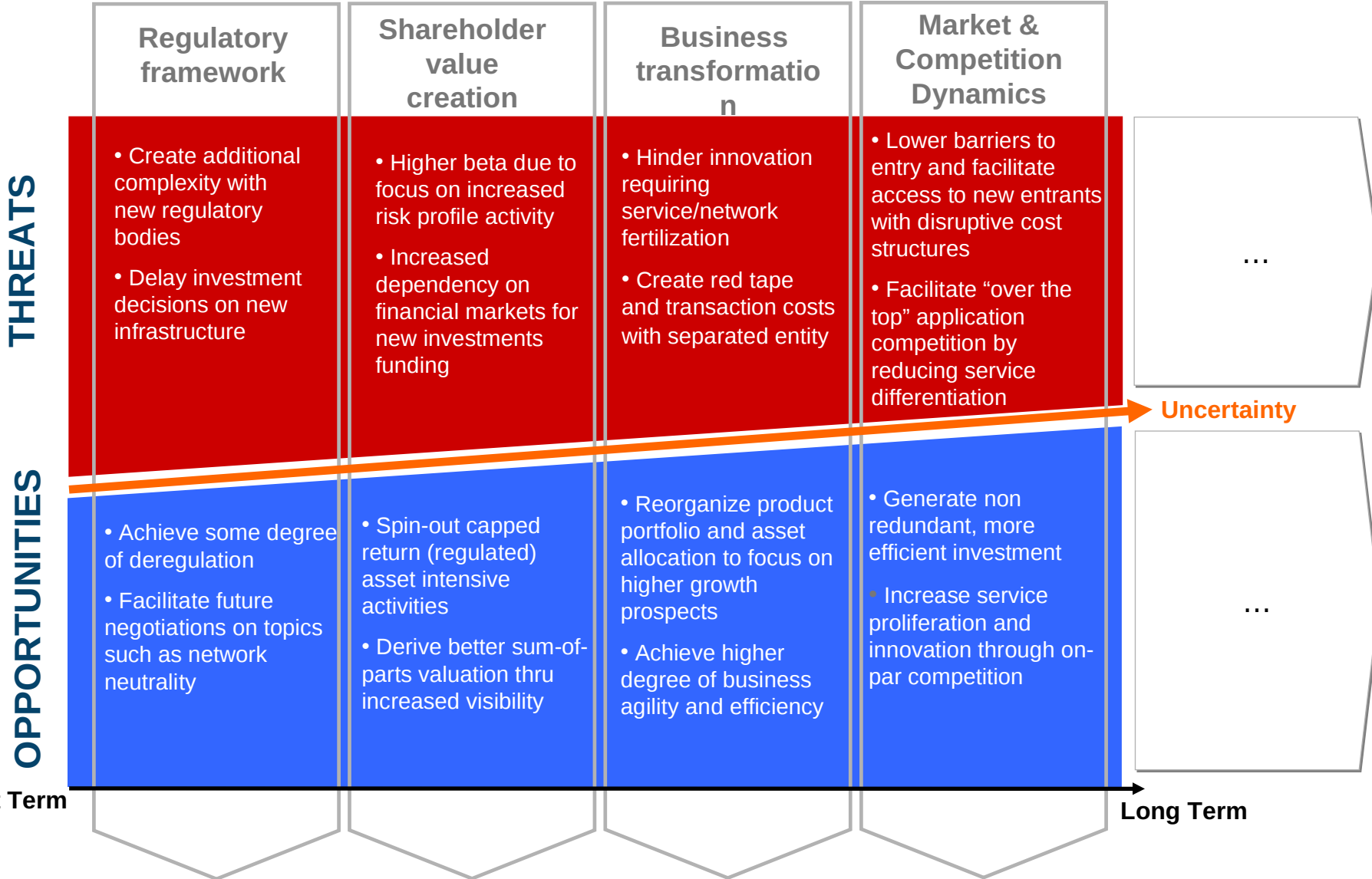
Ofcom completes phase 1 review of telecoms markets and reopens the debate on separation (April 2004)

Ofcom accepts BT's undertakings (September 2005)

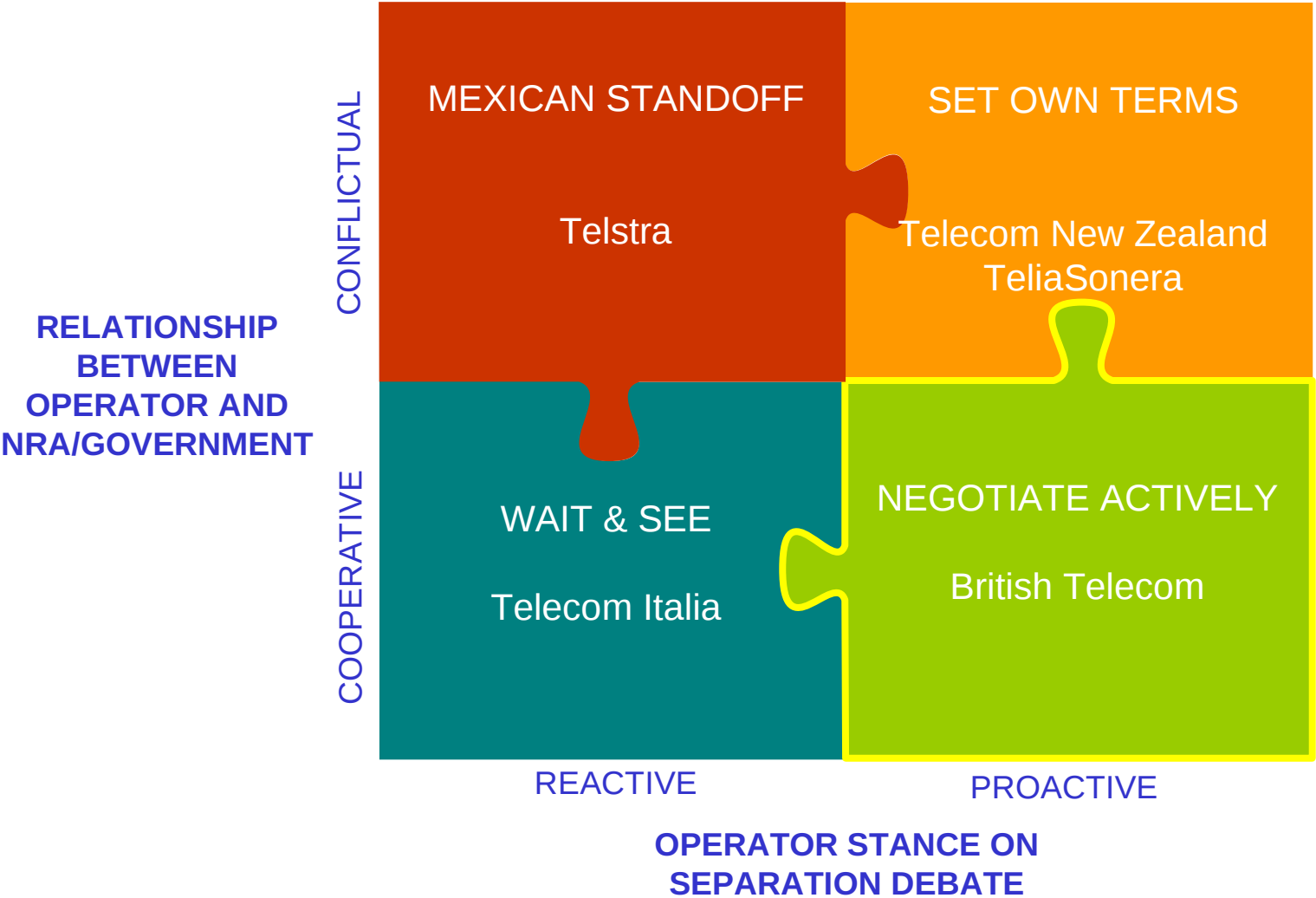
# Same means, different ends ?

		UK	Australia	New Zealand	Sweden	Italy
Separation situation	Separation status	Operational separation effective since September 2005.	Operational separation effective since June 2006.	Should be effective by year end.	Government law calling for operational separation ratified in June 2007. PTS now	Public consultation ended in June 2007.
	Stated objectives for separation	Ensure equality of access when infra competition impossible;  As soon as competitive conditions allow, withdraw from regulation at other levels;	<ul style="list-style-type: none"> <li>Increasing transparency about Telstra's operations</li> <li>Ensuring equivalence among Telstra's wholesale customers</li> <li>Improving regulator's action</li> </ul>	<ul style="list-style-type: none"> <li>More competition,</li> <li>Required transparency, non-discrimination, and equivalence of supply and</li> <li>Facilitated efficient investment.</li> </ul>	Ensuring non-discriminatory and transparent conditions for all operators requesting access to TeliaSonera's network.	<ul style="list-style-type: none"> <li>Efficient supplying of wholesale services</li> <li>Greater competition</li> <li>Progressive liberalization of the retail market</li> </ul>
Market situation	Incumbent wholesale BB market share	71%	NA	94%	NA	81%
	Competition	<ul style="list-style-type: none"> <li>High voice competition but poor ULL performance</li> </ul>	<ul style="list-style-type: none"> <li>Poor ULL performance</li> </ul>	<ul style="list-style-type: none"> <li>Poor broadband penetration performance</li> </ul>	<ul style="list-style-type: none"> <li>Poor broadband penetration performance</li> </ul>	<ul style="list-style-type: none"> <li>Limited infra competition (no cable)</li> </ul>
	Regulatory context	<ul style="list-style-type: none"> <li>LLU since 2000</li> </ul>	<ul style="list-style-type: none"> <li>LLU since 1999</li> </ul>	<ul style="list-style-type: none"> <li>No accounting separation or LLU until separation proposal</li> </ul>	<ul style="list-style-type: none"> <li>Functional separation of TI since 2000</li> </ul>	<ul style="list-style-type: none"> <li>Functional separation of TI since 2000</li> </ul>

# The threat/opportunity tradeoff of separation remains unfavorable for most operators in the short/mid term



# The revisited prisoner's dilemma



**THANK YOU**  
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