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Structural Separation: A Prerequisite for Effective Telecoms Competition

Michael H. Ryan

Sweet & Maxwell Limited
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SWISS COTTAGE
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NW3 3PF
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Structural Separation: A Prerequisite for Effective Telecoms Competition?

Michael H. Ryan *

Despite massive investment by competitors in alternative local telecommunications infrastructures (and in particular, cable modem and wireless access technologies), the traditional telephone company copper-wire pair, or "local loop," remains the means by which most telecoms users get connectivity ("local access") to the public telecommunications network and its vast array of voice, data and internet services. The dominance of local access by incumbent telephone companies has been a concern of regulatory and competition authorities since the liberalisation of telecommunications markets began because of the threat that incumbents may use their dominance of this "bottleneck" to give themselves unfair advantages over competitors in complementary markets. At one time it was thought that the opening of local access markets to competition (a policy which the United States and European Union have pursued since 1996 and 1998, respectively) would alleviate concerns about incumbent dominance of local access. However, while other segments of the telecommunications market have become very competitive, the pace at which competition in local access has developed has been frustratingly slow. Policy-makers are now confronting the possibility that incumbents will retain a dominant position in the provision of local access in the long term.

Against this backdrop, the possibility of "structural separation" of incumbent telephone companies has recently made its way onto US and EU public policy agendas. At its simplest, structural separation of an incumbent telephone company involves dividing the firm into two so that activities deemed competitive (and the corresponding assets) are housed in a different corporation, with different management and financial accounts, than its local access functions. Because structural separation establishes a clear boundary between the two types of activity, practices that discriminate in favour of the incumbent's competitive arm that would be difficult to detect within an integrated operation are exposed and (at least in theory) more easily prevented.

Proposals for structural separation of US incumbent local telephone companies (referred to as "Incumbent Local Exchange Carriers," or "ILECs") have recently been considered by a variety of state regulatory and legislative authorities.[1] In August 2001, legislation was introduced in the US Senate that would impose a form of structural separation on the four companies (Verizon, SBC Communications, BellSouth and Qwest) which dominate the provision of US local exchange service in their respective operating territories.[2] That legislation is still pending. In the United Kingdom, Cable & Wireless and other competitors of the incumbent BT have called on UK authorities to require that ownership of BT's local loop infrastructure be placed in a separate "LoopCo" in response to perceived abuses of BT's dominance of local access.[3] More recently, the debate has moved into the EU forum. At a public hearing on local access convened in July 2002 by DG Competition, several new entrants pressed the case for structural

* *Partner, Arnold & Porter, Solicitors, London. Email: michael_ryan@aporter.com.*

1 Regulators and legislators in the following states have considered structural separation of the local incumbent: Alabama, Florida, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Oklahoma, Pennsylvania, New Jersey, New Mexico, North Carolina, South Carolina, Tennessee, Virginia and Wisconsin. For a review of the status of these various actions, current as of July 2001, see Curtis J. Williams, *Structural Separation in Other States*, prepared for the Florida Public Service Commission Workshop on AT&T, TCG and Media One's Petition for Structural Separation of BellSouth, *www.txutilitylawsection.org/sep2001CLE/williams.htm.*

2 See Telecommunications Fair Competition Enforcement Act of 2001, s.1364, available at *http://thomas.loc.gov*, introduced in the US Senate by Commerce Committee Chairman Ernest Hollings on August 3, 2001. See in particular s.8.

3 In a presentation at the DG Comp Local Loop Unbundling Hearing, Brussels, July 8, 2002, Graham Wallace, CEO of Cable & Wireless, explained the case for the establishment of a LoopCo. "This new LoopCo [he said], would . . . view all competing operators as customers, rather than competitors. It would have the incentive to innovate to serve all of its customers' needs, rather than always having at least one eye on what would benefit its own downstream operations as it does today. LoopCo would obviously need to be regulated tightly, as it would be dominant in the wholesale access market, but not in terms of discrimination. And the considerable upside would be that light touch regulation would be more viable for BT's residual business. And better still, regulatory withdrawal from these markets really would become a realistic medium-term goal." It is part of the Cable & Wireless plan that LoopCo should be placed under separate ownership.

separation of incumbents,[4] citing their "methodical anti-competitive behaviour" in obstructing access to their local networks.[5]

The OECD published a recommendation last year encouraging member countries to consider the possibility of structural separation where a regulated firm is operating simultaneously in a non-competitive activity and a potentially competitive complementary activity.[6] Nevertheless, regulatory and competition law authorities have been slow to embrace structural separation as a means of addressing concerns about dominance. Only one of the jurisdictions that has recently looked into the issue has taken the step of ordering structural separation of a telecoms operator. In 2001, the Pennsylvania Public Utility Commission ordered structural separation of the local ILEC, but that decision was significantly modified before implementation and a less drastic remedy, dubbed "functional structural separation," was substituted.[7] (This case is reviewed below.)

The hesitation of regulatory authorities to adopt structural remedies can be attributed to two main factors[8]:

- The belief that there are considerable economies of scale and scope associated with the integration of local and other services, with the consequence that the welfare losses incurred in implementing structural separation might outweigh any gains flowing from increased competition.
- The concern that structural separation would leave the local entity with a very limited set of functions that would blunt its incentives to innovate. The principle behind separation would, for example, rule out any collaboration between the separated firms aimed at developing new products and services that leverage off the ability to provide integrated functionality.

At present, the conventional wisdom amongst regulators and policy-makers appears to be that mandated access to incumbent local access infrastructure on transparent, cost-oriented and non-discriminatory terms, coupled with non-structural safeguards, such as accounting separation (to permit the detection of unjust price discrimination and cross subsidies) and behavioural rules prohibiting abusive activities, backed by vigorous enforcement of those rules, provide a less disruptive and reasonably satisfactory alternative to structural separation. In this article, I review the recent debate over the issue of structural separation and canvass the key arguments, both pro and con. In doing so, I survey the string of decisions by the Pennsylvania PUC on the matter of structural separation, as well as the evolution of the policy of the UK regulator, Oftel. Both bodies have ultimately rejected structural separation in favour of non-structural safeguards. I comment on the suitability of some of these alternatives, pointing out their frailties. Finally, I conclude with some observations concerning the way forward.

Background

The notion that incumbent dominance can be addressed through the imposition of structural remedies is not a new one. As telecoms markets in North America began to open to competition in the 1970s and 1980s, the imposition of structural separation was actively considered, and in certain cases adopted, as a device for preventing the leverage of a firm's market power into emerging competitive markets. In the First Computer Inquiry in 1971 the US Federal Communications Commission (FCC) decided that, in order to ensure that competition in the data processing business was fair and that telephone companies did not abuse their position as monopoly suppliers of basic local exchange services, the telephone companies would be allowed to participate in that market only through a separate corporate entity.[9]

4 See in particular the presentations by G. Wallace (Cable & Wireless), A. Costa (Wind) and G. Eickers (QSC): *http://europa.eu.int/comm/competition/liberalization/telecom/local_loop/hearing.html*. Concerning the presentation by G. Wallace, see also n.3 above. It is doubtful whether EU authorities, whose competition law powers derive from Arts 81 and 82 EC, have the power to impose structural separation. In the UK, the Office of Fair Trading has the power to make a reference to the Competition Commission if it is considered that there is a scale or complex monopoly. Oftel acquired a similar power upon the enactment of the Enterprise Act 2000.

5 *The Economist*, July 20, 2002, p.63.

6 OECD, *Structural Separation in Regulated Industries*, Report by the Secretariat, DAFFE/CLP(2001)11, April 10, 2001, *www.oecd.org/pdf/M00020000/M00020230.pdf*. The Report was approved in a Recommendation of the OECD Council; see OECD Press Release dated April 30, 2001, available on the same site.

7 See Pennsylvania PUC, *Structural Separation of Bell Atlantic-Pennsylvania, Inc. Retail and Wholesale Operations*, M-00001353, Opinion and Order, adopted March 22, 2001 ("Functional Separation/Code of Conduct Order"), *http://puc.paonline.com/agenda_items/2001/pm032201/osa-111.pdf*, modifying the PUC's "Global Order", P-00991648/9, adopted September 30, 1999, available on the same site.

8 For a critical review of the case for structural separation which touches on the points mentioned below, see R.W. Crandell and J.G. Sidak, "Is Structural Separation of Incumbent Local Exchange Carriers Necessary for Competition" (2002) 19 *Yale Journal on Regulation* 335.

9 *Regulatory and Policy Problems presented by the Interdependence of Computer and Communications Services and Facilities, Final Decision and Order*, 28 FCC 2d 267 (1971).

This policy was extended to all so-called "enhanced services"[10] in the Second Computer Inquiry in 1980.[11] But structural separation was ultimately judged to be unnecessarily costly and cumbersome and not long thereafter the FCC replaced its structural separation requirement with a new regime under which the telephone companies would be permitted to offer basic and enhanced services on an integrated basis subject to rules establishing mandated access on non-discriminatory terms (known as open network architecture (ONA)).[12]

The concept of structural separation was carried a step further with the divestiture of AT&T in 1984.[13] (Divestiture, unlike structural separation, implies that one of the entities will be given separate ownership.) Divestiture was ordered as part of the settlement of Department of Justice (DoJ) claims that AT&T had illegally monopolised the telecommunications industry. The DoJ case reflected a conviction that the market power of the integrated AT&T was so pervasive that competition in the provision of long-distance and information services and equipment manufacturing (all of which had been opened to competition in the 1970s) could not flourish unless AT&T was precluded from providing those services in conjunction with local exchange services. Through a complex series of arrangements, ownership of local networks was transferred to regional companies (the "Regional Bell Operating Companies," or "RBOCs," of which there were originally seven). Under these arrangements, the United States was divided into 161 geographic markets known as "local access and transport areas" or "LATAs". The RBOCs were prohibited from providing long distance services between LATAs to ensure that they could not leverage the market power deriving from their local monopolies into that market.[14] The assumption behind the AT&T divestiture was that, once the provision of local exchange services had been permanently separated from the provision of complementary services, market forces would become strong enough to permit open competition in those other markets. Local exchange services themselves would continue to be regulated in the traditional manner.

The Telecommunications Act of 1996 superseded the arrangements put in place by the AT&T divestiture. The 1996 Act sanctioned removal of restrictions imposed by the AT&T settlement on RBOCs' authority to provide interLATA service, but subject to a requirement that the ILEC demonstrate to the relevant state regulatory authority, before introducing interLATA service in that state, that it has complied with a "competitive checklist" of measures opening the local access market to competition.[15] It was clearly hoped when this structure was put in place that local competition would take hold quickly and that the danger that the ILECs would leverage the market power they derived from their dominance of the local access market into complementary markets would be merely transitory. This hope has proved to be misplaced.

At about this time, the liberalisation process in the European Union, which had lagged behind developments in the United States, was well underway. By 1998, the European Union was in the process of removing the last barriers to facilities-based competition in EU Member States. EU authorities appear to have shared the same expectation as their US counterparts that competition would whittle away the dominant position of incumbents in the provision of local access; the liberalisation measures adopted at the time made no provision for imposition of structural separation. While competition has been quick to establish itself in EU long-distance markets, the incumbents' dominant position in local access has proved as resilient as it has in the United States. A hastily put together scheme for local loop unbundling adopted in 2000,[16] which was aimed at opening the local market to greater competition, has yet to have any discernable impact.

10 *e.g.* voicemail, email, electronic data interchange, online retrieval services.

11 *Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, Docket No. 20828, Final Decision, 77 FCC 2d 384 (1980). During the same timeframe, the Canadian Radio-television and Telecommunications Commission considered, but ultimately rejected, the idea of imposing structural separation on monopoly telephone companies wishing to participate in the provision of enhanced services: see *Enhanced Services*, CRTC Telecom Decision 84–18.

12 That process began with *Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, Report & Order, Docket No. 85–229, Phase I, 104 FCC 2d 958 (1986).

13 Divestiture was an additional restriction, not a replacement, for the separations requirements of the Second Computer Inquiry.

14 Even divestiture did not completely resolve the problems presented by integration of competitive and local access activities as RBOCs were permitted to provide intraLATA long distance service, a market which accounted at the time of divestiture for about 25% of long distance revenue.

15 ss.271 of the Telecommunications Act of 1996, 47 USC §§151 *et seq*. It is a requirement of the 1996 Act that, where participation of an ILEC in the interLATA market is permitted, that activity must be carried on through an affiliate operating independently, having separate officers, directors and employees, and maintaining separate financial records: *ibid.* s.272.

16 Reg.2887/2000 on unbundled access to the local loop [2000] O.J. L336/4.

Local competition: the failed revolution

By any measure, the progress towards the establishment of sustainable local competition has been disappointing. Competitive local exchange carriers in the United States still provide less than 12 per cent of total local connections, even when resale of ILEC local facilities and unbundled ILEC local loops are included. Facilities-based alternatives are available to only 3 to 4 per cent of customers. [17]

The situation in the European Union is similar.[18] In the United Kingdom, where competition in the provision of local access has been possible since 1991, the incumbent BT continues to supply 83 per cent of local exchange lines.[19] In Germany, where competition has been possible in accordance with EU-wide liberalisation policies since 1998, DT has a 97 per cent market local share.[20] In the entire European Union, there are fewer than 1 million unbundled local loops supplied by competitors.[21]

If the weak performance of competitors were purely the result of natural competitive forces, there would be no legitimate ground for concern; however, there has been a steady stream of complaints by competitors about exclusionary practices by incumbents in markets where they act simultaneously as providers of competitive retail services and suppliers of quasi-monopoly local facilities to their competitors.

Many of these complaints arise out of the efforts by competitors to deploy broadband offerings which are competitive with similar incumbent offerings. Local access is a vital component of broadband service which competitors frequently purchase from incumbents. Among the recent EU cases dealing with complaints about discriminatory practices impacting broadband deployment are the following:

- *Telefonica.* In July 2002, as a result of complaints by competitors, the Spanish national regulatory authority (NRA), CMT, ordered that Telefonica reduce its prices for wholesale access to the local loop and imposed reporting requirements as a means of ensuring the non-discriminatory handling of orders by competing service providers.[22] CMT later launched proceedings against Telefonica for practices contrary to free trade.[23]
- *FT/Wanadoo.* On December 19, 2001, the European Commission sent a statement of objections to Wanadoo Interactive, a subsidiary of France Telecom providing internet access, alleging that the company had priced its high-speed ADSL services below their incremental cost. This abuse was said to have taken place at a critical time for the take-off of broadband access services for the residential market.[24]
- *Telecom Italia.* The Italian Competition Authority found that Telecom Italia had abused the advantages it enjoyed as a result of its *de facto* monopoly position on the market for the supply of local connectivity services by failing to provide a wholesale offering to competing downstream providers of ADSL services.[25]
- *Deutsche Telekom.* In December 2001, the German NRA, RegTP, initiated an investigation into possible predatory pricing of DSL by DTAG. That investigation was later dropped as a result of a subsequent 30 per cent price rise by DTAG.[26] However, on May 8, 2002, the European Commission announced that it was initiating its own investigation into pricing of local access, alleging that DTAG had abused its dominant position in the local access market by charging wholesale customers more than its own retail customers for local access.[27]

In addition to complaints about predatory pricing and margin squeezing, competitors frequently cite a range of non-price abuses by incumbents which are also said to result from the incumbents' inherent conflict of interest:

- failure to offer nondiscriminatory collocation (*i.e.* accommodation in local exchanges for the housing of competitor equipment);

17 As of June 30, 2002, competitors provided 21.6 million switched access lines out of a total of 189 million. Of the competitor-provided lines, about 30% were the competitor's own facilities; 21% were resold ILEC facilities; and 50% were provided by means of ILEC-provided unbundled local loops: see FCC, Press Release, December 9, 2002.

18 As of December 2001, there were only six EU countries where customers had a choice of facilities-based direct access supplies: Belgium, Germany, France, the Netherlands, Austria and the UK. See Commission Communication, Seventh Report on the Implementation of the Telecommunications Regulatory Package. COM(2001) 706, Annexes, p.16 (Chart 14).

19 Oftel, *Market Information* (December 2002), p.7.

20 RegTP, *Jahresbericht 2002*, p.18.

21 European Competitive Telecommunications Association, Press Release and DSL Scorecard, August 7, 2002.

22 CMT Resolutions of July 6 and 26, 2001. See also Resolution of November 8, 2001. All available at *www.cmt.es/cmt.*

23 See CMT Resolution of November 8, 2001.

24 Press Release IP/01/1899, December 21, 2001.

25 Press Release A285, May 2, 2001.

26 See "German Regulator Withdraws DSL Pricing Proceedings against DT", *Arnold & Porter Telecom Newsletter, www.aporter.pair.com/newsletter/nlet020122.htm.*

27 Press Release IP/02/686.

- discrimination in the provisioning of conduit space and access to poles;
- denial of access to numbering resources;
- failure to provide non-discriminatory access to operational support services for order processing and other functions;
- problems provisioning competitor orders for local number portability;
- failure to include the directory listings of competitor customers in directory listings databases at the same level of accuracy, timeliness, and reliability as it provides to its own customers.[28]

The cases of abuse that have so far arisen have typically been dealt with (where "guilt" has been established) through traditional remedies, such as directives requiring the ending of offending practices, or fines. For example, in the *FT/Wanadoo* cases, the ART set prices for France Telecom's local access service designed to allow third party operators to offer ADSL on a basis which was "economically equivalent" to the FT offering. In the *Telecom Italia* case, the national competition authority (NCA) imposed fines on Telecom Italia totalling approximately 115 billion lire. While such remedies address specific occurrences of abusive behaviour, they do nothing to remove the incentive to repeat similar behaviour in the future. The impression one gets from a review of the subject is that the rate of recidivism among incumbents is high. In the *FT/Wanadoo* case, for example, the ART and Conseil de la concurrence have found on several occasions that abuses had occurred.[29] The frequency of the occurrences of abusive behaviour, and the prospect of repeat offences, have provided the fuel for the argument that more radical measures are required.

The Pennsylvania proceeding

The Pennsylvania PUC proceeding is noteworthy not only because (as already noted) it resulted in an order for structural separation; it also provides an interesting insight into the difficult policy choices NRAs and NCAs face as they grapple with the challenges posed by incumbent dominance of local exchanges.

Although local exchange service in Pennsylvania was opened to competition in 1995, competition had not taken off. After several years of competition, the ILEC, Bell Atlantic Pennsylvania (now known as Verizon Pennsylvania), controlled over 90 per cent of the local exchange access lines in its service territory, and continued to control bottleneck facilities in virtually all local exchange markets where it operated. The PUC was concerned about the ILEC's "overwhelming competitive presence and concomitant ability to exercise market power, including the ability to provide itself with anti-competitive cross-subsidies and the opportunity and incentive to discriminate against competing telecommunications carriers in the provision of wholesale services".[30] Determined to overcome the impediments that had until then stalled local competition, in 1999 the PUC initiated a proceeding in which it attempted to resolve 20 outstanding competitive issues with a view to "jumpstarting" competition in the local telecommunications market.[31] Central to the resolution of many of these issues was the nature of the regulatory safeguards that should be put in place to prevent the ILEC from abusing its dominance of the local exchange market and the leverage that that dominance gave it in complementary markets. There were two petitions before the PUC. One petition proposed the imposition of "functional separation" on the ILEC, a measure which would require the ILEC to create a separate organisation within the existing corporate structure to provide functions that competitors require to compete with the ILEC at the retail level, including ordering, provisioning, maintenance and operation of network elements, such as local loops. The separation aimed to ensure that the ILEC's and the competitors' retail operations would receive non-discriminatory treatment. The second petition went further and advocated structural separation of

28 These examples are drawn from Nextlink, "Memorandum in Support of the Consideration of the Structural Separation of Bell Atlantic's Wholesale and Retail Operations," December 17, 1999, in Commonwealth of Massachusetts, Department of Telecommunications and Energy, *New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts—Section 271 of the Telecommunications Act of 1996 Compliance Filing*, D.T.E. 99–271.

29 See the following ART decisions: Decision 01–253 (setting prices for ADSL Connect ATM which will allow third party operators to offer ADSL on basis which is "economically equivalent" to FT offering); Decision 01–548 (ordering FT to restructure ADSL Connect ATM to make it more attractive to competitors); and Decision 01–826 (approving waiver of access charges but delays implementation by four weeks to allow competitors to "benefit fully" from implementation of Decision 01–253), all available at *www.art-telecom.fr.* In Decision No. 02–MC–03, February 27, 2002, the Conseil de la concurrence ordered Wanadoo to stop selling its ADSL products at FT outlets until, *inter alia*, FT gave competitors access to the same line information as made available to Wanadoo. In a previous Decision dated February 18, 2000, the Conseil ordered FT to introduce a service allowing competitors to provide a competitive ADSL offering.

30 Global Order, n.7 above, p.3.

31 *ibid.* p.3.

the wholesale and retail arms of the ILEC into distinct corporate entities.

The PUC accepted that there was a potential "conflict of interest" inherent in the ILEC's dual role as both supplier and competitor to other local exchange carriers and said that, if "this dual role is not adequately addressed, an unlevel playing field will be created which will severely hamper the development of a new, vibrant and effective competitive telecommunications market".[32] It concluded that "structural separation is the most efficient tool to ensure local telephone competition where a large incumbent monopoly controls the market . . . [and] structural separation is necessary to provide the local service competition envisioned under [the Telecommunications Act of 1996 and the relevant Pennsylvania statute]".[33]

A proceeding was instituted to implement structural separation. In that proceeding, the ILEC presented evidence that implementation of structural separation would result in a one-time cost to the company of $800 million and a continuing cost of $300 million per year. The accuracy of these figures was hotly disputed and the PUC concluded that the cost estimates were not verifiable.[34] Nevertheless, in its implementation decision released in 2001 the PUC retreated from its original finding in favour of structural separation, substituting what it referred to as "functional structural separation". The ILEC was directed to separate all employees and facilities along wholesale/retail lines through the application of a code of conduct, to be prescribed by the PUC, providing for non-discriminatory access to the wholesale division by all CLECs. The ILEC was also directed to create an advanced services affiliate ("separate and apart from the retail division of its business").[35] One of the reasons for the watering down of the original ruling was the PUC's conclusion that, "even with the implementation of structural separation . . . , no less regulatory oversight than that currently prevailing will be required to ensure compliance".[36]

Since the release of that decision, the PUC has signalled its intention to modify the separations requirement again, proposing "limited" instead of "full" functional separation. In November 2001, the PUC issued a Notice of Proposed Rulemaking in which it said that "full functional separation is an intrusive remedy designed to fix a problem that has not been shown to exist".[37] Under the limited approach, the ILEC would be required to establish a separate wholesale organisation supporting only specified functions; namely, the provision of "preordering, ordering and the processing and transmission of instructions to field forces for the provisioning of services, network elements or facilities to CLECs".[38] A decision in that proceeding is pending.

UK policy on structural separation

Oftel has shown a similar ambivalence towards structural separation. Oftel made its first public statement on the subject of structural separation in 1993 as part of an examination of the terms on which interconnection with BT's local network would be permitted. At the time, it ruled out structural separation, concluding that "structural separation would not solve all of the problems of interconnection by itself" and that "there would remain regulatory questions about the terms and conditions of access to the network". Oftel made the point that "there may well be benefits to telecommunications users from the exploitation of economies of scope by companies offering integrated network and retail services". It concluded that interconnection issues could be addressed through institution of separate accounting for relevant BT activities.[39]

The issue of structural separation arose again in 1995 in the broader context of an Oftel review of the state of network competition and the changes that would best contribute to the achievement of a competitive marketplace. Oftel promised to take active steps to control anti-competitive practices in order to promote an environment in which effective competition could develop, and suggested that, if such measures were not sufficient, "consideration might have to be given to the question of whether it is in the public interest for the various businesses run by BT . . . to remain in single ownership".[40]

In 1999, Oftel maintained the same guarded approach to structural separation. Rejecting arguments put forward by enhanced service providers that fair competition in the provision of enhanced services could only occur if BT's activities in each of these areas were put into separate ownership, Oftel expressed the view

32 *ibid.* p.216.
33 *ibid.* pp.222–223.
34 Functional Separation/Code of Conduct Order, n.7 above, p.9.
35 *ibid.* pp.30–31.
36 *ibid.* p.31.
37 Pennsylvania PUC, *Proposed Rulemaking*, L–00990141, November 30, 2001, 32 Pa.B. 1986 ("PA Proposed Rulemaking").
38 *ibid.*
39 Oftel, *Interconnection and Accounting Separation* (June 1993), para.20.
40 Oftel, *Effective Competition: Framework for Action* (July 1995), para.6.42.

that enhanced services are so closely connected to the provision of network services that it would in fact be difficult to separate the assets used in both activities, and that any such separation could involve a high degree of cross-selling. It also stated that there are economies of scope deriving from the integration of network and enhanced services which would be lost in the event of such a change. It took the position that network integration was likely to benefit the consumer as long as regulatory controls on abuse of dominance, including accounting separation and prohibitions on unfair cross-subsidy and undue discrimination, were sufficient to enable fair competition in the market. But it did not reject structural separation outright. If it should prove impossible to make regulatory control on BT's behaviour work, Oftel stated, it "would look again at the separation of BT's businesses".[41]

By 2001, however, Oftel had become noticeably cooler to the structural separation option. In a statement entitled "Open access: Delivering effective competition in communications markets", Oftel expressed its readiness to intervene where necessary to promote competition,[42] but also indicated its view that structural separation "is unlikely to be a proportionate regulatory response in many cases". Oftel continued:

> Vertical integration can bring consumer benefits by speeding innovation. Well-established regulatory methods—including open access obligations on non-discriminatory terms—are more likely to be the proportionate response where there are concerns about the foreclosing of competition resulting from the combination of vertical integration and market power.[43]

Then, in April 2002, Oftel seemed to all but rule out structural separation, stating that "decisions about BT's corporate structure are a matter for the company".[44]

Over the last few years, however, interest in structural separation has grown in other quarters. In a report released in May 2002, the UK Parliament Select Committee on Culture, Media and Sport noted criticisms of Oftel's record in establishing a competitive UK market for broadband. The Select Committee called on Oftel to undertake remedial action, "taking account of the proposal to require BT's network to stand on its own as a distinct business".[45] In its response, Oftel said that, for it to conclude that there is a compelling argument to support a forced split of BT would require "confidence that the benefits for UK consumers outweigh the disbenefits". To expose BT to the possibility of such a measure, Oftel said, "would be a disproportionate response especially in the light of current turbulence in financial markets".[46] The Oftel position has been supported by the Government. In its own response to the Select Committee Report, the Government, echoing earlier comments by Oftel, said that "[t]he corporate structure of BT, like that of any other private sector company, is a matter for the board and shareholders of the company".[47]

In late 2000, BT instituted a corporate reorganisation that has resulted in the splitting of its UK fixed telephony operations into retail and wholesale divisions. BT Wholesale now manages the UK network and provides services to BT Retail and other BT entities as well as other operators.[48] Although sometimes described by the company as "structural separation", the arrangement more closely resembles what has been described here as "functional separation". Moreover, the reorganisation, motivated by BT's own corporate requirements, does not of itself impose any new obligations on the wholesale division in respect of its dealings with competitors.

41 Oftel, *Promoting Competition in Services over Telecommunications Networks* (February 1996), para.4.2. In 1999, Oftel introduced a new Condition 56B in the licences of mobile operators which, in effect, requires that a mobile licensee which has "market influence" shall carry on the provision of retail services separately from wholesale services. Oftel said that the purpose of this condition was to provide information necessary to monitor the mobile operator's treatment of ISPs relative to its own retail business and tied service providers and in particular to facilitate the detection of instances of undue discrimination or undue preference or cross subsidy: Oftel, *Draft Guidelines on Market Influence Determinations* (April 1999), para.4.16. There are no mobile operators currently designated as having market influence.

42 April 2001, para.S.3.

43 *ibid.* para.6.

44 *Oftel's Management Plan,* 2002–03, April 18, 2002, Ch.5.

45 Select Committee on Culture, Media and Sport, Fourth Report, May 1, 2002, para.74: *www.parliament.the-stationery-office.co.uk/pa/cm/cmcumeds.htm.* See also J. Cubbin and D Currie, "Regulatory Creep and Regulatory Withdrawal: Why Regulatory Withdrawal is Feasible and Necessary" (May 2002), pp.7–8, where it is suggested that the separation of BT into wholesale and retail entities may, based on experience in other sectors, be an "effective way" of dealing with some of the issues that currently block the way to progressive deregulation of the telecoms sector. David Currie has since been appointed Chairman of Ofcom, which will sometime during 2003 inherit responsibility for regulation of the communications sector from Oftel and other existing UK regulatory bodies.

46 *Oftel's Response to the Fourth Report of the Select Committee on Culture, Media and Sport,* Session 2002–2002, July 17, 2002, para.21: *www.oftel.gov.uk/publications/oftel_response/2002/dcms0702.htm.*

47 *Government Response to the Fourth Report of the Select Committee on Culture, Media and Sport,* Session 2001–2002, Cm 5554 (July 2002), p.8: *www.culture.gov.uk/PDF/Communications_govt_resp.pdf.*

48 BT Press Release, April 13, 2000.

At one stage, BT indicated that it was contemplating a voluntary divestiture of its wholesale division as part of its reorganisation, including a flotation up to 25 per cent of the shares of the new company. It was intended that the wholesale organisation would operate on an "arms length" basis from the rest of BT, and trade with the rest of BT and wholesale customers on the same basis.[49] These plans have not, however, been carried into effect.

The alternatives to structural separation

How effective are non-structural alternatives at preventing abuse by incumbents of their dominance of local access? I look next at two of the key elements of these plans, accounting separation and codes of conduct.

Accounting separation

Instead of requiring a formal structural separation of local from other lines of business, regulators have sometimes adopted accounting separation as an alternative. The purpose of accounting separation is to provide a financial picture for each part of the integrated business which reflects as closely as possible how it would have performed if it had operated as a separate business.[50] In principle, when the accounts of the local business are separated out from the accounts of the other parts of the business, the regulator is able to see that internal transactions are taking place on terms similar to transactions between the company and competitors. The regulator can also ensure that revenues from the local business are not being used to cross-subsidise other more competitive lines of business.

The United Kingdom introduced a requirement for the maintenance of separate accounts by BT in 1995,[51] and a similar EU-wide requirement was adopted in 1997.[52] However, the separation of costs is not a straightforward exercise. The difficulty stems from the fact that in a multi-service telecommunications firm the bulk of costs are joint or common to several activities. BT's regulatory accounts, for example, show that about 50 per cent of its costs are either joint or common. Judgments as to how these costs are to be apportioned between activities are inevitably arbitrary in nature and accordingly lead to controversy over the fairness of the results. How does one apportion between local and other activities, for example, the costs of producing a single bill covering both local and other services, or the cost of personnel that support more than a single line of business? Despite the significant effort that Oftel has put into the development of a reliable accounting regime, it recently concluded that BT's "regulatory Financial Statements do not contain or are insufficiently supported by robust disaggregated regulatory financial information for the Director to be able to discharge his duties effectively"; that "[t]he level of disclosure in [BT's] Accounting Documents and the supporting methodologies is not sufficient to understand thoroughly the bases of preparation of the regulatory Financial Statements"; and that the accounting treatment of certain matters "is not sufficiently consistent" between the company's statutory books and its regulatory books.[53] Oftel concluded that "the systems developed by BT to comply with their obligations under the accounting separation regime cannot generally be relied upon to meet Oftel's need for financial information".[54] However, rather than scrap accounting separation in favour of structural or other alternatives, Oftel appears determined for the moment to give its energies to improving current accounting techniques.[55]

Codes of conduct

Behavioural regulation is a key component of the non-structural approach. Where competition law is the primary instrument for the enforcement of policy in this area, these rules typically evolve on a case-by-case basis in response to complaints, drawing on established competition law norms; where *ex ante* regulation is present, these rules will often be articulated in advance. Some US regulators have prescribed detailed "codes of conduct" to regulate the activities of incumbents in relation to sensitive competitive issues. This is not a practice followed in EU jurisdictions, but similar principles are typically embodied in operator licences and/or reg-

49 BT Wholesale Press Release, undated, *www.btwholesale.com/news/mainnews.asp?NewsId=9*.

50 See Commission Recommendation 98/322/EC of April 8, 1998 on interconnection in a liberalised telecommunications market (Pt 2—Accounting separation and cost accounting) [1998] O.J. L141/6.

51 Condition 20B (since superseded and replaced by Condition 50 of the current licence, which is modelled on the requirements of Dir.97/33).

52 Dir.97/33 on interconnection in telecommunications with regard to ensuring universal service and interoperability through the application of the principles of open network provision [1997] O.J. L199/32, Art.8(2). The separate account requirement applies to operators with "significant market power".

53 Oftel, *Draft direction under the provisions of licence condition 78.14*, 21 (August 2002), pp.45–46.

54 *ibid.* p.46.

55 It will be obvious that the author is sceptical about the value of accounting separation as a safeguard. For a fuller discussion, see Ryan, "BT's Separate Accounts" [1996] 2 C.T.L.R. 145.

ulatory rulings. In either case, the rules that have been developed to monitor and control incumbent activities in sensitive areas are complex and inherently difficult to enforce.[56] I have summarised below key elements of the proposed code of conduct currently being considered by the Pennsylvania PUC as part of its proceeding on functional structural separation to give a flavour of the breadth and complexity of the issues that arise.[57]

Non-discrimination

- An ILEC shall not give itself or any competitor any preference or advantage over any other competitor in the pre-ordering, ordering, provisioning, or repair and maintenance of any services or facilities.[58]
- The sale of non-competitive services or facilities shall not be conditional upon the purchase of competitive services or facilities.

Employee conduct

- No ILEC employee may disparage the service of a competitor, or promote any service of the ILEC, while engaged in the installation of equipment or the rendering of service to an end user on behalf of a competitor.
- No ILEC employee may, while processing an order on behalf of a competitor, represent to the end user that such repair or restoration would have occurred sooner if the end user had obtained service from the ILEC.

Corporate advertising and marketing

- The ILEC may not engage in false or deceptive advertising.
- The ILEC may not state or imply that services provided by the ILEC are inherently superior when purchased directly from the ILEC unless that statement can be substantiated.
- An ILEC shall not state or imply that the services rendered by a competitor may not be reliably rendered or are otherwise of a sub-standard nature unless the statement can be substantiated.
- An ILEC shall not state or imply that the continuation of any service from the ILEC is contingent upon taking other services offered by the ILEC.

Cross-subsidisation

- An ILEC shall not use revenues earned or expenses incurred in conjunction with non-competitive activities to subsidise or support any competitive services.

Information sharing and disclosure

- An ILEC employee shall use competitors' proprietary information received in the pre-ordering, ordering, provisioning, billing, maintenance, or repairing of any telecommunications services provided to the competitor solely for the purposes of providing such services to the competitor.
- An ILEC employee shall not disclose any such competitor/proprietary information to employees engaged in the marketing or sales of the ILEC's retail services without the competitor's consent.
- An ILEC employee shall not disclose directly or indirectly, any customer/proprietary information to other entities unless authorised by law.

All such schemes for behavioural regulation, whether codified in this fashion or not, share the same unrealistic expectation that incumbents and their employees can adopt what are, from the incumbent firm's perspective, essentially irrational forms of behaviour. While the firm has a duty to its shareholders, often reinforced by an internal incentive system, to maximise profits, employees in "wholesale" roles are expected to be indifferent as

56 Consider the testimony of Alex Blowers, Director of Regulatory Affairs for UK cable operator NTL, before a House of Commons Select Committee examining the UK local loop unbundling process: "the reason that process has failed is that Oftel does not have the ability to set detailed behavioural rules on BT which act ex ante, so BT does not face a set of obligations which are absolutely clear. The problem here is that competition law is very much geared towards picking up offences after the fact and then punishing them, but what we need here is to have very detailed rules applied right from the get-go, which stop BT from saying, 'Ah, when you said to us you wanted access to our local exchange, we did not realise that what you meant was that you actually wanted a man with a key to open the door for you. You are now going to have to go back to the start process and get a specific obligation which says "The man at the key will turn up at 9 am and unlock the front door".' That is slightly facetious but the actual level of detail involved in local loop unbundling is that kind, and unless you write out the rules up front you are not get going to get anywhere . . . As we reform competition law and communications legislation, it seems to us that we need to have that combination of clear ex ante rules where necessary, and a very clear set of guidelines about how the competition rules are going to be applied in the sector . . . " *Minutes of Evidence*, House of Commons Select Committee on Welsh Affairs, March 5, 2002, Q.22.

57 *PA Proposed Rulemaking*, Annex A.

58 Such measures may be supplemented by quality of service measures to permit comparisons to be made between the quality of services rendered to competitors and to the ILEC's retail customers. See, *e.g.* CRTC Telecom Decision 2001–217, available at *www.crtc.gc.ca*, in which the Canadian Radio-television and Telecommunications Commission established such standards for Canadian incumbent local exchange carriers.

between the firm and its competitors and to actively facilitate the role of the latter not just in winning new customers, but in taking existing customers away from the firm.

The search for a way forward

Although great progress has been made in opening telecommunications markets to competition, the sustainability of widespread competition is still in doubt. That doubt arises because incumbent operators continue to control the local infrastructure which is critical for the provision of virtually all telecommunications services. Moreover, they have repeatedly shown themselves willing to use the market power their dominance of local access gives them to advantage themselves in complementary telecoms markets.

Until now, regulators and policy-makers have typically employed a combination of mandated access and non-structural safeguards to protect competitors from abuse. Competitors, however, contend that, without a fundamental change in the way in which markets are regulated, achievement of a truly competitive environment will remain elusive. In the long run, it is to be hoped that alternate suppliers of local services, possibly deploying new technologies, will emerge. The establishment of vigorous competition in local markets would resolve the issues discussed here. But it has become clear that it will be many years before alternatives to the local loop become available on a wide basis.

In the meantime, regulators and policy-makers are faced with a choice. They must either redouble their efforts to prevent abuse of incumbent dominance of local access through behavioural controls, or they must adopt structural remedies. The former course is likely to result in more intrusive regulation at a time when there are strong pressures in favour of "light-touch" regulation. On the other hand, it is not clear that structural separation alone would provide an effective remedy to problems of abuse: while structural separation may make abusive behaviour more visible and therefore easier to detect, it would not eliminate the incentives for such behaviour. Even post-separation, there would remain a need for on-going scrutiny of the relationship between the local entity and other elements of the incumbent's business to prevent collusive behaviour. Moreover, structural separation may entail costs in the form of loss of some of the economies of scale and scope available to integrated firms, and may have a negative impact on innovation.

Although the choice about the way forward is a difficult one, the status quo is not an option if competition is to thrive. In order to find a resolution to these issues, broad-ranging public debate is required. The debate that is now underway is an essential step toward evaluating these alternatives and defining an appropriate policy response.

Sweet & Maxwell
100 Avenue Road
Swiss Cottage
London NW3 3PF
United Kingdom

http://www.smlawpub.co.uk

Telephone: 020 7393 7000 (UK)
+44 207 393 7000 (International)
Fax: 020 7393 7333 (UK)
+44 207 393 733 (International)