

Legal separation of Openreach from BT

NECESSARY STEPS TO SECURE EFFECTIVE INDEPENDENCE, TRANSPARENCY AND
TO PROMOTE COMPETITION AND INVESTMENT
A REPORT FOR SKY, TALKTALK AND VODAFONE BY TOWERHOUSE LLP



TalkTalk



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1. Executive summary

- 1.1 This report outlines a set of proposals for legal separation of Openreach from BT. These proposals would replace the 2005 undertakings with a less cumbersome and more effective regime, powered primarily by company law. Legal separation means that Openreach would become a wholly-owned subsidiary of BT with separate governance, and strategic and operational autonomy. Ofcom sees benefits to this model over the status quo and, potentially, over structural separation.¹
- 1.2 Ofcom has concluded that greater independence between Openreach and BT's retail divisions would lead to substantial benefits for consumers and help achieve Ofcom's objective of making communications work for everyone. With more independent commercial decision-making, Openreach should deliver more consistent treatment across all competing downstream customers and reduce the potential for competitive distortions.² Investment by Openreach will be more effectively deployed and constraints imposed by BT removed, bringing scope for investment decisions to reflect the interests of all Openreach customers.³ With greater financial autonomy to take strategic decisions, Openreach will have greater opportunities to reach co-investment and risk-sharing agreements with operators other than BT, enabling Openreach to better serve the interests of all UK consumers.⁴
- 1.3 In retail markets, greater independence of Openreach would ensure that BT's retail competitors compete with it on an even playing field. BT's retail divisions should no longer enjoy the enduring structural benefits that Ofcom concludes result from BT's vertical integration. These include, for example:
- (a) removing BT Group's ability to coordinate investment and strategic planning amongst its divisions (so that fixed line network investments are made based on a view of what is likely to grow the UK broadband market, benefiting all consumers, not viewed through the narrower lens of BT's interests);
 - (b) ensuring the incentives and costs (in terms of Openreach network access) faced by BT's retail divisions are the same as those faced by its competitors; and
 - (c) enabling other suppliers to influence Openreach projects.
- 1.4 Greater independence of BT's retail divisions will also impose a significant discipline on Openreach, because Openreach will face the prospect of BT's retail divisions having stronger freedom to choose alternative wholesale inputs. Openreach will then face stronger incentives to deliver good quality of service and a strong and innovative product portfolio if BT is no longer a 'guaranteed' customer.

¹ SRDC initial conclusions, para 6.71. Ofcom notes that legal separation would deliver greater Openreach independence whilst retaining BT Group ownership, 'therefore preserving some of the benefits of vertical integration'.

² SRDC initial conclusions, para 6.65.

³ SRDC initial conclusions, para 6.38.

⁴ SRDC initial conclusions, para 6.66.

- 1.5 Finally, Ofcom considers that securing Openreach’s independence would present an opportunity to simplify significantly the current regulatory rules and processes.⁵ We agree and consider that legal separation would replace many of the existing rules and processes with simple, robust and tested company law obligations. This would ensure that Openreach’s directors have fiduciary duties to promote the success of Openreach – rather than to coordinate its activities to benefit BT Group as a whole.
- 1.6 The existing separation regime between Openreach and BT is complex, out-dated and has been found by Ofcom to be ineffective at addressing strategic decisions.⁶ To secure independence between Openreach and the rest of BT, there must be clear rules governing both sides of the Openreach/BT boundary. It is essential that Openreach is not the sole focus; the other parts of BT must also be obliged to deal with Openreach on an arms-length basis and in exactly the same manner as other Openreach customers. This report does not address the legal mechanisms that Ofcom might use to set those rules (although we agree with Ofcom’s own assessment that it has the power to do so). This report deals with the essential elements of legal separation: identifying the minimum set of outcomes that any regime of legal separation would need to include and pointing to where functional separation obligations will remain necessary.
- 1.7 The proposals are (in summary) set out in **Table 1**.

⁵ SRDC initial conclusions, para 1.47.

⁶ SRDC initial conclusions, para 6.31.

Table 1: Summary of Proposals

Responsible entity			
Issue	BT	Openreach	Ofcom / other
Governance and purpose	Openreach to be a separate company: Proposal 1		
	Articles of Association limited objects: Proposal 2		
	Board/management are independent: Proposal 3		
	Independent Monitoring Trustee oversees compliance: Proposal 4		
Independence of Openreach	BT/Openreach dealings are on arms-length contracts: Proposal 5		<p><u>Continued scrutiny:</u></p> <p>Ongoing responsibility to ensure regulatory regime reflects these requirements; and is complied with</p> <p>IMT to report regularly: Proposal 23</p> <p>Arrangements must be on an enduring basis: Proposal 24</p>
Financial independence	<i>Ongoing responsibility not to subvert these requirements and to ensure Openreach complies</i>	Operate finances and cash handling independently of BT: Proposal 6	
		Capacity to borrow independently: Proposal 7	
		Non-discriminatory co-investment model for all customers: Proposal 8	
		Own Annual Reports and regulated accounts: Proposal 9	
Operational independence		Own (or lease from third parties, not BT) its assets: Proposal 10	
		Manage own corporate functions: Proposal 11	
		No systems or asset sharing: Proposal 12	
Workforce independence	<i>Ongoing responsibility not to subvert these requirements and to ensure Openreach complies</i>	Employ own workforce: Proposal 13	
Organisational and cultural independence		Independence voice on policy and regulatory issues: Proposal 14	
		Independent brand: Proposal 15	
Supporting and promoting competition and investment		EOI for all services: Proposal 16	
		Open consultations on strategy, plans and products: Proposal 17	
		Infrastructure investor buy-in for major capital plans: Proposal 18	
		Open-book accounting: Proposal 19	
Independence of BT		Open procurement: Proposal 21	
	BT staff incentives do not include Openreach performance: Proposal 22		

2. Background

Scope of this report

2.1 In February 2016, Ofcom concluded that:

'... the current model of functional separation fails to remove sufficiently BT's ability to discriminate against competitors. Therefore risks to competition remain.

Given the concerns identified, continuing the status quo is not an option. We have decided to reform the relationship between Openreach and BT Group to give the former greater independence and autonomy. Under this new structure, Openreach should have:

- more independent governance structures and processes, with a responsibility to serve all wholesale customers equally;*
- independent technical and operational capabilities;*
- greater autonomy over its budget, and over its strategic and operational decision making; and*
- an ongoing responsibility to consult with all customers in the same way.*

One option that might achieve this is structural separation, but we recognise that this would entail significant disruption. We will therefore consider whether a strengthened model of functional separation could deliver the greater independence and autonomy for Openreach that we believe is necessary. If functional separation cannot be strengthened, we reserve the right to take forward structural separation.

We are now developing detailed proposals, which we will discuss with the European Commission later this year.⁷

2.2 This report identifies a detailed set of proposals that would secure this objective. These proposals have been designed to work as a single, unitary set of measures that would secure the outcome that Ofcom seeks in the Strategic Review of Digital Communications ('SRDC') initial conclusions, using established concepts of company law and contract as the basic building blocks of the regime and using regulatory powers as a backstop.⁸ It will be clearer, more predictable and more effective than the status quo and supplemented by bespoke functional separation requirements only where necessary.

2.3 The report has been commissioned by Sky, TalkTalk and Vodafone.⁹

⁷ SRDC initial conclusions, section 6, un-numbered paragraph titled 'Overview of our strategy and next steps'.

⁸ We refer to the proposals, or any other variation on the same theme as a 'separation regime' (or set of 'separation rules').

⁹ Sky UK Limited ('Sky'), TalkTalk Telecom Group plc ('TalkTalk') and Vodafone Limited ('Vodafone'), also referred to as 'our clients' or the 'client group'.

Ofcom's objective: A conclusive restriction on BT's influence over Openreach

- 2.4 BT's ubiquitous network and vertical integration creates unique difficulties for UK consumers, operators and investors; no other player has this advantage, and the problems that it has caused are well-documented by Ofcom.
- 2.5 Ofcom identifies an obvious solution: structural separation of Openreach from BT. Unlike the current and previous UK regimes, and unlike even the stronger form of functional and legal separation which Ofcom is currently contemplating, structural separation would address BT's *incentive* to distort competition and investment incentives, not merely seek to restrain BT's *ability* to do so.¹⁰ Structural separation already operates effectively in many other sectors,¹¹ including UK energy and transport markets. The merits of structural remedies in general and structural separation in particular are well-documented, including by competition authorities,¹² the OECD¹³ and each of our clients in their response to Ofcom's SRDC.¹⁴ The merits of structural separation are outside the scope of this report.
- 2.6 Informed by its duties to promote competition and investment, Ofcom's aim in strengthening Openreach's independence from BT is to address the fact that, without intervention by Ofcom, BT Group has both the ability and incentive to discriminate against competing providers.¹⁵ This concern arises as a result of the structure of the market, with BT Group controlling a group of assets (broadly speaking, the access network and associated infrastructure) which it would be uneconomic for other retail competitors to replicate (and upon which all except one of BT competitors rely to reach their customers).¹⁶ BT is therefore a regulated supplier of access to its network, as well as being the biggest customer of that access network.¹⁷

¹⁰ This ability to change incentives, taking pressure away from conduct rules (i.e. sector regulation or undertakings) is one reason why structural remedies are widely recognised as superior to conduct remedies when addressing competition problems in the economy generally. See, e.g., CMA 'Merger Remedies: Competition Commission Guidelines' (2008), para 1.8(a) and European Commission 'Commission Notice on remedies acceptable under the Council Regulation (EC) No 139/2004 and under Commission Regulation (EC) No 802/2004' (2008), para 15.

¹¹ OECD, 'Report on Experiences with Structural Separation' (2011). Available here: <http://www.oecd.org/daf/competition/recommendationconcerningstructuralseparationinregulatedindustries.htm>. ('2011 OECD Report').

¹² EC, 'Commission notice on remedies acceptable under Council Regulation (EC) No 139/2004 and under Commission Regulation' (EC 802/2004).

¹³ See, e.g., 2011 OECD Report.

¹⁴ See, e.g., Sky, 'Sky's response to Ofcom's Strategic Review of Digital Communications – Discussion document'; TalkTalk, 'Ofcom Strategic Review of Digital Communications: *TalkTalk response to July 2015 discussion document*' (October 2015); and Vodafone, 'Response to Ofcom's Consultation: Strategic Review of Digital Communications discussion document' (8 October 2015).

¹⁵ SRDC initial conclusions, para 1.39.

¹⁶ The exception is Virgin Media, which operates its own access network (reflecting the history of that company as the successor to the various regional cable TV networks, formed from a sequence of mergers culminating in the ntl/Telewest merger in [year] – see the OFT decision clearing that merger at Phase 1 at <https://assets.digital.cabinet-office.gov.uk/media/555de415ed915d7ae20000f3/ntltelewest.pdf>. <https://assets.digital.cabinet-office.gov.uk/media/555de415ed915d7ae20000f3/ntltelewest.pdf>.

¹⁷ See, e.g., CMA, 'BT Group plc and EE Limited: A report on the anticipated acquisition by BT Group plc of EE Limited' (15 January 2016), para 2.38 in which the CMA stated that, '*BT's fixed network is ubiquitous in the UK and BT can supply fixed infrastructure, such as leased lines, to almost everywhere in the country ... BT's significant network presence means that it can use this network to self-supply downstream retail services as well as selling services to other CPs that do not have the same level of network coverage.*' ('BT/EE Decision').

- 2.7 During the period prior to 2005, Oftel and then Ofcom sought to address this issue solely by using a regulated access regime governing BT's market conduct (the 'access regime').¹⁸ The access regime aims to restrict BT's ability to favour its own businesses, by obliging BT to offer network access on fair, reasonable and non-discriminatory terms.¹⁹ The terms on which network access are provided are negotiated commercially, with Ofcom resolving disputes that arise.²⁰ Maintaining this regime still consumes the most significant proportion of Ofcom's resources.²¹
- 2.8 The undertakings given by BT in 2005 (the '2005 Undertakings') complement but do not replace the access regime, enhancing the rules concerning discrimination and adding a form of functional separation in which Openreach was constituted as a separate division of BT Group plc.²² BT also made certain commitments about the way in which Openreach and other parts of BT would be managed and conduct their operations.²³ In particular, BT undertook to supply certain services on an 'equivalence of inputs' basis – that is, instead of offering terms that were assumed to be acceptable unless there was a demonstrated problem of discrimination, BT would be obliged to use the same wholesale services provided to its competitors, and deliver those services using the same systems and processes as BT's competitors used.²⁴
- 2.9 Ofcom has now concluded that the access regime and the 2005 Undertakings together (the current regime) are insufficient to address the underlying competition concern. Documenting the concerns raised by stakeholders (including our clients), Ofcom identified a sequence of problems:
- **strategic decision making:** *strategic decisions related to the access network are taken from the perspective of BT as a group, for the benefit of the group, rather than for the market as a whole;*
 - **consultation with customers:** *there is insufficient consultation with all of Openreach's downstream customers, in particular in the early stages of major network investment decisions, leaving the risk that their needs may be neglected;*

¹⁸ For more detail, see Ofcom, 'Final statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002' (22 September 2005).

¹⁹ For example, Article 5 of the Access Directive requires that NRAs impose 'objective, transparent, proportionate and non-discriminatory' obligations and conditions to achieve the objectives set out in Article 8 of the Framework Directive.

²⁰ This is something of a simplification – in practice, a set of regulated reference offers set the starting point for commercial negotiations. In practice, the most significant contractual terms for access are all set, one way or another, by Ofcom.

²¹ For example, the 2014-15 Ofcom Annual Plan specifies that it had spent £2.3 million on promoting effective competition and choice (all the specified activities of which relate to SMP conditions), significantly higher than for any other listed activities.

²² At the time, BT Group plc was named 'British Telecommunications plc'.

²³ Ofcom, 'Final statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002' (Final Statement, 22 September 2005). ('2005 Undertakings').

²⁴ The 2005 Undertakings defines "Equivalence of Inputs" or "EOI" as meaning that 'BT provides, in respect of a particular product or service, the same product or service to all Communications Providers (including BT) on the same timescales, terms and conditions (including price and service levels) by means of the same systems and processes, and includes the provision to all Communications Providers (including BT) of the same Commercial Information about such products, services, systems and processes. In particular, it includes the use by BT of such systems and processes in the same way as other Communications Providers and with the same degree of reliability and performance as experienced by other Communications Providers.'

- **governance and operational independence:** *Openreach lacks autonomy over its operating plan and capital budget. It also lacks the independent technical and operational capabilities required to deliver its priorities in the interest of all customers; and*
- **cost allocation:** *the current structure allows BT to act on its incentive to allocate costs in a way that favours the wider BT Group and therefore distorts competition.*²⁵

2.10 The essence of Ofcom’s concern is summarized in Ofcom’s conclusion that:

‘Openreach is inherently subject to BT Group control in today’s vertically-integrated structure of BT ... [and that] therefore risks to competition remain.’

2.11 It follows that the successor to the current regime must address the issue of BT group’s ability to *influence* the strategy, decisions and behaviour of Openreach, by increasing the independence and autonomy of Openreach. This basic concern is, as we understand it, Ofcom’s objective in reforming the relationship between Openreach and the rest of BT.

2.12 Ofcom considers that the overarching objective of the SRDC can be secured by ensuring that Openreach’s independence from BT is strengthened through the four policy initiatives:

- (a) More independent governance structures with a responsibility to serve all customers equally;
- (b) Increasing Openreach’s autonomy over budget and decision making;
- (c) Improving Openreach’s approach to consultation with its customers; and
- (d) Enhancing Openreach’s operational capability.

2.13 Analysed in this way, it is clear that when Ofcom refers to Openreach’s ‘independence’ it means, in this context, freedom from BT’s influence (and the two concepts, influence and independence, are thus mirror images: Openreach is independent to the extent that BT does not have influence, and vice versa).²⁶

2.14 Annex 1 sets out Ofcom’s most material conclusions from the SRDC.

²⁵ SRDC initial conclusions, para 6.22.

²⁶ In referring to freedom from BT *influence*, we mean influence that goes beyond what BT would be able to exert as a customer of Openreach under structural separation. Such undue influence can arise from either: (i) BT’s position as owner of Openreach (i.e. it is a consequence of ongoing vertical integration) as opposed to influence that would be enjoyed by a similarly placed market player that did not own Openreach; and (ii) any substantial market power BT may have in a market, which would give it inappropriate leverage over Openreach. In this report, we do not propose any constraint on BT’s ability to influence Openreach as a customer (for example, through the Statement of Requirements process, or through the customer engagement models proposed in Section 6: Proposal 17). To reduce sentence clutter, we refer in this report to influence that goes further than BT enjoys as a customer simply as ‘influence’ rather than ‘undue’ or ‘inappropriate’ or ‘illegitimate’ influence.

The status quo in 2016

Current structure of BT Group UK businesses and their activities and functions

- 2.15 BT has three major UK retail divisions (BT Consumer, BT Business and EE), a global services division (BT Global Services) and two wholesale divisions (BT Wholesale and Openreach).²⁷ This structure is discussed in more detail in Annex 2.
- 2.16 In general terms, BT Consumer and BT Business serve those categories of retail customer as their names imply. Acquired in 2016, EE is BT's mobile division.²⁸
- 2.17 BT Wholesale 'sells voice, broadband, and data communications products and services, including backhaul, to fixed and mobile network operators'.²⁹ Most larger CPs compete with BT Wholesale to offer services to other CPs and enterprises, and so BT Wholesale is, in economic terms, largely a downstream BT business that uses Openreach network access to participate in markets in which it competes with other Openreach customers.³⁰ For the most part, this report assumes that BT Wholesale ought to be treated in the same way as the retail divisions.³¹ However, unlike the retail divisions generally, BT Wholesale nevertheless provides some products, the supply of which is governed by SMP conditions (including some business connectivity products and carrier pre-selection).
- 2.18 As noted above, Openreach was established in 2005. It is referred to as 'AS', being BT's 'access services division', in the 2005 Undertakings.³²
- 2.19 BT's 'Technology, Services and Operations' division ('TSO') supports 'customer-facing lines of business'.
- 2.20 BT also has some governance and decision-making functions, and some strategic support functions (such as strategy, finance, legal, product portfolio and policy functions), that are managed at a group level.³³ This includes the BT Group plc CEO and other senior managers, who manage BT's businesses under the governance of the BT Group plc board.³⁴
- 2.21 As a result of this structure, Openreach has a number of different roles and relationships within BT:
- (a) It is subordinate to, and governed by, BT's commercial leadership (and reliant on BT Group-level decisions about funding and major capital expenditure). This includes, for

²⁷ BT/EE Decision, para 3.6.

²⁸ BT/EE Decision.

²⁹ BT/EE Decision, para 3.7.

³⁰ BT Wholesale also supplies some active SMP products (e.g. traditional interface leased lines and carrier pre-selection).

³¹ For simplicity, we sometimes refer in this report to 'BT Retail' or 'BTR' as shorthand for those downstream divisions – that is, 'any one of BT Consumer, BT Business, BT Wholesale and/or EE interchangeably'.

³² We note that 'access services' (in the form of re-sold network access or managed access services that provide the same capabilities as an unmanaged access service) are also sold by BT Wholesale and, in some cases, by BT's retail divisions.

³³ We refer to these functions as 'BT group functions' (or name them specifically) when talking about restrictions specifically aimed at the relationship between those teams and other parts of BT.

³⁴ We use the term 'BT Group plc' to refer to the legal person that owns and operates each of these divisions and BT Group functions. We also refer to 'the BT group' (or to avoid confusion with the smaller group functions, 'the wider BT group') to refer to BT Group plc and all of its businesses.

example, decisions taken by the BT Design Council (which is a sub-committee of BT's Operating Committee, reviews and approves capital expenditure programs and includes all BT business division CEOs) and its decisions about matters such as product development;

- (b) It is a supplier of network access to BT's downstream divisions; and
- (c) It is an internal customer of TSO and relies on many BT Group functions.

BT Undertakings and today's separation regime

- 2.22 Openreach's current structure gives effect to BT's obligations under the 2005 Undertakings. The 2005 Undertakings were given in lieu of a reference to the Competition and Markets Authority ('CMA').³⁵
- 2.23 The 2005 Undertakings were not set by Ofcom; following negotiation between Ofcom and BT, the 2005 Undertakings were offered by BT and accepted by Ofcom. Given that history, they probably reflect neither BT nor Ofcom's first preference as an outcome.
- 2.24 Since the 2005 Undertakings took effect, an enormous amount of time and effort has been given over to implementing and monitoring compliance with them, both by BT (within Openreach itself and in the other parts of BT), by BT's competitors and by Ofcom. Although there have many specific amendments (including some which have had a significant impact on competition, such as allowing Openreach to provide a layer 2 bitstream NGA product and exceptions to the principle of EOI), the basic structure and approach of the undertakings remains today as it was in 2005.

³⁵ At the time, a reference would have been made to the Competition Commission (CC('CC')). In 2012, the CC and the Office of Fair Trading merged to form the CMA.

3. Removing BT's influence: the yardstick to measure proposals

- 3.1 This section explains the framework we have used to develop these proposals. In summary, we asked: what are the minimum necessary steps to achieve Ofcom's objective (which is, as noted in the previous section, is to improve outcomes by influencing Openreach's behaviour and performance)?
- 3.2 Implicit in Ofcom's logic is that any form of influence arising from vertical integration can become a point of intervention that may create risks to competition and distort investment incentives. The 2005 Undertakings contain, on their face, substantial commitments designed (and, at the time perhaps, expected) to address BT's ability to influence Openreach. The experience of the past decade has been that even subtle forms of influence, exercised over time, can compromise Openreach's independence and lead to substantial harmful impacts on competition and levels of investment.³⁶ Given that it is not possible to predict in advance whether a given form of influence will prove to be a problem all sources of influence of BT over Openreach should be treated as material.³⁷
- 3.3 So the right yardstick to assess proposals to reform Openreach is this: does the proposal remove or negate a form of influence that BT would otherwise have over Openreach by virtue of its vertical integration? Proposals should not be assessed on the basis of evidence that the source of influence is currently being used to distort competition and investment incentives (although in many cases, documented in the SRDC, that evidence exists). What matters is the capacity to influence itself, not how or whether it has been used.
- 3.4 In characterising what constitutes 'influence', it is clear that influence arises at a point before it is demonstrated that a relationship of 'control' arises, as that concept would be recognised in competition law, company law or sectoral regulation.³⁸ Influence (in Ofcom's assessment) can arise as a result of, for example, the shaping of Openreach's strategic priorities or the enhanced ability of BT executives to engage with Openreach, compared with the access enjoyed by executives of other CPs. These proposals reflect the need to address these subtler forms of influence.
- 3.5 In assessing proposals, we considered two different perspectives:

³⁶ See, e.g., SRDC initial conclusions, paras 6.21-6.22.

³⁷ Of course, many of the concerns documented by Ofcom in the SRDC are not, in fact, abstract – strategic decision-making about capital investments, for example.

³⁸ In competition law, 'control' is the second limb (along with common ownership) in determining whether two undertakings have ceased to be 'distinct', triggering merger review. Competition law recognises that this can arise where 'the ability directly or indirectly to control *or materially to influence* the policy of a body corporate or the policy of any person in carrying on an enterprise' (see Enterprise Act 2002, s.26(1) and (3)). In company law (and GAAP), consolidation for financial reporting purposes is based on 'control' being exercised. In sector regulation, 'control' is defined in a number of contexts, either using the company law concept (as in the PRA's May 2015 bank ring-fencing statement – see paras 3.10 and the comparison to the discussion of 'influence' at 3.15) or adopting materially the same approach as competition or, in some cases, defining the term for that purpose (for example, standard condition 31B of the UK electricity distribution licences requires completion of a compliance statement certifying how "full managerial and operational independence" of the business is achieved. In particular, the licensee is required to ensure that certain arrangements that might compromise independence (such as sharing premises, systems, equipment, facilities, property and people) do not in fact do so).

- (a) **‘Status quo – plus’.** One approach is to start with the status quo – that is, with the 2005 Undertakings – and ask which elements of the existing rules are failing (in terms of Ofcom’s objectives). That means asking: where should the 2005 Undertakings be made more stringent, so that BT’s capacity to influence Openreach can be reduced?
- (b) **‘Divestment – minus’.** The other approach is to seek to emulate structural separation as closely as possible, then seek to remove all elements of inappropriate influence BT might exercise over Openreach other than BT’s ownership interest. Our proposals mimic this by adopting remedies similar to those required by competition authorities in acquisitions, to manage the concerns arising from vertical integration. ‘Divestment minus’ starts with all of the benefits of structural separation and then seeks to reduce or avoid costs without compromising the overall outcome.

The other way to conceptualize ‘divestment – minus’ is to imagine BT as a notional purchaser of Openreach. What would a competition authority and/or a national regulator expect to see, in terms of separation maintained between an access network operator and its largest downstream customer, given Ofcom’s objective to ensure that BT cannot influence Openreach (and the requirements of competition law)?³⁹ That means asking: if BT took an ownership interest in an independent Openreach, what rights could BT exercise over or in respect of Openreach (starting from a status quo with BT having no rights over Openreach) before its influence would become a risk to competition and investment. This formulation creates scope to draw on, for example, undertakings accepted by competition authorities in relation to vertical mergers where foreclosure concerns arise. This question ought to set a floor but not a ceiling on BT’s obligations since in merger cases, the competition authorities operate in a position of much greater uncertainty than Ofcom does, given Ofcom’s deep understanding of the competition issues arising in communications markets. Thus, Ofcom can and should be expected to go further – potentially, much further – than a competition authority would go in setting the detailed obligations requiring separation, but it certainly must go at least as far.

- 3.6 The main reason to consider both these perspectives is to reduce the effect of path-dependency – that is, the outsized influence that the starting point (in this case, the status quo) can have on the outcome. By calibrating the assessment, we aim to produce a better and more robust set of proposals.
- 3.7 This also maps exactly on to Ofcom’s description of legal separation in the SRDC as fitting between the status quo of the form of functional separation adopted under the 2005 Undertakings (which is insufficiently separate) and the conclusive separation brought about by divestment. The most robust finding would be that both approaches lead to the same outcome: a set of separation requirements that achieves Ofcom’s objective, with the minimum necessary change to the status quo.⁴⁰

³⁹ This assumes that approval would be possible to secure; of course, in practice, a deal with such complex competition issues might not receive merger clearance at all.

⁴⁰ If there was no overlap between these two assessments, that might mean that it would be necessary to pursue structural separation. That is because it would imply that there was no identified strengthening of the current regime that would be equivalently effective in securing Ofcom’s objectives, compared with structural separation.

- 3.8 To the extent that there is a range of outcomes that would work effectively, then we think the right approach is to focus on the minimum necessary changes to the status quo to achieve Ofcom's objective. Defining a minimum set of requirements is most likely to fulfil the relevant legal test of proportionality. It is also likely to be the most efficient approach, and the one that is least exposed to the risk of regulatory error. It is also likely to impose the fewest direct costs on consumers.
- 3.9 Ofcom's statutory duties form the starting point for Ofcom's approach to regulating BT's structure. These duties are set by the European Framework, and are reflected in UK legislation.⁴¹ Although legislation changes rarely, Ofcom periodically re-articulates its statutory duties in order to explain its approach (to itself, its stakeholders and those to whom it is accountable). We have used the characterisation adopted by Ofcom in the SRDC, in which Ofcom described itself as having three core goals:
- (a) Promote competition and ensure that markets work effectively for consumers;
 - (b) Secure standards and improve quality; and
 - (c) Protect consumers from harm.
- 3.10 Ofcom's strategy – as set out in section 4 of the SRDC – is to encourage large-scale deployment of new fibre. To secure this goal, Ofcom has identified the six strategic objectives of the SRDC:
- (a) Shift to more investment in fibre;
 - (b) Step-change in service quality;
 - (c) Reforming Openreach;
 - (d) The right to broadband;
 - (e) Empowering consumers to make informed choices; and
 - (f) De-regulation and simplification.
- 3.11 The initial conclusions of the SRDC set out Ofcom's intended strategies to secure these outcomes. In relation to Openreach, the core principles governing Openreach are:
- (a) Independence;
 - (b) Transparency;
 - (c) Promotion of competition; and

⁴¹ See, Article 8 of the Framework Directive which sets out the policy objectives and regulatory principles to be implemented by NRAs and sections 3 and 4 of the Communications Act 2003 which set out Ofcom's duties and functions, and provide that Ofcom must, in carrying out its functions, give effect to the requirements of Article 8 of the Framework Directive.

(d) Effectiveness.

3.12 These concepts arise recurrently in developing the proposals. We set out some initial comments on them in this section to draw out common themes and explain what we understand by them.

Independence

3.13 As part of its SRDC, Ofcom explains that the competition concerns and market failures identified in 2005 have not been fully addressed by the current functional separation model.⁴² Ofcom goes on to set out that, despite the presence of the 2005 Undertakings, Openreach continues to have the ability and incentive to favour its downstream business in certain respects.⁴³ In particular, Ofcom noted how BT's vertically integrated position has been used to its advantage, for example:

- (a) Strategic decisions relating to the access network are taken from a BT perspective, for the benefit of BT, rather than the market as a whole;
- (b) There is insufficient consultation with Openreach's downstream customers (other than BTR), in particular in the early stages of major network investment decisions, leaving the risk that their needs might be neglected;
- (c) Openreach is directed by BT interests and lacks autonomy over its operating plan and capital budget, as well as lacking independent technical and operational capabilities required to provide its services to all its customers; and
- (d) The current structure allows BT to act on its incentives to allocate costs in a way that favours wider BT interests and therefore distorts competition.⁴⁴

3.14 Ofcom has concluded that the current functional separation model and status quo should not continue.⁴⁵ Accordingly, it is important that Ofcom take all the necessary steps to ensure that BT is no longer able to, either directly or indirectly, use its position as a vertically integrated supplier to discriminate against its downstream competitors.

3.15 Ofcom has decided to reform the relationship between Openreach and BT to give the former greater independence and autonomy. One of the key proposals arising from the SRDC is that Ofcom intends to reform Openreach's governance and secure the independence necessary to take its own decisions on budget, investment and strategy separately to BT.⁴⁶ Under this new structure, Openreach should have:

- (a) more independent governance structures and processes, with a responsibility to serve all wholesale customers equally;

⁴² SRDC initial conclusions, para 6.47.

⁴³ SRDC initial conclusions, para 6.1.

⁴⁴ SRDC initial conclusions, para 6.22.

⁴⁵ SRDC initial conclusions, para 6.47.

⁴⁶ SRDC initial conclusions, para 1.1.

- (b) independent technical and operational capabilities;
- (c) greater autonomy over its budget, and over its strategic and operational decision making; and
- (d) an ongoing responsibility to consult with all customers in the same way.⁴⁷

Functional separation and independence between Openreach and BT - symmetrically

- 3.16 A corollary of the independence of Openreach and BT is that, having established Openreach as a separate legal entity as its subsidiary, there must be strong and effective functional separation between the operations of that subsidiary and other parts of BT.
- 3.17 This will include clarity as to the specific functions and roles to be played by the different parts of BT. That will be based on, for example, the object(s) of Openreach (which provide a positive statement of the things that Openreach exists to do).
- 3.18 It will also include 'line of business' restrictions on the other parts of BT (generally and in relation to specific downstream divisions or entities), so that those downstream businesses do not seek to become providers of infrastructure (thus recreating the vertically integrated structure of BT today). There must also be a requirement not to interfere in Openreach's purpose, and not to engage in activities that might unduly influence or undermine Openreach.
- 3.19 Critically, it will also involve independence of BT's retail divisions from Openreach, so that the competing downstream businesses (BTR and others) are on a level playing-field. In some cases (as described in the bulk of this report) that will involve ensuring that other operators have the same ability to influence Openreach – no more, no less – than BT does. In other cases, it will involve ensuring that BT's retail businesses do not have advantages or characteristics that would not be open to other operators (for example, rewarding their staff for Openreach performance through 'whole of BT' incentive-based schemes, or tying their network to Openreach and enjoying the preferential treatment accorded to an anchor tenant).
- 3.20 As a result, the proposals set out in this report cannot be delivered through the Openreach articles of association and an independent Board alone; it will require some obligations to be imposed on, or assumed by, BT itself and its constituent divisions.

Transparency

- 3.21 In the SRDC initial conclusions, Ofcom explains that it is concerned that the current model of separation '*has failed sufficiently to remove the incentive and ability to discriminate against competing providers*'⁴⁸ and that Openreach '*should behave like, and be seen to behave like, an independent company*'.⁴⁹ Similarly, Ofcom acknowledges that – even where it has not found overt discrimination by Openreach – there is clearly a '*lack of confidence from the industry*

⁴⁷ SRDC initial conclusions, paras 6.1 and 6.66.

⁴⁸ SRDC initial conclusions, para 1.39.

⁴⁹ SRDC initial conclusions, para 1.43, emphasis added.

that [certain processes] are delivered in an equivalent manner',⁵⁰ in particular that the existing undertakings fail to effectively 'address strategic rather than operational discrimination'.⁵¹

3.22 Transparency is important for several reasons:

- (a) First, it provides assurance to the industry about the arrangements in place to secure Openreach's independence and their effectiveness. This assurance is necessary to provide the certainty needed for future investment – by CPs relying on Openreach's infrastructure; for CPs seeking to compete with Openreach for example by investing in their own fixed-line infrastructure; and for any investors potentially looking to co-invest with Openreach in the delivery of new infrastructure.
- (b) Second, it allows oversight by the regulator in order to assess compliance and effectiveness of the new independence requirements and how they impact Openreach and BT's behaviour going forward. Transparency should facilitate early detection of issues. For example, Ofcom has raised concerns that BT's existing regulatory accounting framework is not sufficiently clear and transparent to entirely avoid the risk of inappropriate allocations of costs, which may be difficult to identify.⁵²
- (c) Third, transparency improves the ability of other CPs to engage with Openreach's plans and strategy, improving the prospects for Openreach to address the needs of the industry as a whole. For example, Ofcom is particularly concerned that Openreach failed to consult in a sufficient, timely or transparent manner with all customers regarding strategic decisions.⁵³ This is of particular significance given the prospect of future co-investment options – which might involve CPs sharing the cost of infrastructure investment with Openreach. Clearly, such plans require the utmost confidence that Openreach will assess proposals in an objective way, without regard to (or the risk of sharing information inappropriately with) BT.

3.23 Consequently, Ofcom has stated that any strengthened model of functional separation would need to:

- (a) improve Openreach's approach to consultation with customers; and
- (b) involve commitments about transparency, especially 'when considering new network investments, consideration of any alternative proposals and consultation at an early stage on any favoured proposals'.⁵⁴

Promoting competition and investment

3.24 As a matter of general competition law and the Common Regulatory Framework, Article 8 of the Framework Directive requires that:

⁵⁰ SRDC initial conclusions, para 6.18.

⁵¹ SRDC initial conclusions, para 6.26.

⁵² SRDC initial conclusions, para 6.46.

⁵³ SRDC initial conclusions, para 6.33.

⁵⁴ SRDC initial conclusions, para 6.66.

‘2. The national regulatory authorities shall promote competition in the provision of electronic communications networks, electronic communications services and associated facilities and services by inter alia:

[...]

(b) ensuring that there is no distortion or restriction of competition in the electronic communications sector...

[...]

5. The national regulatory authorities shall, in pursuit of the policy objectives apply objective, transparent, non-discriminatory and proportionate regulatory principles by, inter alia:

[...]

(d) promoting efficient investment and innovation in new and enhanced infrastructures, including by ensuring that any access obligation takes appropriate account of the risk incurred by the investing undertakings and by permitting various cooperative arrangements between investors and parties seeking access to diversify the risk of investment, whilst ensuring that competition in the market and the principle of non discrimination are preserved’

3.25 This is transposed into UK law by section 4(2) of the Communications Act 2003. In the SRDC consultation document, Ofcom recognised that ‘competition has ... been at the heart of Ofcom’s approach to delivering good consumer outcomes’⁵⁵ and that ‘the market is best placed to understand the wide range of consumer needs and how these can be met through existing and new technologies and business models’.⁵⁶

3.26 Through support for functional separation of Openreach as a separate division of BT (and the associated 2005 Undertakings) and imposition by Ofcom of SMP regulation, Ofcom has sought to promote competition and investment in the market: for example, Ofcom has imposed strict obligations of non-discrimination and a requirement for Equivalence of Inputs on BT. These were intended to give all competing providers equal access to BT’s network. However, despite this, Ofcom has identified in the SRDC that:

‘6.47 The competition concerns we have identified as a result of BT’s vertically integrated structure are, in many ways, similar to those we identified in 2005. As a result, whatever the market successes the Undertakings have been able to deliver, we are concerned that they – together with the SMP regulation that sits alongside them – have failed fully to achieve the market outcomes that we think they should. This is because the vertically-integrated structure of BT inherently affects the way in which BT makes significant decisions. It is therefore our view that the important and persistent competition problems

⁵⁵ SRDC consultation, para 3.6.

⁵⁶ SRDC consultation, para 3.4.

and market failures identified in 2005 have not been fully addressed by the current functional separation model.

6.48 Consequently, the status quo is not acceptable; change is needed ...'

- 3.27 Accordingly, Ofcom sets out in the SRDC a number of proposals intended to promote investment and competition in the market.

Effectiveness

- 3.28 The 2005 Undertakings were negotiated and agreed with Ofcom in lieu of a reference to the Competition Commission (now the CMA). Given the limitations arising from the 2005 Undertakings, it is imperative that any decisions regarding the structure of BT and increased independence of Openreach create a level playing field and promote competition in practice.
- 3.29 Any steps to achieve Ofcom's objective must be carefully considered to ensure that they are cost effective, whilst also providing sufficient clarity and stability to the market; they must also be capable of being legally enforced. The precise legal mechanisms that Ofcom uses to secure legal separation are outside the scope of this report.

Structure of the Proposals

- 3.30 The next sections 4 to 7 set out the proposals that comprise the minimum steps necessary to establish an independent Openreach – that is, an entity that is free from BT's influence.
- 3.31 We have set out these proposals in a sequence that roughly maps onto the order in which the proposals could be taken forward. For example, Openreach would not have the capacity to agree arms-length contracts between it and BT governing its dealings until Openreach has been established as a separate legal entity and has an independent Board, and at least some form of commercial leadership. However, this is not intended to be a literal sequence – many of the proposals can be put in place from the outset and many will need to be concluded in a coordinated way under the control of the Openreach Board.
- 3.32 The proposals have been set out in four broad themes:
- (a) **Governance and purpose:** these are the basic elements in establishing Openreach as a special-purpose subsidiary of BT, with a defined purpose and an independent Board;
 - (b) **Independence:** these proposals clarify the basis on which Openreach functions as a stand-alone independent organisation, owning and exercising sole control over the assets, systems, staff and organisation capable of fulfilling its purpose;
 - (c) **Supporting and promoting competition and investment:** these proposals secure Openreach's role as the bedrock of a competitive market in which communications works for everyone and there is a level playing field for investment, complying with rules relating to the conduct of Openreach's core business of providing network access to all CPs on equivalent terms, including developing future plans and services working together with its customers without favouring BT over others; and

- (d) **Continued scrutiny:** these proposals are the recurrent or ongoing obligations that arise during the life of the new legal separation regime.

4. Governance and purpose of Openreach

- 4.1 This section deals with those proposals relating to the basic building blocks to enable reform of Openreach to create an autonomous legally separate entity with governance by an independent Board.
- 4.2 Given Ofcom's findings in the SRDC, it is axiomatic that Openreach and BT must be independent of each other. To achieve that outcome, it is necessary to embed that independence in the relevant legal and business structures that provide the context within which Openreach and BT operate.
- 4.3 The first question that arises is: does Openreach need to be a separate legal entity? This is the choice that Ofcom describe between models '6' and '7' in Ofcom's analysis in the SRDC of the different models of separation.⁵⁷

Proposal 1: BT must establish Openreach as a separate company

- 4.4 Openreach should be a separate legal entity (that is, a company), and not merely a division of BT Group plc.⁵⁸ This proposal is core to the concept of legal separation – all of the other proposals and the efficacy of legal separation depend on it.
- 4.5 Legal separation is necessary because the status quo (the form of functional separation adopted in the 2005 undertakings) has left BT with a material degree of influence over Openreach which is easily obscured and difficult to identify. If Openreach were a separate company, there would be inherently a greater degree of independence (because Openreach would have a Board which owes fiduciary duties to promote the success of the company, rather than to promote the success of the BT group) and the ability to put in place legal instruments such as binding contracts between Openreach and BT (which mean that other forms of influence would be easier to identify and avoid).

⁵⁷ SRDC initial conclusions, Figure 14.

⁵⁸ Following Ofcom's terminology in the SRDC initial conclusions (Figure 14), we refer to Openreach being separately incorporated as a subsidiary of BT Group plc as 'legal separation' (distinct from structural separation or ownership separation on the one hand, where Openreach is owned by someone other than BT Group plc, and functional separation, when Openreach is a division of BT Group plc, on the other). In some cases, we refer to the choice between legal separation and 'functional separation', although as set out in paragraphs A corollary of the independence of Openreach and BT is that, having established Openreach as a separate legal entity as its subsidiary, there must be strong and effective functional separation between the operations of that subsidiary and other parts of BT.- As a result, the proposals set out in this report cannot be delivered through the Openreach articles of association and an independent Board alone; it will require some obligations to be imposed on, or assumed by, BT itself and its constituent divisions., legal separation includes the need for functional separation between the different legal entities. The context determines in each case whether we intend functional separation to mean 'a separation regime relying on functional separation alone rather than legal separation' (most of this report) or 'that degree of functional separation that forms part of a legal separation regime' (paragraphs A corollary of the independence of Openreach and BT is that, having established Openreach as a separate legal entity as its subsidiary, there must be strong and effective functional separation between the operations of that subsidiary and other parts of BT.- As a result, the proposals set out in this report cannot be delivered through the Openreach articles of association and an independent Board alone; it will require some obligations to be imposed on, or assumed by, BT itself and its constituent divisions.).

- 4.6 Currently, Openreach and BT are not separate legal persons. Although 'Openreach' exists as a commercial brand applied to certain activities that BT undertakes, it is not able to take steps that a distinct legal entity can take in its own name, such as:
- (a) agreeing a contract;
 - (b) exercising control or holding an ownership interest in an asset;
 - (c) employing staff;
 - (d) borrowing money;
 - (e) bringing a claim to recover money owed to it; or
 - (f) providing services to customers.
- 4.7 These are all activities that are necessary elements of the conduct of an access services business. Today, when 'Openreach' purports to do any of these things, in law, those things are done by BT Group plc. Openreach owns no assets and holds no liabilities; it employs no staff; it holds no contracts in its own name; and it offers no services, other than by having those things be done by BT Group plc. In each of these respects, Openreach is not independent – Openreach is part of (wholly dependent on) BT Group. As a practical matter, this means for example that:
- (a) Openreach has no contracts with the rest of BT Group plc. No real money changes hands when Openreach supplies a service to BT's retail divisions and Openreach does not need to concern itself with billing or disputes with BT's retail divisions;
 - (b) BT Group plc determines (within regulatory constraints) the assets that Openreach is entitled to use to deliver services and the liabilities it accepts when doing so. Openreach has no ability to source funds without the approval of BT Group plc. For example, Ofcom has recently observed that Openreach has been starved of funds sufficient to ensure it can maintain adequate provisioning timeframes for business connectivity products; and
 - (c) Openreach staff are actually employed by BT Group plc. Their duties are to BT Group plc and, in many cases, their incentive remuneration is aligned with the performance of BT Group plc.
- 4.8 Some of these issues are addressed to some extent by existing regulation. For example, in some cases, BT is required to provide an explanation of differences between the supply of services by Openreach to external customers and the supply of equivalent services to BT's retail divisions. However, none of these constructs provides full independence of Openreach. There remain fundamental issues (like employee duties and the non-existence of binding contractual obligations between Openreach and BT's retail divisions) that can only be addressed with legal separation.

Company law provides the tools to secure Openreach's independence

- 4.9 Legal separation brings critical advantages over any lesser form of separation in relation to governance. This is because corporate governance is a deeply-embedded, well developed and time tested element of modern company law.
- 4.10 Today's separation regime lacks this feature, meaning that any 'independent governance' will be a *sui generis* regulatory construct which endeavours to replicate the situation where Openreach is a separate company. Replicating what company law already does is unnecessary. Further, not only is it unlikely to be as effective as simple reliance on company law in the first place, company law in many ways acts in *the opposite direction* to Ofcom regulation: while Ofcom aims to ensure Openreach is independent, the board of BT Group plc have directors' duties which require it to maximise value for shareholders – even if this is at the expense of UK consumers generally. This tension means that there is an inherent incentive to undermine the purposes of functional separation. Legal separation addresses this risk much better than allowing Openreach and retail divisions to remain in the one company, by ensuring that Openreach has its own board with directors' duties focused on the success of *Openreach* in achieving its corporate objectives rather than the success of BT Group plc.⁵⁹
- 4.11 Legal separation ensures that Openreach's governance comes pre-loaded with full use of established company law instruments, structures and obligations (particularly relating to director's duties and the processes of the Openreach board). These features can be used to deliver Ofcom's objective of ensuring Openreach is independent with far greater efficiency and certainty than sector-specific regulation and (from the perspective of Openreach) will avoid a conflict between the objectives of corporate law and Ofcom's regulatory objectives. If legal separation is not undertaken, then an attempt to replicate many of these structures will be necessary using regulation.
- 4.12 For example, if Openreach is incorporated, and its purpose (object) is stated in its constitution (articles of association), then its board will be bound to act in the best interests of the company and consistent with those objects, as a matter of obligations that exist without requiring any regulatory intervention by Ofcom.⁶⁰ If Openreach remains merely a division of BT, then there is no 'corporate' governance involved in Openreach at all; what is on offer is BT undertaking to create a simulacrum of legal separation, without any guarantee that it will be even partially effective, and with Openreach staff (along with any 'oversight board' or panel) being employed by BT Group plc and having underlying incentives to circumvent the purpose of regulation. Ofcom has concluded in the SRDC that this approach has proved ineffective.

BT's objections lack plausibility

- 4.13 Although it is beyond the scope of this report to deal with the points in detail, we note BT's variously expressed anxieties about the costs and difficulties of legal separation.⁶¹ Even to

⁵⁹ This helps address the problem of incentives to circumvent regulation *from within Openreach*. BT Group plc's board will, however, still have duties to promote the success of BT Group plc as a whole (including its interests in subsidiaries such as Openreach). For this reason, separate functional separation obligations will continue to be necessary to address the incentives of the BT Group plc board.

⁶⁰ Companies Act 2006, part 10, chapter 2.

⁶¹ See, e.g., BT, 'BT's response to Ofcom's discussion document "Strategic Review of Digital Communications" (8 October 2015), section 4.7 and BT, 'Ofcom's Strategic Review of Telecommunications – Phase 2 consultation document: BT's response' (3 February 2005).

cursory examination, these claims are implausible. In modern practice, the creation of separate legal subsidiaries to undertake specific tasks or for specific purposes is the norm, not the exception, and suggests this is a sensible and efficient business practice; BT is entirely an outlier in this regard and its decision not to use a subsidiary may well reflect a perverse incentive created by the current regime to make Openreach less transparent so that appropriate regulation of it is more difficult. Most FTSE100 companies have many subsidiaries performing specialised functions; some have dozens, or even hundreds. Indeed, BT itself operates some parts of its business as wholly-owned subsidiaries – including Plusnet and BT Fleet Services. There are some issues (such as BT’s pension scheme, and the treatment of wayleaves) that raise implementation issues that require attention, but there are no grounds for believing they are insurmountable.

- 4.14 On a smaller scale, ‘legal separation’ is achieved routinely to serve BT’s corporate interests – for example, to enable the sale and lease-back of land to free up capital. If BT had a strong incentive to achieve legal separation (or even structural separation) of Openreach – for example, because a third party offered BT an extremely attractive price for the assets, well above the value to BT itself of owning the network – it is inconceivable that BT’s leadership team would turn down that opportunity because it was too hard (and nor would the capital markets would allow them to remain in post very long if they did so).

Legal separation best serves competition policy goals

- 4.15 As a matter of competition policy, Openreach’s status as a division of BT Group plc creates a material difference in the relationship between Openreach and its external and internal customers. When Openreach deals with external customers, it faces the risks and uncertainties associated with dealing with another legal person. When it deals with internal customers, it does not. Unlike dealings with external customers, dealings between Openreach and BT will never, for example, run the risk of escalating to the point where one party opts to bring a legal claim against the other, or refer that dispute to Ofcom – in law, BT Group plc cannot sue, or have a dispute with, itself. Instead, those issues are resolved as a matter of the exercise of discretion of the entity that is on both sides of the issue: BT Group plc.
- 4.16 Ofcom’s finding in the SRDC is that the status quo does not give Openreach sufficient independence. By itself, this is not dispositive since a separate legal entity might still lack independence. Establishing Openreach as a legal person does not mean, for example, that it becomes a distinct undertaking (as defined in competition law) or is independent of its shareholder.⁶² In the normal course of business, a wholly-owned subsidiary is entirely under the control of its parent company, even though it is a distinct legal person.⁶³ However, it does inherently create some aspects of independence that would otherwise be lacking, for example

⁶² In *Klaus Höfner and Fritz Elser v Macrotron GmbH* (C-41/90), the European Court of Justice stated that, in the context of competition law, ‘... the concept of an undertaking encompasses every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed ...’. The Court applies a “rebuttable presumption” whereby it is presumed that a parent company exerts decisive influence over its wholly owned subsidiary unless ‘... the parent company ... [can] put before the Court any evidence relating to the economic and legal organizational links between its subsidiary and itself which in its view are apt to demonstrate that they do not constitute a single economic entity’, *General Química SA and Others v European Commission* (C-90/09), para 67.

⁶³ *Ibid.*

in the default position that directors owe a fiduciary duty to promote the success of *the company* rather than to its corporate group.

- 4.17 Requiring legal separation as a feature of independence has an established history and track-record in competition policy, without creating undue difficulties or insurmountable implementation issues. For example, legal separation has been successfully implemented (as an intervention that is separate from structural separation) in the energy, transport and banking regimes. In no case that we have reviewed have the issues raised by BT been material obstacles, suggesting that BT's anxiety about them is misplaced.
- 4.18 Of course, the use of legal separation is not limited to commercial contexts; it is used amongst public bodies to create a 'clean break' and establish a new, independent organisation. A salient example is close to home: literally the first legislative provision dealing with Ofcom, section 1(1) of the Office of Communications Act 2002, provides that:

'There shall be a body corporate to be known as the Office of Communications (in this Act referred to as 'OFCOM').'

- 4.19 Under competition law, merger remedies that stop short of divestiture (i.e. structural separation) have used legal separation as an intermediate step. For example, when establishing its gas storage business as an independent entity to address concerns arising from a vertical merger, the CC required of Centrica that:

*'... there should be legal, financial and physical separation between [the entity with market power] and all other parts of Centrica's businesses.'*⁶⁴

- 4.20 Similarly, although still under consultation, the Prudential Regulation Authority ('PRA') has set out rules under which banks will be required to 'ring-fence' their core retail activities from 1 January 2019.⁶⁵ The Banking Reform Act (which amended the Financial Services and Markets Act 2000) set out provisions relating to the legal structure of groups containing ring-fenced banks. The effect of the definition of a 'ring-fenced body' is that any such body must be a separate legal entity from any other entity carrying on excluded activities. A single legal entity cannot carry out both core activities and excluded activities.
- 4.21 In addition, the Second EU Package of Energy Reforms (set out in Directive 2003/55/EC) recognises that 'network access must be non-discriminatory, transparent and fairly priced'. In achieving this, recital 10 of the Directive acknowledges the importance of legal separation stating that:

⁶⁴ Competition Commission 'Centric plc and Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd: A report on the merger situation' (2003), available here: http://webarchive.nationalarchives.gov.uk/20111202195250/http://competition-commission.org.uk/rep_pub/reports/2003/480centrica.htm.

⁶⁵ Prudential Regulation Authority, 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities' (PS10/15, May 2015). Available here: <http://www.bankofengland.co.uk/pru/Documents/publications/ps/2015/ps1015.pdf>.

*'In order to ensure efficient and non-discriminatory network access it is appropriate that the transmission and distribution systems are operated through legally separate entities where vertically integrated undertakings exist ...'*⁶⁶

4.22 Finally, legal separation has been implemented in telecoms in a number of countries including Sweden, Singapore, Australia and New Zealand. Singapore, for example, operates a multi-tiered market structure consisting of: the network operator ('NetCo'), several operating companies ('OpCos') and retail service providers ('RSPs'). Singapore operates a trust structure to separate the management of the passive assets from their beneficial owner, the vertically integrated SingTel. Separation obligations exist between SingTel and the management and operation of the trust assets.

Should BT have a trustee shareholder?

4.23 Assuming ownership separation is not imposed, BT would remain the sole shareholder of Openreach. In this capacity, it would (under normal corporate law principles) be entitled to access Openreach's documents, strategies and decide its budget allocations; and similarly require Openreach to dividend out funds that Openreach might otherwise use for investment consistent with the SRDC principles. In this way, legal separation would not address the prospect of BT indirectly influencing Openreach or using its ownership of Openreach to its own advantage (for example, by withdrawing capital if BT did not approve of Openreach's planned investments and/or obtaining access to Openreach information which reveals the plans of other CPs).

4.24 It would therefore be critical that any rights exercisable by BT as a shareholder provide absolute transparency about Openreach's independence, with the effect that:

- (a) BT must be required to act as a passive shareholder, with limited exceptions such as (for example) transparently setting a financial target for Openreach (potentially within appropriate constraints or with appropriate safeguards to prevent this being used as a means of inappropriately influencing Openreach's investment decisions).⁶⁷ This would provide transparency that BT is not indirectly influencing Openreach's behaviour other than through industry-wide processes that are accessible to all CPs;
- (b) BT's access to Openreach information must be limited to broad, high-level information which is sufficient for BT to exercise its limited shareholder rights (and use and disclosure of the information should be limited to certain parts of the business responsible for group-level decision-making, with particular limitations on disclosure to or use by BT's retail divisions).⁶⁸ This would provide transparency that BT Group plc is not using its ownership of Openreach to obtain an unfair competitive advantage; and

⁶⁶ Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC. For further information, see Annex 3.

⁶⁷ The ultimate controllers of electricity distribution licences must provide undertakings that they will refrain from (and procure that other members of the corporate group will refrain from) any act likely to cause the licensee to breach its regulatory obligations (standard condition 31). Similar obligations apply under Heathrow's licence (condition E2.7). This should be combined with regulatory obligations regarding Openreach's financial resilience to ensure that BT is not able to set inappropriate financial targets.

⁶⁸ This would need to address the rights conferred by ss 431-432 and 1145 of the Companies Act 2006, which provides members of companies with information rights. Such a provision could be similar to that applying to electricity distribution

- (c) Openreach must have a policy on delivering returns to BT that ensures BT's legitimate interest in obtaining a reasonable return on its capital invested in Openreach does not compromise Openreach's ability to make further investments to benefit the industry.

4.25 The requirement for BT to act as a passive shareholder under legal separation might be achieved through:

- (a) a formal trustee arrangement, as is in place in Singapore, or a requirement for BT to appoint an independent proxy which will have the confidence of the industry and Ofcom. A trustee shareholder would be a legal entity which would hold shares in Openreach and exercise the rights associated with such shareholding. However, the financial interest in the shares (including, for example, rights to dividends) would be for the benefit of BT. In this way, a trustee shareholder structure could create separation between the ability to influence over a company that a shareholder normally enjoys, on the one hand, and the direct financial interest of a shareholder, on the other hand. This trustee must be able to bring an action in BT's name against directors of the Openreach board for breach of fiduciary duties, and must have sufficient independent monitoring and enforcement capabilities;
- (b) a set of legal limitations on BT's ability to exercise normal shareholder rights. The starting point should be that no shareholder rights (other than in relation to setting the financial target within appropriate constraints and the right to receive dividends) should be exercised at all, without consent in each case from Ofcom or an independent entity. For example, BT would only have rights to the same financial information made available to the rest of the industry and it would not have control over the appointment of the Openreach board. BT should have the burden of proving which specific exceptions to this rule should be justified and in which circumstances; or
- (c) the involvement of third parties (industry or Ofcom) in Openreach's governance, for example industry and/or Ofcom having:
 - (1) rights to be consulted over certain governance decisions;
 - (2) 'veto rights' over certain governance decisions;
 - (3) rights to make certain governance decisions (e.g., certain decisions needing to be made by a majority of significant CPs); or
 - (4) direct rights as shareholders, which might provide equal voting and other governance rights (including a right to information) as held by BT, but without rights to dividends and with only a nominal equity interest in Openreach. This

networks, which (subject to certain exceptions) are required to 'put in place and at all time maintain managerial and operational systems that prevent any Relevant Licence Holder from having access to Confidential Information except and to the extent that such information: (a) is made available on an equal basis to any Electricity Supplier, gas supplier, or gas shipper; (b) is referable to a Customer who at the time to which the information relates was a Customer of the Relevant Licence Holder; or (c) is of a type that has been confirmed by the Authority in Writing as corporate information' (standard condition 31B.2).

might be similar, for example, to the role of trustee shareholders in The Economist Group set out in Annex 5.

- 4.26 The direct involvement of other CPs in Openreach's governance is likely to raise complex questions about which CPs are represented and how the decision-making process would work. We also expect that Ofcom will be reluctant to take on a role which involves active approvals of decisions about Openreach. We therefore expect that the most workable solution is a trust or proxy structure based on the model adopted in Singapore or a limitation on BT's rights as a shareholder so that BT's interest in Openreach resembles that of a passive minority investor.
- 4.27 Such an arrangement would provide assurance to industry that Openreach is independent and therefore BT is not influencing Openreach's incentives so they are aligned to protecting BT rather than serving the industry as a whole. It would address the current situation, whereby BT/Openreach's incentives (and indeed the corporate law duties of the BT directors) are to promote the success of BT – and therefore Openreach's investment plans and strategy inappropriately reflect the needs of BT's retail divisions – and regulation attempts to resist this. Under new arrangements, Openreach's board would be incentivised to reach the profitability targets set by BT in any manner which Openreach chooses – even if this is not most advantageous to BTR. For example, this model would better facilitate Openreach considering:
- (a) third party funding – for example, where a third party is prepared to offer project funding for a specific network upgrade different to the type of network upgrade than BTR would have funded, Openreach should be incentivised to choose the third party funded project if it provides a better business case for Openreach; and
 - (b) co-investment options – for example, with different CPs agreeing to provide funding to Openreach for specific network upgrades.
- 4.28 These are considered in the relevant proposals in this and the next section.

Proposal 2: Openreach's Articles of Association should limit the objects of the company

- 4.29 Whichever regime is adopted, there will need to be assurance that Openreach has:
- (a) clarity as to the role that it is to play. This will ensure that the board and management take decisions based on the purpose that Openreach is intended to serve; and
 - (b) limits on its ability to operate outside that role.
- 4.30 It is essential for all concerned that Openreach plays a specific and defined role in the provision of network access to all downstream competitors, and does not adopt a commercial strategy that undermines the purpose of functional separation. If Openreach were not subject to 'line of business' restrictions, the Board of Openreach may decide (or feel duty-bound), for example, to acquire or establish its *own* downstream business, recreating the vertically-integrated structure of the existing BT group within Openreach. There would also be concerns that BT's retail divisions might re-invest in wholesale fixed-line infrastructure to avoid Openreach. Clearly either option would undermine the purpose of functional separation and therefore a restriction on this type of behaviour is necessary and proportionate. Importantly,

such a restriction may also benefit BT. Given BT will have limited influence over Openreach's activities, BT may well be concerned as a shareholder about ensuring there are appropriate limits on the purposes for which Openreach will act and the types of investments it will make using the capital BT provides to the business.

- 4.31 Currently, these restrictions are imposed via the 2005 undertakings.
- 4.32 A critical advantage of legal separation is that there is an obvious and resource-efficient way to impose these restrictions: to write those restrictions into the Articles of Association (sometimes termed the 'constitution') which under company law, can specify and thereby restrict the object(s) of the company.⁶⁹ This has the benefit of not requiring any additional new regulatory instrument which would not otherwise be required under legal separation, since it is (in any event) a requirement of the Companies Act that a company to have articles of association in most cases.⁷⁰
- 4.33 We would expect that this to be coupled with a direct regulatory obligation (e.g., undertakings) to prevent those restrictions being amended going forward.
- 4.34 Specifying the objects of an undertaking (i.e. line of business restrictions) is a very powerful tool for shaping that company's operations. The Companies Act 2006 confirms the importance of a company's articles of association, providing that:

*'The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.'*⁷¹

- 4.35 In other regulatory regimes, the limiting or focusing of the activities of a specific undertaking can be achieved by means of licence conditions.⁷² In electronic communications, licence conditions are only relevant in relation to spectrum licences or the grant of the rights of use of telephone numbers. Neither of these seems a useful vehicle to give effect to obligations on Openreach. While these restrictions could be enshrined in undertakings or SMP conditions, benefits of codifying the restrictions in the articles of association include that:
- (a) it highlights that these restrictions are fundamental elements of Openreach's purpose and should be reflected in every aspect of how it conducts its business; and
 - (b) since directors have a duty to act within the powers of the company, it would be a breach of director's duties to cause the company to undertake activities outside the permitted purposes. This should be a powerful incentive on the board to ensure that Openreach does not go beyond those purposes.

⁶⁹ Companies Act 2006, s 31 which states that 'unless a company's articles specifically restrict the objects of the company, its objects are unrestricted'.

⁷⁰ Companies Act 2006, s 18.

⁷¹ Companies Act 2006, s 33.

⁷² For example, standard condition 29 of electricity distribution licences require that '[t]he licensee must not conduct any business or carry on any activity other than an activity of the Distribution Business except in accordance with the provisions of this condition'.

- 4.36 In the context of legal separation, there is significant precedent for using company constitutions or articles of association to set out the separated company's objects, purposes and powers – imposing de facto line of business restrictions. For example:
- (a) in Australia, the constitution of NBN Co Limited (the company rolling out Australia's national broadband network) specifies that its objects are *'are to roll-out, operate and maintain a national wholesale broadband network while working closely with the Commonwealth during the implementation study in order to facilitate the implementation of Australian Government broadband policy and regulation'*, and its powers extend only to doing things *'necessary, convenient or incidental'* to carrying out that object and which are consistent with government policy;⁷³ and
 - (b) in New Zealand, the constitution of Chorus Limited (the network company separated from Spark, previously known as Telecom NZ) specifically requires it to comply with the Deed.⁷⁴ The Deed provides a set of governance undertakings made by Chorus to the New Zealand government,⁷⁵ including requirements such as limiting the services Chorus is allowed to provide and the pricing of those services.
- 4.37 Other examples of entities who are limited as to their purposes include, for example charitable organisations. To be recognised as a charity in law, an organisation must be established for *'charitable purposes'* (Charities Act 2011, s 1). Such purposes are typically set out in the charity's constituent document.

What should the articles of association say?

- 4.38 It is outside the scope of this report to provide a detailed drafted set of articles of association for Openreach. However, it is possible to identify a number of requirements that any drafting would need to incorporate. The articles of association should specify:
- (a) the purpose of Openreach: to operate and manage the fixed-line access network and ancillary network facilities and provide these on an equivalent basis to all CPs;
 - (b) the scope of its services: for example, these might be limited to services at certain levels of the OSI value stack (e.g., no layer 3 services) and expressly prohibit the provision of retail services;
 - (c) the principle of legal, financial and operational independence from BT:
 - (1) Legal: holds rights and can exercise them to fulfil its purpose;
 - (2) Financial: maintains independent controls over funds and business dealings to enable it to achieve its purpose;

⁷³ Available here: <http://www.nbnco.com.au/content/dam/nbnco2/documents/nbn-constitution.pdf>. There are further line of business restrictions set out in the NBN Companies Act 2010 (Cth).

⁷⁴ Available here: <https://www.chorus.co.nz/file/65545/Chorus-Constitution.pdf>.

⁷⁵ Available here: https://www.chorus.co.nz/file/65544/chorusdeedof_operationalandgovernanceundertakings.pdf.

- (3) Operational: Fully independent/stand-alone operations in all respects, including assets, systems, staff and practices; and
 - (4) Organisational: Including a separate brand and identity that supports OR purpose and a separate voice in relation to policy/regulatory issues that are relevant to OR;
- (d) requirements for stand-alone operations, systems, assets; and
- (e) requirements for the delivery of network access:
- (1) to deliver all services on an 'EOI/one service for all' basis;
 - (2) consult with customers equally in relation to plans and produces;
 - (3) to develop a co-investment plan and model; and
 - (4) to manage its passive infrastructure on a standalone basis, through a separate business unit, and in a manner that best preserves flexibility for future disaggregation of the active and passive networks into separate legal entities.

4.39 In relation to matters such as independence and equivalence, it would not necessarily be appropriate to cover those issues exhaustively in the articles of association. However, they could be established as core principles by which Openreach should operate. An open question is whether there would be a need for details about EOI, consultation with customers, and business plans (and things that might change over time, like treatment of passives) or whether such matters should be left to some other instrument (for example, SMP conditions). Our initial proposal would be that the articles of association, coupled with the duties imposed on directors under company law, should be sufficient for most elements of the separation regime, particularly if there was a clear statement from Ofcom as to what it expected to occur as the Openreach board gave effect to those high-level principles. However, those obligations that must be imposed on other parts of BT (such as the requirement to ensure that all dealings with Openreach are on an arms-length basis and that BT retail divisions are not 'guaranteed' sources of business for Openreach) cannot be secured in this way.

Proposal 3: Openreach must have an independent board and senior management

4.40 If Openreach is established as a separate legal entity, it must have a board. By itself, this is insufficient to protect Openreach from BT's influence since, under normal corporate law principles, BT would (as the sole shareholder of Openreach) determine the composition of the board. This would allow BT considerable influence over the directors of Openreach and, consequently, the decisions made by the board. To address this concern, it is necessary that the board be appointed by a process other than a decision of BT, and that the board be independent of BT. It is also necessary that Openreach's senior management are independent of BT.

Composition of the board

4.41 Specific requirements that can help ensure that Openreach is independent include:

- (a) a documented process to explain the process of selecting directors, involving Ofcom and/or the Independent Monitoring Trustee ('IMT') (so that directors were not appointed by BT);
 - (b) a requirement that all directors be independent of BT;
 - (c) a requirement for security of tenure of those independent directors;
 - (d) a majority of directors who are independent of Openreach (i.e. non-executives); and
 - (e) a Chair which is independent of both BT and Openreach (i.e. a non-executive).
- 4.42 A number of executive directors (including the Openreach CEO, CFO and perhaps one other) would then complete the board.
- 4.43 So, for example, if there was an independent board of seven directors:
- (a) all would be selected by an arms-length process with Ofcom and/or the IMT involved in approving the selection criteria or choosing the candidates directly;
 - (b) each of the seven would be required to be independent of BT, both at the time of their appointment and thereafter;
 - (c) each would have assurance of tenure, save for exceptional circumstances;
 - (d) four of the seven directors would be non-executive directors, and hence, independent of Openreach's management team (which is vital in playing their role in governing Openreach);
 - (e) one of the four non-executive directors would be the independent Chair; and
 - (f) the remaining three directors would be executive directors – that is, they would be directors of Openreach but also be employed by Openreach (i.e. Openreach CEO and his or her two most senior team members).
- 4.44 We set out each of these requirements in more detail below. As a general note, however, it will be critical to the industry that there is the utmost confidence in Openreach's performance and independence. At a minimum, we would therefore expect that Openreach would be required to operate to the highest standards of corporate governance, including (except where that would be inconsistent with the other proposals in this report) requirements that would apply if it was a separate company with a premium equity listing on the London Stock Exchange. We have not dealt with these requirements in detail below, but note that these principles below are intended to highlight the need for Openreach to be independent rather than to set out a comprehensive list of the corporate governance practices to which Openreach should be required to adhere.

A documented appointment process

- 4.45 The UK Corporate Governance Code requires that *'There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board'*.⁷⁶ This is particularly essential given Ofcom's concerns about transparency and the risk that board appointments will be a key manner in which BT could exercise residual control over Openreach.
- 4.46 This process, for example, should ensure that Openreach has a board which is sufficiently diverse in skills and experience. It must also ensure that BT's involvement does not lead to it having influence over Openreach, and so it would be inappropriate to allow BT to appoint the directors directly (as would otherwise be the case). At a minimum, any role played by BT would be to manage a structured consultation process with key industry players about appointees; and may require consent from third parties such as the OTA or Ofcom to provide further assurance.
- 4.47 A better approach (and the approach that we think makes sense in this context) is to have the directors appointed directly by Ofcom (in the way that Ofcom currently appoints the Chair of Channel 4) or having appointments made notionally by BT but only with the approval of Ofcom or the IMT (or both).
- 4.48 The UK Corporate Governance Code provides for the board to set up a nomination committee comprised of independent non-executive directors. This would be one option that would maximise the ongoing independence of the board. BT could, for example, have input into the process by having the opportunity to nominate a preference based on recommendations or a set of choices put forward by the nomination committee.

Openreach Board members and senior management should all be independent of BT

- 4.49 If the directors of Openreach are also involved in BT's business, that will facilitate coordination of the business plans of BT and Openreach, and creates opportunities for inappropriate 'leakage' of information between the two businesses. The same considerations apply to Openreach's senior management. Even without conscious intent, a director or senior manager associated with BT may well find it impossible to separate and ignore the interests of the broader BT group when making decisions purportedly for the benefit of Openreach – and this type of influence will often be impossible to detect or identify. For this reason, it would be inappropriate to appoint as directors or senior managers of Openreach anyone who is associated in any way with BT. This would also be consistent with the intention of putting BT in the position of being a 'passive minority investor' with no special influence over the Openreach business by virtue of its ownership interest.
- 4.50 In order to ensure that the Openreach board and senior management are independent of BT, directors and senior management must have no actual or perceived interest in BT's activities (for example, they ought not to be BT shareholders, employees or recent past employees, or involved in BT management). It seems unlikely that an individual who had spent the substantial part of their career at BT should ever qualify.

⁷⁶ Financial Reporting Council, 'The UK Corporate Governance Code' (September 2014), Section B.2 – Appointments to the Board. Available here: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>.

4.51 Under the UK Corporate Governance Code, the board is to identify each non-executive director it considers to be independent. This provides a helpful explanation of the concept of 'independence' and that it is context-specific. The board is required to consider independence in character and judgement and the existence of relationships which are likely to (or could appear to) affect the director's judgement. This includes where the person:

- (1) *has been an employee of the company or group within the last five years;*
- (2) *has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;*
- (3) *has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;*
- (4) *has close family ties with any of the company's advisers, directors or senior employees;*
- (5) *holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;*
- (6) *represents a significant shareholder; or*
- (7) *has served on the board for more than nine years from the date of their first election.*

4.52 This would appear to be a useful basis on which independence should be assessed but should not be seen as an exhaustive list of factors. Considerations of independence should also, for example, include whether the person has a relationship with BT via any political or charitable body that receives the company's support (as referred to in the Pensions Investment Research Consultants UK Shareholder Voting Guidelines).

4.53 Given the absolute importance of ensuring independence of the board to the objectives of legal separation, conflicts of interest (and perceived conflicts) must be absolutely avoided. Ofcom should therefore consider requiring the adoption by the board of a 'code of conduct' of similar stringency to that which applies to Ofcom's own board members. For example, the Ofcom Content Board Conduct of Conduct requires that members 'must avoid any suspicion that their decisions might be influenced in the hope or expectation of future employment with a particular firm or organisation', and therefore many types of prospective and actual relationships with relevant companies are prohibited.⁷⁷

4.54 As a starting point, however, it would be necessary to ensure that the directors are determined to be independent by a third party (e.g. Ofcom or the IMT) in order to ensure an appropriate and independent starting point for the board.

⁷⁷ Available here: <http://www.ofcom.org.uk/about/how-ofcom-is-run/content-board/code-of-conduct/>.

- 4.55 An example of this independence requirement is Centrica Storage Limited ('CSL'). CSL is a wholly owned subsidiary of Centrica plc, but is required to operate at 'arms-length' because it deals with potential competitors to Centrica. In undertakings given to allow the acquisition of CSL assets, Centrica undertook that:
- (a) *'no employee or director of any member of the Centrica Group ... or the agents or Affiliates of any such member shall hold or be nominated to any office of employment or directorship in, or provide any services to CSL'; and*
 - (b) *In terms of line management responsibility, 'the Company Secretary of Centrica has responsibility for CSL or, with the prior approval of the OFT, a full time executive director may be appointed to have responsibility for CSL'.*

Certainty of tenure

- 4.56 All directors would be duty-bound to act to promote the success of Openreach. However, the directors may, nevertheless, feel beholden to BT and reluctant to act against its best interests if their appointment as directors may be terminated by BT.
- 4.57 In particular, it is imperative that BT must not be able to remove from office or re-appoint any of these roles except in clear and narrowly defined circumstances (normally because something has gone drastically wrong – such as gross incompetence or inability to serve).
- 4.58 The term and tenure of Board members (including the Chair) could be expressly provided for under the Openreach articles of association.

A majority of directors who are independent of Openreach

- 4.59 The UK Corporate Governance Code explains that non-executive directors play a key role and should *'constructively challenge and help develop proposals on strategy'*. As the Code explains:

'Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.'

- 4.60 It is therefore important to protect BT's interests as shareholder (given it will have limited capacity to influence the business) to ensure that there is a majority of non-executive directors who can provide oversight over Openreach and ensure it is operating responsibly and optimally. Indeed, the whole of industry will benefit from the assurance that Openreach's management is subject to a high level of scrutiny by respected outside directors that are not involved in the day-to-day running of the company.

An independent Chair

- 4.61 The Chair has special responsibilities for setting the agenda; managing meetings; ensuring all directors are able to contribute effectively; and communicating with BT in its capacity as shareholder.

4.62 It is therefore especially important that the Chair is independent (both of BT and of Openreach management). This similarly reflects requirements in the UK Corporate Governance Code, which requires that the Chair should meet the independence criteria.

Duties of the board

4.63 The role of the Openreach board will be to manage Openreach, primarily by appointing the CEO. There should be a clear demarcation of responsibilities between the board and the management of Openreach. This will need to be clearly documented so there is public transparency about the allocation of responsibilities, and it should ensure that ultimate responsibility for Openreach’s business decisions lies with the board.

4.64 The most consequential decisions will include:

- (a) appointing the Openreach CEO;
- (b) approving Openreach’s strategic and financial plans (budgets);
- (c) securing consultation with all major customers on an equivalent basis to inform those plans, particularly in relation to investment decisions; and
- (d) delegating authority for day-to-day spending and operational decisions to specific Openreach officers (and taking decisions directly where those thresholds are exceeded).

Proposal 4: An Independent Monitoring Trustee appointed to oversee compliance

4.65 We propose that Ofcom appoints an IMT to oversee the establishment of Openreach as a legally separate entity and then to play an active role in supervising the transition to fully independent operations, and report to Ofcom and other stakeholders on progress.

An IMT is a routine method to manage complex transactions

4.66 An IMT is often appointed by a competition authority during or after a merger investigation, generally to oversee divestment and ensure that commitments offered in undertakings are carried out fully and effectively. The IMT’s role may also include assessing what integration has occurred, overseeing performance of the Hold Separate Manager (‘HSM’)⁷⁸ and reaching a view on whether the acquired business can function independently during the authority’s investigation.

4.67 In this context, an IMT could be appointed to monitor, and give effect to, the legal separation requirements. The Commission’s Standard Trustee Mandate⁷⁹ sets out a standard form and process for appointing an IMT. Among other things, the mandate sets out: how a trustee is to be appointed; the general duties and obligations of the trustee (including that the business complies with any undertakings made to the Commission); general duties relating to

⁷⁸ A person appointed to manage a business on a “business as usual” basis in order to preserve the existing market structure during an investigation. The competition authority may also appoint an HSM to operate the acquired businesses separately from the acquirer and in line with any initial measures imposed by the authority. The HSM’s role is a day-to-day operational role in the acquired business.

⁷⁹ Version 5: December 2013. Available here:

http://ec.europa.eu/competition/mergers/legislation/trustee_mandate_en.pdf.

monitoring and managing the divestment business; and obligations to regularly report progress to the Commission.

- 4.68 The IMT model is a better approach to monitoring and enforcement than the existing model of self-monitoring. Currently, compliance by BT with the 2005 Undertakings is overseen by the Equality of Access Board ('EAB'). Clause 10.9 of the 2005 Undertakings defines the EAB's role as a general one of:

'... monitoring, reporting and advising BT on BT's compliance with these Undertakings and the Code of Practice, with a specific focus on the provision of products on an Equivalence of Inputs basis ...'

- 4.69 The EAB consists of five members: three independent members; one member who is a BT executive; and one who is a BT non-executive director (who is also the chair of the EAB). A key problem with having BT staff and non-executives on the EAB is that it creates a risk that the EAB may not act in a truly independent manner.⁸⁰ This lack of independence is exacerbated by the fact that all of the staff who carry out the duties of the EAB and produce its recommendations and decisions are also (as we understand it) BT employees.

Open, independent monthly reporting on progress

- 4.70 The IMT would provide a genuinely arms-length assessment of BT's progress towards to the completion of legal separation, with its reports being provided to Ofcom and then made available to all stakeholders on a transparent basis.
- 4.71 Monthly reporting is routine in the management of a divestment and (applying a 'divestment - minus' perspective) there is no reason to take a different approach.

The IMT could also act as adjudicator between BT and Openreach

- 4.72 As well as monitoring progress towards legal separation and the independent operation of Openreach, the IMT could play a vital role in providing an adjudication function to resolve issues that are not capable of being agreed between BT and Openreach. There is a long history and considerable experience of using specially-appointed entities or individuals to act in this type of capacity in relation to complex processes arising under competition law or regulation – for example, specifically in the communications sector under UK competition law, there is a CRR Adjudicator appointed in relation to the contract rights renewal mechanism imposed on

⁸⁰ Although it is outside the scope of this report, we note that some other problems with the current EAB model include: (1) lack of clarity about constitutes a 'trivial' vs 'non-trivial' breach of the Undertakings – should every breach be reviewed on its own merits?; (2) questions as to whether the informal complaint process works for operators, and whether it can be strengthened (e.g. by increasing the level of transparency or public reporting); (3) scope to increase the frequency of KPI monitoring, e.g., could it be monthly in line with OTA2 reporting; and (4) questions as to whether there are additional ways that self-reporting can be enhanced within BT Group (e.g. tying to performance reviews).

ITV in relation to advertising sales,⁸¹ and the Office of the Adjudicator for Broadcasting Transmission Services dealing with issues arising following the NGW/Arqiva merger.⁸²

- 4.73 There needs to be some form of adjudication mechanism. Disputes ought to arise, given the divergence of interests between the BT Group and the independently assessed views of the Openreach Board. For example, issues may arise in relation to the value of assets to be transferred, the question of whether liabilities as well as assets ought to be transferred, the way in which any costs associated with the transfer are to be divided between the parties and so on. (Indeed, if no disputes arose, it could indicate a potential concern that there was insufficient independence being exercised).
- 4.74 Although it undoubtedly would end up being the ‘escalation point of last resort’ in the event that no provision for adjudicating disputes is made, we think that Ofcom is not well-suited to play this role. Depending on the mechanism used to implement legal separation, there is a question as to whether Ofcom’s resources will be available to support this form of dispute resolution. When it does so, it will be unlikely to be able to limit its terms of reference, since consideration by Ofcom of its policy objectives is likely to be necessary, creating a situation where it would require a more detailed ‘full blown’ policy analysis of an issue (which may be comprehensive, but disproportionate).⁸³
- 4.75 The terms of reference of the IMT would need to specify the basis on which disputes would be resolved. It seems reasonable to include a focus on seeking first to facilitate a negotiated solution (perhaps by suggesting mediation, whilst preserving the independence of the IMT) but ultimately, the IMT will need to be able to produce short, commercially-oriented and legally binding decisions that can unblock obstacles to progress in a pragmatic way. As with other forms of arbitral decision, those decisions would be final, subject to appeal on a point of law.

⁸¹ The merger of Carlton and Granada was approved by the Secretary of State on the condition that the companies abide by a set of rules to protect the advertising community from unfair or discriminatory practices in the selling of television airtime. The Contract Rights Renewal remedy imposes three main conditions: first, it guarantees that advertisers and media buyers will be no worse off following the merger than before; secondly, it puts in place an automatic “ratchet” – a linkage which will reduce the amount advertisers will have to commit if ITV’s audience shrinks; and thirdly, it establishes an Adjudicator to make sure that fair competition prevails. For further information, see: <http://www.adjudicator-crr.org.uk>.

⁸² In its merger decision, the Competition Commission concluded that the merger would lead to a substantial lessening of competition in broadcast transmission services. To resolve the Commission’s concerns, the parties gave and the Commission accepted, undertakings intended to adequately protect existing and new customers over the terms and conditions of supply. This included protection against future price rises and protection against charges in non-price related clauses (such as discrimination issues and service standards). A key aspect of the Adjudicator’s role is to resolve disputes regarding Arqiva’s obligations. The undertakings state that the Adjudicator’s decision is binding on a dispute and not subject to a merits-based appeal. However, the Adjudicator is required to take account of Ofcom’s sectoral regulation when making decisions in order to promote consistency. For further information, see: <http://www.adjudicator-bts.org.uk>.

⁸³ See, e.g., *British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42.

5. Independence

- 5.1 The second theme under which we have grouped our proposals relates to the establishment of Openreach as an independent stand-alone organisation – that is, adding the assets, systems and contractual relationships (including employment relationships) that it needs to conduct its business.
- 5.2 The policy objective of these proposals is to ensure that Openreach has all the tools it needs to fulfil its purpose, independently of BT. The requirement to secure that object will be set out in the articles of association and implementation of these proposals will accordingly largely be governed by the director's duties under company law, rather than specific regulatory intervention. This means that the regime will be a substantially 'lighter touch' arrangement than the status quo, which brings a number of benefits in terms of reducing the scope for regulatory uncertainty and regulatory risk.
- 5.3 Deciding what assets to transfer and how to manage the transition will involve complex commercial issues and require a degree of pragmatism and strong leadership from both Openreach and BT, each of whom will have substantial commercial interest in the outcome of the separation of, for example, assets and systems.
- 5.4 This section begins with an overarching principle necessary to establish Openreach as a stand-alone organisation that all dealings between Openreach and BT must be arms-length contracts. We also deal with more specific issues in relation to financial, operational, workforce and organisational aspects of independence.

Proposal 5: All dealings between BT and Openreach must be arms-length contracts

- 5.5 Once Openreach has the assets that it needs to conduct its business, an essential element of independence is that, to the extent that there are any dealings between Openreach and other parts of BT, those arrangements must be conducted by arms-length contracts.
- 5.6 Given that it will be necessary to ensure that Openreach owns or obtains from third parties all of the relevant assets that it needs to conduct its business (as per proposal 10) and that it will be necessary for Openreach to have within its own management structure or source from third parties the support functions that it needs, we do not anticipate a large number of such contracts between BT and Openreach (the ideal is that there would be none, in fact).
- 5.7 This is critical because:
 - (a) it will enable Openreach to be satisfied that it has the necessary agreements in place to carry out its purpose; and
 - (b) it will crystallize a number of issues that would otherwise create ambiguities about where assets (rights) and liabilities sat as between BT and Openreach.
- 5.8 As well as being integral to Openreach's independence, any such contracts will provide an essential degree of transparency.

- 5.9 Regardless of the precise nature of the separation regime, BT and Openreach are likely to have a number of discrete continuing commercial relationships. For example, BT will be Openreach's shareholder; it may well be the major lender to Openreach; [may have (on a transitional basis) some role in supporting the organisation as it becomes established]; and will likely remain Openreach's biggest customer.
- 5.10 Legal separation and arms-length contracts can help to provide transparency about those arrangements, reducing the scope for each of them to become a source of influence over Openreach. The aim is to ensure that any commercial relationships between Openreach and BT do not compromise Openreach's independence.
- 5.11 Given that they represent a vital element in Ofcom's regulatory intervention in the sector, for the most part, those contracts can and should be published, for maximum transparency and to reduce the burden of oversight on Ofcom. Where publication is not appropriate (for example, to keep competitor-sensitive information confidential), at a minimum, a non-confidential summary should be published and the full document available to Ofcom and the IMT.
- 5.12 Short of divestment, legal separation provides the best assurance that the relationship between BT and Openreach will be properly documented and clear to Ofcom and other stakeholders. At a high level, this is because legal separation is the only option which would:
- (a) enable contracts between Openreach and BT – ensuring their relationship is set out in legally enforceable documents, and that those documents set out the actual prices paid between Openreach and BT;
 - (b) ensure – in a legally enforceable and documented way – that Openreach's management and investment incentives are aligned with the Openreach business and not BT as a whole. Weaker forms of separation do not address these incentives and have relied on regulatory fictions (such as notional contracts) which have failed to provide proper assurance and transparency to the industry as a whole because they fail to accurately reflect how Openreach and BT behave; and
 - (c) open up the market to new forms of infrastructure investment, such as co-investment models, by providing assurance that Openreach will assess business proposals on their own merits.

Financial independence

- 5.13 As well as taking decisions, Openreach's role as a legally separate commercial entity to the BT Group requires that it have a core level of capacity and control over various financial matters.
- 5.14 The basic principle is that Openreach's finances ought to be independent on BT. That means that Openreach controls its own finances, from collecting revenue through to distributing profit, without being subject to influence by BT.
- 5.15 Assuming that legal separation and arms-length dealings are established between Openreach and BT, it may not be necessary for these proposals to be set out in regulation at all. They are, after all, a corollary of the need for Openreach to secure its independence. We include them

here as policy proposals, although recognising that the mechanism by which they might be achieved could well be left to company law.

- 5.16 However, if Ofcom was in any doubt whether these outcomes would result from the simple building blocks of legal separation, independence and transparency, then there would be a case for more explicit regulation to make these obligations clear.

Proposal 6: Openreach should operate finances and cash handling independently of BT

- 5.17 An essential element of independence for a commercial organisation is the ability to control its finances without intervention from outside. This issue is not unique to Openreach; financial independence has been considered and embedded in, for example, merger remedies seeking vertical separation in energy markets.⁸⁴
- 5.18 The first aspect of financial independence is Openreach maintaining a separate bank account. As a separate legal person, Openreach could not draw on BT's accounts, and as a matter of competition policy, it is inappropriate for it to be reliant on BT to secure the financial services appropriate to an organisation of its size. To provide clarity from the outset, it would be appropriate for that to be a new banking relationship.
- 5.19 Openreach will also need to maintain the relevant management functions (finance and treasury) sufficient to enable it to exercise control over its finances to normal standards of commercial and corporate governance.

Transactions between BT and OR must involve cash movements

- 5.20 It follows that transactions between Openreach and the rest of BT (most obviously, for the supply of network access) will involve money being paid from the bank account of the relevant BT business to the bank account of Openreach, rather than an internal transfer within the internal management accounts of BT. There should be no set-off except on arms-length terms and in a way that is equivalent to the inter-operator billing arrangements between Openreach and other network providers.
- 5.21 This creates a far greater degree of rigour and transparency than any alternative basis for BT's dealings with Openreach. It is consistent with the objective of promoting competition and investment because, for the first time, BT's downstream divisions would see money leave 'their' company when it is paid to Openreach. This would help level the playing field between BT and other downstream competitors. The status quo, where all money held by Openreach and the other BT divisions is all, ultimately, money held by the same legal person, creates scope for a less-than-level playing field, where BT businesses do not face an incentive to manage their spend with Openreach in the same way that other competitors do. This creates scope for BT to enjoy influence that other operators do not.
- 5.22 It is worth emphasising that while the transparency benefits are real, this proposal by itself produces only a localised incentive effect (that is, on the divisional management, not the management of BT Group), in the sense that it relies entirely on the artificial constraint of accompanying functional separation to be effective. The money paid by BT to Openreach in fact remains within the BT group, and will ultimately find its way back into the hands of BT

⁸⁴ See, e.g., the Centrica Storage undertakings as described in Annex 4.

shareholders in the form of dividends. But coupled with functional separation that ensures that management of BT's downstream divisions is rewarded only on the basis of its own divisional profits or losses (or other 'localised' metrics), this can still produce incentives and hence behaviours that are a closer approximation of that which would apply in any environment in which Openreach was not owned by BT.

- 5.23 Openreach profits would fund the payment of dividends (in accordance with an established and Board-agreed set of financial targets) to BT. These would be provided to BT Group as a return on the investment made in Openreach and would not be attributable to any downstream division's activities.

Openreach confidential information must not be shared with BT

- 5.24 In some respects, control of information held by Openreach is already subject to legally binding obligations not to disclose information in certain circumstances. This section deals only with the question of what incremental additional restriction might be necessary as part of the separation regime.
- 5.25 The starting point is: what forms of information might either give rise to BT having influence over Openreach or give BT a specific advantage that other CPs would not enjoy?
- 5.26 This could include information that would normally be shared with an owner (shareholder) as a matter of course – particularly in the case of a wholly owned subsidiary which is aggregated in the group accounts for the purposes of financial reporting.
- 5.27 This could create something of a paradox: unless BT has access to information about Openreach, then it is not able to manage its own (aggregate) financial disclosure obligations; on the other hand, if it has a great deal of information about Openreach that its rivals do not have, it could affect the conditions of downstream competition.
- 5.28 Possible solutions to this conundrum include:
- (a) financial information and customer information held by Openreach should be kept confidential to Openreach and not shared with any other part of BT (e.g. in relation to Openreach cost information) except where that happens in a non-discriminatory way with all customers; or
 - (b) putting in place protocols for a 'clean team' within BT's group finance function who would receive information in from the various business units including Openreach for e.g. setting BT group's overall dividend policy. That team would not disclose that information to other parts of BT or at all, except where BT is legally obliged to do so (e.g. in relation to listing rules) and only for the purposes of fulfilling such obligation.
- 5.29 In some cases, however, BT receives information from Openreach that is not in principle confidential – for example data on the run rate of new fibre customers in previous months. Having access to such data puts BT's consumer divisions in a privileged position in the market. Accordingly, there should be a principle that any non-confidential data produced by Openreach should be made available to all CPs on a non-discriminatory basis.

Proposal 7: Openreach must be able to borrow independently and in its own name

- 5.30 One of the freedoms that Openreach must have in order to be independent is the ability to secure funding sufficient to carry out its annual plan, within budget parameters that may need to be agreed between BT and Openreach and that are viewed by the Openreach Board as being sufficient to enable Openreach to fulfil its purpose.
- 5.31 Amongst other things, this will assist in regulatory transparency about the true cost of debt associated with Openreach's activities.
- 5.32 Currently, Openreach's budgetary allowances are set by the BT board. This gives BT significant power to manage Openreach's expenditure and ensure that investment projects go forward only where they benefit the BT group as a whole. This has led, in the past, to investments – such as FTTC – which appear to be designed to maximise BT's market share, and triggered a phase of market development during which BT then grew its already-significant market share in *retail* broadband. There is currently no transparency about Openreach's budget funding or the considerations taken into account by the BT board when deciding on funding.
- 5.33 Any solution short of legal separation will be insufficient to properly address this problem. This is because it is difficult (if not impossible) from an external perspective to fully understand decisions about the funding of particular business units *within* a company, and because Openreach is wholly reliant on BT funding and makes no decisions about the most efficient source of funds.
- 5.34 However, with Openreach being an independent legal entity:
- (a) there would be greater transparency about the specific funding arrangements in place, because it would involve inter-company transfers of funds. This would provide a clear and transparent basis on which Openreach's cost of debt and the capital investments made by BT can be assessed – improving the accuracy of Ofcom price controls (and reducing the risk of regulatory error); and
 - (b) it would be entitled to run its own finances and choose its own sources of debt finance. This reduces the problem whereby BT's motivations for providing funding to Openreach may be unclear. Openreach would be incentivised to consider a range of funding options, including being open to partnerships with industry consortia rather than just BT, and would make investment decisions based on maximising its own returns. It would not accept funding from BT if it were not the most favourable funding option available on the market, or make investments that favour the BT group as a whole unless that maximised value for Openreach.
- 5.35 The prospect of independent funding arrangements for Openreach could therefore unleash significant new investment by CPs, including in the form of co-investment plans by industry consortia. However, to encourage such potential investment plans by CPs, there needs to be transparency as to how Openreach will assess such proposals, to provide assurance that Openreach is acting on a commercial basis and assessing proposals independently of BT. In this respect, Openreach must be required to:

- (a) [consult and] provide to Ofcom [and other major CPs under appropriate confidentiality arrangements] its cost benefit analyses for proposed projects, which would take into account the funding options and likely returns;⁸⁵ and
- (b) publish its annual plan, budget and investment strategy.

5.36 To the extent that BT is a lender (and, possibly, the major lender) for Openreach, there would be a range of concerns if BT were entitled to lend to Openreach on terms similar to a conventional lender (normally, major lenders extract very significant covenants in return for their services). Any form of legal separation would need to address this, in a similar manner to how other regulated sectors in the UK manage legally separate businesses. For example:

- (a) **transparency:** Openreach's debt positions, statutory accounts and financial information should be publicly available to the industry and Ofcom so that there is transparency and assurance that the arrangements do not give rise to conflicts of interest;
- (b) **security interests:** if any CP is permitted to take security over Openreach assets, this would undermine the purpose of legal separation, and – in the case of BT – may ultimately result in a situation where BT 'reclaims' Openreach assets for itself. Therefore, the division of assets between BT and Openreach should be clear and transparent. This division should not be permitted to be undermined through transfer of beneficial interests or allowing the transfer or granting of security interests in Openreach assets to any CP;⁸⁶
- (c) **restrictions on other financial dealings within the BT group:** the benefits of transparency about Openreach's funding situation would be undermined if it was permitted to enter into non-standard financial dealings with other parts of BT. Therefore – consistent with practice in the energy sector – there should be a prohibition on Openreach or BT entering into cross-default obligations, and on Openreach entering into financial transactions (such as granting loans and benefits) with limited exceptions to cover 'day-to-day business', such as legitimate dividends, repayment of loans, and payments for goods and services procured on an arms' length basis on normal commercial terms;⁸⁷ and
- (d) **representations, warranties and covenants:** Openreach should only enter into industry standard facility agreements and there should be limitations on the rights of lenders, including constraining the permissible range of representations, warranties and covenants about the business and how it is to be run. For example, lenders might have rights to obtain full access to detailed financial statements on request, and may have rights to assets or to take over aspects of the business where there is a default on the

⁸⁵ One option would be to consider the obligations on Heathrow to consult relevant parties about major capital expenditure programs: see Part F of Heathrow's licence.

⁸⁶ Standard condition 41 of the standard electricity distribution licence imposes restrictions on indebtedness which might be appropriate for Openreach, including restrictions on agreeing to security interests except in limited circumstances such as arms-length dealings on normal commercial terms.

⁸⁷ See condition 41 of the standard electricity distribution licence.

part of Openreach. These provisions would clearly not be consistent with the objectives of legal separation.⁸⁸

Proposal 8: Openreach must offer customers a non-discriminatory co-investment model

- 5.37 As one element of its independence, Openreach should no longer be wholly reliant on funding and investment decisions made by the BT group. While we would expect BT to exercise a degree of influence over Openreach's investment strategies as a customer of Openreach, any further degree of influence (exercising the rights that would normally be reserved to the shareholder(s) of the company) would go further than this, and could compromise Openreach's independence. Openreach's obligation to consult with its customers (proposal 17) will be the relevant framework within which BT could exert that influence.
- 5.38 The problem of Openreach's financial dependence on BT in terms of investment – and the detrimental impact this has on competition – was evident from the much-criticised decision by BT to invest in an FTTN network.⁸⁹ It was widely understood that this technology was adopted by BT because it favoured the strategic interests of BT Group, rather than the development of the UK broadband market generally. This network design was least attractive to other CPs, provided fewer opportunities for unbundled access, and therefore required CPs to buy VULA rather than a genuine LLU-style passive (dark fibre) product. The impact of this decision on competition is clear from BT's market share in superfast broadband, which is exceptionally and unjustifiably high compared to other services – BT currently accounts for approximately 70% of new Openreach superfast broadband connections, as against 40% for all connections generally (and this market share is continuing to rise over time). In comparison, the high VULA wholesale price makes the economics of other CPs selling superfast broadband based on Openreach's wholesale product extremely challenging. Openreach's reliance on BT for funding and investment decisions has therefore served to allow BT to re-establish an extremely strong position in retail markets. It is unsurprising that it was a particular focus of Ofcom's concern. It is essential that any model of legal separation minimises the risk of such outcomes in future.

⁸⁸ It may be that alternative regulatory requirements should be imposed on BT and/or Openreach to address the risk of insolvency or insufficient funding, and not to dissuade potential debt investors in Openreach. For example, electricity distribution licences in the UK require that:

'The licensee must at all times act in a manner designed to ensure that it has available to itself such resources, including management and financial resources, personnel, fixed and moveable assets, rights, licences, consents, and facilities, on such terms and with all such rights, as will enable it to:

(a) properly and efficiently carry on its Distribution Business; and

(b) comply in all respects with its obligations under this licence and such obligations under the Act as apply to the Distribution Business, including its duty to develop and maintain an efficient, co-ordinated, and economical system of electricity distribution' (standard condition 30.1).

Heathrow's licence requires it to *'at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, to enable it to provide airport operation services at the Airport'* (condition E2.1) and to certify as to compliance with this requirement.

BT could similarly be required to certify each year as to Openreach's financial resources and to report immediately on adverse circumstances that might affect its ability to meet its commitments.

⁸⁹ Openreach deployed a GPON network architecture by which each DSLAM was served by only a single set of fibres (with capacity then split to multiple end users), which essentially dictated that Openreach could only offer a wholesale layer 2 service (since any layer 1 service would involve sharing fibre between different users). Although alternative approaches would have been more expensive, it is likely that they would have received significantly more industry support and enabled greater innovation by CPs.

- 5.39 Financial independence implies that Openreach must be open to alternative funding and investment options, where these offer Openreach a return on investment that makes these options attractive. A key example is that Openreach must be open to a deeper set of options that allow for two-part tariffs to all customers, allowing different business models to operate and contribute to the overall cost of the network. A specific example of this approach which has sufficient momentum to warrant a specific proposal is a requirement on Openreach to offer co-investment proposals, whereby other CPs could jointly provide funding to Openreach to undertake network upgrades that benefit them all, or where different CPs could fund different types of investments or investments in different areas, with a view to agreeing to share the use of those investments. Such a 'co-investment' model offers significant benefits to the industry and consumers, including that it:
- (a) should significantly improve the business case for new fibre investments by ensuring there is (literally) 'buy-in' by CPs representing a significant part of the market, allowing the risks of new investments to be more broadly spread – and less reliant on there being a standalone business case for BT (which is incentivised to make the investments inaccessible to the rest of industry);
 - (b) creates the possibility of substantially more innovation in the market – because investment projects can be floated by many different CPs and will no longer be limited to the imagination and willingness to invest of BT (and the small number of other end-to-end NGA providers);
 - (c) gives participants long-term certainty about the technical aspects and access pricing, with the terms of participation able to be individually negotiated to suit different CPs' business models; and
 - (d) would much better align the incentives and coordination of market participants, enabling sharing of the risks and costs associated with large-scale fibre investment for the benefit of the whole market.
- 5.40 Co-investment models are common and proven in other parts of the telecommunications industry and in the rollout of fibre networks. They have delivered significant and quantified benefits for consumers and the market. For example:
- (a) submarine cables are commonly funded in this way, with CPs providing up-front equity for the projects in return for an indefeasible right to use part of the resultant international capacity, and a discount on ongoing usage charges as a 'reward' for providing up-front funding. For example, the WACS system linking the UK and South Africa is owned by a consortium of twelve CPs;
 - (b) Vodafone is rolling out fibre to 500,000 homes in 50 towns and rural villages in Ireland via a joint venture (SIRO) with electricity line company ESB; and
 - (c) Sky has part funded the launch costs of Astra satellites, in return for lower transponder rental fees.
- 5.41 There is no reason why the type of co-investments Vodafone has participated in elsewhere in Europe could not be replicated – on an even larger scale – in the UK, if Openreach was subject

to the correct incentives. The primary barrier to greater use of co-investment models in the UK today is that BT's cooperation is necessary given its market position in retail markets for superfast broadband. That market position means that BT has (despite its public statements) no incentive to risk its market share by cooperating with other CPs – indeed, its incentive is to leverage its vertical integration by ensuring its investment plans leave it one step ahead of other CPs. This problem should be addressed through legal separation, whereby Openreach's strategic decision-making and investment decisions will be independent from inappropriate BT influence.

Proposal 9: Openreach must set its own budget, Annual Report and regulated accounts

- 5.42 Ofcom's conclusion is that Openreach must have autonomy over its budget and over its strategic and operational decision making.⁹⁰ We agree with Ofcom's view that increasing Openreach's autonomy will help *'address ... concerns related to decision-making by giving Openreach increased financial autonomy to take strategic decisions on network investment, network maintenance and operational systems.'*⁹¹
- 5.43 Currently, Openreach's budget is set by the BT board. This gives BT significant power to manage Openreach's expenditure and ensure that investment projects go forward only where they benefit the BT Group as a whole. Ofcom has found that this influence compromises Openreach's independence, and consequently, any separation regime needs to find ways to secure Openreach's independence from that process.
- 5.44 Under the new model, we propose that Openreach set its own budget. It should be a sustainable business in its own right which, after any initial cash injection by BT, need not be reliant on ongoing funding from its parent and therefore should not require any input from BT in relation to that budget (except to the extent Openreach agrees, for example where BT agrees to fund a major capital project under a co-investment model). Openreach must also be responsible for its own debt financing and can seek finance from other capital sources. We also propose that all decisions about the use and allocation of Openreach funds be taken by Openreach management entirely independently of BT.
- 5.45 Further, in addition to the current obligations in the Undertakings to provide regulated accounts, it is necessary that Openreach issues its own Annual Report (and will be required to do so under company law). By complying with this obligation, Openreach will ensure that Ofcom, stakeholders and other interested persons (including customers, employees and suppliers) are provided with transparent information about the Openreach's activities and financial performance in light of the legal separation requirements. Requiring Openreach to issue its own Annual Report may also assist to promote 'a culture of independence' within Openreach.
- 5.46 In addition, requiring Openreach directors to confirm that they have complied with their duties as directors and other relevant accounting obligations, which will encourage additional care and compliance with the separation regime. This should also promote a similar flow-through effect throughout the organisation.

⁹⁰ SDRC initial conclusions, para 1.43.

⁹¹ SDRC initial conclusions, para 6.66.

Operational independence

5.47 A further aspect of independence is operational independence – that is, freedom from influence in the day-to-day operations of Openreach. It follows that Openreach should own the network assets that are used to provide network access to its customers.

Proposal 10: Openreach must own (or lease from third parties, not BT) the assets it needs

5.48 For Openreach's directors to manage Openreach in a way that they are satisfied will fulfil Openreach's purpose, they will need to be confident that they are able to deliver network access (in a range of different forms, including new passive access services that are Ofcom's strategic focus) reliably and consistent with Openreach's regulatory obligations, such as equivalence of access. One essential element in that assessment will be whether Openreach has sufficient assets to enable it to fulfil its purpose.

5.49 In common with other providers of underlying communications access networks, the 'assets' that Openreach will need are enormously varied, and include:

- (a) interests in land, including freehold and leasehold and other interests in land (including wayleaves), both for network assets and for Openreach's other commercial purposes (offices, depots, and so on);
- (b) passive infrastructure that does not comprise part of the land (such as copper or fibre connections);
- (c) some active assets including those used to provide FTTC and those used to deliver WLR (the line card element) and Ethernet as well as the other elements of network access such as power and accommodation;
- (d) customer supply contracts (which are currently between those customers and BT Group plc);
- (e) a long tail of other assets associated with Openreach's general business activities, including:
 - (1) employment contracts with the workforce that supports Openreach's operations;
 - (2) a vehicle fleet to support Openreach's mobile workforce (currently served by BT Fleet);
 - (3) intellectual property (including a range of material from software licences and trademarks – such as 'Openreach' – and through to documents and databases of various sorts such as asset registers and maps showing the location of network assets); and
 - (4) various other contracts covering the full range of commercial services (such as equipment suppliers, insurance contracts, and various forms of professional advice).

- 5.50 This list does not seek to be exhaustive but illustrates the breadth of assets that it will be necessary to consider. This is consistent with similar exercises undertaken in other jurisdictions, where this type of division has been successfully undertaken.⁹²
- 5.51 The question of how to configure Openreach's relationship with its workforce is dealt with in the section dealing with 'Workforce independence'. This section deals with other assets at a high level, with some other assets (such as systems) dealt with separately where specific issues arise.
- 5.52 In relation to each category of asset, the Openreach Board will need to determine to what extent they will need to own or exercise control over that asset in a way that is consistent with Openreach's purpose. In doing so, they will need to consider:
- (a) Does that degree of ownership or control ensure that Openreach is able to fulfil its purpose in relation to the supply of network access?
 - (b) Does that arrangement ensure that Openreach is independent of BT?
- 5.53 Given those tests, it will be necessary for Openreach either to own the asset itself (which we think would be the norm in most cases) or, in some circumstances, to obtain rights in contract from a third-party (not BT) to use those assets that is sufficient for Openreach to fulfil its purpose. Table 2 illustrates the sort of outcome that process could produce, with some arrangements compatible with Openreach's purpose, and others being incompatible.

⁹² See, e.g., Telecom Corporation of New Zealand Limited 'Overview of the Asset Allocation Plan: section 37 Telecommunications (TSO, Broadband and Other Matters) Amendment Act 2011' (6 September 2011). Available here: <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTA2MjU5fENoaWxkSUQ9LTF8VHlwZT0z&t=1> ('Telecom NZ Asset Allocation Plan').

Table 2: Asset classes and possible arrangements for ownership or control of those assets by Openreach

Asset class		Options compatible with Openreach being independent of BT		Not compatible
		<u>Owns directly</u>	<u>Owned by a third party</u>	<u>Owned by BT</u>
Land	Wayleave	Wayleave used to support ducts and poles held by Openreach	Wayleave held by third party (e.g. independent infrastructure provider) and access provided under contract to Openreach	Wayleave rights held by BT Group plc and delegated by contract to Openreach
	Exchange building	Exchange land/building owned by Openreach	Exchange building that has been the subject of a 'sale and lease-back' – freehold held by third party and leasehold novated from BT Group plc to Openreach	Exchange building sub-leased from or freehold remains with BT Group plc
	Office	Openreach owns freehold	Openreach leases site from third party	Openreach leases site from BT Group plc
Passive infrastructure assets		Transferred from BT Group plc to Openreach	N/A	Leased from BT Group plc
Active infrastructure assets		Owned by Openreach	Owned by third party (e.g. outsourcing provider) and provided under contract to Openreach	Owned by BT and provided under contract to Openreach
Intellectual property		Owned by Openreach	Owned by third party (e.g. software supplier) and licensed to Openreach	Owned by BT and licensed to Openreach
Supply contract (e.g. equipment supply contract)		Held by Openreach (novated from BT)	N/A	Held by BT and supplied to Openreach by BT
Vehicle fleet		Owned by Openreach	Leased from third party	Leased from BT

- 5.54 In most cases, the starting point should be that any asset currently owned by BT that is necessary for the conduct of Openreach's business will need to be transferred from BT to Openreach. There is no reason to believe that this will be an unduly difficult process (we assume that BT has an asset and contract management system in place). In almost all cases, it is reasonable to expect that sale of an asset or novation of a contract from BT to a wholly-owned subsidiary is likely to be permitted without re-opening those agreements – this is normally the case in many standard commercial contracts, including wayleaves and other relevant rights. Nor is this likely to create undue or avoidable transaction costs (in the case of transfers of interests in land, for example, stamp duty relief is available for transfers within a corporate group).⁹³
- 5.55 It is not appropriate for assets to be provided to Openreach under contract but remain owned by BT. In those circumstances, certain rights in respect of those assets will remain with BT, and those rights are potential sources of influence. Further concerns with allowing assets to continue to be owned or controlled by BT include that:
- (a) As a matter of principle, it leaves Openreach dependent on BT for that asset. Dependence is not compatible with independence – and BT's ownership will remain a source of influence. Ownership rights are the bedrock of true economic and legal independence; while tenants have certain rights, in relation to the land they lease they are not generally considered to be able to act *independent* of their landlords.
 - (b) Critically, Ofcom's strategy for increased fibre roll-out depends on Openreach taking steps to make passive access and other forms of network access that support fibre roll-out more likely to be commercially attractive. This means that Openreach cannot be limited to reselling the forms of physical infrastructure rights offered to it contractually; it will need to undertake work that is, literally and figuratively, deeper than that. This task is inherently linked to the right to transform, re-configure and make available physical infrastructure in a range of ways, including structures that are part of the underlying asset (the land) such as ducts or poles. This is incompatible with BT continuing to own those underlying assets, since Openreach cannot achieve these tasks as a tenant.
 - (c) Equally, continued ownership of underlying assets such as property or physical infrastructure is likely to convey undue advantages on BT in giving it access to an understanding of Openreach's affairs that no other CP would enjoy. For example, it would leave BT able to veto (or even simply to have visibility of) Openreach's dealings in property, in a way that could compromise Openreach's purpose.
 - (d) Commercially, it would leave Openreach exposed to being 'sandwiched' in between BT as its landlord and BT as its customer. BT's ability to coordinate those relationships would give it an advantage that no other CP would enjoy.

⁹³ HMRC, 'Stamp Duty Land Tax Manual', section SDLTM23010. Available here: <https://www.gov.uk/hmrc-internal-manuals/stamp-duty-land-tax-manual/sdltm23010>.

- (e) As a matter of regulatory policy, Openreach's ownership of those assets will assist various regulatory objectives – for example, it will create greater transparency in relation to costs.
- 5.56 This separation of assets will demand the establishment (for the first time) of clear boundaries between Openreach and BT assets. BT will be required to request access to the network and contract with Openreach for those services on the same terms as other CPs. Accordingly, this will allow for more transparent engagement between BTR and Openreach.
- 5.57 This proposal is also consistent with the notion that the separation between BT and Openreach should be 'divestment – minus' – that is, the only difference between the outcome we reach and structural separation is that BT owns its subsidiary, Openreach. In all other respects, the independence of Openreach and the removal of BT's influence is equivalent to that if divestment had occurred. Clearly, any divestment of Openreach would require BT to agree with the new owner what assets would be transferred in that transaction.
- 5.58 Experience in other sectors is that there is nothing inherently insurmountable in this sort of asset division.
- (a) Under competition law, divestments are a routine process. The only difference here is that the final step would be missing (the transfer of an ownership interest in the shares of the 'divested' element (Openreach)). Indeed, one of the reasons why we think that appointing an IMT to oversee this process makes sense is because this transaction looks in many respects exactly like a divestment (except in the final step).
- (b) In a regulatory context, such asset divisions are also unremarkable:
- (1) In energy, asset unbundling proceeded largely uneventfully and there is no reason to believe that the same would not be true of the BT network assets.⁹⁴ The European Commission's 'third energy package' which facilitated transmission system operators being unbundled (or independent) from generation, production and supply interests in the energy market, and are required to be certified as doing so (see for example sections 10A-10O of the Electricity Act 1986, and sections 8C-8Q of the Gas Act 1986). The rationale behind this package was that it should eliminate any conflict of interests between these activities and prevent network operators from favouring their own energy production and supply companies. These concerns mirror the concerns that Ofcom has regarding the level of influence that BT currently has over Openreach.
- (2) In telecoms, structural separation has been undertaken successfully in New Zealand. In order to participate in the New Zealand Government's Ultra-Fast Broadband ('UFB') initiative, which provided public funding to roll out FTTP, Telecom NZ agreed to structural separation. It entered an 'Interim Period Agreement' in May 2011, under which it agreed to undergo voluntary structural

⁹⁴ The third energy package consists of two Directives, one concerning common rules for the internal market in gas (2009/73/EC), one concerning common rules for the internal market in electricity (2009/72/EC) and three Regulations, one on conditions for access to the natural gas transmission networks ((EC) No 715/2009), one on conditions for access to the network for cross-border exchange of electricity ((EC) No 714/2009) and one on the establishment of the Agency for the Cooperation of Energy Regulators ACER ((EC) No 713/2009). They were adopted in July 2009.

separation in return for Chorus (its infrastructure business) being the UFB partner in 24 of the 33 regions. To give effect to the demerger, Telecom NZ was required to transfer infrastructure assets from Telecom NZ to a separate Chorus entity. The asset split meant that:⁹⁵

- (A) Chorus assets included: 130,000 km of copper and 27,600 km of fibre; the majority of the exchanges; regional backhaul network; and access electronics, including DSLAMs; and
- (B) Telecom assets included: the mobile networks; PSTN equipment; the core national transport network; and international assets (including Telecom NZ's 50% ownership interest in the Southern Cross international cable).

Proposal 11: Openreach has its own corporate functions necessary to support its operations

- 5.59 Currently Openreach relies on BT Group for a range of 'corporate' functions that provide a close-knit set of relationships between BT Group management and Openreach's strategic and commercial decision-making community.
- 5.60 A simpler and better principle is this: Openreach must maintain its own corporate functions. The rationale for this is straightforward: those corporate functions advise and support the work of the Openreach board and management team, and Openreach maintaining its own corporate functions is the only basis on which the Openreach board and Openreach management can be confident that it is able to act independently and without risk of influence by BT.
- 5.61 Anticipating concerns expressed about convenience and practicality, there are strong arguments against the retention of shared corporate functions between BT and Openreach:
- (a) the strategic significance of corporate functions means that the norm in organisational practice is that most large commercial organisations maintain them in-house on a stand-alone basis (indeed, this is what defines them: they are the functions typically residing in the corporate centre, supporting the CEO, CFO and other senior officers of the company);
 - (b) whilst there are undoubtedly some economies of scale and scope associated with corporate functions, they are not so strong as to be determinative (if they were, then organisations smaller than Openreach would invariably outsource or find other ways to share such functions, and of course, that is not the case – many organisations many times smaller than Openreach opt to have stand-alone functions in order to ensure that the strategically important activities and sources of advice to the company's board remain entirely independent of outside influence); and
 - (c) the risk of BT having influence in relation to shared corporate functions is very high. The role played by corporate functions is often strategic and relates to decisions that have wider implications for the business. It is obvious that, for example, Openreach will need to have a full and independent capability to support the decision-making by the board

⁹⁵ For further information, see the Telecom NZ Asset Allocation Plan.

and support to Openreach’s executive decision-making (i.e. by Openreach’s senior managers).

Proposal 12: No sharing of systems or any other assets across Openreach and BT

- 5.62 Equally, it is vital that BT will not be able to influence Openreach through the control of common operational or corporate support systems.
- 5.63 There is no compelling reason why it is *necessary* for there to be shared systems between Openreach and BT. The economic case, based on efficiency, is weak when weighed against the other disadvantages. Based on Ofcom’s findings, it is clear that the highest priority is the need to avoid any scope for shared systems to be a source of influence that compromises Openreach’s independence. This weighs against allowing any such overlaps of systems. Operating shared systems also creates operational and resilience risks, each of which can also become a source of influence by BT over Openreach.
- 5.64 Critically, separating operational and support systems was a commitment given, but never delivered, under the 2005 Undertakings. Ten years after the original undertakings, Ofcom still routinely deals with applications from BT to permit complex arrangements as between different BT systems that were inappropriately shared between Openreach and BT, contrary to the originally-understood vision of both the signatories to the undertakings that such systems would only ever be shared on a ‘transitional’ basis.⁹⁶
- 5.65 At a minimum, strong and irrevocable *logical* separation of such systems is a necessity; the question of whether *physical* separation of such systems is also necessary is likely to be a case-by-case assessment that could be negotiated between BT and an independent Openreach, with the IMT resolving any disputes.

Workforce independence

- 5.66 The final set of proposals relate to the establishment of Openreach’s operational independence in relation to its workforce (‘workforce independence’).
- 5.67 As well as being capital intensive, Openreach’s work is labour-intensive, with a large workforce engaged in activity at local exchanges, and on a mobile basis.
- 5.68 All of these proposals assume that it will be a common objective of BT and Openreach to ensure that any changes that involve the position or rights of its workforce will need to be undertaken in a prudent way. We assume BT and Openreach will proceed in a manner which is mindful of the impact on the individuals and the desirability of developing plans that enjoy the support of all stakeholders including, for example, the various partner trade unions.

Openreach must have workforce policies that ensure its independence from BT

- 5.69 As with other parts of the separation regime, the approach taken to Openreach’s workforce should serve the objective of ensuring that Openreach is independent of BT. Equally, it is

⁹⁶ See, e.g., BT’s request ‘for agreement to allow BT to temporarily use shared computer systems for specified Openreach Operational Support Systems’ (24 September 2015), available here: http://stakeholders.ofcom.org.uk/binaries/telecoms/policy/bt/1515106/BT_letter_to_Ofcom_re_five_Openreach_OSS.PDF.

important that where arrangements are struck, those arrangements must ensure transparency as between Openreach and BT and support the purposes of Openreach to act in ways that provide a level playing field between Openreach's customers.

- 5.70 Currently, Openreach has no legal identity separate from BT Group plc, and so all of the work that is done on its behalf is done by employees of BT that are providing a service on an undocumented basis. This arrangement means that Openreach is dependent on BT for its workforce, and that there is no transparency between the two organisations.

Proposal 13: Openreach should employ its workforce directly

- 5.71 The obvious way to ensure that Openreach has full control over its affairs and is able to act independently of BT is to have Openreach employ its workforce directly.
- 5.72 It is outside the scope of this report to discuss the detailed mechanics of that process, although we note that the legislative framework for such transfers is very well established and – with few exceptions – there is unlikely to be any ambiguity about how it works in this case.
- 5.73 One complicating factor is that the incentives on those who work to support Openreach include incentive schemes that have not yet matured or that are still in place (e.g. workplace share purchase schemes or bonuses accrued over multiple years).
- 5.74 Provided that there is sufficient clarity that Openreach's independence must be preserved and that the norm is to be separate arrangements, then further specific aspects of Openreach's workforce independence will ultimately be a matter for the Openreach Board. However, a number of initial points can be made now that help illustrate what workforce independence might demand:
- (a) As is today, all incentive schemes rewarding Openreach employees (including the Openreach CEO and other senior executives) must base any organisational element of performance to Openreach performance against its objectives (or some subset of Openreach – for example, a relevant team or division of Openreach). Above all, such schemes must be entirely independent of any measure of performance by BT or BT business units (and hence must not be paid in BT shares);
 - (b) no Openreach employee ought to hold shares in BT Group (or any other CP). Clearly, there are many members of Openreach's current workforce who do hold shares; it would be a matter for the Openreach Board whether to ask BT to purchase all such shares for cash prior to the transfer of that workforce or to offer to swap BT shares for 'UK telecoms tracker' shares for employees, widening the relevant financial interest to the whole of the sector;
 - (c) Openreach should maintain and update its Code of Conduct for its workforce to reflect the fact that Openreach will, in future, be independent of BT; and
 - (d) Openreach should commit to a mandatory training and compliance scheme to embed the new requirements widely and deeply amongst its workforce.
- 5.75 Equally, in relation to BT incentive schemes, it is not appropriate to reward any BT executive for Openreach performance (indeed, it would be unfair and inappropriate to do so, since if

Openreach is independent of BT, then those executives cannot control or be held accountable for Openreach's performance). This issue arises in two distinct ways:

- (a) first, in relation to the way in which performance is measured. In this case, it should be obvious that BT executives should be rewarded for the performance of 'their' part of BT (or in the case of BT Group executives, all of the divisions other than Openreach); and
- (b) secondly, in relation to the way in which incentives are paid. In particular, if reward schemes are denominated in BT shares, not (for example) cash, then they include a de facto element of reward for Openreach performance. It follows that one of the consequences of ensuring that BT is independent of Openreach is that the BT executive reward scheme should be an exclusively cash reward, not an award of BT shares.

5.76 In order to enforce such independence, Openreach (and indeed BT) would need to have in place the appropriate systems and processes. Other processes or obligations that support workforce independence include that:

- (a) other than as part of the initial transfer, any movement of staff between BT and Openreach (in either direction) should involve a 3 month period where the individual is not involved in operational work for BT and has no access to confidential information during that time. This period should be 6 months for managers and 12 months for senior executives. These are no longer than is typically required in most competitive industries where the movement of people can compromise confidentiality and there is a need to ensure that strategic information (which generally has a 'shelf-life' of 6-12 months) is protected. This requirement also recognises the need to break down the strong bonds of influence that BT enjoys over Openreach by virtue of the historic ownership of Openreach by BT. This requirement might be relaxed after a period of, say, 3-5 years; and
- (b) all current areas of shared HR management should be separated as part of the transition. That means:
 - (1) the Openreach Talent programme should be separately run and distinct from BT, with no cross-visibility or use of either list;
 - (2) job opportunities for Openreach and BT should be listed separately;
 - (3) no BT Scotland or other regional boards to include Openreach (or vice versa);
 - (4) no Openreach people on BT committees/groups;
 - (5) internal communications should be separate, with a separate Openreach intranet (not 'BT Today');
 - (6) no offering of BT retail products (voice, broadband, mobile or TV) provided to Openreach staff as a benefit, either free or at any cost not available to the public generally. If Openreach offers communications services on a subsidised basis for its workforce, that must be on the basis of vouchers that can be redeemed for the services of any participating CP; and

- (7) Openreach should maintain its own internal staff directory and the BT internal on-line people directory should not provide access to, or list, Openreach people.

Organisational and cultural independence

- 5.77 Finally, this section deals with issues relevant to ensuring that Openreach establishes and maintains a distinct corporate cultural aligned to its purposes.
- 5.78 Scope to affect corporate behaviour through ‘soft power’ and the ability to influence amongst different parts of the same corporate group is widely recognised as a legitimate concern in competition policy contexts where separation is undertaken. For example, in the Centrica Storage undertakings, Centrica agreed that:

‘... no other member of the Centrica Group or the agents or Affiliates of any such member, or its employees or directors, shall directly or indirectly participate in the formulation or making of, or influence or attempt to influence, the commercial policy of CSL other than through responses to formal public consultation.’

Proposal 14: Openreach to be an independent voice on relevant policy and regulatory issues

- 5.79 There is an analogy here with product development – in a sense, Openreach’s submissions and regulatory positions are ‘products’ that should be developed with open opportunity for input from customers equally or independently by Openreach. Currently, BT can use Openreach as a ‘big gun’ in regulatory debates: it alone can speak with authority on what it believes Openreach is likely to do in terms of current services or future investments. As a result, it has the scope to link the regulatory positions of different players at different parts of the supply chain merely because they are all parts of BT.⁹⁷
- 5.80 In addition, Openreach should be an independent voice in policy proceedings (such as market reviews) that tap into Openreach’s market experience and understanding of the competitive dynamics of the sector.
- 5.81 It is inconsistent with Ofcom’s SRDC findings for BT to enjoy a unique advantage, through BT’s retail divisions having their voices amplified by (i) being grouped with Openreach; and (ii) influencing what Openreach (the largest local access provider in the UK) says to Ofcom.

Proposal 15: Openreach’s brand and livery must be entirely independent of BT

- 5.82 Openreach must be branded entirely separately from BT, with no common elements or associated logos.
- 5.83 Even a seemingly modest degree of overlap in branding has been demonstrated to have a pernicious influence, undermining the integrity of separation. For example, in the 2005 Undertakings, BT committed that Openreach would not be branded as ‘BT’. This was a material commitment, and one that was debated within Ofcom including at Board level. But a

⁹⁷ Based on non-confidential versions of BT submissions, this issue arises in relation to, for example, VULA pricing issues, where a policy that is focused on downstream competition becomes linked to the question of whether and to what extent Openreach is prepared to invest.

steady erosion of this position has meant that even the UK Government has, at times, openly referred to 'BT Openreach'. This does not engender confidence in those arrangements.

- 5.84 Legal separation would require that Openreach operate its own brand independently of BT. Any common brand could become a source of influence – either directly tilting the playing field (for example, because BT charged Openreach a licence fee for the use of the brand) or indirectly (because the need to coordinate activities under and with respect to that brand provided a source of interaction that could lead to influence).

6. Supporting and promoting competition and investment

6.1 In achieving Ofcom’s vision of making communications work for everyone, Openreach has a specific and vital role to play: to provide network access to all CPs on an equivalent basis, so that BT has no ability to act on its incentive to distort downstream competition and investment incentives. This section deals with the proposals that deal with the processes and approaches that are necessary to secure Openreach’s core objective of equivalence of access for all CPs. Each of these proposals is required to support and promote competition and protect investment incentives.

Proposal 16: Openreach must offer all services on an EOI/‘one service for all’ basis

6.2 The most basic requirement is that Openreach must supply all services on an equivalence of inputs (‘EOI’) basis, avoiding the use of service quality or price discrimination that can arise through the use of service variants that are de facto buyer-specific offers. That means adding to the concept of EOI to include the principle of ‘one service for all’ – no exceptions.

6.3 The 2005 Undertakings (as amended) require BT to supply services on an EOI basis. This is defined as requiring BT to provide:

‘... in respect of a particular product or service, the same product or service to all Communications Providers (including BT) on the same timescales, terms and conditions (including price and service levels) by means of the same systems and processes, and includes the provision to all Communications Providers (including BT) of the same Commercial Information about such products, services, systems and processes. In particular, it includes the use by BT of such systems and processes in the same way as other Communications Providers and with the same degree of reliability and performance as experienced by other Communications Providers ...’

6.4 In theory, the obligation for Openreach to provide all services on an EOI basis should ensure that all CPs are purchasing the same services or products at (notionally) the same prices, on the same transparent terms, whilst being subject to the same processes and timescales. This obligation is intended to encourage transparency within the market and also to ensure a level playing field upon which downstream competitors can trade and compete for consumers. BT and its downstream competitors should be trading on equivalent terms with Openreach.

6.5 However, under the current model of functional separation, Ofcom has permitted a number of exceptions to this obligation, which has reduced its effectiveness. Exemptions and variations meant that the EOI obligation has only ever applied to a relatively narrow sub-set of services. Over time, as the relative importance of different forms of access has changed (for example, as between copper and fibre), the significance of these ‘carve outs’ has grown to a point where Ofcom can no longer assert confidently that the current regime is fit for purpose. The effect of these exceptions is to allow BT to continue to trade with Openreach on preferential terms for services that are not available to all other CPs.

6.6 In order for the EOI obligation to be effective and enhance competition in the way that it was intended, no variations or exemptions should be permitted. It is imperative that the EOI

obligation is bolstered to prevent this under the new legal separation model – this would include Ofcom removing any exemptions and variations already in place.

- 6.7 We note that occasions may arise where a CP may request provision of a variant of a product or service. In this situation, under the model of legal separation, it would be necessary, in the interests of transparency, that Openreach consult with all CPs on those proposals (through some successor to the current ‘statement of requirements’ process, albeit one not marred by the problems with the current process). Openreach would need to review any responses from CPs and in determining whether to agree to a variation to a product or service, would need to ensure that no variation be allowed that would unfairly discriminate against other CPs; in addition, at a strategic level the Board would need to ensure that any variation was in the best interests of the industry as a whole and aligned with Openreach’s (not BT’s) business interests.

Proposal 17: Openreach must consult with all customers in setting strategy, plans and developing new services

- 6.8 A critical failure of the status quo stems from the fact that BT Group does not adequately consult with all Openreach customers on investment and product development decisions.⁹⁸ As a result, the status quo *‘fails to remove sufficiently BT’s ability to discriminate against competitors. Therefore risks to competition remain.’*⁹⁹
- 6.9 Our clients highlighted concerns with Openreach’s failure to adequately consult in their submissions to Ofcom on the SDRC. For example, Vodafone argued that:¹⁰⁰

‘As we have already mentioned, the Undertakings specifically allow for Group strategy decision making. The structure of TSO as a shared support unit between Openreach and other BT units can lead to a situation where technology decisions are taken independently of other retail CPs, and competition is all-too-often an afterthought ...

When Openreach wishes to deploy a new technology, a whole raft of decisions will be made by BT as a group, for the group, rather than for the market as whole, which would be its modus operandi if those decisions were taken in Openreach and it was required to engage its customers in those decisions.’

- 6.10 Ofcom expressed its concern that:¹⁰¹

‘... alternative outcomes are not fully tested and the interests and needs of all downstream providers are not necessarily taken into account. If strategic decisions relating to Openreach are taken with limited consultation, this leaves the risk that the needs of downstream customers other than BT may be neglected, or not given appropriate weight. More broadly, a lack of

⁹⁸ SDRC initial conclusions, para 1.39.

⁹⁹ SDRC initial conclusions, Section 6 – Summary.

¹⁰⁰ Vodafone, ‘Response to Ofcom’s Consultation: Strategic Review of Digital Communications discussion document’ (8 October 2015), p 27.

¹⁰¹ SDRC initial conclusions, para 6.34.

consultation may create the risk of an investment outcome which is sub-optimal for the UK as a whole.'

- 6.11 To resolve this concern, we propose that a mandatory obligation to engage in industry-wide consultation on matters relating to strategy, plans and development of new services be inserted into Openreach's articles of association. Any consultation must occur in a transparent and non-discriminatory manner, e.g. through an industry forum, and enable all customers the equal opportunity to submit proposals and recommendations to Openreach. This proposal is obviously closely related to the obligation to offer a non-discriminatory co-investment model, which would itself need to be the subject of consultation and co-development with Openreach customers.
- 6.12 While we have not set out the precise terms of the obligation, we set out an example of a relevant consultation obligations below.

Telstra Corporation Limited (Telstra) – Structural Separation Undertaking

- 6.13 Under the structural separation undertakings ('SSU') given by Telstra to the Australian Competition and Consumer Commission, Telstra agreed to a range of 'Information Equivalence' obligations.¹⁰²
- 6.14 At a broad level, clause 14.1(a) of the SSU states that:

*'The objective of this clause 14.1 is to establish measures which demonstrate that the quality and timeliness of information provided by Telstra to Wholesale Customers in respect of network activities, circumstances or events that are likely to affect the delivery or operational quality of Regulated Services, is equivalent to the quality and timeliness of information provided by Telstra to Retail Business Units in respect of Equivalent Services (**information equivalence objective**).'*

- 6.15 To achieve this, clause 14.1(c) of the SSU states that

'Telstra will satisfy the information equivalence objective by establishing and maintaining customer engagements with Wholesale Customers ... that enable Telstra to: (i) keep each Wholesale Customer informed on a periodic basis ... (ii) provide a forum for Telstra to consult in good faith about the likely impact of those matters on Wholesale Customers, including answering questions and responding to reasonable concerns; and (iii) issue a series of network notifications ... which provide Wholesale Customers with periodic information and updates about the matters ... relevant to the Regulated Services they are acquiring.'

- 6.16 In terms of concrete proposals, the SSU requires that Telstra appoint separate managers and customer representatives to deal with each wholesale customer, conduct monthly customer reviews which Telstra must use as a 'vehicle for consulting in good faith', and keep customers

¹⁰² Structural Separation Undertaking given by Telstra Corporation Limited to the Australian Competition and Consumer Commission under section 577A of the Telecommunications Act 1997 dated 23 February 2012 (including variations up to 19 June 2013), clause 14, available here: <https://www.accc.gov.au/system/files/Structural%20Separation%20Undertaking.pdf>. ('Telstra SSU').

notified of any activities, circumstances or events which may impact the delivery or operational quality of the regulated services (e.g. network upgrades, network closures, planned outages and any information about unplanned events such as information relating to disaster recovery planning).

Proposal 18: Openreach must obtain buy-in from major infrastructure investors in relation to major capital plans (whether via consultation or through some other form of engagement)

- 6.17 Openreach currently spends money on big capital projects through a process that is, in substance, identical to the process for any other BT Group company or division. As a result, Ofcom has observed scope for control over major capital projects to be a source of substantial influence over Openreach. Together with proposals 8 and 17 (which also deal with the ways that Openreach engages with its customers) this proposal is designed to restore balance in Openreach's degree of responsiveness to its various customers to address this problem.
- 6.18 This concern has arisen in other sectors, and their experience may offer some useful insights into a better way to manage such projects. In any regulatory regime, concern over the capital expenditure (capex) of an operator that does not face competition, and the manner in which such an operator procures assets (and/or the networks and facilities it uses to access downstream markets) is likely to be relevant to the question of overall economic efficiency. While regulators often focus on an incumbent's level of capex – as an input to price controls – there is increasing regulatory scrutiny of the associated *procurement* approaches and processes, and also the timing and treatment of an incumbent's capex. A greater degree of oversight and control ensures that an incumbent's capex, and importantly, its overall procurement strategy, is consistent with competitive market outcomes.
- 6.19 A good example of this is the framework applied by the Civil Aviation Authority ('CAA') to the regulation of Heathrow Airport's capex. The CAA's model of capex and procurement regulation could be readily applied to Openreach and used as a means of securing greater efficiency, and a greater degree of engagement between Openreach and its customers, taken as a group.

Heathrow Airport Limited – Licence condition and third-party governance

- 6.20 Heathrow Airport Limited ('HAL') regularly consults with airport users on a wide range of topics, including capital expenditure, airport charges and non-regulated charges. The Civil Aviation Authority has imposed obligations on HAL to consult with users.¹⁰³
- 6.21 In particular, Part F of HAL's licence states that HAL must consult relevant parties on (among other things): proposals for future investment in the short, medium and long term that have the potential to affect those parties; its proposals for the development and delivery of key capital projects identified in its future investment proposals; and its policies and proposals for any other airport operation service it provides.

¹⁰³ Licence Granted to Heathrow Airport Limited by the Civil Aviation Authority (5 May 2015), available here: <https://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294975875>.

- 6.22 In addition, through the consultation process, HAL must provide relevant parties with sufficient information to enable them to take an informed view, and take the views of relevant parties into account in deciding on the future development of the proposals.
- 6.23 In addition to the industry governance process, there is also an IFS (independent funds surveyor).¹⁰⁴ The IFS provides on-going assessment of the reasonableness of decisions made on key projects and to ensure that capital is being used effectively to deliver the outcomes described in the various business cases. Heathrow and major airlines agreed the terms of the IFS as a joint appointment.
- 6.24 The IFS reports at (programme) Gateways and on a monthly basis during the development and delivery phase of projects, also presenting a monthly report at the Capital Portfolio Board ('CPB'). The IFS has so far been engaged on 20 of Heathrow's key capital projects and we assume will also be engaged on additional projects during the course of future projects.
- 6.25 The IFS's website notes that:

'The commission [to be the IFS] is to provide Independent Fund Surveyor services which involves review of key projects within the capital investment plan as part of the economic regulation of the airport.

The contract is a joint appointment by Heathrow AOC Ltd representing over 90 airlines and Heathrow Airport Limited, with a duty of care to the industry regulator, the Civil Aviation Authority (CAA).'

- 6.26 A similar obligation set for Openreach could lead to a better and more open process, with independent monitoring of capital expenditure with a duty of care to Ofcom to ensure transparency and efficiency.

Proposal 19: Openreach must provide 'open-book' accounting on its activities to its customers, including how costs are allocated amongst different services

- 6.27 Finally, we note that there will be an ongoing need for transparency *within* Openreach – that is, transparency about how various overheads and common costs are allocated across different services. Ofcom observes in the SRDC initial conclusions that a key outcome of greater Openreach independence should be greater transparency over the allocation of costs.¹⁰⁵
- 6.28 While (likely) all of Openreach's services would be regulated to some extent under SMP conditions, Openreach will retain incentives to inappropriately shift costs between these services, for example:
- (a) shifting costs onto services for which demand is increasing, and away from services for which demand is decreasing; and

¹⁰⁴ <http://www.gardiner.com/projects/?sc=16&proj=392..>

¹⁰⁵ SRDC initial conclusions, para 1.43.

- (b) moving costs between services in ways which ‘game’ the timing of Ofcom’s various market reviews.
- 6.29 Accordingly, it will be essential that Openreach provide ‘open-book’ accounting on its activities to its customers, including how costs are allocated amongst different services. These obligations should be modelled on the existing obligations that apply to BT to prepare and publish regulatory financial statements and set out how those statements have been prepared.
- 6.30 While legal separation does not offer a complete panacea for the risk of inappropriate cost allocations, it goes much further than the status quo by at least:
- (a) isolating costs of Openreach’s activities from those of the rest of BT – ensuring that only legitimate costs are passed onto CPs and avoiding the risk of scenarios such as BT’s recent allocation of costs associated with its acquisition of EE to regulated markets;
 - (b) ensuring any externally sourced overheads are procured on a documented basis and paid for with real cash and through open procurement processes – minimising the risk of Openreach and BT gaming by artificially adjusting the prices of Openreach inputs; and
 - (c) ensuring costs cannot be shifted from non-regulated to regulated markets.
- 6.31 Accordingly, legal separation should enhance transparency and simplicity of Openreach’s regulatory accounts. There is, therefore, no basis to remove the existing reporting obligations that apply to BT – indeed, those obligations should continue, and will become more useful to Ofcom and more effective at promoting confidence in the regulatory regime for other CPs, under a regime of legal separation.

Proposal 20: Separate unit within Openreach to sell passives

- 6.32 As a separate concern, there is likely to continue to be a degree of vertical integration within Openreach. For example, we expect that Openreach will supply passive infrastructure to CPs (such as duct and pole access), while also using the same passive infrastructure to produce downstream products (such as dark fibre or LLU, or active products such as Ethernet services or WLR). Clearly, Openreach will have the same incentives currently held by BT to favour its own business, so that it can capture more of the value chain and thereby maximise its profits.
- 6.33 While some other jurisdictions such as Singapore have addressed this issue by imposing further layers of separation (for example, structural separation between passive and active assets), we recognise that Ofcom may consider this disproportionate at this stage. However, Ofcom has also recognised in the DSR that, at the very least, the assets owned by Openreach might need to ‘change in future to reflect market developments or a shift in our fixed competition strategy’.¹⁰⁶ Given Ofcom’s emphasis in the SRDC on promoting investment based on access to Openreach passive infrastructure, concerns that Openreach could foreclose competition through its vertical integration will remain relevant.

¹⁰⁶ SRDC initial conclusions, para 6.72.

- 6.34 One approach that would address this concern would be a separate business unit within Openreach responsible for managing passive assets and subject to operational separation. Any such business unit must be required to manage the assets on a separate basis, provide services to the rest of Openreach and to external customers on an EOI basis, and otherwise be subject to the same requirements that apply to services provided by Openreach to BT today. In particular, there would need to be assurance that the rest of Openreach could not enjoy any advantage over external customers in terms of product development or network information.
- 6.35 The need for separation between active and passive assets has been recognised in other jurisdictions:
- (a) In New Zealand, companies could compete to participate in a public-private partnership to roll out fibre networks in particular parts of the country. These ‘local fibre companies’ or ‘LFCs’ were initially permitted to offer only layer 2 services but were required to undertake to supply unbundled (layer 1) services on a non-discriminatory basis from 2020;¹⁰⁷ and
 - (b) in Australia, there has been concern by the Federal Government to ensure that the government-owned company rolling out the National Broadband Network does so at the lowest possible layer in the value stack – allowing free competition wherever feasible. The government’s Statement of Expectations issued to NBN Co provides that it should ‘operate at the lowest practical levels in the network stack’.¹⁰⁸ The Federal Government’s policy is also to require NBN Co to operate with ‘optionality for future restructuring or disaggregation ... to provide future governments with greater policy and financial flexibility’.¹⁰⁹

Independence of BT from Openreach

- 6.36 Independence is not a one-way concern; it is also critical that BT’s operations are independent of Openreach in certain respects. As previously noted, this is essential to ensure that competing downstream businesses (BTR and others) are on a level playing-field. In some cases (as described in the bulk of this report) that will involve ensuring that other operators have the some ability to influence Openreach – no more, no less – than BT does. In other cases, it will involve ensuring that BT’s retail businesses do not have advantages or characteristics that would not be open to other operators (for example, rewarding their staff for Openreach performance through ‘whole of BT’ incentive-based schemes, or tying their network to Openreach and enjoying the preferential treatment accorded to an anchor tenant).

Proposal 21: Open procurement principle: no purchase from OR without open procurement

- 6.37 In the SRDC, Ofcom notes that a benefit of a wholly owned subsidiary model is that BT’s retail divisions may continue to act as an ‘anchor tenant’ for Openreach.¹¹⁰ However, if BT’s retail divisions are beholden to Openreach (i.e., Openreach considers that it has no risk of losing

¹⁰⁷ *Telecommunications Act 2001* (NZ) s 156AD. Requirements were originally set out in the government’s Invitation to Participate in the UFB: see <http://www.crownfibre.govt.nz/media/4824/invitation-to-participate.pdf>.

¹⁰⁸ See https://www.communications.gov.au/sites/g/files/net301/f/SOE_Shareholder_Minister_letter.pdf.

¹⁰⁹ See Australian Government, ‘Telecommunications Regulatory and Structural Reform’ (December 2014) p 6.

¹¹⁰ SRDC initial conclusions, para 6.71.

business from BT's retail divisions), that would inevitably risk Openreach treating input from BT customers as being a greater significance or weight than input from other customers. This concern is particularly severe given BT's retail divisions will likely remain, for a considerable period of time, Openreach's largest customer. BT's retail businesses operating as 'anchor tenants' also undermines Openreach's incentives to pursue two-part tariffs (including co-investment) – particularly in the status quo, where the benefit of co-investment would be offset against the competitive risk to BT retail businesses in deciding whether to allow Openreach to invest.

6.38 Accordingly, it is important that any decision to purchase from Openreach made by a BT retail division should be made on an arms-length and open basis: that is, the services that Openreach offers to it should be market-tested to see whether the price that Openreach is seeking reflects market conditions. Obviously, in many circumstances, there will be no relevant market offer (Openreach has and will retain SMP in many markets and for most circumstances) but in other cases (for example, in relation to areas where there are non-Openreach fibre rollouts), it may be the case that other suppliers can compete to offer network access to BT divisions.

6.39 In those circumstances, it is beneficial to consumers and investors that there be open competition to supply BT's businesses. This has the benefit of ensuring BT exercises countervailing buyer power against Openreach, putting pressure on it (to the extent possible given Openreach's market position) to deliver services that are fit-for-purpose and of an appropriate quality.

6.40 As described further in Annex 7, open procurement obligations are imposed on regulated firms in other sectors such as aviation. Specifically, Heathrow is under an obligation to:

*'... as is reasonably practicable, secure the procurement of capital projects in an efficient and economical manner, taking account of value for money including scope, aggregated direct and indirect costs for the airlines affected by the project, programme timing risk and benefit to users of air transport services.'*¹¹¹

6.41 This general obligation is supplemented by obligations to publish a Procurement Code of Practice designed to ensure that capital projects are designed and delivered in an appropriate way (e.g., in terms of balancing cost certainty and risks); principles applied to contractors; and setting out how contractors will be incentivised to be efficient.

6.42 In order to ensure the independence of both BT and Openreach, it is imperative that more transparent trading processes are put in place. As set out above, the terms of trade upon which Openreach and BTR operate are not open and transparent. Investment decisions in relation to Openreach and BT are made at the BT level and the reasons why a decision is made are not always clear to the industry.

6.43 In addition to Openreach being required to change the way that it engages with both BT and CPs, it is also imperative for BT to make corresponding changes. For example, before an investment decision is made at the BT level, BT should be required to undertake, at least, a market feasibility test undertaken to assess the cost required and value to be attained by

¹¹¹ Licence granted to Heathrow Airport Limited under the Civil Aviation Act, condition C3.

proceedings. This enables industry to prepare for changes to service provisioning, or underlying technology to the service provided in good time. Further, previously, Openreach has stepped in to provide BTR with services and/or undertake work at the behest of BT. This process would have to change in the face of a newly independent Openreach. Accordingly, there should be a requirement on BT that, instead of purchasing services solely from Openreach that it should engage in open procurement processes which would provide other CPs with the opportunity to provide services to BT, which in turn will create more competition in the market.

Proposal 22: BT staff incentives should not include OR performance

- 6.44 Performance-based rewards (including bonuses) for BT staff (including senior executives) should not be linked to the performance of Openreach.
- 6.45 Currently, BT divisions are led by senior executives who are members of BT's senior management community and who are given incentives based on the performance of BT overall, including Openreach. This means that they have distorted incentives, in the sense that they are aware that intra-group payments as between Openreach and other parts of BT are relatively unimportant to them, and therefore that they have little incentive to ensure that dealings between BT divisions and Openreach are truly arms-length. That also creates incentives to push group-level common costs into the configuration that favours the BT Group, not necessarily their division. This is not the case with the leadership of Openreach's other customers, who must be concerned to ensure that transactions with Openreach reflect a fair measure of value.
- 6.46 In light of the legal separation of BT and Openreach, and the requirement for Openreach's independence from the BT, adjustments should also be made to BT employee incentives and employment structure. In light of the fact that Openreach would be making its own decisions, in the interests of Openreach, and that investment decisions would be made separately to those relating to BT, the performance of Openreach should be assessed separately to that of BT, or indeed BTR. Accordingly, executive bonuses for personnel from BTR should not be linked in any way to the performance of Openreach.

7. Continued scrutiny

7.1 This section deals with proposals dealing with obligations on Openreach and BT during the life of the new separation regime.

Proposal 23: The IMT must report regularly on status

7.2 The role of the IMT will be to monitor, and give effect to, the legal separation requirements, oversee the establishment of Openreach as a legally separate entity and then to play an active role in supervising the transition to fully independent operations. This will include reporting to Ofcom and other stakeholders on progress. This would be separate from Openreach's own reporting, which would be concerned with meeting its obligations to provide transparency as to its finances and operations (see proposal 4).

7.3 As discussed previously, monthly reporting is routine in the management of divestment (applying a 'divestment -minus' perspective).¹¹² There is no good reason to take a different approach here. It is therefore necessary that the IMT reports monthly to Ofcom and to stakeholders to monitor legal separation, the progress, and process, of disputes and oversee arms-lengths contracts between Openreach and BT.

Proposal 24: The arrangements must be made on an enduring basis

7.4 It is necessary for CPs to have a sufficient degree of regulatory certainty and stability in order to plan, attract investment in and build large-scale fibre networks. There therefore needs to be commitment from BT and Ofcom that the legal separation arrangements will remain stable, with changes only being permitted after a lengthy period, following industry consultation, and with a high threshold required to justify any changes.

7.5 It would be appropriate, however, for Ofcom to indicate an intention to review the arrangements at an appropriate point.¹¹³ A review period of three years (as provided for under the Authorisation Directive) is obviously insufficient for providing the appropriate level of certainty for such investment. For example, when New Zealand initially rolled out its plan to partially publicly fund a fibre-based rollout, it initially committed to regulatory forbearance (subsequently replaced with a contractual regime to provide certainty of returns) for a period of 8.5 years.¹¹⁴

7.6 Given it will take time for industry to understand, develop confidence in and respond to the arrangements proposed in this report – and given that the type of innovations and network rollouts which might result from these new arrangements are unclear – we consider that a period greater than the length of time proposed in New Zealand would be appropriate. We also consider that any changes should be made subject to a lengthy notice period to minimise

¹¹² See the discussion of the IMT's reporting at paragraph 4.70.

¹¹³ This would be similar to Ofcom's approach to issuing spectrum licences, where many licences are now of indefinite duration, but have an "initial term" (eg, 20 years) which provides certainty for stakeholders.

¹¹⁴ See <https://www.beehive.govt.nz/release/regulatory-forbearance-be-replaced>.

the impact on existing or planned investments made by industry on the basis of the existing arrangements.

- 7.7 Ofcom should therefore aim to conduct a review of the legal separation arrangements in ten years from the date of implementation, subject to any issues it identifies through its monitoring arrangements which may cause it to undertake a review earlier, and commit to not introducing changes to the regime without five years' notice.

8. Conclusions

- 8.1 Although we share Ofcom's view that the only conclusive solution remains structural separation, legal separation of Openreach in line with the proposals set out in this report is not only feasible but offers the only real opportunity (absent structural structural) to achieve a step change in the effectiveness of competition and increased investment.
- 8.2 The proposals set out in this report would be less cumbersome than the current regime. They would rely on company law obligations, helping to address (to a much greater extent than any alternative except structural separation) the underlying divergence between BT's responsibilities to its shareholders and Ofcom's regulatory objectives. Bespoke functional separation would nevertheless be required (particularly to address the incentives of the BT Group plc board to maximise shareholder value, even at the expense of competition and the interests of UK consumers). However, such obligations could be more limited than under the current model and apply only where company law obligations do not provide for sufficient independence of Openreach and BT's retail divisions.
- 8.3 In section 3 of this report, we set out the framework we used to develop our proposals. We started with the view that we should suggest the minimum necessary steps to achieve Ofcom's objective. That is, we sought to suggest the minimum changes required to remove the distortive effects of vertical integration on competition and investment incentives, by seeking to eliminate BT's inappropriate influence – and *potential* influence – over Openreach. Our proposals deliver the right outcome assessed against two perspectives:
- (a) **'Status quo – plus'**. The 2005 Undertakings have failed to provide for Openreach's independence and transparency. Legal separation is a necessary addition to this regime in order to achieve a step change in independence (including by ensuring Openreach's board and management owe duties to *Openreach*, not BT as a whole) and transparency (including by enabling Openreach to ensure its dealings with the rest of BT are documented and legally binding).
 - (b) **'Divestment – minus'**. Our proposals seek to emulate structural separation as closely as possible. They seek to remove all elements of inappropriate influence BT might exercise over Openreach other than BT's ownership interest. Our proposals mimic this by adopting remedies similar to those required by competition authorities in acquisitions, to manage the concerns arising from vertical integration.
- 8.4 Further, legal separation would better fulfil each of Ofcom's objectives than any other model short of structural separation:
- (a) Independence – legal separation is the only option that ensures Openreach has an independent board with directors whose fiduciary duty is to promote the success of Openreach rather than the BT group as a whole. It is also the only option which secures that Openreach has its own employees, legally binding contracts, can directly control its own assets and has the ability to borrow and manage its own affairs;

- (b) Transparency – legal separation means that Openreach will be capable (and should be required) to secure any external inputs on an arms-length and properly documented basis with real money changing hands. It addresses many of the concerns associated with the current cost allocation regulatory framework by legally isolating regulated markets;
 - (c) Promotion of competition and investment – because BT’s retail divisions and other CPs will all be free to source wholesale inputs from competitors, Openreach will face countervailing buyer power, providing stronger incentives for it to deliver adequate quality of service. Conversely, a requirement on Openreach to objectively assess co-investment proposals from CPs other than BT’s retail divisions will help ensure the industry develops in a manner that serves UK consumers, and that fixed line network investment does not just maximise profitability for the BT Group; and
 - (d) Effectiveness – an independent board for Openreach and an IMT will together provide significantly more confidence to CPs that the objective and the specific requirements of the new arrangements are being complied with. This will provide significantly more confidence to invest in UK telecommunications markets than CPs have enjoyed to date.
- 8.5 We have drawn from other sectors and the experience in other countries in developing our proposals. These resources have shown that, while there would be a number of implementation issues, they are far from insurmountable. The experience in New Zealand and Singapore, for example, show that divisions of assets, allocations of employees and separations of systems can be achieved in a reasonable timeframe and without prohibitive cost. Indeed, in comparison to many of the systems issues that have been experienced in the UK and Australia under operational and functional separation models, it may well be that (even leaving aside the benefits) legal separation is lower cost in the long term.

9. List of annexes

- Annex 1: Ofcom's SRDC conclusions
- Annex 2: BT Group and its subsidiaries
- Annex 3: Energy markets – the European 'second package' regime
- Annex 4: Energy markets – the Centrica Rough Gas Storage facility undertakings
- Annex 5: Media markets - Editorial independence (BBC/BBC Trust & The Economist)
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- Annex 7: Civil aviation – Heathrow capex project – procurement rules
- Annex 8: International case-study – Singapore (trustee share ownership model)
- Annex 9: International case-study – Australian (NBNC0)
- Annex 10: International case-study – New Zealand (TNZ asset division on separation)

ANNEX 1: Ofcom's SRDC initial conclusions

Failures of the current regime

- A1.1 In its February 2016 initial conclusions, Ofcom identified a number of serious concerns with Openreach's performance and structure, and the impact of these for UK consumers.
- A1.2 Ofcom found that functional separation of the BT Group from Openreach under the 2005 Undertakings had failed to remove the incentive and the ability of BT to discriminate against downstream competitors due to the vertical integrated nature of the BT Group.¹¹⁵ Ofcom's findings in relation to the undertakings include that:
- (a) since the 2005 Undertakings were put in place, BT breached them 'in a non-trivial manner 59 times';
 - (b) there was no apparent decline in this trend;¹¹⁶
 - (c) BT does not always use the same products as its competitors, rendering equivalence ineffective and allowing BT's retail divisions to deliver an improved retail customer experience;¹¹⁷ and
 - (d) even with functional separation, BT's competitors have not been protected from poor performance by Openreach in supplying products.
- A1.3 Ofcom noted concerns that developments in the market, such as increasing demand for bundles, might provide further incentives for Openreach to discriminate against downstream providers which compete with its retail divisions.¹¹⁸
- A1.4 It also observed that the model of functional separation in the 2005 Undertakings was subject to limits inherent in the current BT corporate structure. Without a structural solution (whether through legal separation or 'functional separation plus') Ofcom's view was that underlying incentives to discriminate would remain and the failures of the current regime outlined would persist.
- A1.5 Ofcom therefore concluded that 'the status quo is not acceptable', noting:
- (a) 2.4 million households and small businesses (around 8% of all UK premises) cannot yet access broadband at a speed of 10Mbit/s, and that superfast broadband coverage is much lower in rural areas (37%);

¹¹⁵ The identified issues were its inferior quality of wholesale products, slow product development, poor processes, and a general lack of transparency. See para 6.2 of the initial conclusions.

¹¹⁶ SDRC initial conclusions, para 6.15.

¹¹⁷ Ofcom, 'Strategic Review of Digital Communications: Discussion document' (16 July 2015), para 11.31. ('Ofcom Discussion Document').

¹¹⁸ Ofcom Discussion Document, para 11.32.

- (b) there are high levels of dissatisfaction among small and medium enterprises (SMEs) with broadband quality of service, with 42% of SME internet users reporting experiencing issues with internet connectivity and poor service reliability (29%); and
- (c) on certain metrics the UK is lagging – FTTP is only available to 2 % of UK premises, much less than in countries like Japan (70%), Spain and South Korean (over 60%).

A1.6 Its specific concerns in relation to Openreach are set out below.

BT Group control over Openreach and equivalence

A1.7 Ofcom considered that the 2005 Undertakings had not sufficiently disciplined BT's ability to influence Openreach's strategic decisions over the long term, including in ways that discriminate against competing downstream providers. Ofcom supported respondents' concerns that, since strategic decisions on investment are taken at BT Group level, Openreach's decision-making independence is compromised.

A1.8 BT Group Board is responsible for approving Openreach's annual operating plan. Whilst this gives the Openreach management team a certain degree of autonomy within the annual operating plan such 'autonomy' is capped to investment decisions below £75 million. The broader concern is that BT's vertical integration, budgetary co-dependence and position in the market allows it to inappropriately influence Openreach's decisions regarding network developments and its decisions to take forward network investments based on the effect on downstream competitors.

Consultation on investment

A1.9 Ofcom believes that, under the current functional separation regime, BT has made strategic decisions related to the network without Openreach consulting with its downstream customers in a 'sufficient, timely or transparent manner' (for example, in relation to the 2015 rolling out of ultrafast broadband). Ofcom's concerns on this front are that alternatives are not fully tested and the interests of downstream stakeholders are not properly taken into account. Ofcom's concern to increase Openreach's consultation obligations is premised on its view that, under the current regime, there is a risk that investment outcomes will be sub-optimal for the UK as a whole.

Lack of independent governance

A1.10 For Ofcom, the fact that BT's Group board is simultaneously responsible for key decisions concerning Openreach's commercial strategy and those concerning other BT downstream decisions, means BT's board will take a group perspective and important strategic decisions about Openreach become influenced by the impact on the BT Group. It also means that Openreach does not have the incentive to respond to third parties request for network investment without first seeking approval from the BT Group board, which will have regard to the impact on other parts of the BT Group.

Lack of standalone capabilities

A1.11 Within the current structure, Openreach has to compete for resources, capital and management focus within the BT Group. For Ofcom this competition is concerning because it

has led to constraints in Openreach's operational performance in favour of BT's downstream divisions.

A1.12 Furthermore, operationally, Openreach is dependent on shared BT Group functions. Ofcom is therefore concerned that Openreach may not have sufficient internal capability to develop its own strategy and manage its own operational delivery. For Ofcom, this leaves a risk that Openreach will remain beholden to the rest of the BT Group and will have a lack of operational autonomy leaving it unable to freely deliver for all downstream customers.

Necessary features of Openreach in future

A1.13 Ofcom acknowledges that the competition concerns identified in the SRDC are similar to those identified in 2005. As a result, Ofcom's conclusion is that the 2005 Undertakings have not corrected the market failures they original sought to address. Ofcom's view is therefore that any new model of separation adopted must reform the vertically-integrated structure of BT as this 'inherently affects the way BT makes significant decisions'.

A1.14 Ofcom retains the option of structural separation but is concerned about potentially substantial costs. Accordingly, Ofcom's primary interest appears to be in a strengthened model of functional separation.

A1.15 Given all the above concerns, Ofcom considers that any new regime would require the following characteristics:

- (a) *Independent governance structures and processes* – Openreach should act independently and be seen to act independently. In reforming the current regime, Ofcom states that it will seek to simplify current rules and processes regarding non-discrimination. Ofcom will also ensure any reformed regime improves Openreach's financial autonomy to take strategic decisions on network investment, network maintenance and operational systems.
- (b) *Independent technical and operational capabilities* – Ofcom considers that Openreach should be able to develop options for upgrading its network, improving operational performance and meeting wholesale customers' future needs without recourse to the rest of the BT Group.
- (c) *Improve Openreach's responsibility to serve all wholesale customers equally* – Ofcom proposes to do strengthen this responsibility by entrenching it as an Openreach objective and/or enhancing Openreach's governance independence.
- (d) *Autonomy over its budget and capital investment* – Ofcom considers that this can be achieved either by the Openreach's management board being given more autonomy over capital investment or by requiring BT Group to finance Openreach without directly influencing how the funds are spent.
- (e) *Ongoing responsibility to consult with all customers in the same way* – Ofcom this will allow for more bilateral discussion of specific proposals between Openreach and all its customers in a manner that does not inappropriately favour the BT Group. Ofcom is

considering establishing an obligation to consult with downstream operators at least on substantial investments and innovation decisions.

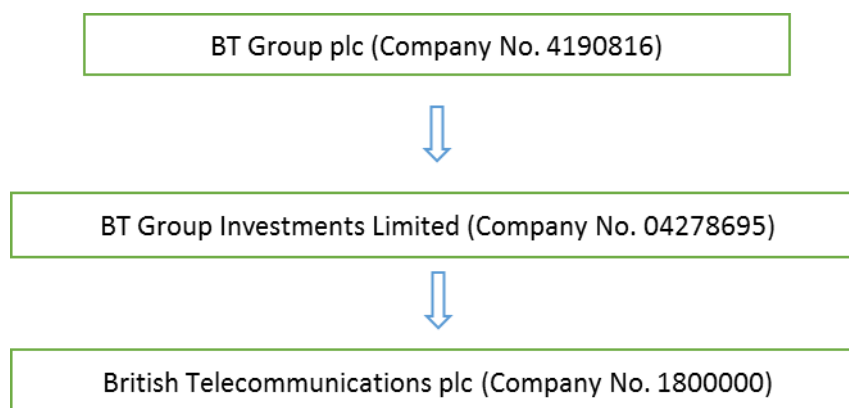
- (f) *Transparency over cost and asset allocation as between different parts of the BT* – this is intended to help ensure that BT does not allocate its costs in a way that artificially increases prices for regulated services.

ANNEX 2: BT Group and its subsidiaries

A2.1 This Annex contains a brief outline of the structure of the BT Group (based on publicly available information).

BT Group

A2.2 BT Group plc is a holding company which indirectly owns British Telecommunications plc as illustrated by the following structure, where each entity is wholly owned by its parent company:



A2.3 Consistent with its status as a multinational company, BT Group directly and indirectly owns hundreds of trading and non-trading companies in the UK and across the globe, with or without the BT brand.

A2.4 Its main trading entity in the UK is British Telecommunications plc.

A2.5 BT Group is organised in 6 lines of business: Openreach, Global Services, Business and Public Sector, Consumer, EE, and Wholesale and Ventures. A seventh line, Technology, Service & Operations also exists, but only to serve the Group as an internal service unit.

A2.6 While Global Services and EE exist as subsidiaries whose ultimate owner is the BT Group, the other lines of business are not legally separate entities but reflect the group's organisation in a commercial sense.

A2.7 Each division is tasked with serving specific markets, which are mostly self-explanatory¹¹⁹.

Openreach

A2.8 Openreach is the Group's functionally separate network access entity, created in 2006 following undertakings given to Ofcom by BT in lieu of a reference to the Competition Commission (as it was known at the time) under the Enterprise Act 2002. Its role is to serve all

¹¹⁹ See, e.g., <http://www.btplc.com/Thegroup/Ourcompany/Groupbusinesses/index.htm>.

CPs on an equal basis, including BT's other divisions. Its main products are LLU, Ethernet, GEA, WLR and PIA.

Global Services

A2.9 Global Services provides managed services to large corporate and public sector customers in the UK and abroad. This is the multinational arm of the Group which relies on hundreds of locally incorporated entities in other countries.

Business and Public Sector

A2.10 BT Business is the Group's business to business arm in the UK and Ireland. It focuses on SMEs in the fixed voice and data markets as well as those for mobility and IT services.

Consumer

A2.11 This division serves end users directly and represents what most people will know to be 'BT', selling fixed line products such as broadband, telephone and television products to the public.

EE

A2.12 This line of business is the result of the well-publicised acquisition of mobile operator Everything Everywhere by BT in 2016. Following its approval by the Competition and Markets Authority, this transaction has given BT access to new customers for mobile services both in the consumer and business markets. So far, BT has stated it will preserve the EE brand as it is well known to the public.

Wholesale and Ventures

A2.13 This business arm serves CPs directly as well as other BT lines of business. The difference with Openreach is that BT Wholesale must also provision access products from Openreach, as if it were a separate CP. BT Wholesale mainly offers wholesale Ethernet and broadband products amongst other things.

Technology, Service & Operations

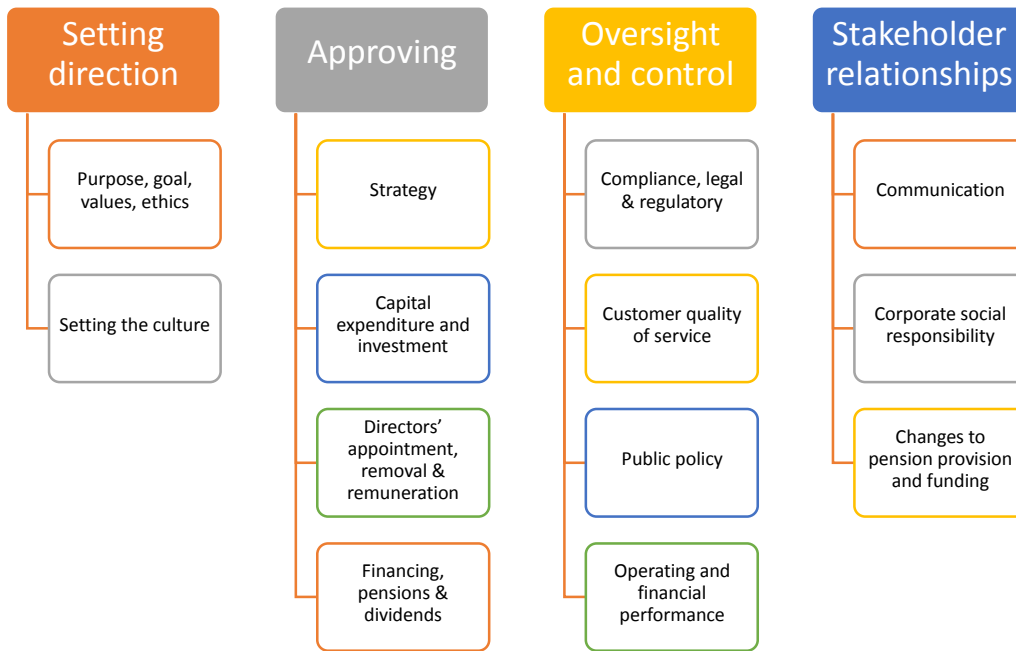
A2.14 This unit is responsible for delivering networks, platforms and IT systems to the other 6 lines of business. It also manages the Group's research and patent portfolio.

BT Group

Functions of the BT Group plc Board

A2.15 The Board controls the Group and is responsible for its strategy and performance.

A2.16 It delegates authority to committees which are tasked with specific matters. However, its main duties can be illustrated as follows:

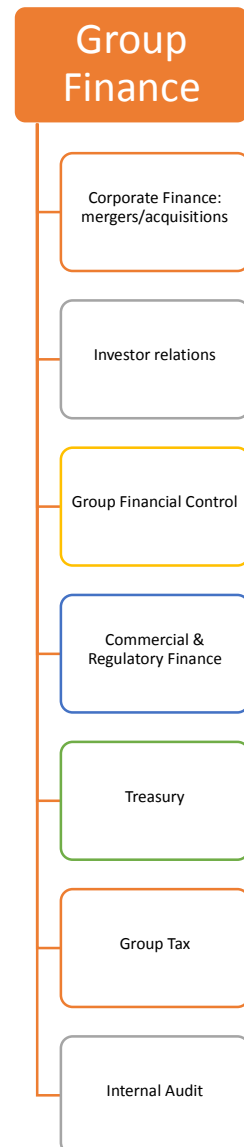


A2.17 Committees are organised as follows. Committees can make decisions on the basis of the authority delegated to them by the Board, except for those which fall within the remit of the Board in which case the latter’s approval is needed.

Equality of Access Board	<ul style="list-style-type: none"> Established as part of the Undertakings
Audit & Risk Committee	
Remuneration Committee	
Nominating & Governance Committee	
BT Pensions Committee	
Technology Committee	
Committee for Sustainable and Responsible Business	

A2.18 BT Group is also divided into 13 separate business units tasked with administrative duties necessary to the running of the Group:

- (a) **Strategy and management** (i.e. the tasks of the Group CEO): Group Strategy's principal role is to maximise long term value for shareholders by ensuring it is competitive. Group Strategy operates across all of BT's lines of business to ensure the Group's development.
- (b) **Finance:** Group Finance is divided into further sub-divisions as shown in the diagram on the right
- (c) **Group HR:** This department is responsible for recruitment and health & safety.
- (d) **Group Comp Secretary:** The Group Company Secretary services the Board, oversees the Annual Report, supports the Equality of Access Board and oversees corporate governance matters and compliance.
- (e) **Group Regulatory Affairs and Regulatory Compliance:** This department ensures BT operates within the rules and takes part in the regulatory dialogue in the UK and the EU, adopting an assumed deregulatory stance.
- (f) **Group Legal:** This is the in-house department which advises the Group on all relevant legal matters.
- (g) **Group Communications:** Group Communications liaises with journalists and represents the Group on public policy matters, but also directs communication towards employees and overall ensures the image of the Group is projected as intended.
- (h) **Group Security:** This department is sub-divided into further teams: Policy and Communications, and Asset Protection and Investigations. Group Security's role is to protect BT's assets and people as well as detect and investigate any criminal activity.
- (i) **Group Property:** BT owns thousands of properties which are managed by Group Property which employs its own surveyors, engineers and building managers. Group Property also exists as an incorporated, separate entity, wholly owned by British Telecommunications plc.
- (j) **BT Fleet:** The Group relies on a large fleet of vehicles to run its business, relying on BT Fleet to supply cars and vehicles to BT. It also exists as an incorporated, separate entity, wholly owned by British Telecommunications plc.
- (k) **Procurement and Supply Chain:** This department is responsible for procurement, supply chain and mail services.



- (l) **European Affairs:** This unit is BT's voice in Brussels, whose role is to influence European policy as well as making sure BT takes EU policy into account when designing its own strategy.
- (m) **Portfolio Centre of Excellence:** The Portfolio Centre of Excellence is the Group's cost-cutting and efficiency unit.

Openreach¹²⁰

A2.19 BT's functionally separated access division has no separate legal identity. It reflects the promises made to Ofcom by BT in the Undertakings. Its internal structure is therefore within BT's control and not subject to the regime of company law.

A2.20 Openreach describes itself as being made up of four main departments: customer service, service delivery, infrastructure delivery and headquarters, as detailed below.

- (a) Corporate headquarters (1,290 people)
 - (1) Strategy and management: The executive team is made up of 12 members, led by the Openreach CEO who reports directly to BT's CEO. However, this management team is not a board of directors in the legal sense (and therefore not subject to any fiduciary duties), as Openreach is not a separate legal entity. As such, Openreach cannot guarantee its strategic decisions are taken independently of the influence of BT Group.
- (b) Finance
 - (1) Raising capital
 - (A) Raising capital is not specifically addressed by the Undertakings, nor is it detailed in any publication such as annual reports. However, section 5.28 requires Openreach to establish an annual operating plan for approval by the Board of BT Group plc.
 - (B) Capital expenditure above £75 million must also be approved by BT Group in accordance with section 5.29 of the Undertakings.
 - (2) Balance sheet management: Openreach has no obligation to publish company accounts or an annual return in the normal sense as it has no legal personality. The only public insight into its financial affairs comes in the form of the regulated accounts BT must publish, and limited information in BT's annual report.
 - (3) Register of assets: This aspect too is only visible in BT's regulated accounts.
- (c) Marketing:

¹²⁰ This split of Openreach's functions is taken from <https://www.openreach.co.uk/orgp/home/aboutus/ourorganisation/businessinfo.do>.

- (1) Sales and branding are addressed in the Undertakings at section 5.47 onwards. Openreach can only accept orders from CPs (including BT) and is not allowed to incorporate 'BT' or 'British Telecom' into its brand name, save 'in proximity to an endorsement containing the words 'a BT Group business'.
 - (2) In practical terms, Openreach does its marketing via its website where it hosts brochures and videos on its products.
- (d) Other headquarters departments include:
- (1) Legal/risk management;
 - (2) Human Resources;
 - (3) Communications & Public Affairs (regulatory); and
 - (4) IT.
- (e) Subject to any restrictions in the Undertakings, each and any of these divisions are free to call on BT Group resources for its own purposes. For instance, they can ask Technology, Strategy and Operations to develop new systems or require legal advice using BT Group lawyers.
- (f) Customer service: Customer service employs 1,000 people and is split into the following lines of business:
- (1) Strategic planning for current and future demand
 - (2) Account management
 - (3) 24x7 service and network management of the Ethernet, NGA and LLU Power platforms.
 - (4) Management of all CP complaints into Openreach.
- (g) Service delivery: The Service Delivery team, comprised of 19,000 employees, is responsible for the last mile in terms of maintenance and new connections. The team undertakes:
- (1) Provision and repair jobs and cabinet-only visits (29,000 visits a day)
 - (2) In-exchange work (providing new connections and removing jumpers)
- (h) Infrastructure delivery: This 6,500-strong team is tasked with fulfilling BT's commitment to achieve 95% coverage of the country by fibre by the end of 2017, entailing the following activities:
- (1) Building the core and fibre network, subject to the 95% coverage commitment;

- (2) BDUK delivery programme which is the government's subsidy of the above, amongst other things (rural access, mobile infrastructure);
- (3) Building new connections with the ambition of connection of all new property developments;
- (4) Civils work;
- (5) Testing/maintenance; and
- (6) Responsibility for looking after network records

ANNEX 3: Energy – the European regime

Market structure

A3.1 In order to supply gas to UK homes and businesses, it is necessary to:

- (a) obtain gas that has been extracted from underground (or under the seabed);
- (b) use facilities to store gas;
- (c) use facilities to interconnect the transmission network in the UK with the transmission networks in other countries, in order to enable cross-border gas trading;
- (d) transport gas to the place where it is to be burned. Gas must normally be transported from the producer:
 - (1) via the transmission network, at high pressure on a large scale; and then
 - (2) via a distribution network, which normally connects the transmission network to the user's premises; and
- (e) contract with customers to deliver gas to homes or businesses, a task undertaken by gas suppliers.

A3.2 Electricity on the other hand can be produced (generated) but not, on an industrial scale, easily stored. As a result, much of the concern of the electricity sector is to ensure that supply and demand are matched effectively. In order to supply electricity to UK homes and businesses, it is therefore necessary to:

- (a) generate electricity;
- (b) transport electricity to the place where it is to be consumers. Electricity must normally be transported from the producer:
 - (1) via the transmission network, at high voltage on a large scale; and then
 - (2) via a distribution network, which normally connects the transmission network to the user's premises; and
- (c) contract with customers to deliver electricity to homes or businesses, a task undertaken by electricity suppliers.

A3.3 A highly stylised view of the structure of energy markets comprises five main functional stages as illustrated in the diagram on the right of this page:

Independence requirements

A3.4 The present level of legal separation provided for in EU legislation is to a large degree a reaction to concerns voiced by the Commission a decade ago, when it suspected (and found, in the conclusion of investigations into energy companies) that a number of infringements of Articles 81 and 82 (as they were known at the time) had taken place in several Member States.

A3.5 The Second Package of energy reforms (set out in Directive 2003/55/EC) recognise that 'network access must be non-discriminatory, transparent and fairly priced'. In achieving this, recital 10 Directive acknowledges the importance of legal separation between different vertically integrated elements of the value chain, along with independent decision-making rights and autonomy of the legal entity responsible for a particular function in the value chain:

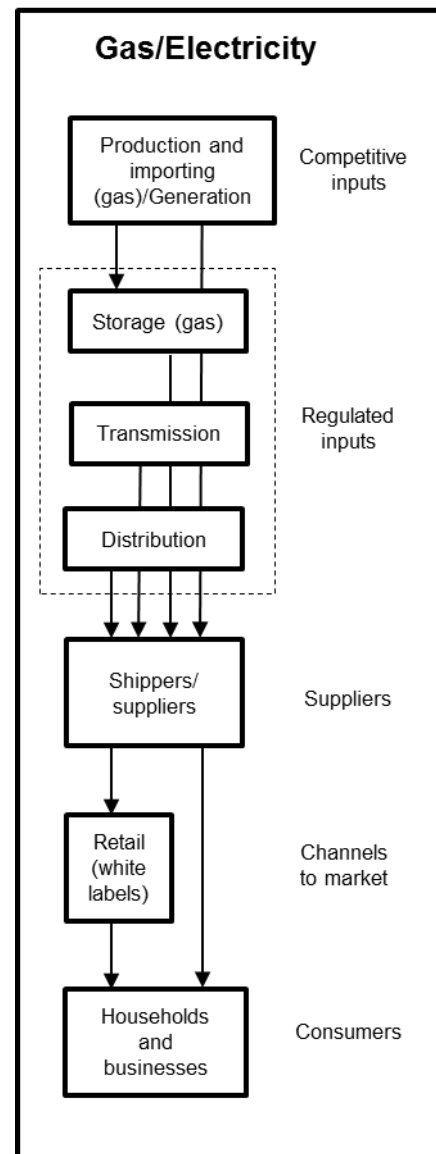
'In order to ensure efficient and non-discriminatory network access it is appropriate that the transmission and distribution systems are operated through legally separate entities where vertically integrated undertakings exist. ...

It is also appropriate that the transmission and distribution system operators have effective decision making rights with respect to assets necessary to maintain and operate and develop networks when the assets in question are owned and operated by vertically integrated undertakings.

It is important however to distinguish between such legal separation and ownership unbundling. Legal separation implies neither a change of ownership of assets and nothing prevents similar or identical employment conditions applying throughout the whole of the vertically integrated undertakings. However, a non-discriminatory decision-making process should be ensured through organisational measures regarding the independence of the decision-makers responsible.'

A3.6 These requirements are reflected in operative article 9 of the Directive, which provides that:

'1. Where the transmission system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision making from other activities not relating to transmission. These rules shall not create an



obligation to separate the ownership of assets of the transmission system from the vertically integrated undertaking.

2. In order to ensure the independence of the transmission system operator referred to in paragraph 1, the following minimum criteria shall apply:

(a) those persons responsible for the management of the transmission system operator may not participate in company structures of the integrated natural gas undertaking responsible, directly or indirectly, for the day-to-day operation of the production, distribution and supply of natural gas;

(b) appropriate measures must be taken to ensure that the professional interests of persons responsible for the management of the transmission system operator are taken into account in a manner that ensures that they are capable of acting independently;

(c) the transmission system operator shall have effective decision-making rights, independent from the integrated gas undertaking, with respect to assets necessary to operate, maintain or develop the network. This should not prevent the existence of appropriate coordination mechanisms to ensure that the economic and management supervision rights of the parent company in respect of return on assets regulated indirectly in accordance with Article 25(2) in a subsidiary are protected. In particular, this shall enable the parent company to approve the annual financial plan, or any equivalent instrument, of the transmission system operator and to set global limits on the levels of indebtedness of its subsidiary. It shall not permit the parent company to give instructions regarding day-to-day operations, nor with respect to individual decisions concerning the construction or upgrading of transmission lines, that do not exceed the terms of the approved financial plan, or any equivalent instrument;

(d) the transmission system operator shall establish a compliance programme, which sets out measures taken to ensure that discriminatory conduct is excluded, and ensure that observance of it is adequately monitored. The programme shall set out the specific obligations of employees to meet this objective. An annual report, setting out the measures taken, shall be submitted by the person or body responsible for monitoring the compliance programme to the regulatory authority referred to in Article 25(1) and shall be published.'

A3.7 These requirements for independence and legal separation were strengthened in the Third Package, which imposed a requirement of full ownership separation at certain points in the value chain.¹²¹ Specifically, transmission system operators (TSOs) must now be unbundled (or independent) from generation, production and supply interests,¹²² according to five statutory tests.¹²³

¹²¹ Directive 2009/73/EC on 'common rules for the internal market in natural gas and repealing Directive 2003/55/EC' (13 July 2009).

¹²² The Third Gas Directive was transposed into UK law through the Electricity and Gas (Internal Markets) Regulations 2011 (the '2011 Regulations').

¹²³ Certification proceeds under section 8C of the 1986 Act. The tests themselves are set out in section 8H. In summary, the first test is that the gas transporter: (1) does not control a relevant producer or supplier; (2) does not have a majority shareholding in a relevant producer or supplier; and (3) will not, on or after the relevant date, exercise shareholder rights

in relation to a relevant producer or supplier. The second test is that, in respect of the gas transporter, none of its senior officers has been, or may be, appointed by a person who: (1) controls a gas undertaking which is a relevant producer or supplier; or (2) has a majority shareholding in a gas undertaking which is a relevant producer or supplier. The third test is that, in respect of the gas transporter, none of its senior officers is also a senior officer of a gas undertaking which is a relevant producer or supplier. The fourth test is that the gas transporter is not controlled by a person who controls a relevant producer or supplier. The fifth test is that the gas transporter is not controlled by a person who has a majority shareholding in a relevant producer or supplier. This is a simplified account of the five tests – section 8H, GA86 sets out the full text, which includes, in some circumstances, alternative ways of passing certain tests, depending on how the circumstances arose that might otherwise lead to a gas transporter failing the test. This account also ignores the role of gas interconnectors, who are also required to be certified as independent.

ANNEX 4: Energy – Centrica Rough Gas Storage facility undertakings

A4.1 Centrica PLC was formed by the demerger of British Gas PLC in February 1997 into two parts—Centrica and BG Group. Centrica PLC’s brands now include British Gas, Bord Gais Energy, Centrica, Centrica Storage, Direct Energy, Dyno and Hive.

A4.2 This annex concerns the legal structure of Centrica Storage. Centrica Storage is a wholly-owned subsidiary of Centrica PLC that is legally, financially and physically separate from all other Centrica businesses. The reasons for the legal separation of Centrica Storage from Centrica and the statutory undertakings agreed as part of the merger process are set out in more detail in this Annex.

Background

A4.3 Centrica Storage acts as a storage facility for gas shippers, gas producers, suppliers and traders allowing them to nominate gas for withdrawal into the National Transmission System and inject gas into the reservoir on demand.

A4.4 Rough (now branded as Centrica Storage) was originally owned by British Gas PLC, but was, as part of the 1997 demerger process, passed to the new BG Group. Rough was regulated with BG Group’s assets under the transportation licence.

A4.5 Following a review by the regulator, price controls on the Rough business were lifted in favour of a set of informal undertakings given by BG Group. The main elements of these undertakings were that BG Group would offer:

- (a) the full capacity of Rough to potential users on non-discriminatory terms under the provisions of a standard storage services contract;
- (b) to sell all capacity by an auction procedure agreed with Ofgas;
- (c) to auction at least half the capacity for periods of not less than five years and the remainder for periods of not less than one year;
- (d) to facilitate the development of a secondary market in storage services; and
- (e) to maintain full separation between the storage operation and the rest of BG Group.

A4.6 Dynergy, a US company, purchased Rough from BG Group in 2001 and gave statutory undertakings in lieu of the acquisition being referred to the Competition Commission (‘CC’). These incorporated the main elements of BG Group’s undertakings, save that Dynergy was allowed to sell capacity by means other than auctions.

A4.7 In 2003, after Dynergy ran into financial difficulties, Dynergy began to divest its European assets. As part of that process, Centrica acquired Rough from Dynergy in a private sale.

Issues arising in the merger

- A4.8 The merger of Rough and Centrica was investigated by the CC to determine whether the merger operated, or could be expected to operate, against the public interest.
- A4.9 The CC had significant concerns arising from the vertical integration resulting from the merger. A major issue was whether, as a result of the merger, Centrica would be likely to withhold sources of flexible gas in order to force up wholesale gas prices. The CC observed that it appeared that Centrica had the ability and potential incentives to do this. The CC also noted that, in the absence of further constraints, Centrica would be expected to discriminate between customers in giving access to capacity at Rough; to use to its advantage sensitive information gained from the operation of Rough; to withhold information about the operation of Rough; to be less innovative in marketing Rough products than another owner; and to invest less in expanding Rough's capacity than another owner.

Independence requirements

- A4.10 The CC concluded that the adverse effects identified could be remedied by Centrica giving statutory undertakings¹²⁴ regarding its behaviour as the owner of Rough. The major relevant elements of these undertakings include obligations to:
- (a) supply Rough's full capacity on non-discriminatory terms (paragraph 2.1);
 - (b) maintain legal, financial and physical separation between its storage business and all other parts of the group; ensure that no commercially sensitive information arising from the operation of Rough is passed to other parts of Centrica; and make any disclosure of information relating to the storage operations to all market participants simultaneously (paragraphs 5 and 6); and
 - (c) arrange for an independent review of compliance with all undertakings by Centrica's Audit Committee, with annual reports to the CMA and the Office of Gas and Electricity Markets (paragraph 17).

- A4.11 Annex 3 of the Undertakings sets out the obligations regarding 'Legal, Financial and Physical Separation – Information to be provided to CMA and Ofgem' and provides as follows:

'Save as agreed by CMA pursuant to paragraph 5.2 of the Undertakings, Centrica and CSL will, on or by 1 December 2003, provide to CMA and Ofgem, evidence which demonstrates that:

¹²⁴ The Undertakings were given and agreed by the Secretary of State for Trade and Industry in 2003 and were further revised in March 2012. The CMA has recently conducted a review of the Undertakings and published a provisional decision which found that as Rough ages its performance may become increasingly unpredictable, so that Centrica Storage cannot meet its capacity obligations. In addition, more immediately, there is a need to reduce gas pressure whilst Centrica Storage carries out tests on the facility also means it is unlikely to meet the same obligations for the 2016/2017 Storage Year. Therefore, the CMA has provisionally concluded that it should vary the undertakings to introduce an adjustment mechanism which would allow Ofgem, as energy regulator, to vary the capacity obligations if Centrica Storage is able to demonstrate that there is an issue which will have a substantial impact on Rough's capacity. The statutory timetable requires a final decision by May 2016. For further information, see <https://www.gov.uk/government/news/cma-consults-on-rough-gas-storage-undertakings-request>.

- (a) a separate Centrica Storage business unit has been created;*
- (b) the separate management reporting structure reporting into the Company Secretary of Centrica has been implemented;*
- (c) the boards of CSHL and its subsidiaries (the 'CSHL Group') are comprised of persons not holding any office of employment or directorship in, or provide any services to CSL (save as allowed by paragraphs 5.3(e) and (i) of the Undertakings);*
- (d) separate audited statutory annual report and accounts will continue to be filed at Companies House for CSHL Group companies (consolidated group reporting of annual results of the Centrica group of companies will include the CSHL Group companies);*
- (e) separate premises for Centrica Storage have been obtained (separate from any other part of Centrica carrying out gas supply, shipping, trading, storage procurement and asset operations); and*
- (f) restrictions have been put in place to prevent directors and employees of other members of the Centrica Group (or their agents or Affiliates) having access to the communication or electronic networks and systems or facilities (or parts of those facilities, where relevant) used by CSL (and vice versa).'*

ANNEX 5: Media - Editorial independence (BBC/BBC Trust & The Economist)

The Economist

- A5.1 The Economist Group is a privately owned company, which publishes The Economist magazine. The company has an articles of association and ownership structure which is intended to preserve its editorial independence from the interests of its shareholders. It does so by imposing limits on the ability of any person to control the company; providing independent oversight over potential changes in shareholdings; and requiring approval for key transactions.
- A5.2 The articles of association provide that:
- (a) No person may own or control more than 50% of its total share capital;
 - (b) No person may own or control more than 20% of voting rights;
 - (c) In addition to ordinary and special shares held by investors and staff, there are trust shares held by trustees whose consent is needed for specific corporate activities (including share transfers). Trustee shareholders must not be connected with the Economist Group; and
 - (d) The employment contract between the company and the editor must provide for editorial independence and require the editor to protect the newspaper's character and traditions.
- A5.3 The trustee shares have nominal value, and the trustee shareholders do not have the right to vote, receive dividends or have any economic interest in the company. However, they exercise rights relevant to the editorial independence of the newspaper, such as the right to approve the appointment of the editor and the chairman of The Economist, to dismiss an editor, or to sell major assets of the company. The trustees are eminent individuals, presently Baroness Bottomley of Nettlestone PC, DL; Tim Clark; Lord O'Donnell CB, KCB, GCB; and Bryan Sanderson.
- A5.4 Ownership of The Economist has been remarkably stable. Pearson (owner of the Financial Times) held a non-controlling 50% stake in The Economist since 1928.
- A5.5 The ownership of the Economist changed in mid-2015, when Pearson sold down its stake. 60% of the Pearson shares were sold to an existing shareholder, Exor, with the remainder bought back by the Economist's parent company. The independent trustees approved the transaction subject to its shareholder agreeing to new safeguards that placed 'extra limits on the influence of any individual shareholder', especially given the concentration of voting rights that would otherwise have been enjoyed by Exor. Exor now owns 43.4% of total share capital.

The BBC Trust

A5.6 The BBC's Royal Charter sets out a number of requirements to guarantee its independence and specify its functions, including:

- (a) setting out the BBC's object of promoting certain specific public purposes (arts 3 and 4) and the manner by which it should do so (i.e. the provision of information, education and entertainment delivered by television, radio, online and related means) (art 5); and
- (b) requiring the BBC to be 'independent in all matters concerning the content of its output, the times and manner in which this is supplied, and in the management of its affairs' (art 6).

A5.7 Independence is enshrined through the role of the BBC Trust, whose role is to set the overall strategic direction and priorities of the BBC and exercise general oversight over the work of the board, in the public interest 'particularly the interest of licence fee payers' (art 7). The Trust is a body of trustees who are appointed on advice of Ministers after an open selection process, and whose duties include to 'secure that the independence of the BBC is maintained' (art 23).

A5.8 Various measures are in place to ensure the independence of the BBC Trust from the BBC board and management, including that:

- (a) the Royal Charter requires the Trust to maintain its independence of the Board (art 9) and never to act with the Board as a single body (art 8);
- (b) the BBC Trust is sovereign, 'it may always fully exercise [a function granted under the Royal Charter] as it sees fit and require the Executive Board to act in ways which respect and are compatible with how the Trust has seen fit to exercise that function' (art 9);
- (c) staff working for the Trust report only to the Chairman and Trustees and are not subject to and are prohibited from acting on behalf of the BBC board (art 43). The Royal Charter provides that the Trust appoints its own staff and determines their terms and conditions and the movement of staff between the Trust and management needs to be agreed by both (art 42);
- (d) the unit is clearly separated from the rest of the BBC and administered separately.

A5.9 In March 2016, the Clementi report¹²⁵ concluded that the trust model was flawed because it conflated governance and regulatory functions within the trust. It recommended that the model not be adopted and that the strongest argument was for Ofcom – as an independent regulator – to impose regulatory oversight over the BBC. The board would then retain responsibility for maintaining the independence of the BBC.

A5.10 The Clementi report, however, canvassed a number of alternative options to protect the BBC's independence. These included an independent appointments committee to appoint the Chair of the board (subject to a confirmatory hearing by the culture, media and sport parliamentary

¹²⁵ Sir David Clementi, 'A review of the Governance and Regulation of the BBC' (March 2016), available here: <https://www.gov.uk/government/publications/a-review-of-the-governance-and-regulation-of-the-bbc>. ('Clementi Report').

committee) or a government-appointed committee to transparently consult and recommend a candidate to be appointed by the minister after the person's suitability was assessed by parliamentary committee.¹²⁶

¹²⁶ Clementi Report, paras 79-81.

ANNEX 6: Rail– EU regime for independent track and operating companies

Market structure

A6.1 Rail differs significantly from other regulated industries by virtue of the role played by Government. As in other countries, the taxpayer contributes to rail services to reflect the policy objective that rail services are socially valuable and require significant investment.

A6.2 The delivery of rail services involves:

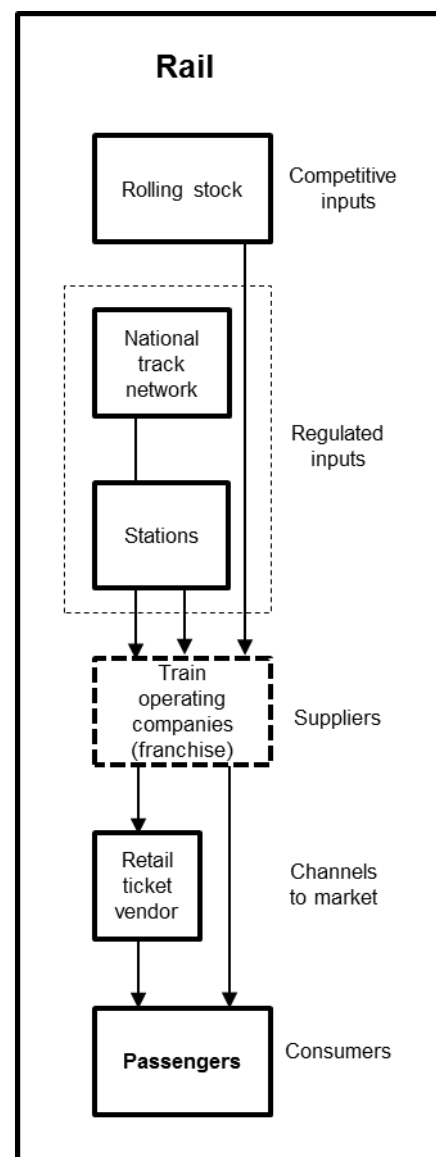
- (a) provision of rolling stock (i.e. trains) which are leased out to train operation businesses. In the UK, three of these companies inherited their assets following the privatisation of British Rail;
- (b) operation of rail infrastructure, such as the track network and stations. In the UK, rail infrastructure is typically operated by Network Rail, which is regulated by the Office of Rail and Road ('ORR');
- (c) train operations, which provide transport services using rail infrastructure. Operators bid for franchises, awarded by the Department for Transport ('DfT') as competitively procured contracts containing conditions that set minimum service levels to be observed by the winning bidder; and
- (d) retail channels to market.

A6.3 A highly stylised view of the rail industry in the UK is shown in the diagram to the right:

Independence requirements – EU

A6.4 Economic regulation of the rail sector has been the subject of three successive packages mandated by the European Commission, with a fourth currently progressing through the European legislative process.

A6.5 The current regime governing competition and economic regulation (as well as technical and safety aspects) of the rail industry at a European level is set out in a Recast Directive¹²⁷ which consolidated and simplified the previous three packages.



¹²⁷ Directive 2012/34/EU on 'establishing a single European railway area'.

- A6.6 The Recast Directive consolidated the concept of independence and separation between infrastructure operators and providers of transport services:

[Recitals]

(6) In order to ensure the future development and efficient operation of the railway system, a distinction should be made between the provision of transport services and the operation of infrastructure. Given that situation, it is necessary for these two activities to be managed separately and to have separate accounts.

...

Article 7.1

Member States shall ensure that the essential functions determining equitable and non-discriminatory access to infrastructure, are entrusted to bodies or firms that do not themselves provide any rail transport services. Regardless of organisational structures, this objective shall be shown to have been achieved.

...

Article 10.1

Railway undertakings shall be granted, under equitable, non-discriminatory and transparent conditions, the right to access to the railway infrastructure in all Member States for the purpose of operating all types of rail freight services.'

- A6.7 Structural separation is not mandated as the only potential remedy, so long as independence is achieved between the infrastructure and service aspects of the industry. Whether this is achieved by structural rather than functional separation is a matter for Member States.

Independence requirements – UK

- A6.8 The rail industry in the UK is subject to a regime of structural separation between infrastructure and services. Network Rail operates rail infrastructure, and operating companies such as Virgin Rail bid for franchises. There is horizontal route separation in train operations – that is, each franchise covers a given set of routes (and may include operation of certain stations).
- A6.9 This is largely a product of the history of the UK rail sector. Before privatisation began in the 1990s, British Rail was a vertically state-owned entity, responsible for the country's infrastructure (track, depots and stations), rolling stock and operations.
- A6.10 The sector underwent many significant and incremental changes, starting with the Railways Act 1993 which paved the way for a structurally separated entity (Railtrack, the predecessor of Network Rail) responsible for a regulated input, namely the infrastructure (tracks, depots and stations). Although this particular model failed as a result of Railtrack's financial difficulties, the principle of legal separation between regulated inputs and customer-facing commercial services is still in place today.

ANNEX 7: Procurement rules in civil aviation

A7.1 This Annex discusses in brief terms the approach taken in the airport regulatory regime to ensuring that major capex projects are the subject of input from a range of stakeholders, by reference to the requirements that apply to Heathrow airport.

Market structure

A7.2 The provision of aviation services requires a number of different market players:

- (a) airports – which in the UK are sometimes privately owned, sometimes majority publicly owned and are sometimes jointly privately and publicly owned. The British Airports Authority previously owned a significant proportion of UK airports (in 2007, serving 60% of all UK air passengers) but was privatised and then subject to a hostile takeover, before many of its airports being divested following a Competition Commission reference. Gatwick and Heathrow airports are economically regulated by the CAA due to their market power;
- (b) air traffic control – carried out by National Air Traffic Services ('NATS'), which is regulated by the CAA under the Transport Act 2000. NATS operates as a public/private partnership, with the industry (under the umbrella Airlines Group) holding 42%, and the UK Government 49% and a golden share;¹²⁸
- (c) slot coordination – the increased number of airlines has led to competition for slots at key airports. Slot allocation is regulated at a European level¹²⁹ and in the UK, slots at 'co-ordinated airports' (currently Heathrow, Gatwick, Stansted, London City and Manchester) must be allocated by an independent co-ordinator. In the UK, this is done by Airport Coordination Limited ('ACL');
- (d) airlines – which have in the UK always been separate for airports and slot coordination, and the market for which has been fully liberalised since 1993; and
- (e) channels to market.

¹²⁸ The other shareholders are Heathrow (4%) and NATS staff (5%). In 2013 the Airline Group shareholder group changed, with Thomas Cook, TUI Travel, Lufthansa and Virgin Atlantic selling most of their shareholdings to USS (Universities Superannuation Scheme Ltd), whilst leaving British Airways, Easyjet, Airline Co Ltd and the retirement plan of Monarch Airlines with their previous holding.

¹²⁹ Regulation EEC/95/93 on 'common rules for the allocation of slots at Community airports' and Regulation EC/793/2004 amending Regulation EEC/95/93.

A7.3 A highly stylised view of the market structure is set out in the diagram to the right.

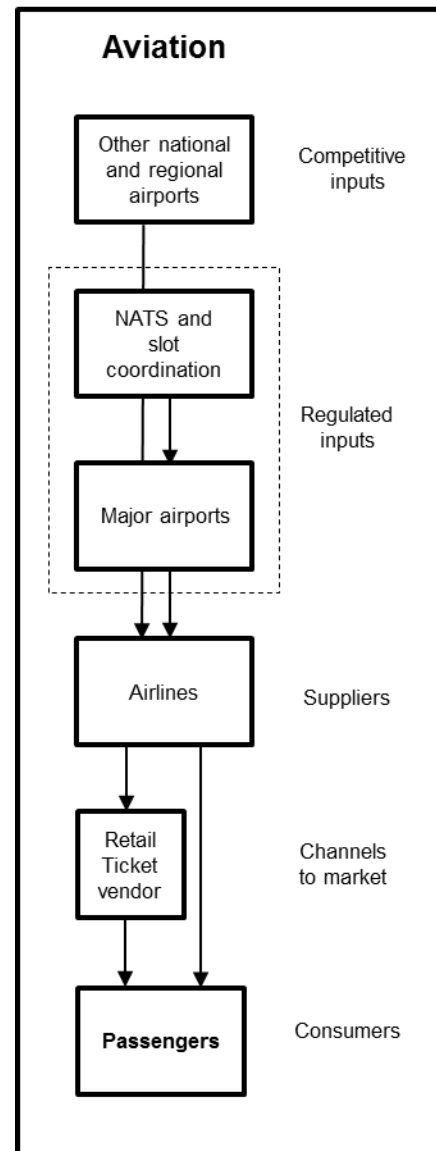
Consultation requirements

A7.4 Since privatisation, certain designated airports including Heathrow have been subject to economic regulation by way of a licensing arrangement.

A7.5 In developing the regulatory framework governing Heathrow's capex the CAA acknowledged that, 'where capital investments are ultimately being paid for by the airlines, it would be in the interests of those airlines, for their end-customers, to ensure that Heathrow carries out procurement for its capital investment projects efficiently and effectively'¹³⁰.

A7.6 The CAA's regulation of Heathrow's capex and procurement is designed to help facilitate competitive market-oriented outcomes. Absent the CAA's requirements, Heathrow as a dominant supplier (of airport operation services) may not have incentives to efficiency. Moreover, the market for the supply of services to Heathrow may also be affected, with outcomes determined by 'monopsony type' procurement strategies.

A7.7 Specifically, Heathrow's licence requires it to undergo a consultative and open process for procurement of capital projects. In simple terms, the constraints imposed by the licence condition imply that Heathrow cannot unilaterally invest significant amounts on assets or resources without proper industry consultation, or effectively, customer agreement. The licence condition is as follows:



'C3 Procurement of capital projects

C3.1 The Licensee shall, so far as is reasonably practicable, secure the procurement of capital projects in an efficient and economical manner, taking account of value for money including scope, aggregated direct and indirect costs for the airlines affected by the project, programme timing risk and benefit to users of air transport services.

C3.2 The following obligations in this Condition C3 are without prejudice to the generality of Condition C3.1 and compliance with the following obligations shall not necessarily be treated in itself as sufficient to secure compliance with

¹³⁰ Civil Aviation Authority, 'Economic regulation at Heathrow from April 2014: Notice granting the licence' (CAP1151, February 2014).

Condition C3.1. In fulfilling these obligations, the Licensee shall at all times comply with Condition C3.1.

Publication of a Procurement Code of Practice

C.3.3 By 1 October 2014 the Licensee shall publish a Procurement Code of Practice setting out the principles, policies and processes by which it will comply with Condition C3.1.

C.3.4 As a minimum, the Procurement Code of Practice shall include the following information:

(a) the acquisition principles, which shall ensure that the design and delivery of relevant capital projects are carried out in a manner which provides an appropriate balance of responsibility between the parties for cost certainty, risk, schedule and specification;

(b) The options for acquisition models that the Licensee intends to apply;

(c) The critical criteria that the Licensee intends to apply for adopting a particular acquisition model; and

(d) The key principles that the Licensee will apply to all contractors with regards to the operational requirements of airlines and the Licensee's own airport operation services.

C.3.5 The information required under Condition C3.4 shall demonstrate how the Licensee will:

(a) Further the objective for procurement in Condition C3.1;

(b) Incentivise efficiency by its contractors; and

(c) Take account of the overall performance of its contractors in awarding additional projects.

...

C3.7 The Licensee shall publish by 1 February each year a report identifying instances where significant capital investment work has not been procured in line with the Procurement Code of Practice, providing in each case evidence and analysis as to why an alternative procurement method better met the objective.'

A7.8 Heathrow is also under an obligation to consult generally on its capital projects:

'The Licensee shall ensure that: (a) it consults relevant parties on, as a minimum:

(i) its proposals for future investment in the short, medium and long term that have the potential to affect those parties; (ii) its proposals for the development

and delivery of key capital projects identified in its future investment proposals in Condition F1.1.(a)(i)'

- A7.9 Thus, Heathrow must secure its procurement of capital projects efficiently and economically (so far as is reasonably practicable). In doing so, Heathrow must take account of a number of factors, not least, the capital programme risks and the direct and indirect cost to airlines (Heathrow's customers). Importantly, Heathrow is also obliged to consult on, and specify, the options and criteria it intends to apply in acquiring assets and resources, and on the wider development of its capital programme.
- A7.10 Moreover, each capital programme is subject to ongoing scrutiny and industry engagement, by way of regular programme meetings and audit, and so-called gateways; these gateways are used to determine latest cost estimates, timing and other factors, and whether the programme should proceed etc.¹³¹ Each projects goes through a multi-stage management and governance process, with (at a certain point in the process) projects needing to be jointly agreed between Heathrow and the airlines, and 'regulatory triggers' being set to incentivise on time delivery of the project and its benefits. In the event of disagreement or dispute, the CAA has the discretion to intervene and determine matters if Heathrow cannot confirm project and/or asset costs with the airlines. In short, the CAA would assess whether Heathrow had, so far as reasonably practicable, made reasonable assumptions about the assumed project and/or asset costs.
- A7.11 In addition to the industry governance process, there is also an independent funds surveyor ('IFS'). The IFS provides on-going assessment of the reasonableness of decisions made on key projects and to ensure that capital is being used effectively to deliver the outcomes described in the various business cases. Heathrow and the Airlines agreed the terms of the IFS as a joint appointment.

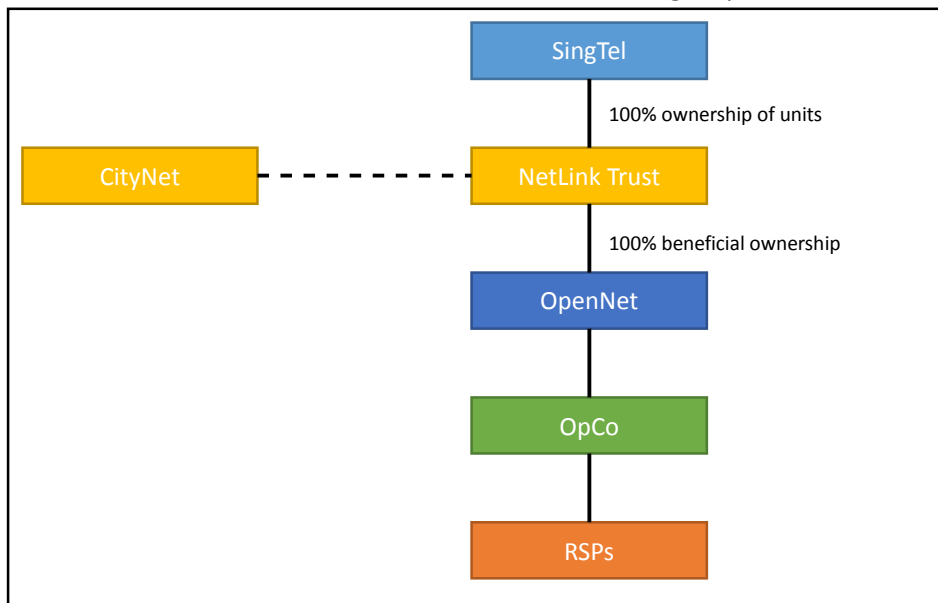
¹³¹ There are a number of related and detailed processes and documents, e.g., Capital efficiency handbook and the industry engagement process relating to the adoption of different categories of capex (core and development), all of which go beyond the scope of this short note.

ANNEX 8: Case-study – Singapore (trustee share ownership model)

Market structure pre-2014

A8.1 Singapore operates a multi-tiered fixed line telecoms market structure consisting of: the network operator (NetCo); several operating companies (OpCos) and retail service providers (RSPs).

A8.2 Prior to 2014, the market was structured in the following way:¹³²



A8.3 The key features of each operator were as follows:

- (a) Layer 1: OpenNet was the initial NetCo appointed by the Singaporean telecommunications authority (IDA). OpenNet (a consortium formed by Singtel, SP Telecommunications, Singapore Press Holdings and Canada's Axia NetMedia) was responsible for designing, building and operating the passive infrastructure. As part of its RFP bid commitment, OpenNet set up CityNet and the NetLink Trust as the neutral party for SingTel to transfer the relevant passive infrastructure assets (i.e. ducts, manholes and exchange buildings) that will be used by OpenNet for its deployment of fibre for the Next Gen NBN (effectively, Layer 0). SingTel was the 100% unitholder of the NetLink Trust and the beneficial owner of the trust's assets. SingTel was required to reduce its unitholdings to less than 25% by April 2014 (although this was superseded by a consolidation transaction in October 2014).
- (b) Layer 2: Nucleus Connect Pte Ltd (Nucleus Connect) was selected by the IDA as the initial OpCo. There are now many commercial wholesale network operators, which are integrated with RSPs. The OpCo provides wholesale network services over the active

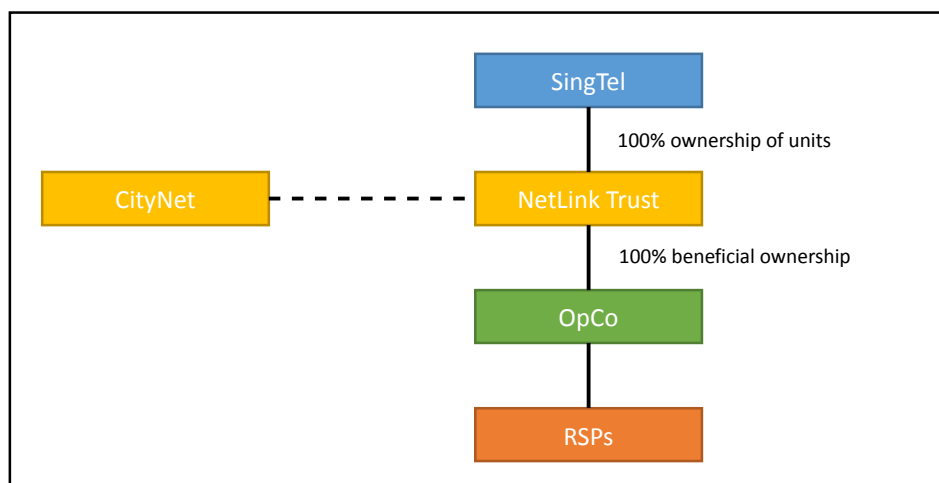
¹³² Simplified from IDA, Consultation paper on the 'Long Form Consolidation Application submitted by OpenNet Pte Ltd, NetLink Trust, CityNet Infrastructure Management Pte Ltd and Singapore Telecommunications Ltd' (28 August 2013), available here: https://www.ida.gov.sg/~media/Files/PCDG/Consultations/20130828_LongFormConsoOpenNet/LFCAOpenNet_20130828.pdf, p 4. ('IDA Consultation Paper').

infrastructure and has an obligation to provide wholesale bandwidth services to RSPs on non-discriminatory terms. There is structural separation between OpCo and NetCo.

- (c) Layer 3: Wholesale service providers in the OpCo layer provide wholesale bandwidth services to RSPs, operating in Layer 3, to offer retail services to consumers and business end-users. There is operational separation between the RSPs and OpCo (i.e. RSPs purchase bandwidth connectivity and non-discriminatory and non-exclusive prices).

Current market structure

A8.4 In October 2014, the IDA approved CityNet (in its capacity as Trustee-Manager of the NetLink Trust)′s acquisition of OpenNet. As a result, there is no longer structural separation between Layer 0 and Layer 1. The new structure is as follows:¹³³



A8.5 Because SingTel had an ownership stake in OpenNet, the consolidation would have resulted in SingTel having an indirect interest in the NetLink Trust. To prevent this, the IDA imposed the following conditions on SingTel.

Independence requirements following the transaction

A8.6 First, SingTel was required to divest its stake in OpenNet and sell down its unitholding in the NetLink Trust to less than 25% by 22 April 2018.

A8.7 Second, SingTel undertook that, so long as SingTel is the beneficial owner of 25% or more of the unitholdings in the NetLink Trust, SingTel will not:

- (a) remove CityNet as the Trustee-Manager of the NetLink Trust;
- (b) approve any amendments to the Trust Deed that are contrary to the control and ownership requirements set out in Singapore’s Next Generation National Broadband Project – Network Company (‘NetCo’) Request-for-Proposal dated 11 December 2007;

¹³³ Simplified from IDA Consultation Paper, p 6.

- (c) approve any amendments to the Trust Deed to vary the requirement to obtain IDA's approval for those matters set out in the Trust Deed;
- (d) take any action relating to the NetLink Trust that requires approval from the IDA under the Trust Deed without first obtaining approval;
- (e) approve or direct the winding up of the NetLink Trust, unless such action is to facilitate the final structure for the divestment; and
- (f) amalgamate or reconstruct, or change the structure or set up of the NetLink Trust or the manner in which any trust property is held, or any merger of the NetLink Trust, without the IDA's approval.

A8.8 Further, SingTel was required to amend the Trust Deed such that the OpenNet board and the CityNet board consist of no more than 5 directors where 25% are appointed by SingTel and the remaining 75% comprise independent directors (provided that there is always at least 1 SingTel director). The reason for this is *'to eliminate any perception that SingTel possesses control over the decision-making in OpenNet and/or CityNet'*.¹³⁴

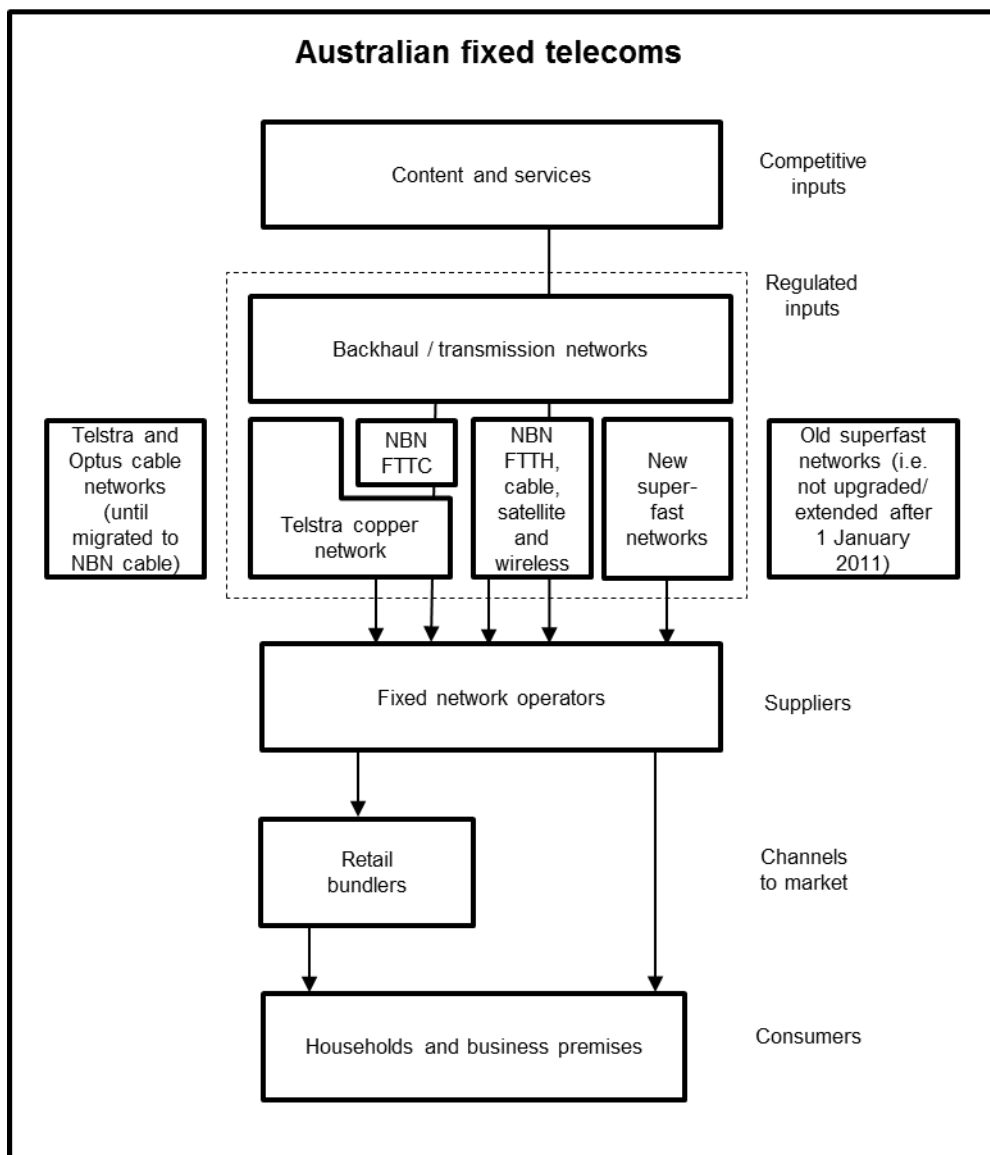
A8.9 SingTel was required to terminate four agreements it had with OpenNet within 12 months of the commencement of the consolidation. These were agreements by which SingTel provided certain services to OpenNet (e.g. engineering, maintenance and duct use).

¹³⁴ IDA Consultation Paper, para 52(e).

ANNEX 9: International case-study – Australia

Market structure

- 9.1 The Australian fixed telecommunications market includes:
- (a) international capacity – a number of different fibre-optic cables link Australia to Asia and the United States. These are generally owned by Australian and/or overseas operators or consortia of these operators. There have not been significant competition concerns about access to international capacity;
 - (b) domestic transmission – this comprises the inter-city capacity that links to the local access network at the local exchange level, which in the UK would form part of the ‘core’ network. The Australian competition regulator (the Australian Competition and Consumer Commission or ‘ACCC’) regulates access to certain domestic transmission services, on the basis that the market is not competitive in practice (broadly, because the incumbent, Telstra, remains the dominant supplier of such services). Certain major routes that the ACCC considers to be competitive have been excluded from regulation; and
 - (c) end user access – Telstra is the incumbent operator, and owns the legacy copper access network. Both Telstra and the second-largest fixed line operator, Optus, operate cable networks in some major urban areas. A Federal Government-owned entity, NBN Co, has been tasked with deploying and operating a wholesale-only end user network (the National Broadband Network or NBN) using a combination of fibre-to-the-premises (‘FTTP’), fibre-to-the-node (‘FTTN’), fixed wireless and satellite technologies. In connection with these plans, Telstra agreed to provide access to its physical infrastructure (in this context, primarily ducts and poles) and to transfer ownership of its copper and cable networks to NBN Co. Optus has also agreed to sell its cable network to NBN Co.
- 9.2 All layers in the value chain are at least theoretically open to competition (in the sense that there are no legal prohibitions on doing so, beyond obtaining a carrier licence), but transmission (outside of certain high-volume routes) and end user access largely remain bottlenecks in practice.
- 9.3 Certain new superfast broadband networks that would compete with the NBN are also subject to access regulation.
- 9.4 The market structure is illustrated in a highly stylised way in the following diagram:



Independence requirements

9.5 Separation regimes currently apply to Telstra, NBN Co and entities that provide alternative superfast networks to the public generally.

9.6 Telstra is subject to:

- (a) eventual structural separation – Telstra has undertaken to not supply fixed line retail services (directly or indirectly) using a network over which it is in a position to exercise control after 1 July 2018.¹³⁵ It plans to meet this requirement by migrating its retail customers to the NBN by that date. The structural separation requirement is that:

'(i) Telstra will not supply Non-Exempt Services to retail customers in Australia using a Non-Exempt Network over which Telstra is in a position to exercise control; and (ii)

¹³⁵ Telstra SSU, clause 5. Telstra gave these undertakings after legislation was passed requiring it to choose between (i) mandatory functional separation and a likely prohibition on bidding in the digital dividend auction (and potentially acquiring other 4G-ready spectrum); and (ii) voluntary structural separation and divestment of its cable network and interest in Pay TV operator Foxtel (or an exemption from the divestment requirements).

Telstra will not be in a position to exercise control of a company that supplies Non-Exempt Services to retail customers in Australia using a Non-Exempt Network over which Telstra is in a position to exercise control'; and

- (b) an 'initial' operational separation regime – a set of rules that is akin to, but somewhat weaker than, the 2005 Undertakings given by BT. The rules govern how Telstra is to ensure equivalence between regulated services it provides to its wholesale customers and the equivalents it supplies to its retail business, during the 'initial' period while it is still migrating its retail customers to the NBN.

9.7 The *National Broadband Network Companies Act 2011* (Cth) imposes stringent separation requirements:

- (a) NBN Co is prohibited from supplying content services or any non-communications services and investing in businesses unrelated to its communications services; and
- (b) to facilitate any future separation, Government policy is that NBN Co should maintain separate accounts for its satellite, fixed wireless, fibre access networks, cable and transit networks and operate in a way that preserves the option for future disaggregation of the business.

9.8 The Act also requires that NBN co-operate on a wholesale-only basis and generally not operate a retail business. Under the *National Broadband Network Companies Act 2011* (Cth), it *'must not supply an eligible service [these being the only services NBN Co is permitted to supply] to another person unless the other person is: (a) a carrier; or (b) a service provider.'*

9.9 The regulatory regime also provides for future functional separation of NBN Co if the government considers it appropriate (for example, to separate its provision of services (i.e. the 'active' network business) from its physical infrastructure (the 'passive' network business)) and allows the government to require it to divest assets.¹³⁶ If NBN Co is privatised, regulations may proscribe 'unacceptable private ownership or control situations', which a court would be permitted to remedy (for example, by directing the disposal of shares).¹³⁷ These provisions are all intended to preserve NBN Co's independence from retail providers.

9.10 Structural separation requirements also apply to other fixed-line local access networks that are built, upgraded, altered or extended after 1 January 2011 to provide services of greater than 25 Mbps to residential or small business owners ('superfast networks').¹³⁸ Their wholesale-only obligation is expressed as follows:

*'A person who is in a position to exercise control of the network, or a person who is an associate of such a person, must not use the local access line, either alone or jointly with one or more other persons, to supply an eligible service unless the service is supplied to: (a) a carrier; or (b) a service provider.'*¹³⁹

¹³⁶ *National Broadband Network Companies Act 2011* (Cth), divs 3 and 4.

¹³⁷ *National Broadband Network Companies Act 2011* (Cth), s 73.

¹³⁸ *Telecommunications Act 1997* (Cth), Part 7. These superfast networks are generally required to operate on a wholesale-only basis.

¹³⁹ *Telecommunications Act 1997*, s 143.

9.11 In addition, since early 2015, certain other types of networks that were similar to, but were able to avoid regulation as, superfast networks, are required to provide wholesale services on a non-discriminatory and equivalent basis and (after 1 July 2015) have legally and functionally separate retail and wholesale businesses.

ANNEX 10: International case-study – New Zealand

Market structure

A10.1 The fixed-line retail market is open to competition, with major players at the retail level including Spark (the retail operation demerged from the previous incumbent, Telecom New Zealand ('TNZ')), Vodafone and CallPlus. In terms of network competition:

- (a) Chorus operates the incumbent copper end user network (which has been extended to FTTN in many parts of the country);
- (b) Vodafone operates a cable network in limited urban areas of New Zealand; and
- (c) Chorus and a number of other operators operate wholesale-only FTTP networks, primarily through participating in the Government's UFB initiative, which provided public funding to roll out FTTP.

A10.2 As described further below, participants in the UFB – which includes Chorus and others – were required to give undertakings, intended to ensure the UFB participant was wholesale-only and could not favour itself or its associated entities in providing access to the FTTP network.¹⁴⁰

A10.3 Chorus was incorporated as a result of a demerger from the previous incumbent operator, Telecom NZ in 2011. It is subject to additional legislative separation requirements to prevent its future re-entry into retail markets. The demerger of Telecom NZ resulted in a division of assets between:

- (a) Telecom (now known as Spark) – which owns what was previously Telecom NZ's retail business and some backhaul and international network assets; and
- (b) Chorus – which owns what was previously Telecom NZ's fixed line network.

A10.4 Both companies are publicly listed on the NZ stock exchange. While they had the same shareholder base at the time of the demerger, their shareholder base should diverge over time.¹⁴¹

A10.5 A diagram outlining the current market structure in a highly stylised form is set out below:

¹⁴⁰ *Telecommunications Act 2001* (NZ), s 156AD. Requirements were originally set out in the government's Invitation to Participate in the UFB: see <http://www.crownfibre.govt.nz/media/4824/invitation-to-participate.pdf>. ('Crown Fibre Invitation to Participate').

¹⁴¹ A copy of the Separation Deed setting out the mechanics of the demerger is available here: <http://www.sec.gov/Archives/edgar/data/875809/000119312512367374/d377363dex421.htm>.

Independence requirements

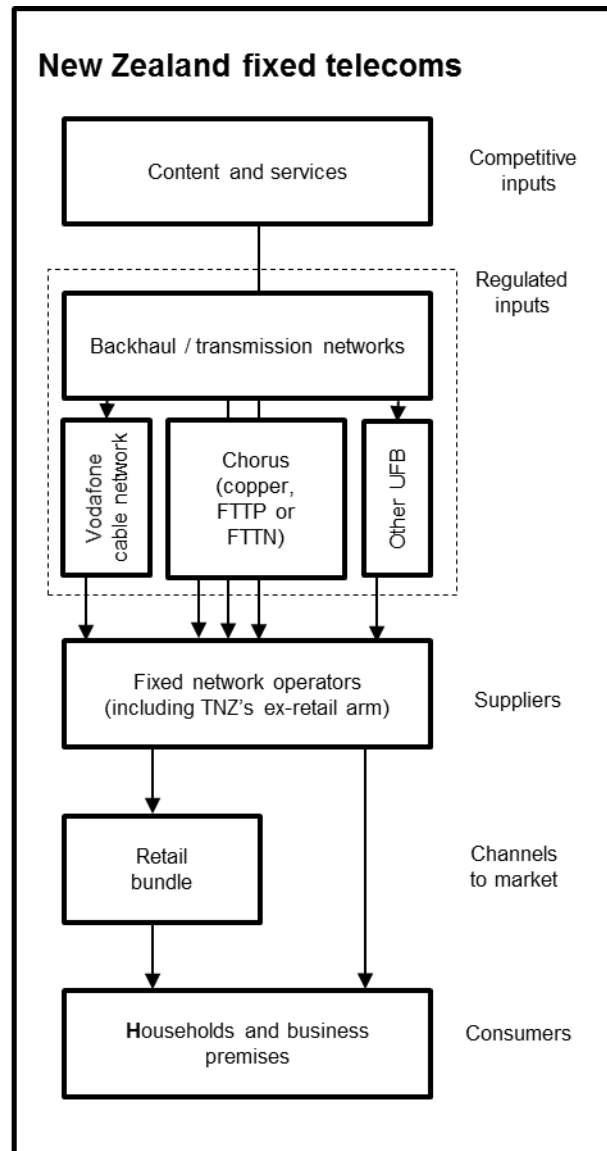
Local fibre companies generally

9.12 Structural separation requirements were implemented pursuant to the UFB initiative. The scheme provides NZD 1.35 billion in public funding with a view to rolling out FTTH to 75% of New Zealanders by 2019. It divided the country into 33 regions and is administered by a government-owned entity, Crown Fibre Holdings Limited (CFH). Under the scheme, companies could enter bids to participate in the UFB in particular regions.

9.13 The Government's Invitation to Participate ('ITP') set out the expectations as to structural separation and many of these are now set out in legislation¹⁴² (although the arrangements with Chorus, in particular, are bespoke). The vehicle rolling out FTTP in each area is referred to as a 'local fibre company' ('LFC'). In short, the successful bidder (referred to as the Partner) is expected to invest in a joint venture limited liability corporation (initially with CFH and the Partner having equal equity stakes, but with CFH's interest decreasing as end users are migrated to fibre), such that the LFC would be an open-access, wholesale-only entity, although there was flexibility to agree different arrangements. Each LFC must give undertakings relating to non-discrimination and open access.

9.14 The requirement for joint investment with the government also acts as a structural constraint on coordination between the LFC and any retail provider (since the NZ state would be a JV partner with the LFC investor, and have visibility of any corporate governance process that contemplated vertical integration).

9.15 The ITP set out the expectation that each LFC would:



¹⁴² Telecommunications Act 2001 (NZ), Part 4AA

- (a) be a newly incorporated special purpose limited liability company (i.e., be legally separate); and
- (b) operate independently of its shareholders, with its own premises, staff and operational systems.¹⁴³

9.16 In particular, the ITP provided that:

'In the event that a prospective Partner, or a related or associated entity of the Partner, currently (or at any time while a Partner) owns or controls a business which provides any Telecommunications Service other than the Permitted Services, the Partner: (a) must fully divest, or must ensure that the Partner's related or associated entity fully divests, itself of that business; or (b) may not appoint the majority of directors to the Board of the relevant LFC, and the chair of the LFC Board must be an independent chair agreed to by all shareholders.'

9.17 Each LFC is required to give undertakings to (among other things):

- (a) supply unbundled (layer 1) services from 2020;
- (b) achieve non-discrimination in the supply of services (meaning, in this context, 'to not treat differently, except to the extent a particular difference in treatment is objectively justifiable and does not harm, and is unlikely to harm, competition in any telecommunications market') and, from 2020, to achieve equivalence in relation to the supply of unbundled layer 1 services;
- (c) deal with the investing entity on arms'-length terms (unless it is not a separate legal entity); and
- (d) make its terms and conditions transparent and predictable, by maximising its use of standard terms.¹⁴⁴

9.18 The ITP allowed each partner to choose the measures to achieve this objective in their own undertakings. The undertakings also prohibit LFCs and their related entities from supplying services directly to end-users.

The position of Chorus

9.19 In order to participate in the UFB, Telecom NZ agreed to structural separation. It entered an 'Initial Period Agreement' in May 2011, under which it agreed to undergo voluntary structural separation in return for Chorus being the UFB Partner in 24 of the 33 regions.

9.20 In relation to Chorus, the legislation imposes additional requirements on Telecom NZ's undertakings to secure structural separation.¹⁴⁵ It imposes:

- (a) A wholesale-only requirement:

¹⁴³ Crown Fibre Invitation to Participate, cl 9.

¹⁴⁴ *Telecommunications Act 2001* (NZ), s 156AD. Requirements were originally set out in the [Crown](#) Fibre Invitation to Participate.

¹⁴⁵ *Telecommunications Act 2001* (NZ), Part 2A.

*Chorus, or any related party of Chorus, must not participate in the supply of a telecommunications service to a person (A) if 25% or more of the services supplied, or to be supplied, by Chorus to A in any year are or will be supplied— (a) for A’s own use or consumption; or (b) for the use or consumption of persons who are related parties of A.*¹⁴⁶

- (b) A prohibition on providing services above layer 2:

*‘Every undertaking entered into by Chorus in favour of the Crown under subpart 4 of this Part or Part 4AA must include a prohibition on participation by Chorus, or any related party of Chorus, in services above layer 2 services.’*¹⁴⁷

- (c) A prohibition on providing end-to-end links (that is, between two end-user sites):

*‘Chorus, or any related party of Chorus, must not provide telecommunications links to customers except— (a) between an end-user’s building (or, in the case of a commercial building, the 2 building distribution frames) and a Chorus local or regional aggregation point; and (b) between 2 Chorus local or regional aggregation points.’*¹⁴⁸

- 9.21 Chorus also had to give undertakings requiring it to (among other things) achieve non-discrimination and equivalence of supply in the supply of certain services; develop KPIs in relation to non-discrimination and equivalence; and implement a policy to manage access seeker commercial information.¹⁴⁹ It also entered into a separate deed with the New Zealand Government to ensure ‘no person who is an Associated Person of a person which provides Telecommunications Services in New Zealand (other than the services to be provided by Chorus) shall, at any time after Structural Separation Completion, be appointed to or hold office as a Director’.¹⁵⁰ This provision also appears in Chorus’s constitution.¹⁵¹

¹⁴⁶ Note that although we have described this as a ‘wholesale-only’ requirement, the true position is somewhat more confusing, and not very clear. The effect is that unless 75% of services will be sold on by a person, then Chorus can’t supply that person. *Telecommunications Act 2001* (NZ), s 69O.

¹⁴⁷ *Telecommunications Act 2001* (NZ), s 69R.

¹⁴⁸ *Telecommunications Act 2001* (NZ), s 69S.

¹⁴⁹ *Telecommunications Act 2001* (NZ), s 69XB.

¹⁵⁰ https://www.chorus.co.nz/file/58821/chorusdeedof_operationalandgovernanceundertakings.pdf.

¹⁵¹ Constitution cl 17.3, available here: <https://www.chorus.co.nz/file/58822/Chorus-Constitution.pdf>.

About the authors

David Stewart

David Stewart joined Towerhouse LLP in July 2013. David is a competition and regulatory lawyer with a career-long specialisation in telecommunications and currently advises clients in a range of sectors, including telecoms, energy and transport. He is also an experienced transactional lawyer, with specialist experience in relation to access and interconnection issues.



During 2005 – 2013, David was a senior management team member at Ofcom. As Competition Policy Director, David led Ofcom's programme of fixed and mobile telecoms market reviews under the European Framework, including advising on mergers in the sector. As Director of Investigations, David was responsible for enforcing consumer law and regulatory rules and resolving access and interconnection disputes. He held a governance role in relation to Ofcom's work on competition in broadcasting markets (including pay TV), spectrum clearance and awards, consumer policy, internet policy and enforcement. He was also involved in Ofcom's engagement in European and international regulatory issues, representing Ofcom in dealings with national regulators and the European Commission.

In commercial life, David was Director of Public Policy and Regulatory Affairs at Energis (a top 3 UK telecoms operator) and Director of Legal and Regulatory Affairs for the international division of Cable & Wireless (then a multi-national FTSE100 company), advising the incumbent national telcos in 31 countries. He was previously a lawyer in private practice with Gilbert & Tobin and Minter Ellison.

Paul Brisby

Paul is recognised as one of the UK's leading telecoms lawyers by the independent legal directories who have variously described him as an 'outstanding strategic thinker...', 'exceptionally talented...', and 'commercially astute and aware'.



Paul's practice is focussed on the commercial implications of regulation as well as in more traditional commercial law. He has particular expertise in competition issues and policy questions. In recent years much of his time has been spent on contentious matters before the Competition Appeal Tribunal and Competition Commission, and also on expert witness work.

Paul has worked on UK telecoms regulation since 1995. In that time he has advised on almost every significant regulatory and policy matter in one capacity or another as well as on numerous high-profile commercial transactions. He has worked in private practice and in-house, including at One2One (where he was Regulatory Counsel and a signatory in the UK's 3G spectrum auction) and COLT (where he was Group Director of Regulatory Affairs and Public Policy, with global responsibility).

Paul has an MA from Oxford University. His legal qualifications are from the College of Law.

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Rosio Cafarelli

Rosio joined Towerhouse in September 2015, having just completed an MSc in Regulation at the London School of Economics and Political Sciences (LSE). At LSE, Rosio focused her studies in the regulation of network industries such as energy, telecommunication and financial services.

Rosio gained specialised academic knowledge of the sector through her dissertation on the regulation of telecommunications in politically unstable economies.

Since joining the firm, Rosio has gained experience in consumer protection law in relation to the regulation of switching in the telecommunication market. Rosio has also become engaged in the business connectivity market review and the discussion surrounding passive remedies. She has developed an insight into the new rules of procedures at the Competition Appeals Tribunal.

Rosio holds a Bachelor of Laws and International Law degree from the University of Sheffield (including a year at the University of Copenhagen as part of the international law programme). Rosio is currently undertaking her Legal Practice Course to qualify as a solicitor.



Lucas Ford

Lucas has extensive experience in the policy and contentious aspects of competition and consumer protection, including investigations, regulation and public policy development gained working at a number of National Regulatory Authorities.

Lucas was previously a Senior Associate at Ofcom in the competition investigations team where he worked on enquiries and disputes relating to charge controls, competition, numbering and requirements to be fair and reasonable.

Prior to Ofcom, Lucas was Regulatory Manager, at the Legal Services Board, the oversight regulator of the legal services regulators in the UK. Lucas played a leading role in reviewing complaints handling across the legal profession and developing a new set of regulatory principles for regulators. He also reviewed regulators codes of conduct for competition and consumer protection issues.

In Australia, Lucas was Assistant Director at the Australian Competition and Consumer Commission (ACCC). His responsibilities included the development and enforcement of national sectorial regulation, competition and consumer protection investigations and copyright policy development and litigation. This included managing cases on behalf of the ACCC at Copyright Tribunal of Australia. He was educated at Monash University and the College of Law in Melbourne, Australia. He has bachelor degrees in Laws and Economics. He has also studied the law and economics of access regulation at a masters level at Melbourne University.



Helen Gill-Williams

Helen joined Towerhouse in April 2012 and since then has gained significant experience in the electronic communications, aviation, post and health care sectors advising on competition and regulatory law issues.

In particular, Helen has been involved in ongoing commercial and regulatory litigation at the Competition Appeal Tribunal, Competition and Markets Authority, Administrative Court, Court of Appeal and Supreme Court. Helen has also advised clients on responding to consultations from Ofcom, Ofgem, Ofwat, Law Commission, PhonePay Plus, the Civil Aviation Authority and Government departments such as BIS and DCMS; provided advice on consumer protection, compliance issues and public policy matters; and participated in telecommunications contract negotiations and reviews with Openreach and BT Wholesale.

Helen graduated from Warwick University in 2010 after studying towards a Bachelor in Laws. The following year she completed her post graduate qualification at the College of Law, obtaining a distinction. Helen qualified as a solicitor in June 2014.



Zach Meyers

Zach joined Towerhouse in November 2014.

Zach spent several years at one of Australia's largest law firms, where he advised Australia's telecommunications incumbent, Telstra, on all aspects of telecommunications regulation and competition law. This included advising Telstra on virtually all its wholesale infrastructure product offerings, and representing Telstra in its AUD 11bn negotiations with the Australian Government's National Broadband Network company, which included a 50+ year duct access agreement. He has also advised the World Bank and a number of developing country governments on telecoms law and policy reform throughout the Pacific. In 2013, he was recognised by Australia's *Lawyers Weekly* magazine as one of Australia's top 3 telecoms, media and technology lawyers under 30.



He most recently spent one year at a major firm in New York, advising on corporate governance and major commercial transactions. Zach graduated from the University of Melbourne in 2008 with Bachelor in Laws (First Class Hons) and Bachelor of Arts. He also holds a Diploma of Modern Languages (French) and a Master of Public & International Law from the University of Melbourne, and a Graduate Diploma in Legal Practice from the College of Law.

James Singer

James joined Towerhouse in 2015 with a wealth of experience from both in-house and private practice environments. He spent 3 years at BT plc, providing regulatory and legal support to the commercial teams responsible for rolling out managed services in dozens of countries. His experience in the sector also includes data protection audits, Competition Appeal Tribunal cases, preparation for the ladder pricing case and for BT France, contractual drafting. James perfected his



expertise of international telecoms regulation in a regulatory advisory role to global clients at Webb Henderson and Shepherd and Wedderburn in London.

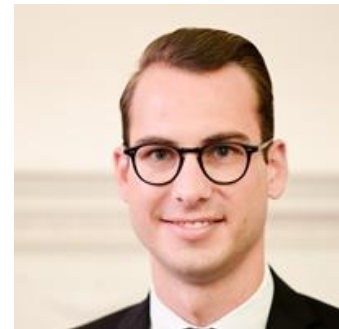
Since joining Towerhouse, James has been involved in pricing disputes between communications providers, premium services regulation, settlements following regulatory determinations and contractual drafting for IT companies, as well as building on his knowledge of the regulated health and mail industries.

James is native French speaker and a keen classical guitarist, having studied music at the University of Southampton (BA Mus, MA) before beginning his career in law, qualifications for which were obtained at the College of Law in Guildford (GDL, LPC).

Daniel van der Wel

Daniel joined Towerhouse in 2015. He has a number of years' experience advising on electronic communications and new media law in the UK and Asia-Pacific.

In the UK, Daniel previously worked for a competition law and telecommunications boutique firm where he extensively advised one of the UK's major telcos on a range of regulatory and competition matters in the UK, and throughout Europe and in the Asia-Pacific region. This included advising BT on an investigation by the OFT in relation to the supply of ICT services in the UK. Daniel also advised a number of trade associations and IT companies on a range of regulatory and policy matters.



Prior to moving to London, Daniel spent several years at one of New Zealand's largest law firms where he advised a number of telecommunications clients on competition and policy issues. This included advising 2degrees mobile on the regulation of mobile termination rates in New Zealand.

Daniel graduated from the University of Auckland in 2010 with a Bachelor of Laws (honours) and Bachelor of Commerce (economics).

Since joining Towerhouse, Daniel has advised a number of UK operators on regulatory disputes as well as providing policy advice in relation to various industry consultations.