



# Strengthening Openreach's strategic and operational independence

Proposal for comment

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Closing Date for Responses: 4 October 2016

## About this document

In February 2016, Ofcom published its initial conclusions from its Strategic Review of Digital Communications. That document set out a range of actions to make communications work for everyone.

One of those actions was to increase Openreach's independence from BT so it is more responsive to all of its customers. This document sets out our more detailed proposal to achieve this. It also sets out BT's formal proposal to reorganise Openreach.

This consultation will close on 4 October 2016. Please send your responses via our [web form](#).

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## Section 1

# Executive summary

## Ofcom's vision: making digital communications work for everyone

- 1.1 In February 2016, we published our Strategic Review of Digital Communications<sup>1</sup>. We found that the availability and affordability of digital communications services had improved dramatically over the last decade. However, demand is increasing at such a rate that greater investment will be needed to meet future consumer demands for better quality of service and the latest ultrafast broadband technologies.
- 1.2 We set out a ten-year vision for ensuring the quality and availability of communications services in the UK. This means that:
- everyone in the UK will enjoy fast, reliable broadband services. Most consumers and businesses will move from 'superfast' to 'ultrafast' broadband, and the latest mobile phone technologies will be rolled out across the UK's geography;
  - the UK will move towards a fibre future, with widespread availability of competing networks, including new networks that take fibre all the way to the home or business. As consumers and businesses enjoy greater choice, competition will drive both innovation and affordable prices;
  - people who do not have a choice of providers, lack a basic level of service, or find it hard to take advantage of offers in the market will be protected through effective, targeted intervention; and
  - the UK will be a world leader in the availability and capability of its digital networks.
- 1.3 We also set out a strategy to deliver this vision, recognising that our approach must vary across different parts of the UK. In the denser, urban areas of the UK we have placed renewed emphasis on competition between different networks, so that people and businesses do not rely entirely on Openreach for their communications services. These network competitors will be able to deploy innovative new technologies, for example rolling out fibre all the way to the home. Today we have also published an update on our progress on implementing duct and pole access<sup>2</sup>.
- 1.4 Network competition is the most effective spur for continued investment in high quality, fibre-based networks. At present, about half the country has access to two network providers. We have suggested that a good long-term outcome would be to achieve full competition between three or more networks for around 40% of premises, with competition from two providers in many areas beyond that.
- 1.5 In areas where full network competition is not viable, most consumers and businesses will continue to depend on service providers who purchase access to the Openreach network. This includes broadband services delivered to homes and small

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<sup>1</sup> Ofcom, [Making Communications Work for Everyone](#), 25 February 2016.

<sup>2</sup> Ofcom, [Duct and Pole Access \(DPA\) progress update](#), 26 July 2016.

businesses, high-bandwidth connections to larger businesses, and those mobile services that rely on Openreach to provide connections to mobile masts. The decisions that Openreach takes on how and where to invest, and how to operate its network, are fundamental to the choice and quality of these services.

- 1.6 Openreach must become more responsive to the needs of the service providers, people and businesses that depend on its network. We said in February that it is necessary to reform the relationship between Openreach and BT Group, to give Openreach greater independence and ensure it serves all of its customers equally. This document sets out the details of our proposed reform.
- 1.7 We expect a more responsive Openreach to deliver two sets of benefits:
- It should result in a more competitive market. Effective competition will ensure that people and businesses have a choice of services from different providers, with quality and pricing that meets their needs
  - It should support continued investment in new networks and services, in particular new ultrafast broadband networks. Investment decisions that are currently in the pipeline would be taken in the interest of all of Openreach's customers. New models of investment will become more likely, including models that share risk across a broader base of customers.
- 1.8 We recognise that greater independence for Openreach is part of a broader package of reforms that need to happen. We are also taking forward several other areas of work.
- We said that, above all, fixed and mobile services should be available to all people and businesses. We promised to work with the Government to deliver a new universal right to decent, affordable broadband for every household and small business in the UK.<sup>3</sup>
  - We highlighted the need for a step change in quality of service across the industry. We are setting tougher quality of service standards for Openreach; we will publish performance data for all operators; and ensure consumers and small businesses receive automatic compensation if things go wrong.<sup>4</sup> In April, we introduced new service-quality standards for the bespoke broadband services used by larger businesses.<sup>5</sup>
  - We plan to make it easier for people to switch mobile phone provider<sup>6</sup>; as well as TV, phone and broadband. We will publish our plans to improve the process for switching TV, phone and broadband shortly.

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<sup>3</sup> Ofcom, [Designing the Universal Service Obligation](#), 7 April 2016.

<sup>4</sup> Ofcom, [Automatic Compensation - Call for Inputs](#), 10 June 2016.

<sup>5</sup> Ofcom, [Business Connectivity Market Review](#), 28 April 2016.

<sup>6</sup> Ofcom, [Consumer Switching - Proposals to Reform Switching of Mobile Communications Services](#), 23 March 2016.

## Our concern with Openreach's current structure

- 1.9 BT Group is a 'vertically-integrated' company, combining two very different businesses.
- At the wholesale level, BT Group (through Openreach) owns and operates the network that delivers most fixed-line communications services to UK consumers and businesses. The network is the only one to deliver nationwide coverage, alongside obligations to connect every home and small business in the UK.
  - At the retail level, BT Consumer and BT Business are just two of a number of competing companies – that go beyond BT - selling services carried over that network.
- 1.10 This structure presents a long-standing competition concern: that BT can use control of its network to undermine retail competition. This risk arises if BT can offer access to its network on terms that favour its own retail businesses over that of competitors. BT has the incentive to do this, in order to protect its own retail business.
- 1.11 When Ofcom conducted a strategic review of telecommunications in the UK in 2005,<sup>7</sup> we concluded that this was indeed happening. We found that competitors reliant on BT's networks faced a range of problems. These included inferior-quality wholesale products, slow product development, poor processes, and a general lack of transparency. We were concerned that, in an increasingly dynamic market, this would reduce the level of innovation, range and choice of services available to consumers and businesses.
- 1.12 We sought to address this concern through significant changes in the way BT acted and sold its services. We accepted undertakings from BT which comprised two main pillars:
- The creation of Openreach as a 'functionally separate' part of BT Group, with a culture and management incentives designed to ensure that it serves all customers equally.
  - A requirement that, where Openreach supplies a product to other parts of BT, it must supply an identical product to BT's competitors. This requirement is referred to as 'Equivalence of Inputs', since it ensures that BT's competitors are able to develop their services using the same inputs as BT itself, with their success or failure depending only on the value they are able to add.
- 1.13 These interventions have broadly addressed the concern we identified in 2005. In particular, they have enabled BT's competitors to achieve a retail scale comparable to BT itself. In 2005, BT's competitors had a 2% share of broadband connections using local loop unbundling<sup>8</sup>; that share has now increased to 40%<sup>9</sup>. This increased level of competition has in turn benefited consumers and businesses, broadband take-up having grown from 31% to 78%.

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<sup>7</sup> Ofcom, [Strategic Review of Telecommunications](#), 2005.

<sup>8</sup> Ofcom, [Communications Market Report](#), 2006, Fig 3.4.

<sup>9</sup> Analysys Mason, [Report for BT - International Benchmarking Report](#), September 2015.

- 1.14 However, the underlying incentive for BT to discriminate against its competitors remains. Going forward, we concluded in February that BT can act on this incentive through the way strategic decisions are made about new investments by Openreach. Despite the measures we put in place in 2005, such decisions are still largely determined at the level of BT Group. Specifically, we concluded that:
- BT Group has retained control over Openreach's strategic decision-making. This includes decisions about the budget that is spent on parts of the network used by competitors;
  - BT does not consult sufficiently with all Openreach customers on new investments in the network;
  - Openreach's governance lacks independence from BT Group; and
  - Openreach does not have its own capability, independent of BT, in areas such as research and development.
- 1.15 We also concluded that a step change is required in the outcomes delivered to consumers and businesses. Our ambition for the future is that more homes and offices receive 'fibre to the premises' (FTTP). This technology, which offers average broadband speeds many times higher than those of today, is currently available to just 2% of premises in the UK, compared to 60% and higher in world-leading countries<sup>10</sup>.
- 1.16 We said that, in view of these concerns, Openreach must change. A new structure is required, under which Openreach has:
- more independent governance structures and processes, with a responsibility to serve all wholesale customers equally;
  - greater independent technical and operational capabilities;
  - greater independence over its planning, its strategic and operational decision making; and
  - an ongoing responsibility to consult with all its wholesale customers in the same way.
- 1.17 Several possible models for the structure of Openreach are summarised in Table 1<sup>11</sup>. Each model provides successively tighter constraints on the ability of Openreach to discriminate between competing providers. At the same time, the measures become more intrusive.

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<sup>10</sup> Source: Analysys Mason, September 2015.

<sup>11</sup> Martin Cave, [Six Degrees of Separation: Operational Separation as a Remedy in European Telecommunications Regulation](#), p.94; BEREC, [Guidance on functional separation](#).

**Table 1: Models of separation**

<b>1. Accounting separation</b>	Separate financial reporting, with costs and revenues of the upstream and downstream products allocated into different baskets
<b>2. Creation of a wholesale division</b>	A separate wholesale division established to supply inputs to competitors, but without equivalence of access
<b>3. Virtual separation</b>	Services offered to internal and external customers on equal terms, without any physical separation of the businesses
<b>4. Functional separation</b>	Physical separation of the business and its processes, e.g. location, staff, branding, management information systems
<b>5. Functional separation with local incentives</b>	Functional separation with separate governance and different management incentives to those of the wider firm
<b>6. Functional separation with independent governance</b>	Creation of a divisional Board with non-executive members who act independently from the group Board
<b>7. Legal separation</b>	Upstream business is established as a separate legal entity within the wider group, but remains under the same overall ownership
<b>8. Structural separation</b>	Split of the vertically-integrated operations into separate legal entities, with no significant common ownership and 'line-of-business' restrictions to prevent them re-entering each other's markets

- 1.18 The current structure of Openreach is broadly equivalent to **option 5** in this table – functional separation, with financial incentives for senior management that are aligned with Openreach's purpose, but without independent governance.
- 1.19 We suggested in February that one way forward might be a strengthened form of functional separation, under which Openreach becomes a wholly owned subsidiary of BT Group, with its own purpose and its own Board (**option 7** in the table). This remains our preferred option, and we set it out in more detail below.
- 1.20 If our preferred model of legal separation cannot be made to work, then full structural separation remains an option.

## Our preferred model for Openreach

- 1.21 Our preferred model is designed to secure greater strategic and operational independence for Openreach on how and where the organisation focuses. This is intended to ensure that Openreach makes strategic decisions in a manner that reflects the interests of all its customers. Any model that does not achieve this does not resolve our competition concern.
- 1.22 We recognise that BT Group remains the owner of Openreach in any model of functional separation. This brings with it a set of interests and responsibilities that are different from those faced by competing providers, in particular a continuing need for effective corporate governance by the BT Group Board. Our view, taking into account advice from our expert advisors, is that the proposal we have developed allows for such effective corporate governance to continue.
- 1.23 Our preferred model provides Openreach with the greatest degree of strategic and operational independence that is practically possible within a model of functional separation. There are models that go further by ring fencing Openreach's cash and assets. However, our view is that these are likely to trigger very significant costs, in particular costs relating to the BT pension scheme, and these could be comparable



to those that would be triggered by structural separation. We remain of the view that structural separation is a credible option, but believe that it would be disproportionate to move to structural separation without first giving BT an opportunity to make legal separation work.

1.24 The main features of our preferred model for Openreach are:

- i) **Openreach as a distinct company.** We are proposing that Openreach should be separately incorporated, becoming a company in its own right. It would have its own purpose, set out in its Articles of Association; and its own governance arrangements, including a board of directors. We do not believe our competition concern is likely to be addressed effectively simply by the addition of more complex behavioural rules attached to the existing Openreach structure.
- ii) **Openreach's purpose and directors' duties.** The new Articles of Association should make clear that one of the company's purposes is to act in the interests of all downstream customers equally, and that the Openreach directors must act accordingly.
- iii) **The Openreach Board.** The Openreach Board would have a majority of non-executive directors, including the Chair. These would be appointed and removed by BT. Crucially, these non-executive directors would not be affiliated in any way to BT Group, and Ofcom must be consulted on – and approve – each appointment and removal.
- iv) **The Openreach Executive.** The Openreach Chief Executive would be appointed by, and accountable to, the Openreach Board. The Chief Executive would be responsible for other executive appointments. There must be no direct lines of reporting from Openreach executives to BT Group executives or functions, except where this is specifically agreed with Ofcom.
- v) **Greater consultation with customers on investment plans.** Openreach would be obliged to consult formally with all downstream customers on large-scale investments. There would be a new 'confidential' phase where customers can discuss ideas – for example, joint ventures with Openreach – without this information being disclosed to BT Group.
- vi) **Greater independent financial control within an agreed budget.** BT Group would set a 'financial envelope' (a set spending capacity). Within this envelope, Openreach would have delegated authority to develop and manage its own strategic and annual operating plans. Openreach would also be able to make recommendations to the BT Group Board for increased spending.
- vii) **Openreach employees.** Our strong preference is that people who work for Openreach would be employees of the new company, rather than employees of BT Group. This would prevent any real or perceived conflict of interest, and allow Openreach to develop its own distinct organisational culture. We recognise that these employee arrangements would present some issues, particularly in relation to pensions, but we believe these can be appropriately addressed.
- viii) **Openreach assets.** Our starting position is that Openreach should own those assets it already controls, namely the underlying infrastructure (such as underground ducts and telegraph poles) associated with the current Openreach network. We recognise, however, that some asset transfers may trigger material costs, including in relation to pensions. In those circumstances, we are open to

proposals that would mitigate such costs by means of agreements between Openreach and BT.

- ix) **Increased resources and capability to support effective governance of Openreach.** Openreach would have greater resources, giving it the technical and commercial capability to develop strategy and manage its operational delivery without relying on BT Group.
  - x) **Openreach to have its own brand, independent of BT.** Openreach would have its own brand, not affiliated with BT Group, to help embed the organisational culture of an independent company enabled by the other changes set out above.
  - xi) **Regulatory compliance ensured by the Openreach Board.** The new model would no longer require the Equivalence of Access Board (EAB), which is the current mechanism for ensuring compliance. Its responsibilities would instead become a duty of the Openreach Board, discharged by a sub-committee of non-executive members.
- 1.25 We are interested in stakeholders' views on our proposal: given the complexity and inter-related nature of the design and potential costs, we have not reached a definitive position on the total proposal. Rather, we have set out our preferred model to understand the effectiveness of the model and the potential costs (and mitigations) available. Where, as a result of evidence from stakeholders, issues and challenges emerge that cannot be mitigated, we are open to changes.

## An effective but proportionate model

- 1.26 Any model we propose should be an effective and proportionate response to the competition concerns we have identified.
- 1.27 We have therefore considered the costs that would be imposed on BT by our preferred model for Openreach. We have also considered the opportunities to mitigate those costs, where this does not undermine the effectiveness of our proposed model.
- 1.28 The most significant potential cost could be associated with BT's pension scheme. If our proposal increased the BT Pension Scheme Trustees' assessment of the risks facing the scheme, they may require additional cash contributions to mitigate these risks. Such contributions could be significant and could represent the largest single cost caused by our proposals.
- 1.29 We have considered this issue in some detail, and understand there are a number of remedial actions available that would be consistent with our preferred model. These include:
- retaining the BT Pension Scheme (BTPS) in its entirety with British Telecommunications plc (BT plc), with Openreach becoming a participating employer;
  - ensuring that BTPS has the same access to Openreach's assets and revenues in the new model as it has now. This could be supported through BT Group's continuing ownership of Openreach, and through additional pensions-specific agreements, such as guarantees between Openreach and BT Group to ensure BT continues to meet its obligations in the same way as today; and

- working with Government to consider further the implications of our proposals for the Crown Guarantee. The Crown Guarantee is only applicable in the (unlikely) event that BT is wound up. In this case, the Guarantee would mean the UK Government assumes BT's liabilities to the BTPS.

1.30 Overall, our view is that pension costs, and those other costs associated with our proposal, could be kept to a level where our suggested reforms are a proportionate response to the concerns we have identified. However, it is not our intention to create disproportionate costs, or to undermine BT's ability to support and meet its liabilities. We will therefore consider any amendments to our proposal that meet our competition concern in lower cost ways.

## **BT's proposal to Ofcom**

1.31 We noted in February that we were open to voluntary proposals from BT, but that these must effectively address the concerns we have identified. At this time, BT had made an informal proposal, which in our view did not go far enough.

1.32 Since February, we have continued to discuss BT's informal proposal with the company. On 18 July 2016, BT submitted to us a further proposal<sup>12</sup>, which it intends to implement, for an enhanced form of functional separation. This retains the existing model of Openreach as a division within BT Group, but with enhanced governance arrangements and strategic capability.

1.33 The main elements of BT's plan include:

- Openreach is to be a functionally separate division of British Telecommunications plc (BT plc), the operating company and wholly owned subsidiary of BT Group plc that includes the majority of BT's operations and assets. BT plc's Articles of Association are to be amended to embed Openreach delegations and a requirement for equal treatment of customers;
- Openreach is to be governed by a committee of the BT plc Board<sup>13</sup>. BT refers to this body as the 'Openreach Board'. It will have a majority of independent members (not affiliated with BT), with one of these members chairing the Openreach committee. Members of the committee would be subject to duties under a governance protocol;
- delegated authority over strategy and delivery, within an agreed financial envelope, subject to a governance protocol detailing delegations and situations where decisions are escalated to BT Group for consideration;
- a continued role for the BT Group Chief Executive, including in the appointment of the Openreach Chief Executive, oversight of plans submitted to the Openreach Board, and access to confidential information;

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<sup>12</sup> BT has notified its intention to implement its further proposal under section 89C of the Communications Act 2003 and has also made an application for a variation to the existing undertakings under the Enterprise Act 2002. See

[http://stakeholders.ofcom.org.uk/binaries/consultations/strengthening-openreaches-independence/annexes/BTs\\_Proposal.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/strengthening-openreaches-independence/annexes/BTs_Proposal.pdf)

<sup>13</sup> The Directors of BT plc in 2015/16 were Tony Chanmugam, Glyn Parry and Sean Williams: British Telecommunications plc, [Annual Report and Form 20F 2016](#), p.56.

- a revised, formal Openreach consultation process for large-scale investments, featuring a confidential phase where information cannot go outside Openreach (except, in certain circumstances to the BT Group Chief Executive and Chief Financial Officers); and
  - strengthened Openreach capabilities, with certain operational functions to be enhanced or transferred into Openreach. Where Openreach does receive services from BT Group, the latter will retain responsibility for delivery.
- 1.34 We welcome elements of BT's plan, including BT's suggestions on financial delegations, customer consultation and strengthening of Openreach capabilities.
- 1.35 However, there are three elements which, taken together, mean that BT Group retains a high degree of control:
- the status of Openreach as a division of BT plc, rather than as a separate legal entity, and the consequent lack of any formal company directors on the 'Openreach Board';
  - the high degree of direct involvement and engagement of the BT Group Chief Executive and Chief Financial Officer in Openreach's management; and
  - the ability of these executives to access confidential customer information during the confidential Openreach consultation process between Openreach and BT's competitors.
- 1.36 For these reasons, our view is that BT's plan does not fully address our concerns.

### **BT's competitors have set out a 10-point plan for Openreach reform**

- 1.37 BT's competitors have set out their proposal for Openreach reform in the form of a '10-point' plan. This proposal has much in common with ours – in particular, its focus on identifying a workable form of legal separation, based on Openreach becoming a wholly owned subsidiary of BT.
- 1.38 However, some elements of the 10-point plan go further than our preferred model, and may trigger costs similar to those that would be triggered by full separation. Therefore, we do not consider the plan in total a proportionate response to the competition concern that we have identified.
- 1.39 The main elements of the 10-point plan are:
- i) **Openreach is established as a legally-separate company.** This is consistent with our proposal.
  - ii) **Openreach has its own independent Board.** Our proposal is for a Board appointed by BT, but with a majority of members who have no affiliation to BT.
  - iii) **An independent body to oversee transition and act as an adjudicator.** Our proposal has a set of defined criteria against which we will measure its success.
  - iv) **Openreach owns and controls its assets.** This is consistent with our proposal as a matter of principle, though we also recognise issues of practicability.

- v) **Openreach has its own distinctive and independent branding.** This is consistent with our proposal.
  - vi) **Openreach is financially independent, with autonomy over its budget.** This is not consistent with our proposal. Our proposal stops short of full budgetary autonomy and the ability to raise third party finance given the potential costs this would impose on BT Group overall. Such an approach would result in costs approaching those of full structural separation.
  - vii) **Openreach provides its services and information on an equal basis.** This is consistent with our proposal.
  - viii) **Openreach properly consults with all its customers on strategy, capital expenditure and product design.** This is consistent with our proposal.
- 1.40 Note that we have not here considered elements 9 and 10 of the 10-point plan. These relate to requiring BT to tender for network providers for its retail operations, and requiring Openreach to demonstrate the commercial case where it over-builds smaller alternative operators' networks. Neither of these proposals relates directly to Openreach's strategic and operational independence.

## The regulatory framework

- 1.41 Our Strategic Review of Digital Communication is a forward-looking review of communications markets, setting out our strategy for the next ten years. The Communications Act 2003 sets out the domestic statutory framework for such forward-looking regulation, based on the harmonised European Framework. In our February initial conclusions document we explained that our next step was to prepare a proposal for submission to the European Commission in accordance with procedures set out in the Communications Act.
- 1.42 Since then, the UK has voted in a referendum to leave the European Union. Whilst that vote did not itself have any immediate legal effect, it is clearly important that at a future point the relevant legislation in the UK may be amended. When and how this will be done is a matter for the UK Government and Parliament. Until any legislative change occurs, the Communications Act 2003 remains in force in its present form.
- 1.43 We believe that action is required now to deliver better outcomes for consumers and citizens. Subject to considering any representations received in response to this document, we will proceed with our proposal as quickly as possible.
- 1.44 As set out in our February document, we remain open to the potential for agreeing voluntary proposals if they effectively address our concerns. The Communications Act 2003 provides for voluntary arrangements and BT has submitted its proposal to us under the relevant provisions of that Act.

## Measuring the success of our proposals

- 1.45 We have developed several measures by which to judge the effectiveness of our proposed model.
- 1.46 The most direct measure of success will be whether Openreach Board decisions are taken in an independent manner, without undue influence from BT Group. The increased transparency resulting from the new governance processes will be one of

the most important aspects of this assessment. We will also seek evidence from customers on the responsiveness of Openreach, in particular to new investment ideas and new models of co-investment.

- 1.47 We would include in our assessment the outcomes for people and businesses. We will recognise that these are not solely under the control of Openreach, but they still need to form part of our assessment, since these are the ultimate goal of our intervention. They include
- effective retail competition, so that people and businesses have a choice of services from different providers, with quality and pricing that meets their needs
  - further innovation by all retail providers using Openreach's network; and
  - improved investment outcomes arising from new potential models of investment, such as co-investment and risk sharing.
- 1.48 Our proposal will combine with our wider DCR actions to bring about a step change in quality of service and an increased number of competing fibre networks. Together, these actions should mean over time that consumers enjoy better quality communications services, in more parts of the country and from a greater choice of providers.
- 1.49 In order to gauge the success of our proposed model, we will publish periodic monitoring reports. These reports will initially be published every six months, and then annually.
- 1.50 If these monitoring reports suggest that the model is not delivering on the outcomes that we have set out here, we would carry out a more detailed review. The core question for that review would be whether legal separation is still a workable solution to our competition concerns, or whether it is necessary to move to a model based on full structural separation.

## Section 2

# Introduction

## Background to this document

- 2.1 In February 2016, we published our long-term strategy to make digital communications work for everyone. Our strategy focused on five broad areas:
  - 2.1.1 the guarantee of universal broadband availability at a sufficient speed to meet modern consumer needs;
  - 2.1.2 support for investment and innovation in ultrafast broadband networks (such as fibre to homes or businesses) by giving BT's competitors improved access to its infrastructure;
  - 2.1.3 improvements in the quality of service delivered by the whole of the telecoms industry, including Openreach, BT's access network division;
  - 2.1.4 increased independence of Openreach from BT so that it is more responsive to all of its customers; and
  - 2.1.5 greater consumer empowerment so that people can understand the array of choices available to them and are able to switch to the best value deal easily.
- 2.2 At the heart of our strategy is a major strategic shift to encourage investment in new telecoms networks, including the rollout of new 'fibre to the premise' networks to homes and businesses, as an alternative to BT's planned innovation in copper-based technologies. To deliver this, we are making it easier for competing providers to build their own fibre networks, across as much of the UK as is practicable, by providing them with access to Openreach's network of underground ducts and telegraph poles.
- 2.3 Network competition is the most effective spur for continued investment in high quality, fibre-based networks. At present, about half the country has access to two network providers. We have suggested that a good long-term outcome would be to achieve full competition between three or more networks for around 40% of premises, with competition from two providers in many areas beyond that.
- 2.4 In areas where full network competition is not viable, most consumers and businesses will continue to depend on service providers who purchase access to the Openreach network. This includes broadband services delivered to homes and small businesses, high-bandwidth connections to larger businesses, and those mobile services that rely on Openreach to provide connections to mobile masts. The decisions that Openreach takes on how and where to invest, and how to operate its network, are fundamental to the choice and quality of these services.
- 2.5 It is therefore critical that Openreach operates in a way that is responsive to its customers. This is particularly important given the crucial role Openreach has to play in ensuring that consumers and businesses enjoy good communications services, given its market position and the continued reliance competitors will have on its network.



- 2.6 In our strategy, we expressed concern that the current model of functional separation fails to remove sufficiently BT's ability to discriminate against competitors. This stemmed from the control retained by BT Group over Openreach's strategic decision-making and over specific decisions on the budget that is spent on the parts of the network used by competitors.
- 2.7 If Openreach is not responsive to the needs of all its customers, this could create risks to competition and investment, and ultimately the service received by UK consumers and business. Without a level playing field between BT and its competitors, consumers and businesses are less likely to see the benefits of competition, which include improvements to the price, choice and quality of communication services. Where major investments in the network favour the interests of BT Group, there is a risk that these investments do not match to the needs of a wider group of UK consumers and businesses.

## **Our proposal to strengthen Openreach's strategic and operational independence**

- 2.8 In February 2016, we reached an initial conclusion that a strengthened model of functional separation could deliver the greater independence for Openreach that we believe is necessary to address our concerns. We committed to developing detailed proposals aimed at securing the necessary independence for Openreach required to address our concerns.
- 2.9 Our overall aim is to increase materially the independence of Openreach in relation to strategic and operational decision-making and ensure that Openreach is focused on the interests of all its customers.
- 2.10 At the same time, we recognise that BT Group remains the owner of Openreach in any model of functional separation. This brings with it a continuing need for effective corporate governance by the BT Group Board. We are also aware of the importance of ensuring that the costs of our solution do not become disproportionate. In particular, models of functional separation which incur costs which are comparable to those associated with full structural separation are unlikely to be a sensible way forward. Our proposal is set out in more detail in Section 4.

## **Our proposal is both an effective and proportionate means to address the competition concern identified**

- 2.11 We believe that our proposed model allows Openreach greater independence in respect of strategic and operational decisions, while being consistent with its status as a wholly owned subsidiary within BT Group.
- 2.12 The proportionality of our proposal depends both on its effectiveness and the costs involved. In developing our proposal, we have considered the costs and practical challenges that could arise, alongside the mitigations available to address these. We address these issues in Section 5.
- 2.13 If successful, we believe that our approach will deliver improvements in competition and investment that will ultimately benefit those consumers and business who continue to rely on the Openreach network. However, if we see evidence that our proposed model of legal separation fails to meet our objectives, we would then return to the question of structural separation. We have developed measures of success



against which we will judge how effective our proposal is in addressing the concerns we have identified. These are set out in Section 6.

## **BT's proposal, and proposals from its competitors**

- 2.14 We have compared our proposal against the proposal BT has notified to us<sup>14</sup>. This retains the existing model of Openreach as a functionally separate division with BT Group, but enhances the governance arrangements for Openreach, as well as increasing its strategic capability. We discuss this in more detail in Section 7.
- 2.15 We have also compared our proposal to submissions made to us by other stakeholders, including a model of separation proposed by Sky, TalkTalk and Vodafone<sup>15</sup>. This was a '10-point' plan for Openreach reform. The proposal has much in common with our own, in particular the focus on identifying a workable form of legal separation based on Openreach becoming a wholly-owned subsidiary of BT. We discuss this in more detail in Section 8.

## **Structure of this document**

- 2.16 The rest of this document covers the following:
- Section 3: Why we need to make Openreach's governance more independent from BT
  - Section 4: Our proposal to secure greater independence for Openreach
  - Section 5: The potential cost of implementing our proposal
  - Section 6: Measuring the success of our proposal
  - Section 7: BT's proposal
  - Section 8: The industry submission
  - Section 9: The way forward
- 2.17 We are inviting comments on our proposal for reforming Openreach's independence. The deadline for providing comments is 4 October 2016.

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<sup>14</sup> BT has notified its intention to implement its proposal under section 89C of the Communications Act 2003 and has also made an application for a variation to the existing undertakings under the Enterprise Act 2002.

<sup>15</sup> "Legal separation of Openreach from BT: necessary steps to secure effective independence, transparency and to promote competition and investment" dated 6 May 2016.

## Section 3

# Why we need to make Openreach's governance more independent from BT

- 3.1 In this section, we explain why we need to reform the relationship between BT and Openreach. At the heart of our concern is the continuing incentive and ability of BT to discriminate against its downstream customers due to its vertically integrated structure and position of significant market power.
- 3.2 Given this incentive, we are concerned that the degree of BT Group's influence over strategic decisions, including lack of consultation by Openreach with its downstream customers, creates risks to both competition and investment. To address this concern we are proposing to give Openreach greater independence over strategic and operational decisions affecting the network, so that these decisions reflect the interests of all its customers, not just BT Group.
- 3.3 A more independent Openreach that is responsive to the needs of all its customers could deliver a number of benefits:
- 3.3.1 maintaining the intensity of competition as new superfast and ultrafast broadband networks emerge;
  - 3.3.2 supporting new models of investment and better targeted investments in communications networks and products; and
  - 3.3.3 enabling further innovation and differentiation of communications services for consumers and businesses.
- 3.4 Taken together, these will help ensure that consumers and businesses can benefit from the widespread availability and choice of improving networks and services. These benefits are set out in more detail in Section 6.

## The current regulatory context

- 3.5 Today, BT is subject to regulation through a combination of significant market power (SMP) obligations imposed in individual product markets under the Communications Act 2003, which gives effect to the European electronic communications framework, and the Undertakings.
- 3.6 Although the SMP obligations we impose vary from market to market, they typically include a number of common measures. For example, price controls, obligations to allow rival operators network access and obligations to provide rival operators with the same level of service. They also include obligations to supply a range of upstream products on an equivalence of inputs (EOI) basis. This means they are supplied to BT's downstream competitors in the same way as to BT's own downstream divisions, with the same timescales, terms (including price and service levels) and processes. This principle aims to ensure a level playing field between BT and its downstream competitors, notwithstanding BT's vertical integration. Taken together, the aim of the SMP conditions is to address the competition problems that could otherwise arise from a firm exercising its significant market power.

- 3.7 The Undertakings were established in 2005 following Ofcom's Strategic Review of Telecommunications (TSR).<sup>16</sup> In 2005, we were concerned that BT's vertically integrated structure and position of market power gave it the incentive and the ability to discriminate against those competitors who rely on its network.
- 3.8 We saw evidence that competitors reliant on BT's networks had faced a range of issues. These issues included inferior quality wholesale products, slow product development, poor processes, and a general lack of transparency<sup>17</sup>. As a result, UK fixed telecoms was underperforming for citizens and consumers. For example, broadband take-up and innovation were limited given the development of the network at that stage.
- 3.9 We sought to address these competition concerns through undertakings from BT, which required some significant behavioural changes in the way BT operated and sold its services. They consist of two main pillars:
- The functional separation of BT's upstream operations, which supply regulated access to its network and downstream operations, which supply communications services to consumers and businesses.
  - A requirement on BT to supply a range of upstream products on an EOI basis. As set out above, these requirements have since also been imposed as regulatory conditions on BT in markets where it has SMP.
- 3.10 These two pillars are complementary. While EOI establishes rules to ensure equal treatment in the way BT supplies specific products, functional separation of Openreach should create the culture and incentives for senior management that ensure that those rules go with the grain of the organisation.
- 3.11 The Undertakings also set out a number of detailed obligations designed to support these pillars, for example separation of certain employees and the requirement for a separate Openreach Management Board.

## The problem with the status quo

- 3.12 Today, SMP obligations and the Undertakings have achieved good outcomes by preventing BT from supplying inferior products and services to its competitors compared with its own retail businesses. However, as they only apply once Openreach has invested in the network, they do not limit the ability of BT to discriminate when making key decisions that shape the network itself.
- 3.13 In the Strategic Review of Digital Communications (DCR)<sup>18</sup>, we explained how the telecoms market has changed markedly since the TSR. We explained our concern that the model of functional separation has failed sufficiently to address BT's incentive and ability to use its vertically integrated structure to discriminate against competing communications providers in the market. We have identified a number of

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<sup>16</sup> Ofcom, [Final Statements on the Strategic Review of Telecommunications, and Undertakings in lieu of a Reference under the Enterprise Act 2002, 22 September 2005](#).

<sup>17</sup> Ofcom, [Strategic Review of Telecommunications Phase 2 Consultation Document](#), 18 November 2004, p. 11.

<sup>18</sup> Ofcom, [Making Communications Work for Everyone](#), 25 February 2016.

concerns with the existing model of Openreach, which suggest that there are persisting competition problems.

- 3.14 Taken together, these concerns mean that, practically, BT has the incentive and ability to influence or determine strategic investment and operational decisions that favour its own retail businesses over the retail businesses of others. Where BT acts on this incentive, other retail providers will be less able to deliver the innovation and services that their customers demand, unless this accords with the needs of BT Group. Over time, this can reduce the range and choice of services available to end users, as well as risk slower introduction of new service launches.
- 3.15 We recognised in the DCR that the UK has performed comparatively well on some measures, including the availability and take up of superfast broadband.<sup>19</sup> However, there remain areas of concern relating to BT's performance overall, including on quality of service, and on the level of investment in UK infrastructure in general, especially the rollout of fibre to the premises.
- 3.16 Looking ahead, we are concerned that leaving the status quo creates a risk that investment and operational decisions lead to poor outcomes for UK consumers who rely on Openreach's network. We need a set of arrangements that are more likely to ensure Openreach makes strategic investment and operational decisions that reflect the needs and interests of the whole market, rather than just those of BT Group.
- 3.17 Before setting out our proposal, we explain below the ways in which BT Group has the ability to influence the decisions of Openreach under the current structure of functional separation and why this is a cause of concern.

## **BT Group influence over Openreach strategy and decision-making**

### Openreach's status and governance

- 3.18 Today Openreach is run as a separate business division of BT. It has its own management team led by a Chief Executive (CEO) who is appointed by the BT Group CEO. As would be expected in a vertically integrated company, Openreach's governance is set within the wider BT Group governance structure. This structure affords the CEO of each business division, including Openreach, general responsibility for that area of business. However, within this structure specific matters are reserved to the BT Group Board, BT Group governance committees or specific individuals.
- 3.19 In practice, this governance structure means that major strategic and operational decisions relating to Openreach are subject to the oversight of the BT Group Board. Currently, directors on the BT Group Board with responsibility for such decisions have a legal duty to act in the interests of BT Group as a whole, which includes Openreach and the other BT divisions. This means that major strategic and operational decisions are taken in the interests not just of Openreach but also of BT's downstream divisions, potentially to the detriment of other Openreach customers.
- 3.20 Major decisions relating to the Openreach network are important for BT, but are also important for the wider UK telecoms industry, including BT's retail competitors. If BT Group is able to use the governance described above to influence these decisions to

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<sup>19</sup> Ofcom, [Making Communications Work for Everyone](#), 25 February 2016, pp. 16-17.

its own competitive advantage, we are concerned that its retail competitors may suffer, to the overall detriment of consumers and business as whole.

- 3.21 For example, there could be a particular network investment that is more favourable to BT's retail competitors than its own divisions. Under the current structure, BT Group has an incentive, and importantly has the ability, not to make that investment. This is regardless of whether it would be profitable for Openreach on a standalone basis or in the wider interests of consumers and businesses as a whole.

### Openreach operating plan and investment decisions

- 3.22 Each year Openreach produces an annual operating plan (AOP) that sets out its plans for the year ahead, including financial targets, operational plans and key investments. Our understanding is that the plan is initiated by the Openreach executive team, led by Openreach's CEO. However, the plan is then reviewed by the BT Group CEO prior to submission to the BT Group Board for approval.<sup>20</sup> This process affords BT Group a significant degree of control over Openreach's decisions relating to its plans and priorities.
- 3.23 Once the annual operating plan is established, the Openreach management team has a limited level of independence under the current arrangements. Openreach management can plan and approve specific investment decisions, but only up to a limit of £75 million per investment. Any investment proposals exceeding this amount must be approved by the BT Group Board.<sup>21</sup>
- 3.24 This governance structure means that the way Openreach allocates its capital expenditure can be influenced by the priorities of BT Group rather than the needs of all Openreach customers, particularly in relation to investments over £75 million. As a result, the interests of all customers may not be properly reflected in Openreach investment decisions. This creates the risk that such decisions are taken in a manner that gives preferential treatment to the interests of BT's own downstream divisions over its competitors, to the detriment of consumers and businesses that rely on services delivered over the Openreach network.

### Involvement of BT Group governance committees and other divisions

- 3.25 Under the current arrangements, a number of BT Group committees and other divisions are involved in Openreach's decision-making and operation. Examples of BT Group involvement include the following.
- The Operating Committee is the key management committee within BT Group and is chaired by the BT Group CEO. It monitors the group's financial, operational and customer service performance and has oversight of all lines of business. It also reviews key risks to BT Group and considers any potential threats and opportunities. The Openreach CEO is not a member of the Operating Committee but attends meetings where appropriate.<sup>22</sup>
  - The Design Council is a sub-committee of the Operating Committee described above. It is collectively responsible for aligning BT's capital investments in its

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<sup>20</sup> BT Response to Q2a Information request, 14 June 2016.

<sup>21</sup> See [Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002](#), Section 5.29.

<sup>22</sup> BT Group plc, [Annual report and Form 20F](#) 2016, p. 26.

networks, systems, platforms and products so that they are directed towards achieving its overall purpose and strategy, serve the needs of all of its customers and are delivered in a cost-effective manner.<sup>23</sup> Its members are drawn from all of BT's downstream divisions, with Openreach in attendance. We understand that the Design Council can discuss matters related to Openreach that fall within the scope of its responsibilities.

- The Technology Committee is a committee of the BT Group Board responsible for BT's overall technology strategy. The Openreach CEO is not a member of the Technology Committee and does not attend discussions. However, its terms of reference show that the Committee's remit includes technology strategy for Openreach. For example, the most recent Chairman's report features a review of BT's strategy and progress on ultrafast broadband.<sup>24</sup>
- Openreach depends on shared BT Group functions. For example, Openreach relies on the Technology, Service and Operations (TSO) group for enhancements to Openreach products and processes. This includes the operational systems that sit behind the delivery of specific products and quality of service levels.<sup>25</sup> Similarly, we understand that the development of major technology upgrades to the network (such as G.Fast)<sup>26</sup> sits mainly within the BT Group research and development function, rather than Openreach.

## Consultation with customers

- 3.26 Alongside BT Group's involvement in Openreach decisions, we are concerned about the extent to which BT Group and Openreach take into account the views of those service providers who compete with BT when taking major network investment decisions. In certain key cases, we consider that Openreach has not consulted in a sufficient, timely or transparent manner with all its customers, on matters that are of strategic importance to them, and to UK consumers and businesses.
- 3.27 For example, our understanding is that BT Group made the initial strategic decision to invest in ultrafast broadband and adopt a particular technology without consulting Openreach's customers.<sup>27</sup> This decision is of fundamental importance to everyone in the UK, since it specifies what type of next generation broadband service will be made available over the next decade, and the nature of competition over the same period. However, BT made the announcement in January 2015 (including the technology choice and specific deployment targets), with formal industry consultation only taking place later in the year, and being limited in scope.<sup>28</sup>
- 3.28 Without effective and timely consultation with all Openreach customers, there is a risk that the interests of customers other than BT are neglected or not given appropriate weight. This is particularly important for significant decisions about the

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<sup>23</sup> BT Group plc, [Annual report and Form 20F](#) 2016, p. 30, 105.

<sup>24</sup> Technology Committee Chairman's report, BT 4 May 2016 (BT Group plc, [Annual report and Form 20-F](#) 2016, p. 127)

<sup>25</sup> BT Group plc, [Annual report and Form 20F](#) 2016, p. 90.

<sup>26</sup> G.Fast is a new technology that enables faster broadband services to be delivered over a hybrid fibre / copper network for use over shorter final copper connection, with expected speeds of up to 300Mbit/s

<sup>27</sup> BT response to Q3 information request, 14 June 2016.

<sup>28</sup> [BT ultrafast broadband announcement](#), 30 January 2015.



operation of Openreach and the future of its network, with the risk that demand from certain groups of consumers is not necessarily taken into account and therefore alternative approaches to investment are not fully tested.

- 3.29 More broadly, this situation creates the risk of a poor investment outcome for the UK as whole. This is where the timing or technology choice of investments in the Openreach network is based on the needs of only a specific group of consumers and businesses. For example, those consumers or businesses targeted by BT's own retail divisions. Ultimately, this creates a risk that a significant part of the country reliant on the Openreach network might not have the broadband, phone or TV services that meet their needs.
- 3.30 The Undertakings do contain provisions designed to address some of our concerns related to lack of consultation. However, these are specific to those major investments envisaged in 2005, in particular BT's original next-generation core network<sup>29</sup>. Since 2005, BT has moved its focus away from core networks and the majority of its strategic investment has been in access networks, which form the last mile connections to customers. Despite this change of focus, we believe the same intent and principles that applied to BT's next-generation core network plans described above should clearly have applied to subsequent investment decisions. However, this has not occurred to the same degree.
- 3.31 Examples such as these illustrate the need to move away from specific behavioural rules around future investment decisions towards changing the responsibility, purpose, and culture of Openreach through a new governance approach.

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<sup>29</sup> [Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002](#), Section 11.

## Section 4

# Our proposal to secure greater independence for Openreach

- 4.1 In light of the competition concern described in Section 3, we believe that it is necessary to reform the relationship between BT Group and Openreach. Our objective is to give Openreach greater independence over strategic and operational decisions affecting the network, so that these decisions reflect the needs of all its customers, not just BT Group.
- 4.2 In our February 2016 strategy we outlined the range of separation models<sup>30</sup>. These are summarised in Figure 1 below.

**Figure 2: Models of separation**

<b>1. Accounting separation</b>	Separate financial reporting, with costs and revenues of the upstream and downstream products allocated into different baskets
<b>2. Creation of a wholesale division</b>	A separate wholesale division established to supply inputs to competitors, but without equivalence of access
<b>3. Virtual separation</b>	Services offered to internal and external customers on equal terms, without any physical separation of the businesses
<b>4. Functional separation</b>	Physical separation of the business and its processes, e.g. location, staff, branding, management information systems
<b>5. Functional separation with local incentives</b>	Functional separation with separate governance and different management incentives to those of the wider firm
<b>6. Functional separation with independent governance</b>	Creation of a divisional Board with non-executive members who act independently from the group Board
<b>7. Legal separation</b>	Upstream business is established as a separate legal entity within the wider group, but remains under the same overall ownership
<b>8. Structural separation</b>	Split of the vertically-integrated operations into separate legal entities, with no significant common ownership and 'line-of-business' restrictions to prevent them re-entering each other's markets

- 4.3 The current model of separation required by the BT Undertakings broadly equates to model five in Figure 1. We suggested in February that one way to address our competition concern might be legal separation, under which Openreach becomes a wholly owned subsidiary of BT Group, with its own purpose and its own Board (broadly model seven). This remains our preferred option.

<sup>30</sup> Martin Cave, *Six Degrees of Separation: Operational Separation as a Remedy in European Telecommunications Regulation*, p.94; BEREC, *Guidance on functional separation*.



- 4.4 Setting up Openreach as a distinct company, with its own purposes and statutory board of directors, is a more structural solution to our competition concerns. Instead of just adding new and more complex behavioural rules to the existing arrangements, it implements a new structure that is inherently more independent. Our view, based on our previous experience with complex behavioural remedies, is that such an approach is much more likely to be effective.
- 4.5 Our objective is to create a governance and operational structure that gives the right incentives and sufficient authority for the Openreach Board to take decisions that are not influenced by the wider interests of BT Group. The Openreach Board must consider equally the interests of all downstream customers, alongside the success of Openreach as a company. We have designed a governance model that seeks appropriately to insulate the Openreach Board from the direct interests of the wider BT Group's other divisions. Such insulation should allow the Openreach Board and Executive to effectively discharge their duties both to the company's success and act in the equal interest of all downstream customers
- 4.6 At the same time, we recognise that BT Group remains the owner of Openreach in any model of functional separation. This brings with it a set of interests and responsibilities that are different from those faced by competing providers, in particular a continuing need for effective corporate governance by the BT Group Board.
- 4.7 We have taken specialist advice on this matter<sup>31</sup>. Our advice sets out how an investor can have sufficient control through the ability to appoint or remove a majority of Board members. This can avoid substantial costs from arising, for example those triggered by de-consolidation of Openreach's financial performance from that of BT Group. We believe that setting up such a relationship between BT Group and an Openreach Board that comprises a majority of members not affiliated to BT Group, and with specific duties to act in the equal interests of all downstream customers, can deliver on our aim of greater independence without incurring significant and disproportionate costs.
- 4.8 In day-to-day operation, our proposed model should ensure greater transparency for Ofcom on how and when decisions are taken, and what the Openreach Board thinks is the right approach. We expect interventions from BT Group would be exceptional and clearly transparent, as they would require changes to the Openreach Board membership. For example, BT may direct Openreach in the event of substantial underperformance in the subsidiary, or as a result of wider Group challenges that require material changes to BT Groups' plans for its business units and subsidiaries.
- 4.9 Our preferred model provides Openreach with the greatest degree of strategic and operational independence to Openreach that is practically possible within a model of legal separation. We therefore consider that this is a proportionate response to the concerns that we have identified.
- 4.10 There are models, which go further, by ring fencing Openreach's cash and assets. However, our view is that these are likely to trigger very significant costs, in particular costs relating to the BT pension scheme, and these could be comparable to those that would be triggered by structural separation. We remain of the view that structural separation is a credible option, but believe that it would be disproportionate to move

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<sup>31</sup> BDO, [Advice on corporate governance and accounting](#), 13 July 2016.

to structural separation without first giving BT an opportunity to make legal separation work. We will assess whether our model of legal separation is effective using the measures set out in Section 6.

## Our proposed model

- 4.11 We set out below our proposed model to secure greater independence for Openreach, which consists of the following key elements:
- 4.11.1 **Openreach as a distinct company:** We are proposing Openreach is established as a wholly owned subsidiary of BT plc, with its own purpose, board of directors and governance arrangements.
  - 4.11.2 **Openreach purpose and Directors' duties:** The Articles of Association of Openreach will make clear that a core purpose for the company is to act in the interests of all downstream customers equally, and the Openreach Directors will have duties to act accordingly.
  - 4.11.3 **Openreach Board:** The Openreach Board would have a majority of non-executive directors, including the chair. They would be appointed by BT, but, crucially, they would not be affiliated to BT Group, and Ofcom would be consulted on this as part of the appointment process.
  - 4.11.4 **Openreach Executive:** The Openreach CEO would be appointed by and report directly to the Openreach Board. There should be no direct lines of reporting from Openreach executives to Group executives, with any exceptions to be agreed with Ofcom.
  - 4.11.5 **Greater consultation with customers on investment plans:** Openreach would have an obligation to consult formally with all downstream customers on large-scale investments. There would be a new 'confidential' phase where customers can discuss ideas with Openreach without this information being disclosed to BT Group.
  - 4.11.6 **Greater independent financial control within an agreed budget:** BT Group would set a 'financial envelope' (a set spending capacity). Openreach would develop its own strategic and annual operating plans within that financial envelope, and be able to make recommendations to the BT Group Board for increased spending.
  - 4.11.7 **Openreach employees:** Our strong preference is that people who work for Openreach would be employees of the new company, rather than employees of BT Group. This is to ensure that there is no conflict of interest, actual or perceived, and to ensure that Openreach is able to develop its own distinct culture.
  - 4.11.8 **Openreach assets:** Our starting position is that Openreach should own those assets that it already controls under the current Undertakings, subject to any costs that might arise. We are open to proposals that would mitigate such costs by means of agreements between Openreach and BT.
  - 4.11.9 **Increased Openreach resources and capability:** Openreach would have enhanced internal capability to ensure it has the capabilities required to develop strategy and manage operational delivery in the interests of all its customers, without relying overly on BT Group.

4.11.10 **Openreach to have its own brand, independent of BT:** Openreach would have its own brand, not affiliated with BT Group, to help embed the organisational culture of an independent company enabled by the other changes set out.

4.11.11 **Regulatory compliance ensured by the Openreach Board:** Responsibility for monitoring compliance would be a duty of the independent Openreach Board, potentially discharged by a sub-committee of independent members.

4.12 We set out each element of the proposal in more detail below.

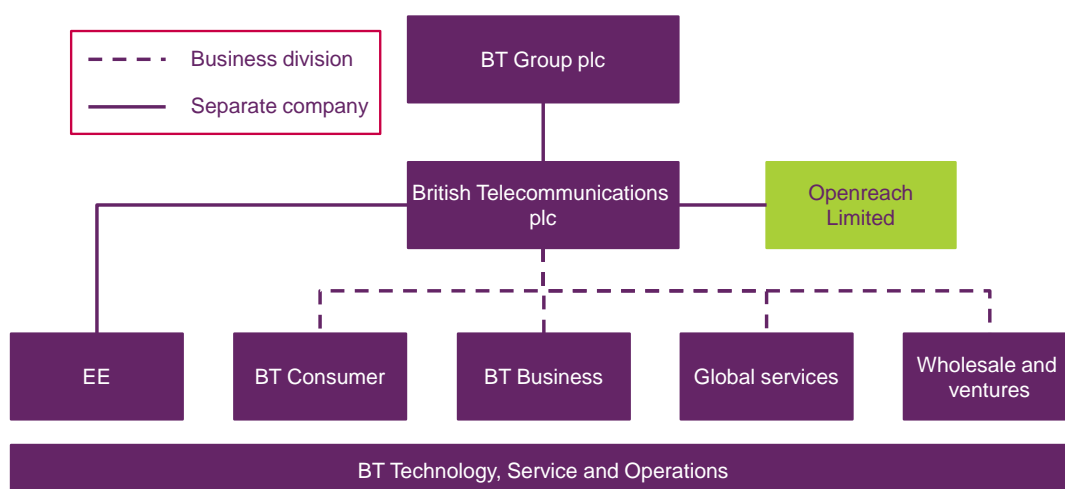
## Openreach as a distinct company

4.13 We are proposing greater corporate separation between the management of Openreach and BT Group plc. Such separation would have three key advantages necessary to achieving our objective:

- it would allow a separate governance structure to be put in place to secure greater independence for Openreach, in particular for its management. This helps to address our concerns on strategic investments and operational decisions;
- a separate Openreach governance process would make the relationship between Openreach and BT's other divisions more transparent. This would give Openreach's customers greater confidence that their interests are being taken into account; and
- greater corporate separation would reinforce an internal organisational culture where Openreach employees are focused on treating customers equally rather than serving the interests of its parent group.

4.14 Consequently, we propose requiring BT to establish Openreach as a separate wholly owned subsidiary of British Telecommunications plc (BT plc). BT Group would continue ultimately to be the sole shareholder of Openreach, but Openreach would be a distinct company with its own purposes, board of directors and governance arrangements. This governance model would be underpinned by company law.

**Figure 3: Potential structure of BT Group and Openreach Limited under our proposal**



Source: Ofcom

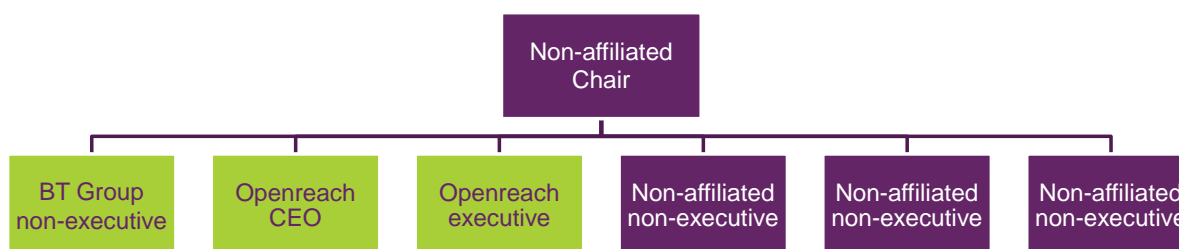
## Openreach Board

- 4.15 Under our proposed model, Openreach would have its own Board of Directors (the 'Openreach Board'). The Board's members would be subject to duties underpinned by company law. The Openreach Board would owe primary duties to Openreach under company law and be demonstrably independent of BT Group in areas where it has clearly defined delegations. Such delegations are set out in paragraphs 4.40-4.53. The Board would be tasked with the success of Openreach as a company, along with discharging Openreach's other purposes as set out in paragraphs 4.29-4.34, including acting in the interests of all customers.
- 4.16 We consider below the composition of the Openreach Board and the various governance arrangements that should apply to it.

### Board role and membership

- 4.17 In order to address our concerns, the overall membership of the Openreach Board would need to be sufficiently independent of BT Group plc, while at the same time avoiding significant and disproportionate costs. Our view is that to ensure the level of independence required to address our concerns, the Openreach Board would need to have a majority of non-executive directors who are not affiliated with BT Group. One of these directors would also chair the Openreach Board.
- 4.18 Non-affiliated non-executive directors on the Openreach Board could not be:
- A current employee of BT or Openreach
  - A former employee of BT or Openreach, except where that is necessary in ensuring the Board has specific expertise, and where Ofcom agrees that this does not create too great a conflict of interest
  - A non-executive director of BT Group, or any other company within BT Group
  - A current director or senior executive of any UK communication provider
  - A person with close family ties to any person falling within the categories above
  - An employee of Ofcom
  - A shareholder, or a representative / employee of a shareholder, in BT or any other UK telecoms or media company.
- 4.19 We recognise that BT Group directors have a legitimate interest in Openreach's activities, as the latter has the potential to affect the interests of the wider BT Group. Therefore, it is appropriate that BT Group should have a presence on the Openreach Board, but in a way that affords appropriate oversight without undermining the aim of achieving greater independence. We believe that the most effective way of achieving this would be the presence of a BT non-executive director on the Openreach Board.
- 4.20 Under our proposal, the Openreach Board would be completed by the presence of two Openreach executives, including the Openreach CEO. The overall composition of the Openreach Board is illustrated in Figure 3 below.

**Figure 4: Openreach Board membership**



Source: Ofcom

4.21 It would be for the Openreach Board to establish sub-committees. For example, this would include a committee responsible for ensuring compliance with regulatory obligations (see paragraphs 4.87-4.90 below). Depending on the purpose of each committee, Ofcom would need to be consulted to ensure the right membership in terms of independence.

### Appointments to the Openreach Board

4.22 Under our proposal, the appointment and removal of new directors would be carried out by BT Group. Ofcom would be consulted on the potential candidates during the process and appointments would not go ahead without our approval. Ofcom's role in approving appointments could be similar to the role of the Prudential Regulatory Authority, which approves appointments to senior management functions, including the directors and Chairman, of banks operating in the UK.

4.23 BT Group, Ofcom or other telecoms companies would not have a role in the appointment of any Openreach executives. This would be the responsibility of the Openreach Board. Once the Openreach CEO is appointed by the Openreach Board, they would then be responsible for the appointment of other senior Openreach executives. The Openreach Board would be responsible for removal of the Openreach CEO if their performance does not meet the required standards.

4.24 BT Group would continue to have a degree of control over the composition of the Openreach Board, both initially through its role in making appointments described above and more regularly through votes on the reappointment of directors at Annual General Meetings.

4.25 As the sole shareholder, BT would also have the ability to remove directors by resolution under company law. Clearly, we would be concerned were BT to use this control in a way that undermined the independence of the Openreach Board. However, given that this would be a drastic and clearly visible intervention, we think that the transparency of any intervention by BT Group would be sufficient protection from such actions.

### Openreach executives

4.26 In addition to ensuring that the majority of Openreach Board members are not affiliated to BT Group, it would be necessary to ensure that the Openreach Board is more independent operationally from BT Group plc on a day-to-day basis.

- 4.27 We are concerned that the current direct lines of executive reporting, from Openreach to BT Group, lack transparency and would undermine the effectiveness of our model. To ensure transparency, we start from the basis that all accountability from Openreach to BT Group should be mediated through the Openreach Board. This means that Openreach executives (including the Openreach CEO) would not have any direct lines of reporting into BT Group executives. The Openreach CEO will report directly to the Chairman of the Openreach Board.
- 4.28 There might be rare instances where executive reporting to BT Group is a necessary part of good corporate governance. Such reporting would need to be established after agreement with Ofcom.

## **Openreach's purpose and directors' duties**

- 4.29 To address our competition concern, Openreach's strategic and operational decisions must be taken in a manner that does not favour BT's own retail business. Our objective therefore is for the management of Openreach to have primary duties owed to Openreach and its success, but also to require them to ensure that Openreach acts in the interests of all customers equally when making strategic and operational decisions.
- 4.30 To achieve this, we propose that the Articles of Association make clear that the company's core purposes include acting in the interests of all customers equally. Openreach directors will therefore have to act accordingly. Under s.172 of the Companies Act 2006 where a company's purposes consist of or include purposes other than for the benefit of its members, the directors must act in the way they consider, in good faith, would be most likely to achieve those purposes
- 4.31 Note that this does not mean we expect Openreach to agree all proposals that are put to it. Openreach must retain discretion as to how best to allocate its resources between competing proposals from its customers, as well as any initiatives of its own. What matters is that it exercises that discretion in a manner that is receptive to the interests and needs of all its customers.
- 4.32 The Articles would also require the directors to ensure that Openreach complied with its regulatory obligations. Finally, the directors would also have the standard statutory duties that apply to all company directors, including a duty to promote the success of Openreach.
- 4.33 Taken together, we consider that when combined with other governance changes explained above, this would limit the extent to which the directors on the Openreach Board are obliged to act in the interests of BT Group.
- 4.34 We recognise that the proposed BT Group non-executive director on the Openreach Board would owe general duties to both BT Group and to Openreach. This could give rise to situations in which that person found themselves in a position of a conflict of duties as between Openreach and BT Group. We would expect any such potential conflict to be addressed by the relevant Boards who could, in accordance with s.175 Companies Act 2006, authorise how the director in question is to act in those circumstances. However, given the majority of non-affiliated, non-executive Board members, this one member would not be able to ensure the Board's overall decisions favoured BT Group.



## Greater consultation with customers on investment plans

- 4.35 One of our concerns is that Openreach does not currently consult sufficiently with all its downstream customers in the early stages of major network and product decisions. Therefore, alongside ensuring that Openreach can make strategic decisions related to the network independently, our proposal would impose a requirement on Openreach to consult in a sufficient, timely and transparent manner with all its downstream customers.
- 4.36 We are proposing to establish a formal process on this basis that would have three main elements:
- 4.36.1 An obligation for Openreach to consult formally on major investments in networks and products, and the development of new services before decisions (even in principle) are taken to invest. In practice, this would mean that Openreach has to run a transparent consultation process in the early stages of any major new Openreach developments. For example, by sharing and gathering feedback on its plans with customers through industry forums. The consultation process would be viewed in light of the duty placed on Openreach Directors to ensure the equal treatment of all its downstream customers.
  - 4.36.2 A new 'confidential' engagement phase where customers can discuss investment ideas with Openreach without this information being disclosed outside of Openreach employees. Here the Openreach Board could review and approve business plans developed by Openreach executives in conjunction with downstream customers. At this stage, information would only be disclosed to BT Group with the consent of the customer.
  - 4.36.3 Downstream divisions of BT Group would need to use the same process to initiate major new investments. BT Group would not be able to initiate new investment ideas outside this process. Openreach itself would be able to initiate major network investments or operational changes where this was in the interests of Openreach. For example, where pro-active maintenance was required to ensure good quality of service over the network.
- 4.37 Outside of this process, the Openreach Board or Executive would be responsible for close engagement with its downstream customers. For example, through regular senior management meetings with major communications providers or a standing item at Openreach Board meetings to hear representations from customers.

## Confidentiality obligations

- 4.38 Our proposal would prohibit Openreach and BT Group from sharing any information that is provided during confidential discussions between Openreach and its customers, except where explicit consent is given by the customer.
- 4.39 The sharing of other commercially sensitive information with BT Group would be established only by exception, subject to explicit agreement with Ofcom. This contrasts with the current position under the Undertakings, where the arrangements set out in Annex 2 allow a number of BT Group employees to access certain

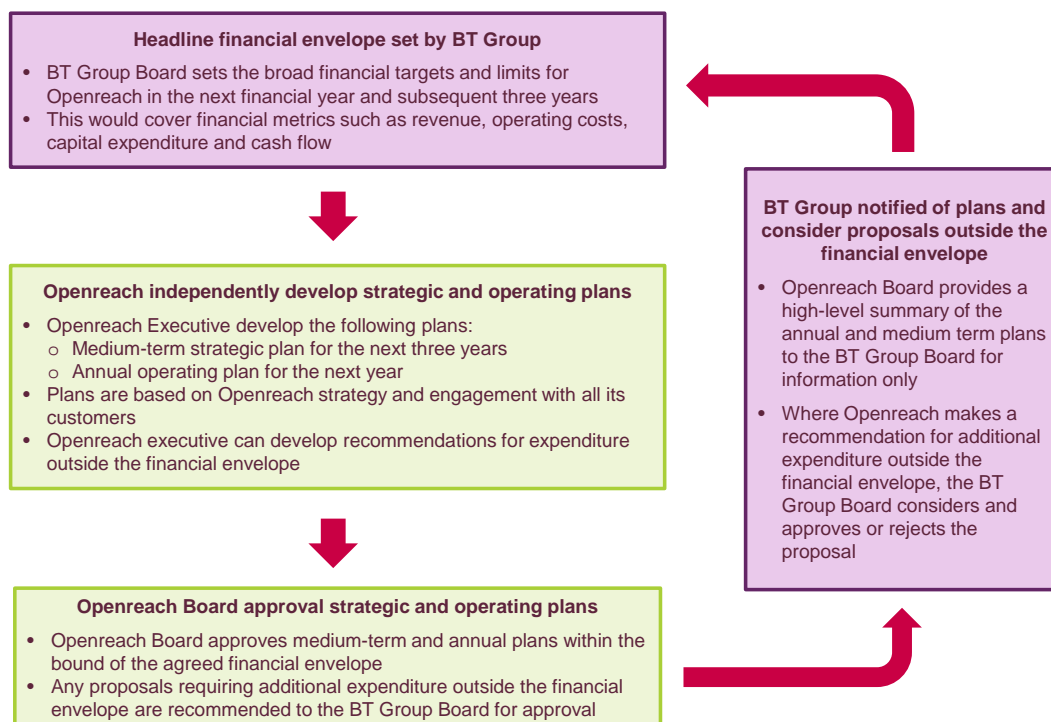
confidential customer information held by Openreach. This includes the BT Group plc Board, BT Group Operating Committee, as well as employees operating within specific functions, for example BT Group Strategy<sup>32</sup>.

## Greater independent financial control within an agreed budget

4.40 Openreach should have greater independent control over its strategy, operation and allocation of the agreed finances. This would require the Openreach Board to be given sufficient delegated authority on such issues within a financial envelope agreed with BT Group Board. The financial envelope and associated delegations to the Openreach Board would be significantly greater than the current level of delegation for the Openreach CEO, which requires any expenditure greater than £75m to be agreed by the BT Group Board.

4.41 Figure 4 below provides an indication of how this might work in practice.

**Figure 5: Indicative overview of process for Openreach strategy and budget setting**



Source: Ofcom

4.42 The following sections set out the principles to which these decision-making processes should adhere so that Openreach has the necessary degree of independence. As illustrated in Figure 4, we provide indications of how these might work in practice. However, the specific details of financial management and decision-making processes would be for BT to develop and propose to Ofcom.

## Openreach strategy and budget allocation within an agreed financial envelope

<sup>32</sup> [Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002](#), Annex 2.



- 4.43 Under our proposal, BT Group would retain oversight of Openreach performance through a financial envelope, initially set by the BT Group Board to the Openreach Board. The financial envelope would contain high-level financial metrics in a number of areas including revenue, operating expenditure, capital expenditure, profitability, and cash flow.
- 4.44 The overall aim of this approach would be to provide certainty for BT Group on the returns available to it from Openreach's activities, and define when the Openreach Board would need to return to BT Group for major variations (see below). Once agreed, delivery to the financial envelope would be delegated by BT Group Board to the Openreach Board, with some ongoing reporting processes (see below).
- 4.45 Once the financial envelope has been set, Openreach would independently develop its priorities, in the interests of all its customers. Openreach executives would develop a medium-term (e.g. three year) strategic plan, which would contain a committed strategy and financial budget for the first year and an outline strategy and financial budget for years two and three. The plans would be informed by the indicative headline financial envelope from BT Group.
- 4.46 Based on the priorities established in the three-year strategic plan, Openreach executives would develop an annual operating plan detailing the strategy and financial budget for the year ahead. We would expect this plan to be kept up to date by Openreach, for example on an annual basis and re-forecast at reasonable periods (e.g. twice a year).
- 4.47 It would be for the Openreach Board to decide the exact nature of the information contained in the strategic and annual operating plans. However, we expect that they would include key financial and operational metrics, such as product volumes, investment plans and cost forecasts. The priorities in the plans would be informed by consultation with Openreach customers on new products and major network investment decisions (see below on consultation processes).
- 4.48 Openreach executives would submit draft versions of the plans to the Openreach Board for review and approval. Once the detailed plans are agreed by the Openreach Board, a high-level summary of the key elements of each plan would be shared with the BT Group Board. Here the BT Group Board would have the opportunity to comment, but would not have a formal approval role on the detailed priorities chosen by Openreach, so long as the proposal was within the original indicative financial envelope.
- 4.49 Where major new investment proposals within the strategic and operating plans fall outside the indicative financial envelope, the Openreach Board would recommend these to the BT Group Board for approval, including more detail on the specific business case. This would follow the process for major variations or new investment proposals set out in paragraphs 4.54-4.66 below.

### **Openreach decisions within the financial envelope**

- 4.50 Within the financial envelope described above, the Openreach Board would hold executive powers of decision-making over Openreach's activities. Decisions would be taken in the interests of the legally separate Openreach and in a way that ensures equal treatment of its downstream customers. This means Openreach could take any decisions on the use of resources or nature of investment projects that does not materially vary the agreed budget. BT Group does not need to have direct control

over any of the decisions made by Openreach within this budget, as these are decisions for the Openreach Board.

- 4.51 In practice, we would expect the reformed governance and delegations to allow Openreach to take a range of decisions within an agreed financial envelope, with only high level BT Group oversight. Examples might include:
- The form, technical design and timing of significant access network investments that can be delivered within the agreed financial envelope. In this context, Openreach delivered its FTTC upgrade within the capital envelope defined by BT Group. BT has said it also plans to deliver G.Fast within a similar envelope in future<sup>33</sup>.
  - New strategic products and technologies or enhancements to existing products. For example, future variations of the VULA wholesale product for superfast broadband or Ethernet wholesale products used by businesses and other communications providers. This could potentially include new mobile backhaul products, designed in consultation with MNO customers.
  - Investments and initiatives relating to Openreach quality of service. For example, the allocation of capital towards proactive maintenance for the copper network or the provisioning of lines for new-build housing developments.
- 4.52 Openreach would have its own treasury function (i.e. own bank accounts) for the management of cash and financial risks within the boundaries defined in the agreed financial envelope. It would be responsible for ensuring that Openreach has the cash it needs to manage its day-to-day business priorities, but with cash returns returned to BT Group as agreed in the financial envelope.
- 4.53 If Openreach has its own treasury function, such that it collects its revenues from transactions with BT Group, this would create greater transparency on the transfer between Openreach and BT Group downstream divisions. In addition, it would place BT Group downstream divisions in a similar place to other communications providers because cash would need to leave their accounts for transactions with Openreach.

## **BT Group oversight of proposals and variations outside the financial envelope**

### New investment proposals

- 4.54 To ensure that the Openreach Board has sufficient independence, while protecting BT's duties as the ultimate shareholder, BT Group would need to have visibility of major investment or operational decisions that could have a material bearing on BT Group finances. It would also need to be able to decide whether or not to proceed with these.
- 4.55 We envisage that major decisions would be those with the potential for a material financial impact on the wider BT Group, such as a significant additional capex requirement or a decision with effects on BT Group assets and/or risks.
- 4.56 Such Openreach decisions would need to be recommended to the BT Group Board for approval. Where Openreach recommends a major decision, it would be an

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<sup>33</sup> <http://www.btplc.com/Sharesandperformance/downloads/PDFdownloads/q315-transcript.pdf>, p.7.

independent recommendation, free from the risk of undue influence from BT Group and its wider interests, including its own downstream operations.

- 4.57 Any decision by the BT Group Board not to proceed with such a recommendation would be transparent to the independent members of the Openreach Board. It would also be transparent to Ofcom, and be taken into consideration in Ofcom's ongoing reviews of the effectiveness of our preferred model (see Section 6).
- 4.58 Examples of the types of decisions that might require a recommendation from the Openreach Board to the BT Group Board include:
- Major access network investments where there is significant demand side risk, in the form of uncertainty on customer take-up or pricing, and where this risk would be borne by BT Group. An example would be a large-scale FTTP investment with returns dependent on high take-up or significant price premiums, or with no offsetting volume, revenue or capital expenditure commitments from downstream customers.
  - Major network transitions and closures where BT Group might bear the risk to overall asset values or claims of failure in delivering network services. For example, the closure of BT's traditional voice telephony network and a move to a new broadband based voice service.
  - Co-investment or minimum revenue guarantee business models where there is a risk that the third parties involved could fail, leaving BT Group bearing investment risk.
  - Co-investment business models, which resulted in shared ownership of new network assets as this would in effect change the underlying asset base of BT Group.
- 4.59 Any decisions requiring BT Group approval taken on these matters should be reported regularly by the BT Group Board and in a manner that is transparent to the Openreach Board and Ofcom in light of our overall monitoring and reporting. The overall nature and number of such decisions should be disclosed in either the Openreach or BT Group annual report.
- 4.60 Clear delegation rules would need to be established as a means of identifying which major Openreach decisions would require BT Group Board approval. For example, an upper limit for capital investments, with proposals over this limit requiring BT Group Board approval.
- 4.61 Our proposal does not seek to define these detailed delegations. Instead, we would expect BT to prepare governance rules that would define the delegations for decisions requiring BT Group Board approval. This could be similar to the governance protocol described in BT's plans (see Section 7). Such governance rules would be subject to consultation with Ofcom and once agreed made publicly available.
- 4.62 Where such major decisions were known in the annual planning process, BT Group oversight of these matters would be achieved through approval of the Openreach medium-term strategic plan and annual operating plan. Ad-hoc major decisions that emerge during the course of the plan (i.e. a new co-investment proposal from a downstream customer) would need to be recommended separately by the Openreach Board to the BT Group Board at an appropriate time.

## Performance variations

- 4.63 There may be circumstances within the year where Openreach seeks to go beyond or amend the financial envelope agreed with BT Group. This would most likely occur when the performance of Openreach in relation to key financial metrics, such as revenue, operating costs or cash flow, varies from the levels agreed with BT Group in the financial envelope.
- 4.64 As with major decisions requiring BT Group approval, we are not seeking to define the exact threshold above which variations from the financial envelope would require BT Group approval. As above, we would expect this to be set out in governance rules proposed by BT Group, subject to consultation with Ofcom. However, we would expect the Openreach executive and Board to follow the following principles:
- 4.64.1 For variances below a given threshold, Openreach executives would notify the Openreach Board and recommend action to address the variance. The Openreach Board would notify the BT Group Board of the action taken, but BT Group would not have a formal approval role.
- 4.64.2 For variances above a given threshold, Openreach executives would notify the Openreach Board and recommend action to address the variance. The Openreach Board would recommend any actions to BT Group Board for approval.
- 4.65 Alongside major decisions and variations to the financial envelope, there could be exceptional circumstances where BT Group would need to step in and retain oversight over specific aspects of Openreach's activities.
- 4.66 Such circumstances could include major underperformance by Openreach Board that exposes BT Group to significant risks, such as financial underperformance or failure to deliver minimum standards resulting in material fine risk. However, this could also apply to extreme performance issues outside of Openreach, for example the failure of a BT Group division, that challenge BT Group's overall financial viability and require access to Openreach cash or assets. Such circumstances have been rare since BT was privatised. As above, we would expect a defined list of circumstances where it would be appropriate for BT Group to exercise step-in rights to be proposed by BT Group in any detailed governance rules.

## **Regular reporting to BT Group on performance**

- 4.67 BT Group would retain oversight of performance against the agreed financial envelope through regular reports. This would also ensure that BT Group could be confident that Openreach is not incurring any significant unexpected risks while at the same time protecting Openreach's increased independence. This interaction between Openreach and BT Group would be mediated through the Openreach Board. As set out in paragraphs 4.26-4.28, outside of potential Openreach Board membership, we believe BT Group executives should have limited direct involvement with decisions made by and performance of the Openreach Board.
- 4.68 As an example, the Openreach Board would report to the BT Group Board on a quarterly basis with information on financial and operational performance against the objectives agreed in the Openreach strategic and annual operating plans. Such reports would highlight expected variations to the agreed overall plan in order for BT Group to manage potential risks for its shareholders, following the procedure for such variations set out above.

- 4.69 This reporting would reflect the normal process of performance reporting to shareholders for publicly listed companies, including reporting:
- At periods e.g. quarterly reporting
  - on financial performance against the agreed plan
  - on major risks faced by Openreach
  - on key performance indicators relevant to understand financial performance or risk
- 4.70 Key performance metrics would need to be defined based on the risks faced by the business. For example, metrics might include performance against minimum standards levels or connection rates for new networks where there is significant demand side risk for Openreach. The intention of this reporting would be to indicate overall performance against the plan; it would not be to give more detailed management information on performance. In particular, Openreach customer specific information, such as the share of new network connections by different downstream customers, would not be shared.

## Openreach employees

- 4.71 Our strong preference is that all the people that work for Openreach to be employees of the new company, rather than employees of BT Group. This should reinforce a more independent organisational culture within Openreach, focused on the equal treatment of all its downstream customers. It also ensures that there are no conflicts of interest, actual or perceived. For the same reasons, the remuneration arrangements of Openreach employees should remain solely related to the performance of Openreach, as established today within the Undertakings.
- 4.72 To achieve this, BT employees may need to be transferred to Openreach via the Transfer of Undertakings (Protection of Employment) Regulations (TUPE). The number of BT employees currently working in the Openreach division is around 32,000, approximately 30% of BT's workforce.<sup>34</sup>
- 4.73 We recognise that such a transfer would be a major undertaking and could have a knock-on effect on the BT Pension Scheme. In particular, BT plc is the entity to which the Crown Guarantee attaches in legislation. The effect of moving employees out of BT plc may be that, absent any changes, the future obligations BT Group has to the transferred members may not be covered by the Guarantee. Therefore, it is important that any transfer of employees is carried out in a way that seeks to mitigate any impact on the BT Pension Scheme. This is discussed in more detail in Section 5.
- 4.74 Where it is not possible or desirable to transfer employees given the potential associated costs, we would explore alternatives such as employee service agreements. This is where BT plc employees are contracted to work for and on behalf of Openreach.
- 4.75 We also understand and take seriously the concerns expressed to us by Prospect and the Communications Workers Union related to the transfer of employees from

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<sup>34</sup> See BT Group plc, Annual report and Form 20F 2016, p. 58.

BT to Openreach. We are keen that any reorganisation of BT Group does not limit career development or people movement, or change the position of existing employees for example on terms and conditions of employment. We do not believe that any of these outcomes need to be the case, and that BT Group can create Openreach as an incorporated company in ways that do not cause any detriment to current employees. These issues are also discussed in more detail in Section 5.

## Openreach assets

- 4.76 An important aspect of the new structure for Openreach is the status of its assets, for example, its physical network infrastructure and associated electronics. In considering the extent to which different classes of assets need to be owned by Openreach, our objective is to deliver on our goal of more strategic and operational independence, but avoid going further than is necessary.
- 4.77 Ownership of assets would make Openreach a more visibly independent business and ensure its ability to manage the strategy and operation of the network more independently. Given the aim of having an Openreach Board able to consider the interests of all its downstream customers, this board needs to be able to take effective investment and operational decisions that will enhance the services of its customers. The Openreach Board would also have duties to the overall success of the company, which would in part depend on its investment in and stewardship of Openreach assets.
- 4.78 Our starting position is that any assets critical to the Openreach Board in discharging its duties should be owned and operated by Openreach. To achieve this, our starting point would be to transfer those assets Openreach controls today under the Undertakings. These are the physical assets within BT's access network, and some transmission assets, mainly related to wholesale VULA products<sup>35</sup>. Transfer of non-network assets may be less critical, for example, property and fleet. These could be accessed based on supply agreements.
- 4.79 However, given the shared nature, and volume, of physical and electronic assets associated with operating the access network, identifying and dividing assets might create costs or complexity. Asset transfers into Openreach could also have implications for the financial position of BT Group and its ability to support and meet its liabilities, including the BT Pension Scheme (see Section 5).
- 4.80 Where significant costs or complexity might arise from asset transfers, we would consider alternative mechanisms to secure Openreach access to these assets that delivered similar outcomes in terms of operational control and investment incentives.
- 4.81 Such alternatives could be secured through contractual supply arrangements with BT Group, as witnessed for some products and services today. As long as the Openreach Board is set up to consider the interests of its downstream customers and the success of Openreach as a company, it should be incentivised to invest in new and improved networks and services to deliver on its customers' needs.

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<sup>35</sup> [Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002](#), Section 5. Access network refers to physical connections: ducting, copper and fibre. Transmission assets refers to electronic equipment that connects to this access network to deliver services, for example ADSL or VDSL electronic equipment.

## Increased Openreach resources and capability

- 4.82 Within the current structure of functional separation, we are concerned that Openreach may not have sufficient internal capability to develop its own technical and commercial strategy, and manage its own operational delivery in the interest of all customers. Openreach should not have to rely day-to-day on BT Group resources in these areas. Therefore, to ensure it is sufficiently independent, Openreach should have capabilities required to develop strategy and manage operational delivery without overly relying on BT Group.
- 4.83 Consistent with this aim, we are proposing a significant increase in the capabilities Openreach is able to draw on independently from BT Group. It would be for the Openreach Board and senior executives in the first instance to decide the level of Openreach resource required in each area, but we would expect to see a significant increase in independent capability and / or responsibility in key functions. For example:
- Strategy, technology and network development
  - Operational delivery
  - Commercial and external supply arrangements
  - Regulatory and public affairs
- 4.84 Where Openreach continues to receive services from other lines of business within BT Group or externally, the Openreach Board would retain responsibility for decisions on their use and delivery. Openreach must have sufficient internal capability to manage those relationships independently.

## Openreach to have its own brand, independent of BT

- 4.85 A number of the changes proposed are aimed at promoting and embedding cultural change in Openreach and how it engages with its customers. This aim is supported by a clearer sense of identity as a company, specific and clear governance local procedures, and the potential to move employees.
- 4.86 To further embed the cultural change and sense of independence among Openreach staff we are seeking, we believe Openreach should have its own brand, not associated with BT Group.

## Regulatory compliance ensured by the Openreach Board

- 4.87 In order to support the measures we are proposing to strengthen the independence of Openreach, we consider that it would be necessary to include a requirement that BT monitor compliance with these measures in order to provide transparency.
- 4.88 In our view, a sufficiently independent and appropriately constituted Openreach Board should be able to hold responsibility for regulatory compliance by Openreach. Under our proposal, we would require the Openreach Board to establish a sub-committee responsible for compliance. This sub-committee would be chaired by the Openreach Board Chair and the three other non-affiliated non-executives would be members.



- 4.89 The main duties of the sub-committee would be to review and report back on any alleged breaches of our proposed model of legal separation or complaints relating to Openreach's compliance. This would include regular reporting to the Openreach Board and Ofcom of the details of any breaches and complaints. The sub-committee would prepare an annual report reviewing Openreach compliance.
- 4.90 The sub-committee would need to be supported by an executive office, i.e. a function similar to that undertaken by the Equality of Access Office (EAO) today. The remit of this function would be to support the sub-committee in detailed matters relating to compliance.
- 4.91 Given that the responsibility for compliance would be held by the independent Openreach Board, our proposal does not include a continuing role for the existing Equality of Access Board (EAB) in relation to Openreach. In the event that the EAB was unwound, we would work through any current responsibilities of the EAB in monitoring regulatory compliance relating to BT Group (as opposed to Openreach specifically) that may need to pass to BT Group.

### **We have considered how this proposal would work for consumers and businesses in Northern Ireland**

- 4.92 As we set out in our February document, Northern Ireland differs from the rest of the UK in that the access network and wholesale telecoms services are managed by a single entity within BT - Northern Ireland Networks. Openreach does not exist in Northern Ireland.
- 4.93 We committed to considering whether these arrangements remain appropriate. As part of this process, we have engaged with competing providers in Northern Ireland, consumer representatives, BT and other stakeholders.
- 4.94 The current engineering practices in Northern Ireland, which depend on sharing engineering resources between BT's own operations and the functions it performs on behalf of Openreach, are working well. Currently, BT's quality of service performance in Northern Ireland consistently outperforms Openreach in Great Britain. Whilst stakeholders have raised concerns about consumer perceptions of the arrangements in place, we did not receive evidence of any problems caused by the model throughout the course of our engagement.
- 4.95 With respect to strategic and network investment decisions, we understand that BT Northern Ireland already has a significant degree of independence from the rest of BT Group. Decisions are made based on the interests of people and businesses in Northern Ireland. This approach is consistent with our proposals for BT's operations in the rest of the UK and we expect this process to continue. In addition, we expect Northern Ireland to benefit in the same way as the rest of the UK from our new proposed model of Openreach, under which strategic and network investment decisions and guidance relating to access and backhaul networks will reflect the needs of all UK consumers and businesses, and not just that of BT Group.
- 4.96 Given performance of Northern Ireland networks to date, discussions with other stakeholders, and given we expect some of the benefits of the new model of Openreach to spill over into Northern Ireland, we do not believe it would be proportionate to change the current arrangements. We will continue to monitor BT Northern Ireland's performance and regulatory compliance.



- 4.97 Just as BT Northern Ireland has adapted its operational processes to reflect more closely those of Openreach since the introduction of the Undertakings in 2005, we expect BT Northern Ireland to continue to improve its efforts in this respect, mirroring the new model as far as possible, and adopting similar principles insofar as it can.

## Section 5

# The potential cost of implementing our proposal

- 5.1 In this section, we consider the potential costs of implementing our proposal, and the likely impact of those costs.
- 5.2 We have designed our model in order to ensure that the costs are proportionate, in light of the benefits delivered. However, we are also aware that any effective model is likely to result in some costs being incurred. This was illustrated by the original creation of Openreach, in 2005, which generated costs in a number of areas, including IT systems, organisational change and rebranding.
- 5.3 The specific costs incurred, and their scale, vary significantly based on the detailed model of separation adopted. BT's pension scheme represents a significant cost to BT. If our proposal increased the risk for the BT pension scheme, this could lead to increased costs for BT. These have the potential to be the most significant cost item arising from our preferred model. In designing our preferred model, we have paid particular attention to the effect of our proposal in this regard.
- 5.4 Other potential costs include those related to:
- People costs beyond pensions
  - Assets and contracts
  - IT systems and processes
  - Tax

### **BT pension costs are a key consideration in any new model**

- 5.5 As noted above, the impact of our proposal on the BT pension scheme depends on, amongst other things, the Trustees' assessment of the risks facing the scheme. We recognise that some aspects of our proposal, such as incorporation of Openreach and the transfer of assets and people, could increase the Trustees' assessment of these risks.
- 5.6 We understand that there are ways to mitigate these risks. However, we also understand that this is ultimately a matter for the Trustees. If the Trustees were to conclude that some of the increased risk could not be mitigated, then it is possible that they would require further mitigation in the form of additional cash contributions. Given the size of the scheme, such contributions could be significant and could represent the largest single cost caused by our proposals.
- 5.7 As we set out above, our intention is not to undermine BT's ability to support and meet its liabilities. In the event that any increased risks resulting from our proposals could not be sufficiently mitigated, we are open to considering alternative approaches that would avoid incurring significant costs disproportionate to the benefits from any intervention.

### *Current status of the BT Pension Scheme*

- 5.8 The BT pension scheme (BTPS) is the largest private sector pension scheme in the UK, available to BT employees who joined the scheme until it closed to new members in 2001. Currently, the scheme has more than 300,000 members, of which 37,000 are active employees and still accruing benefits. It has a significant funding deficit, last valued in 2014 at £7bn.<sup>36</sup>
- 5.9 Its trustees rely on the sponsoring employer, British Telecommunications plc, to provide financial support to the fund; this is known as the employer covenant. The strength of the employer covenant relies on a number of factors including the size of BT's net assets, expected cash flows and profitability.
- 5.10 At present, BT's liabilities to the pension scheme are guaranteed by the Government (the Crown Guarantee) as a result of legislation in 1984 enacted on the privatisation of BT. The Crown Guarantee is only applicable in the (unlikely) event that it is wound up. In this case the Guarantee would mean the UK Government assumes BT's liabilities to the BTPS.
- 5.11 Under pensions regulations, the Crown Guarantee is not taken into account by the trustees in any valuation of the funding deficit, the investment strategy or the structure of the recovery plan. Nonetheless, we recognise that trustees and members place a significant value on the existence of the Crown Guarantee.
- 5.12 Our proposed model seeks to limit the potential effects on the pension by the fact that BT retains ultimate access, as the sole shareholder, to Openreach's activities, assets and cash flow
- 5.13 As noted above, the strength of the employer covenant (or the promise to pay pensions that are owed) relies on the assets, expected cash flows and profits available to the scheme. If a reduction in the ultimate control that BT has over Openreach means a reduction in access by the BTPS to the entire group's cash flow or assets, this could potentially have a significant impact on the BTPS investment strategy.
- 5.14 In this case, the trustees might seek a lower-risk investment strategy. This in turn could lead to a lower rate of return from its investments and a subsequent increase in the funding deficit. An increase in the deficit could have a significant impact on the ongoing costs of our proposal and would have to be dealt with as part of an ongoing pension recovery plan.
- 5.15 Therefore, a critical element in determining the scale of any potential costs is the extent to which the Trustees consider it essential that BT Group retains ultimate recourse to the assets and cash flow of Openreach to meet its pension obligations. As set out in Section 4, we have sought to design the governance structure for Openreach specifically to ensure that it can do so.
- 5.16 Where features of the proposal raise pension cost risks that cannot be effectively mitigated, we are open to considering alternative approaches. For example, were asset and employee transfers to trigger significant costs, we could consider alternatives around supply and employment agreements between BT plc and

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<sup>36</sup> [BTPS Annual Report and Accounts 2015](#).

Openreach that guaranteed access and operational control of core assets and people to Openreach. Similarly, if incorporation was shown unavoidably to trigger disproportionate levels of cost, we would reconsider our current proposal.

- 5.17 Below, we set out potential mitigations to pensions cost risks, and the linkage to the Crown Guarantee.

*Mitigations are available to address any costs not avoided through structure of the model*

- 5.18 While we believe that our model can address any substantive concern that might arise, we recognise that this is ultimately a matter of judgement for the trustees of the pension fund. Given their role, the trustees are likely to be cautious in applying their judgement, and are likely to take into account a range of factors, including the complexity of any new arrangements.

- 5.19 We have therefore taken expert advice to consider whether there are any further measures, which could be taken to mitigate any residual concerns. We draw on this advice below. Ultimately, it would be for BT to consider and implement any changes required to the pension scheme following negotiations with the Trustee of the BTPS.

- 5.20 The main risk mitigation is to keep the BTPS as close to its current structure as possible. Our proposal allows for BT plc remaining responsible for the entire scheme, covering scheme members' service benefits up to the point of further functional separation. Going forwards, Openreach could become a participating employer within the overall BTPS.

- 5.21 However, we recognise that BT's obligations to the scheme rely on Openreach's net assets and profitability. Therefore, our advisers have identified a number of mitigations involving guarantees of different types by Openreach to BT Group:

5.21.1 Openreach could provide a guarantee to British Telecommunications plc and the BTPS that in the event of insolvency of British Telecommunications plc, the BTPS would have a charge over any Openreach assets that are transferred from British Telecommunications plc to Openreach. In the case of insolvency, pensions contributions would be prioritised over any payments due to any other creditor. Given that under our model, Openreach does not have the ability to raise finance independently, there should be no conflict in the provision of this guarantee.

5.21.2 Openreach could provide assurances, known as 'negative pledges', to the BTPS that restrict certain actions by Openreach or ensure a minimum cash contribution to British Telecommunications plc, to allow BT to meet BTPS contributions. This would be consistent with our proposal in Section 4 as we recognise that BT Group needs certainty on the returns available from Openreach's activities.

5.21.3 Other possible mitigations could include maintaining the BTPS governance structure such that the trustees are able to handle pension scheme negotiations with multiple employers (i.e. British Telecommunications plc and Openreach).

5.21.4 Additionally, a non-compete agreement between BT and Openreach could be put in place, although we would have concerns if this prevented joint ventures between Openreach and other communications providers.

- 5.22 We recognise that these forms of agreement are likely to be highly detailed and complex. They would need to be reached via detailed negotiation between BT and the BTPS trustees. However, drawing on advice from a range of experts, we understand that these types of contractual pledges and guarantees are commonplace in the industry.
- 5.23 It is possible in principle that even with such mitigations exhausted, the Trustees may consider there to be some residual risk. The final mitigation available would be a one off or recurring cash payment from BT Group into the Scheme. Even if the residual risk is small, the size of the Scheme means that the potential payment may be significant. As we work through the detail of our proposals, a core aim will be to minimise any such costs, and ensure that it does not have a material impact on BT's broader investment programme.
- 5.24 An alternative approach to ensure maintained protection for Openreach employees who are members of the BTPS would be not to transfer Openreach employees to the new company, but create an employee service agreement. Such an agreement would mean employees continue to stay within BT plc formally, but would work entirely within Openreach, and be managed by Openreach executives through the service contracts. Continued employment by BT would mean Openreach employees would stay in BT and a re-charge system could be put in place, such that Openreach paid BT for their employees' services.

#### *Issues arising from the Crown Guarantee*

- 5.25 As set out above, the Crown Guarantee applies to the liabilities of British Telecommunications plc in the unlikely event that BT is wound up. We have received advice that future liabilities (for example, payments to fill a funding gap) of a legally separate Openreach to the BTPS would not automatically be covered by the Crown Guarantee. The treatment of future liabilities with respect to the Crown Guarantee will have a bearing on all members of the scheme as contributions from both BT plc and Openreach will contribute to the funding of benefits.
- 5.26 The status of the Crown Guarantee is a matter for Government. We will be working with Government to consider further the implications of our proposals for the Crown Guarantee. It is not our intention through this proposal to affect the benefits or protections for any members of the BTPS.

#### Other employee costs (non-pensions)

### **We expect some other costs to arise from transferring employees to Openreach, but there are mitigations**

- 5.27 There are approximately 32,000 BT employees currently working in the Openreach division – around 30% of BT's workforce.<sup>37</sup> As set out in Section 4, our starting point is that these should be employees of the new company, rather than employees of BT Group plc.
- 5.28 In addition, enhancing Openreach's strategic or operational decision-making capabilities may require the transfer of some staff from other business units, including Group functions, or hiring of new staff.

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<sup>37</sup> See BT Group plc, Annual report and Form 20F 2016, p. 58.

- 5.29 There are likely to be one-off costs of administering and managing this transfer. These could include the costs of TUPE<sup>38</sup> consultation and administration, transferring employee records, change management, discussions with unions and retention payments.
- 5.30 In addition to these direct costs, we recognise that employees of BT would be concerned if the transfer resulted in changes to their terms and conditions of employment, or limited their options for career development. We have discussed these concerns with the Communications Workers Union and Prospect, who represent employees who might be affected.
- 5.31 We understand and take seriously the concerns expressed to us by Prospect and the Communications Workers Union in relation to the possible transfer of employees from BT to Openreach<sup>39</sup>. Our proposal would not require, or intend to result in, any changes to the terms and condition or benefits of employment for current Openreach or BT staff. We believe that our proposal would allow BT to address fully these concerns, whilst recognising that employment matters are not for us to decide. BT could, for example, provide guarantees as to terms and conditions, and put in place arrangements for job vacancies in Openreach and the rest of BT to be advertised to all employees.
- 5.32 In the event that employee transfers were likely, however, to trigger significant costs, we would consider (as set out in Section 4) alternatives such as employee service agreements between BT plc and Openreach.

### Assets and Contracts

#### **Our proposal could give rise to costs related to assets and contract transfers, but we consider that there are a number of mitigations to reduce them**

- 5.33 BT Group currently manages the contracts for the various services used by Openreach. Examples include labour outsourcing, infrastructure systems and systems licences. It also handles agreements on wayleaves and property leases used by Openreach. Under our proposal, there would potentially be the need to change the contracting party from BT plc to Openreach. This might cause one-off administration and legal costs. Specific examples where this could arise are where:
- contracts with customers and suppliers that are relied on by Openreach are in the name of BT rather than Openreach;
  - wayleave agreements with landowners are currently made with British Telecommunications plc rather than Openreach; and
  - leasing conditions of BT's UK properties are subject to a sale and leaseback agreement with a third party company. Openreach uses or occupies the vast majority of BT's UK properties but the agreements are in the name of BT.
- 5.34 In the examples above, legal separation of Openreach could result in costs associated with negotiating consents and restructuring the agreement with the third

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<sup>38</sup> TUPE refers to the *Transfer of Undertakings (Protection of Employment) Regulations*.

<sup>39</sup> Letter from CWU and Prospect to Ofcom, *The Ofcom DCR and the future of BT*, 25 January 2016.

party property company. Subject to the type of lease arrangement agreed, stamp duty may be payable. This is also discussed in the tax section below.

- 5.35 On an ongoing basis, there could be a loss of scale economies in relation to future procurement contracts where these are negotiated with a smaller Openreach entity rather than the larger BT Group.
- 5.36 There might also be additional one-off costs relating to separating network assets and transferring ownership to Openreach. Where assets are used by both Openreach and the rest of BT it may be particularly challenging to i) identify and value the specific assets that should be transferred to Openreach and ii) agree and put in place arrangements for other parts of BT to use those assets where necessary.
- 5.37 We consider that there are options to reduce potential costs. For example, there may be a possibility of seeking consent to include Openreach in existing agreements where possible, which would be a less onerous process than negotiating new contracts.
- 5.38 In addition, we understand that a number of current wayleaves agreements could potentially be re-assigned to any company that takes over BT or any contractors employed by BT<sup>40</sup>. In such a case, a notification to the landowner may suffice, resulting in a much lower cost for the transfer of wayleaves from BT to Openreach. However, we will need to understand the details of the agreements to determine how many agreements can be dealt with in this way. As set out above, our proposal is clear that we would consider alternative options to specific asset transfers if it was shown to raise significant costs or practical challenges.

## IT systems and processes

### **Our proposal may incur some IT costs but we envisage that the existing separation of systems would generally be sufficient**

- 5.39 The current Undertakings place a number of obligations on BT in relation to the separation of its IT support systems. The obligations range from physical separation of systems to implementing controls over shared systems so that users only have access to data relevant to their role and line of business.
- 5.40 The separation of IT systems, including some physical separation requirements, was potentially one of the largest cost items arising from the TSR. BT said that it spent in the region of £1bn achieving the physical systems separation under the Undertakings.<sup>41</sup> We recognise that further systems separation could be complex, costly and come with a number of risks.
- 5.41 Today, compared to 2005, IT systems can be increasingly separated 'logically', to support the independence of different divisions. While full physical separation of IT systems could provide an additional layer of protection, the associated costs are unlikely to be proportionate. We therefore envisage that the existing separation of systems would generally be sufficient.

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<sup>40</sup> Extract from BT's standard A1000 wayleave agreement: In reference to British Telecommunications plc: "*The term 'us' includes anyone who takes over our business, and our contractors*". Available at <https://www.openreach.co.uk/orpg/home/contactus/wayleaves/wayleavesfaqs/wayleavesfaqs.do>

<sup>41</sup> [BT's response to Ofcom's discussion document](#), p. 91.

## Tax

### **Some tax costs might arise relating to asset transfers and leases**

- 5.42 A number of tax costs could potentially be incurred if Openreach were set up as a legally separate subsidiary. The amount of tax payable would depend on the nature of any assets transferred and the model of governance applied to Openreach. We have considered three broad areas of tax-related costs:
- **Corporation tax** which includes;
    - taxable gains on any assets transferred, which could arise if Openreach is not considered to be part of the BT tax group. BT needs to have a beneficial ownership in Openreach for it to be included in the same tax group;
    - accelerated payment of deferred tax liabilities, which could occur if HMRC considers that the existing trading activities of British Telecommunications plc as a standalone company have ceased and a new trade has commenced; and
    - reduced tax relief from the Patent Box regime, which BT Group currently benefits from.<sup>42</sup>
  - **Stamp duty land tax (SDLT)** may arise where land and buildings are transferred into Openreach due to the structure of the sale and lease back transaction entered into by BT in 2001.
  - **Business rates** could also be affected by the separation of Openreach. BT pays business rates<sup>43</sup> on both non-operational properties, such as its offices and workshops, and on its 'cumulo' assessment. BT's cumulo assessment covers the business rates it pays on operational properties (mainly exchange buildings) and its other rateable network assets which include its duct, fibre, copper, cabinets and payphones.<sup>44</sup> BT's cumulo rates are assessed and administered by different organisations across the UK. In England and Wales rates are assessed by the Valuation Office Agency (VOA) whereas in Scotland it is the Assessor.
- 5.43 Given that our proposal would see BT retain its shareholder rights in respect of Openreach, we do not consider that BT would incur significant corporation tax costs. We expect Openreach to remain part of the BT tax group and, as such, taxable gains on any transferred assets would not become payable. We also consider that it is unlikely that HMRC would consider the existing trading activities of British Telecommunications plc to have ceased and therefore payments of deferred tax liabilities are unlikely to be accelerated.
- 5.44 However, we recognise that there may be some tax costs incurred. The separation of Openreach would require an assessment of whether the existing Patent Box benefits

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<sup>42</sup> The Patent Box is an agreement with HMRC where income from patents is taxed at a lower rate than the standard corporation tax rate. See <https://www.gov.uk/guidance/corporation-tax-the-patent-box>.

<sup>43</sup> Non-domestic rates.

<sup>44</sup> [BT Cumulo Rates, Non-confidential version of BT presentation to Ofcom](#), August 2011.



can be maintained either by the group or separately within Openreach and the rest of BT.<sup>45</sup> Additionally, to the extent that land and buildings are transferred into Openreach under our model, stamp duty may be payable. However, as we say in Section 4, it may be less critical for Openreach's independence to transfer non-network assets such as property and fleet to Openreach. These could be accessed based on supply agreements instead, if significant costs were incurred in the transfer of property assets.

- 5.45 Establishing Openreach as a separate legal entity would be unlikely to change the way BT's non-operational properties are assessed but could affect the way assets within BT's current cumulo assessment are valued. BT's current cumulo assessment might need to be split between Openreach and the rest of BT. This might be a significant task for both the rating authorities (such as the VOA) and BT. It is unclear what the impact would be on the total business rates paid on assets occupied by Openreach and those occupied by the rest of BT plc. However, any changes in asset ownership would be unlikely to change the business rates paid as business rates are assessed on occupation rather than ownership.

### Financing

- 5.46 We consider that the impact on BT's financing costs, such as its credit rating and ability to raise finance, would be limited since our proposal sees BT retaining ultimate access to Openreach cash and assets and does not envisage Openreach raising its own debt.<sup>46</sup> There may be some costs associated with payments to bondholders and other providers of finance to the extent that the relevant agreements include provisions restricting the transfer of parts of the business to subsidiaries.

### **BT has estimated a range of costs under its own set of scenarios**

- 5.47 BT has confidentially provided us with a range of costs that it estimates would be incurred under different models of separation. These models assume differing levels of control for BT Group, ranging from simple incorporation, and running up to and including a full demerger.
- 5.48 While we broadly agree with BT on the cost categories, which may arise as a result of making Openreach more independent – see discussion above – BT's cost estimates are not specific to our preferred model. In addition, BT's estimates do not include any of the mitigations, discussed above, particularly for pensions.

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<sup>45</sup> We understand that tax costs associated with the Patent Box regime may arise if patents are transferred into the new Openreach subsidiary.

<sup>46</sup> We recognise that if our proposal resulted in a significant reduction in control, for example sufficient to cause the deconsolidation of Openreach from the group accounts, then the impact on BT's financing costs could be greater, including impacting its credit rating and breaching existing debt covenants. Also, if Openreach was incorporated as a subsidiary of a BT Group company other than BT Telecommunications plc this could lead to additional financing costs.

## Section 6

# Measuring the success of our proposal

- 6.1 The real test of whether this model is effective is whether it delivers the outcomes we intend. We set out these outcomes in this chapter, to provide a basis for subsequent review.
- 6.2 The positive outcomes that we would expect to see from our proposal, if implemented, fall into three broad categories:
- i) Openreach behaviours, in particular its responsiveness to customers;
  - ii) Industry outcomes, in particular levels of competition, investment and innovation; and
  - iii) Consumer and business outcomes, including availability, quality, choice and pricing of services.
- 6.3 The ultimate aim of our strategy is better outcomes for consumers and businesses. We recognise that these outcomes are not solely under the control of Openreach, but they are still a critical part of our assessment, since they are the ultimate goal of our intervention.
- 6.4 We discuss these different types of outcomes in turn below.

## **We propose to use a number of measures to assess Openreach behaviours and its responsiveness to customers**

- 6.5 One of the most important measures of success of our proposal is our ability to assess whether Openreach Board decisions are taken in an independent manner, without undue influence from BT Group. The increased transparency resulting from the new governance processes will be one of the most important aspects of this assessment. We propose also to seek evidence from customers on the responsiveness of Openreach, in particular to new investment ideas and new models of co-investment.
- 6.6 In practice, there are a number of measures of success against which we propose to judge how effective our model is in addressing the concerns we have identified. Some examples include:
- 6.6.1 The ability for Ofcom to assess whether Openreach Board decisions are taken independently, without undue influence from BT Group
  - 6.6.2 Evidence from customers on the responsiveness of Openreach, in particular to new investment ideas and new models of co-investment
  - 6.6.3 Whether Openreach has the necessary commercial and technical resource required to deliver its priorities in the interests of all its customers
  - 6.6.4 A published Openreach annual report, setting out how Openreach has determined its priorities and what it has done to deliver these

- 6.6.5 Compliance with rules related to the proposed model, in particular those rules relating to new governance arrangements for Openreach

## **A more independent Openreach would support positive industry outcomes in terms of competition, investment and innovation**

- 6.7 Our proposals on Openreach would support improvements for consumers and business by:
- maintaining the intensity of competition as new superfast and ultrafast broadband networks emerge;
  - supporting new models of investment and better targeted investments in communications networks and products; and
  - enabling further innovation and differentiation of communications services for consumers and businesses.
- 6.8 Given the importance of the communications sector to both UK society and the economy<sup>47</sup>, the current risks of poorer investment choices, less effective competition and less innovation could ultimately have a substantially negative effect on outcomes for consumers, businesses and the UK more generally.
- 6.9 Our proposal is designed to minimise these risks. It should ensure that the interests of the wider communications sector are reflected in investment decisions, reducing the risk of investment and operational decisions that do not effectively consider the needs of the entire UK, its nations and regions.

### **Maintaining the intensity of competition as new superfast and ultrafast broadband networks emerge**

- 6.10 As the technology underlying networks and services continues to evolve, we must safeguard against the risk that technology choices are made which result in less effective retail competition. Our proposal should reduce BT's ability to influence the design of and investment in services in a way that makes them more favourable to the retail arms of BT, such that BT Group as a whole is in a competitively

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<sup>47</sup> The Office for National Statistics (ONS) estimates that in 2014 the value added by the UK communications industry was over £29 billion – or 1.8 per cent of the UK's Gross Value Added ([Data tables UK Non-Financial Business Economy, June 2016](#)). By comparison, the combined radio and TV sector contributed less than 1 per cent. Analysis by SQW ([SQW, UK Broadband Impact Study](#)) in 2013 estimated that the impact of faster broadband speeds could add up to £17 billion to the UK's Gross Value Added over a twenty-five year period. Similarly, a study by KPMG ([KPMG, Delivering Britain's Digital Future: An Economic Impact Study](#)) on behalf of BT estimated that the introduction of the G.Fast technology to improve broadband speeds could add a total of £20-30 billion to UK GDP. An Oxera study for Virgin Media ([Economic effects of Virgin Media's investment in network expansion](#)) also suggested that Virgin's £3 billion investment in Project Lightning will have a combined effect of £7.7bn on the economy, consumers and businesses. Clearly, measuring just how much communications services have contributed to economic growth is far from straightforward. Most studies do suggest however that the pervasive influence of communications on all sectors of the economy means that the continued development of communications networks is important if the UK is to maintain its position as one of the World's leading industrialised nations.

advantageous position. It should therefore ensure that in making decisions of this nature, UK consumers and businesses drive this rather than BT Group.

- 6.11 By giving potential entrants confidence that Openreach will treat all downstream customers equally in reaching network decisions, the measures should foster a greater degree of competition at the retail level. This is because wholesale customers should be better able to tailor their services to what their retail customers demand, therefore making them better able to act as a competitive constraint on BT's downstream operations.

### **Supporting new models of investment and better targeted investments in communications networks and products**

- 6.12 Increasing Openreach's independence and embedding a commitment to consult should ensure that investment decisions reflect all downstream customers, not just BT Group. This should lessen the risk of investment choices being made that are skewed towards minimising competition, reducing the risk of disrupting existing investments or focused on a subset of UK consumers and businesses, rather than for the benefit of the UK as a whole.
- 6.13 The proposal should also result in new models of investment, by making Openreach a much more attractive and open partner for risk-sharing and co-investment opportunities. These make it easier to deploy new networks, including those based on fibre to the home. This is because they allow the demand from different providers to be aggregated, thereby making it easier to achieve the necessary penetration for such deployments to be profitable, and they spread the associated risk across multiple providers.
- 6.14 The proposal may additionally have a subsequent positive impact on investment incentives for non-BT network providers if it promotes competition for service quality or functionality, in some geographic areas. For example, current network owners may be incentivised to invest more in their infrastructure to compete with any investment that Openreach makes to improve its network because of the threat of losing wholesale customers to a better Openreach network. To the extent that these investments would not be made under the current regime of functional separation, they would be additional indirect benefits from our proposed model.

### **Enabling further innovation and differentiation of services for consumers and businesses**

- 6.15 An Openreach that is responsive and works constructively with all its downstream customers on its investment and operational choices will be better placed to support continued retail innovation and differentiation in services. This can then support a more diverse range of services, tailored for the needs of an increasingly diverse base of UK consumers and businesses.

### **Consumers and businesses should benefit from better services and continued choice because of our preferred model**

- 6.16 We want to ensure consumers and businesses can benefit from the widespread availability of improving networks and services. It is these networks and services, which will support an increasingly digital UK society and economy. In order to deliver such good headline outcomes, we need to see:

- increasingly high quality fibre broadband services, delivered by faster and more reliable networks, driven by actual consumer and business demand;
- continued choice in who provides consumer and business broadband, and by extension, an increasing range of over the top services;
- innovation and differentiation in how services are delivered, packaged and priced, matching the needs of an increasingly diverse UK society and economy; and
- competitive prices for communications services.

6.17 As noted above, we recognise that consumer and business outcomes are not completely under Openreach's control. These positive outcomes for consumers and businesses will therefore be complemented by our wider programme of work under the DCR strategy. Specifically, consumers and businesses should benefit from:

- a renewed emphasis on competition between different networks (through duct and pole access and regulated pricing decisions), so that consumers and businesses are not just dependent on Openreach for their communications services;
- universal availability of fixed and mobile services, delivered via a new universal right to decent, affordable broadband for every household and small business in the UK; and
- a step change in quality of service, with tougher quality of service standards for Openreach, published performance data for all operators, and automatic compensation if things go wrong.

6.18 We will continue to monitor and report on consumer and business outcomes in fixed telecoms services, including metrics such as availability, speed, quality, reliability, consumer satisfaction and switching. These will be delivered through our annual publications, including the Connected Nations Report, Quality of Service Annual Report and Communications Market Report.

## **We propose to monitor and review the implementation and success of our model over time**

6.19 In order to gauge the success of our proposed model, we will publish periodic implementation reports. These will initially be published every six months, and then annually.

6.20 If these implementation reports suggest that the model is not delivering on the outcomes which we have set out here, we would carry out a more detailed review. The core question for that review would be whether legal separation is still a workable solution to our competition concerns, or whether it is necessary to move to a model based on full structural separation.

## Section 7

# BT's Proposal

- 7.1 We noted in February that we were open to voluntary proposals from BT, but that these must effectively address the concerns we have identified. At this time, BT had made an informal proposal which in our view did not go far enough.
- 7.2 Since February, we have continued to discuss BT's informal proposal with the company. On 18 July 2016, BT submitted to us a further proposal, which it intends to implement, for an enhanced form of functional separation<sup>48</sup>. This retains the existing model of Openreach as a division within BT Group, but with enhanced governance arrangements and strategic capability.
- 7.3 BT has notified its plans to Ofcom under the Communications Act 2003, and has made an accompanying application to vary its Undertakings under the Enterprise Act 2002.
- 7.4 This section briefly describes BT's plans and considers how they compare to our proposal.

## Summary of BT's plans

### **BT intends to leave Openreach as a functionally separate division, governed by a new committee of the BT plc Board**

- 7.5 BT does not plan legal separation of Openreach from British Telecommunications plc (BT plc). Instead, BT intends that Openreach remains a business unit of BT.
- 7.6 BT proposes to establish an 'Openreach Board' as a committee of the BT plc Board. The committee will not be a formal Board of Directors recognised under corporate law, but BT will refer to it as a board<sup>49</sup>. This committee will have delegated authority to operate Openreach in accordance with the terms of a Governance Protocol, comprising:
- 7.6.1 The terms of reference for the Openreach committee;
  - 7.6.2 The duties of the Openreach executive management team; and
  - 7.6.3 Delegations to the Openreach committee and matters that are reserved for the BT Group plc Board and the BT plc Board.
- 7.7 The Governance Protocol is described in more detail below. It will be put in place by amendments BT intends to make to the Articles of Association of BT plc. In addition, BT has set out details of an enhanced customer consultation procedure and enhancements to Openreach resources and capability.

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<sup>48</sup> [BT Proposal](#), 18 July 2016.

<sup>49</sup> Article 17.5 of the British Telecommunications plc Articles of Association says: "A committee or sub-committee of the Board can be called a "board" or a "council" or any other name the board decide.

7.8 Below we set out some key features of the BT Notification.

### **Openreach purpose, committee duties and members' duties**

- 7.9 As a business division, Openreach will not have its own Articles of Association – it will operate under the Articles of Association for BT plc which will be amended specifically to reflect Openreach's purpose and delegate authority to the Openreach committee. BT intends that Openreach's purpose, the committee's duties and committee members' duties are governed by the Governance Protocol. This protocol is given effect through the BT plc Articles of Association. The BT plc Articles of Association will be amended to include the delegation of specific powers, authorities and discretion in respect of the management and operation of the Openreach line of business. The specific powers and responsibilities of the committee are summarised below.
- 7.10 The BT plc Articles of Association will further set out the obligation of the Openreach committee to treat all customers equally, particularly with regard to customer consultation, strategy and investment decisions (in terms of the process followed). In addition, the Openreach committee will be required to ensure that Openreach complies with its regulatory obligations in relation to equivalence of inputs as a remedy for SMP and that Openreach treats all customers equally. A further duty of the committee will be to consider and address as appropriate representations from Communications Providers, Ofcom and other stakeholders.
- 7.11 Under the Governance Protocol, each member of the Openreach committee will owe duties in respect of Openreach, including (amongst others):
- 7.11.1 To act within the powers of the Governance Protocol and the BT Governance Policies;
  - 7.11.2 To promote the success of Openreach with regard to (inter alia) the long-term consequences of any decisions, the interests of BT employees working for Openreach, and the need to foster relationships with suppliers, customers, and others;
  - 7.11.3 To exercise its own independent judgment and avoid conflicts of interest; and,
  - 7.11.4 To act in the best interests of BT plc and its shareholders.

### **Openreach committee membership and appointments**

- 7.12 Under the Governance Protocol, the Openreach committee will consist of:
- 7.12.1 An independent Chairman appointed by BT Group plc following consultation with Ofcom (who can also be removed by BT Group plc);
  - 7.12.2 Three independent non-executives<sup>50</sup> appointed by the Openreach committee, following consultation with Ofcom and the BT Group plc

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<sup>50</sup> Under the Governance Protocol, independent non-executives shall not be (inter alia): an employee or former employee of BT (within the last five years); a material shareholder (directly or indirectly) in

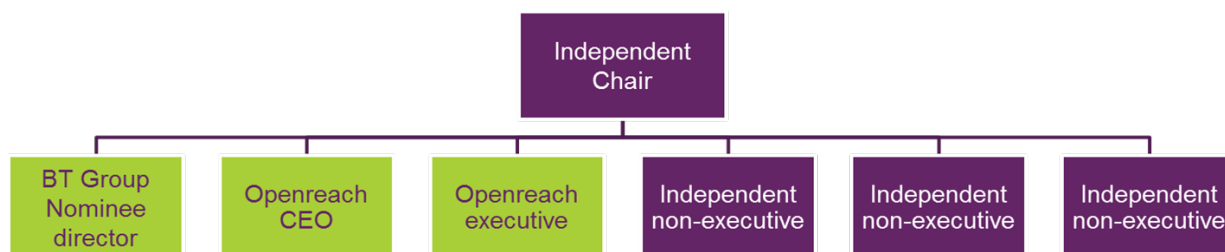


nominating and governance committee (who can be removed by the Openreach committee);

- 7.12.3 One BT nominee member appointed by BT Group plc, without consultation with Ofcom (who can also be removed by BT Group plc);
- 7.12.4 The Openreach CEO who is appointed (and can be removed) by BT Group plc CEO, without consultation with Ofcom; and,
- 7.12.5 One further Openreach executive who is appointed (and can be removed) by the Openreach committee on recommendation of the Openreach CEO, without consultation with Ofcom.

7.13 This is set out in Figure 5 below:

**Figure 6: Openreach committee set out in the BT Notification**



7.14 The Openreach committee will aim to reach decisions on a unanimous basis. Where it is unable to do so, decisions will be made on a majority basis. The Openreach CEO will report to the BT Group plc CEO, and also be accountable to the Openreach committee for ensuring the Openreach Executive's duties are carried out and be responsible for promoting the success of Openreach. The Openreach CEO will not be a member of the BT Group Operating Committee, but may attend its meetings where matters relating to Openreach are discussed and where it is appropriate to do so.

7.15 The independent Openreach Chairman will report to the Chairman of the BT Group plc Board following each Openreach committee meeting and the minutes of the Openreach committee will be shared with the BT Group plc Company Secretary, CEO, and CFO. Such information-sharing may include confidential information pertaining to Openreach.

**Increased Openreach decision making on strategy and budget**

7.16 The Openreach committee will have delegated authority for the strategy and operational performance of Openreach, subject to the Governance Protocol and matters reserved to the BT Group plc and/or BT plc boards.

7.17 In particular, the Openreach management team (the Openreach Executive) is responsible for:

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BT Group plc or any other Communications Provider; a director, senior executive or employee of any Communications Provider; or an Ofcom employee.

- 7.17.1 **Medium term strategic and financial planning:** the annual production of a medium term plan (MTP) and budget which will include the Annual Operating Plan (AOP), which is a detailed plan for the first year, and outline strategic plans and budgets for subsequent years. The Openreach management team will develop the MTP and AOP based on indicative targets for revenue, EBITDA, capex, and cash flow proposed by the BT Group plc Board. It will submit the draft MTP and AOP to the BT Group plc CEO and CFO for review, before submitting them to the Openreach committee for review and approval.
- 7.17.2 **External engagement:** engagement with Openreach's customers and other stakeholders (including Ofcom) and their issues and concerns; and,
- 7.17.3 **Major operational and investment business case development:** the development of plans for major decisions including form, technical design and timing of access network investments, new products and technologies and the timing and prioritising of product, system and process investment.
- 7.18 The main matters and duties for the Openreach committee are:
- 7.18.1 **Approval and submission of the MTP and AOP:** the Openreach committee shall review and approve the MTP and AOP and submit a high-level outline of the MTP and AOP to the BT Group plc Board for approval.
- 7.18.2 **Achieving agreed financial and operational performance:** the Openreach committee is responsible for the Openreach Executive's ability to execute the agreed AOP and MTP including in relation to quality of service, investment and productivity. As part of this, the Openreach committee must ensure Openreach delivers a high quality of service in compliance with regulation and in fulfilment of Openreach's customers' needs, and to ensure that this objective is captured in the AOP and MTP.
- 7.18.3 **Recommending investments outside of the MTP and AOP:** the Openreach committee can recommend:
- a) to the BT Group plc Board for approval strategic investment proposals outside of the MTP and AOP greater than £100m
  - b) to the BT Group plc Board for approval strategic investment proposals or significant strategic importance; or
  - c) to the BT Group plc CEO and CFO for investments less than £100m.
- 7.18.4 The Openreach committee can also request additional capital from BT Group plc (incremental to the MTP and AOP) for the purposes of specific investment opportunities identified by Openreach as benefiting Openreach's customers, even where such an investment opportunity would otherwise be net-present-value negative for Openreach.
- 7.18.5 **Regulatory compliance:** the Openreach committee is responsible for BT plc's compliance with its regulatory obligations in relation to Openreach. Practically, this is to be achieved through the creation of a compliance committee, as described below.

- 7.19 In addition, the Openreach committee will ensure that customers are treated equally, report to the BT Group plc CFO on the financial results of Openreach and engage with Ofcom (including annual joint Openreach and Ofcom “board-to-board” meetings if requested by Ofcom).
- 7.20 BT plc will ensure that Openreach controls and operates Openreach's assets and liabilities in accordance with the direction of the Openreach committee, provided that those directions are in accordance with the Governance Protocol and the Undertakings and that Openreach is operating within its authorised AOP and MTP.

### **Greater consultation with customers**

- 7.21 BT plc (through the Openreach committee) must ensure that Openreach treats all its customers equally. There will be a formal process for consulting its customers in the early stages of significant investment decisions related to the future development of its network. This process will be imposed on the Openreach executive and the Openreach committee under the Governance Protocol which provides for the following process:
- 7.21.1 A confidential phase during which communications providers can discuss investment ideas with Openreach without this information being disclosed outside Openreach. Such investment proposals would not be shared with BT Group without the consent of the communications providers. Three exceptions apply:
- where Openreach considers a proposal for investment to be of significant strategic importance;
  - where a proposal for investment cannot be financed within the agreed capital expenditure budget of Openreach, or
  - where the proposal for investment is identified by Openreach as benefiting Openreach's customers and would otherwise be net-present-value negative for Openreach.
- In the above exceptions, the Openreach CEO shall advise the BT Group plc CEO and CFO. Proposed investments of less than £100m require the prior approval of the BT Group plc CEO and CFO; investments of more than £100m or of significant strategic importance require the prior approval of the BT Group plc Board.
- 7.21.2 A public phase whereby Openreach announces publicly an intention to consider seriously a significant investment in its networks and products and which it considers could form the basis for new forms of network access. During this phase Openreach will consult with communications providers to establish their needs and potential demand for the proposed new networks and products; and
- 7.21.3 A committed phase, which begins with the announcement by Openreach of an intention to proceed with a proposal, subject to an approved business case and continues until the new network is deployed or the new service launched.
- 7.22 Openreach will be open to receiving well-developed proposals from communications providers regarding the development of its networks and products, including on a co-

investment or risk-sharing basis. BT Group's downstream divisions will use the same process of consultation to initiate their proposals for major new investments.

### **Enhanced Openreach resources and capability**

- 7.23 BT's proposed changes to the Undertakings specify that Openreach will have the capabilities necessary to develop plans for review by the Openreach committee on major operational and investment decisions and manage and control its day-to-day activities and operational decisions. BT has set out specific areas and functions where Openreach capabilities may be increased, including links to other lines of business.
- 7.24 The Undertakings also delineate how Openreach will receive services from other lines of business within BT plc, particularly TSO which includes BT's research and innovation, and networks teams.
- 7.25 Under the proposed changes, the BT TSO and Openreach relationship will be governed such that:
- 7.25.1 Openreach will consult with BT TSO on decisions relating to BT TSO services;
  - 7.25.2 Openreach will retain responsibility for any ultimate decision on the use of BT TSO services or those from a third party provider; and,
  - 7.25.3 BT TSO will retain responsibility for delivering BT TSO services where Openreach chooses to receive such services.

### **Transfer of assets and people to Openreach**

- 7.26 Openreach will remain a business unit of BT, and so there is no change in the ownership of assets and contracts with employees. As set out above, BT plc will ensure that Openreach controls and operates Openreach's assets and liabilities in accordance with the direction of the Openreach committee. However, as described above, the arrangement seeks to enhance Openreach's resources.

### **Compliance with regulation**

- 7.27 The Openreach committee will establish an Openreach Compliance Committee (OCC) with the role of reviewing compliance with the Undertakings and the Governance Protocol. The OCC will consist of the three independent directors of the Openreach committee and the independent Openreach Chairman, who will also be the chairman of the OCC. This would replace the Equality of Access Board (EAB).
- 7.28 The OCC will review the content of the Code of Practice for BT employees in Openreach and compliance with and breaches of the Undertakings. It will report regularly to the Openreach committee on Openreach's compliance.

### **Quality of service**

- 7.29 Openreach intends to deliver a high quality of service, in compliance with regulation and in fulfilment of its customers' needs. The Openreach committee will carry out its duties to this end. The committee will ensure the AOP and MTP take account of this aim. It will also ensure the Openreach Executive effectively executes the AOP and MTP in relation to quality of service.

## Our view of BT's Proposal

- 7.30 We consider BT's plans demonstrate several areas of common ground between Ofcom and BT on how specific measures could support greater strategic and operational independence for Openreach. In particular, the confidential process for consultation on new investment proposals, the composition of the Openreach committee (with a majority of independent members) and enhanced resources for stronger strategic and technical capabilities within Openreach would help address concerns regarding Openreach's focus on investing and developing new products that serve the best interests of all Communications Providers. BT's intention that there be an obligation on Openreach to treat all customers equally would also help to ensure that the focus of Openreach is on its customers.
- 7.31 However, there are a number of features that we consider do not achieve the goal of more independent decision making by Openreach. Specifically, there are three broad features of BT's plans that raise concern:
- 7.31.1 the status of Openreach as a division of BT plc, rather than as a separate legal entity, and the consequent lack of any formal company directors on the Openreach committee, and no transfer of employees;
  - 7.31.2 the high degree of direct involvement and engagement of the BT Group Chief Executive and Chief Financial Officer in Openreach's management; and,
  - 7.31.3 the ability of these executives to access confidential customer information during the confidential Openreach consultation process between Openreach and BT's competitors.
- 7.32 Taken together these raise a significant risk of continued, direct, but hard to identify BT Group influence over Openreach's decision making even within the bounds of its delegations. As a result, as planned, the Openreach committee would not be suitably enabled to take or recommend more independent decisions in the interests of all its customers. We set out specific concerns on BT's plans below.

### No incorporation of Openreach

- 7.33 Establishing a degree of corporate separation would allow a separate governance structure to be put in place to secure greater independence for Openreach, would foster an internal organisational culture and would provide transparency on the relationship with BT Group.
- 7.34 We are concerned that under BT's plans, Openreach will not be incorporated as a distinct company. Instead, BT plans to rely on an Openreach Governance Code and changes to the Articles of Association of BT plc. In this model, Openreach's committee members will not formally be company directors with duties under company law, nor will Openreach have its own Articles of Association defining its specific purpose.
- 7.35 Although BT's plan to establish a separate Openreach committee goes some way to achieving our objective, we do not consider that the degree of separation under BT's plan would be sufficient to address our concern. Since the Openreach committee is not the board of an incorporated company, the duties on the members of that committee are contractual rather than underpinned by company law.

- 7.36 Further, under BT's plan, while the management of Openreach lies with the Openreach committee sitting within BT plc, the employees will not move. Consequently, there is unlikely to be a corresponding change to the Openreach internal organisational culture.
- 7.37 Overall, we consider BT's plan to resemble more closely the current arrangement based on behavioural rules, which we have found to be ineffective at addressing our competition concern. We believe BT's planned changes to Openreach's structure are likely to be insufficient effectively to change Openreach's purpose, capabilities and culture.
- 7.38 As a result, we do not consider that this aspect of BT's plan sufficiently addresses the concerns that we have identified. Our view is that incorporation of Openreach is important to give it the required level of independence. We also consider that the transfer of employees and assets to an incorporated Openreach is important to reinforce a more independent organisational culture within Openreach, focused on the equal treatment of all its downstream customers. Any decision on incorporation and the transfer of people and assets would be subject to the costs that might flow from these actions.

#### BT Group executive oversight and influence

- 7.39 In addition to incorporating Openreach as a distinct company, we consider it is important to ensure that Openreach governance is independent operationally from BT Group plc on a day-to-day basis.
- 7.40 We consider that the specific delegations and duties provided to the Openreach committee (with some exceptions relating to Group CEO involvement) which BT intends to implement are broadly positive for more independent decision making. BT's plans give significant delegated authority from the BT plc Board for the strategy, operational performance and regulatory compliance of Openreach, subject to certain matters reserved for the BT Group plc Board. For example, we consider it reasonable that BT Group plc has the ability to approve the financial envelope for the annual operating and medium term plans produced by Openreach based on a high-level summary of Openreach's plans.
- 7.41 However, we disagree with BT's plans on the extent of the BT Group CEO and CFO's direct influence over the activities of Openreach. BT's plan creates a number of avenues for direct influence over the activities of Openreach in ways that would not be transparent. This risks sidestepping the role and purpose of the new Openreach governance bodies. For example:
- The BT Group CEO and CFO would review Openreach's medium-term and annual operating plans (MTPs and AOPs) before the Openreach executive could recommend these to the Openreach committee for approval.
  - Both would be also be consulted during the confidential phase of new investment proposals, where the proposal is either of 'significant strategic importance', cannot be financed within the agreed Openreach budget, or would be net-present-value negative for Openreach. This consultation would happen before Openreach had made a decision to recommend actions to the BT Group Board.
  - Both would need to approve investments outside the agreed operating plan that are under £100m.

- 7.42 All of these points give the BT Group CEO and CFO a material role in influencing strategic investment and operational decisions by Openreach. This would be before any plans or decisions were considered by the Openreach committee, and then by the BT Group Board as appropriate.
- 7.43 There is also the prospect of significant indirect influence arising from the direct relationship between the Openreach CEO and BT Group CEO. The Openreach CEO would be appointed by, and report directly to, the BT Group plc CEO. This is of particular concern combined with other elements of BT's plan. For example, BT intends to give delegated authority to the Openreach CEO for amendments to the annual operating plan within the agreed financial envelope without involving the Openreach committee.
- 7.44 On this basis, we do not currently consider that BT's plans give Openreach governance sufficient strategic and operational independence from BT Group plc.

### Customer consultation

- 7.45 To address our concern around insufficient consultation with all downstream customers on decisions regarding the network, we consider it is necessary to impose a requirement on Openreach to consult in a sufficient, timely and transparent manner with all its downstream customers.
- 7.46 While we consider that the consultation process in BT's plan addresses our concerns to some extent, it falls short in one key respect. While there is a confidential phase as part of the consultation process, we are concerned that the effectiveness of this is undermined by the fact that Openreach can disclose investment discussions to BT Group without the consent of the communications provider proposing the investment.
- 7.47 We believe that for any consultation and co-investment processes to be effective, all customers of Openreach need to have confidence that confidential information will be kept within Openreach and not shared with a company that is a downstream competitor until such point as specific decisions (for example capital commitments outside of Openreach's delegated authority) need to be made.

### **Provisional Conclusion**

- 7.48 Whilst BT's plan has a number of positive features, common with our proposal, that could address some of our competition concerns, we think there are a number of specific problems with it as set out above, and so do not consider overall that it is sufficient in addressing the competition concerns identified.
- 7.49 We are open to receiving further proposals from BT as to how it might voluntarily address our competition concerns effectively in view of the considerations we have set out above, particularly with regard to the three main areas where we have concerns with regard to BT's present plans. We would need to carefully consider the specific details of any such further proposals.



## Section 8

# The industry submission

- 8.1 A number of stakeholders, including Sky, TalkTalk, and Vodafone, have put forward a ‘ten-point plan’ on revisions required to the current regulatory framework including ideas on how to legally separate Openreach from BT (the ‘Industry Submission’).<sup>51</sup> We have taken this submission into account in determining the details of our own proposal.
- 8.2 In this section, we provide an overview of the ten-point plan, setting out those areas where we agree with the Industry Submission and have incorporated their suggestions into our proposal. We further address those parts of the Industry Submission we have not included given the nature of the competition concern we have identified.

## Summary of the Industry Submission

- 8.3 Figure 6 below sets out the key elements of the ‘ten point’ plan, and how these compare to our proposal.

**Figure 7: Comparison of Industry Submission and our proposal**

Industry Submission	Our proposal
Point 1: Openreach should be a separate legal company	We agree that the incorporation of Openreach will allow for a separate governance regime, underpinned by company law, to secure greater independence for Openreach.
Point 2: Openreach should have its own Board composed of directors who are all independent of and not appointed by BT. Instead, directors would be selected through a process involving Ofcom and an Independent Monitoring Trustee.	We agree that Openreach should have its own Board of Directors who are majority independent  However, we consider the Industry Submission with regard to its composition and appointments to be disproportionate, as further addressed below.  We propose that BT, unless BT retains the ability to appoint (and remove) Openreach Board members, in consultation with Ofcom, it will result in significant additional costs. The Board should comprise a majority of directors who are unaffiliated to BT.
Point 3: Ofcom appoints an Independent Monitoring Trustee to oversee the transition of Openreach as a legally separate entity and adjudicate on any disputes that arise between BT Group and Openreach.	We propose that an Openreach Board with a majority of non-executive directors who are unaffiliated to BT can effectively monitor compliance with regulation. Ofcom will also undertake ongoing monitoring of the model.
Point 4: Openreach owns and controls the assets it needs to deliver network access services reliably.	We agree that Openreach should control the assets critical to the delivery of its core purpose, so long as this does not trigger material costs or complexity in organisational boundaries that outweigh the benefits of asset transfer. Our starting point is the transfer of those network assets controlled by Openreach as a result of the Undertakings.

<sup>51</sup> Towerhouse LLP report, Legal separation of Openreach from BT, 6 May 2016; Towerhouse LLP supplementary report, Legal separation: an effective, proportionate remedy, 1 July 2016; Sky, TalkTalk Group, Vodafone, INCA, and the FCS, [A 10-point plan for a better Openreach](#), 16 May 2016.

Point 5: Openreach should have its own brand and livery.	We would expect Openreach as a separate company to have its own brand, not affiliated to BT.
Point 6: Openreach should be financially independent. It should set its own budget (after an initial cash injection by BT) and decide on the use of its funds entirely independently.	We recognise the importance of Openreach being able to take strategic decisions independently. However, we consider the Industry Submission on this point would incur costs approaching those of structural separation, and risk being disproportionate to our addressing our competition concern, as further addressed below.
Point 7: Openreach should provide its services and information on an equal basis to all downstream operators.	We agree with the principle behind this point, and have proposed embedding it in Openreach's articles of association. However, some of the more detailed elements of this proposal, such as sharing of commercial information with potential competitors may be impractical to implement in practice.
Point 8: Openreach should engage in industry-wide consultation on its strategy, plans and the development and design of new products and services.	We agree with this point, and have included reformed industry consultation in our proposals. However, we are focused on major strategic investment in networks and products
Point 9: BT should be subject to open procurement obligations, so that network operators can compete with Openreach to supply BT's business.	We do not consider these points relevant to the competition concern identified on greater independence on strategic and operational decision making for Openreach. This is covered further below.
Point 10: To minimize the risk of overbuild, Openreach should be required to demonstrate sufficient commercial rationale before building out its network in areas where smaller alternative operators have rolled out an FTTP network.	

## Our view of the Industry Submission

- 8.5 We consider the Industry Submission to have provided a range of valuable ideas and thoughts on how to further separate Openreach to deliver against our competition concern. However, there are two broad challenges with the proposals as set out:
- their effect in totality, and individually in some cases, on proportionality; and
  - the relevance of some proposals to the competition concerns identified.

### Proportionality

- 8.6 Taken as a whole, the ten point plan and associated proposals combines to effectively deliver 'structural separation minus': a model that resembles full structural separation in its outcomes, without requiring the full divestment of Openreach by BT Group.
- 8.7 The Industry Submission fails to establish that the extensive level of separation it proposes is required to address our competition concern effectively and in the least onerous way possible. For example, under the Industry Submission, BT Group would transfer assets and workforce to Openreach and provide it with funding, but have to act as a passive shareholder with no influence over how Openreach uses its assets, workforce, or funds. This level of autonomy for Openreach would remove BT's oversight, while leaving it exposed to the associated risks of owning the business, including risks to its wider operations from actions taken by its subsidiary. Such a model is likely to incur significant costs.

- 8.8 The Industry Submission also fails to recognise BT Group's ongoing legitimate interest in Openreach's activities as its sole shareholder. For instance, it is not clear how BT Group's Board would be able to exercise effective corporate governance if it lacks all oversight and ability to direct Openreach's use of BT funds in more exceptional circumstances.
- 8.9 In our proposal, we have sought to develop a model that goes no further than is necessary to address the competition concerns identified by increasing materially Openreach's strategic and operational independence. In doing so, we have also had regard to the potential broader costs and consequences of reformed governance. For instance, we propose that BT Group has an ongoing role in the composition of and key decisions taken by the Openreach Board. This would allow the Openreach Board to be more independent, while avoiding some of the more significant costs that could otherwise arise.
- 8.10 The Industry Submission does not address the potential costs, complexity, or timescales of implementing the ten-point plan in full. We believe that implementing the ten-point plan would generate substantial costs, potentially similar in scale to full structural separation.
- 8.11 In our proposal, we have sought ways to deliver an effective solution to the competition problems identified without incurring unnecessary costs. For example, we propose to transfer assets to Openreach subject to considerations of practicability and cost. Where appropriate, our proposal would secure suitable Openreach influence over and access to assets through arms-length contracts.

## Relevance

- 8.12 A number of the ten-point plan's proposals are not directly related to the competition concern we have identified: the need for more independent strategic and operational decision-making by Openreach.
- 8.13 For example, the Industry Submission proposes to remove the exemptions and variations to the Equivalence of Inputs rules presently in place. It further argues that there should be an operationally separate sub-unit within Openreach, which provides passive access products on an EOI basis both to other operators and to internal divisions of Openreach (such as those which provide active products).
- 8.14 Whilst potentially valid points in the wider regulatory context, we consider that proposals of this type are not directly related to our present competition concern. Instead, these submissions raise points that can be addressed through our normal process of periodic market reviews and SMP-based regulation, including our upcoming work on duct and pole access.
- 8.15 Similarly, the proposal to limit Openreach's ability to build out its network in areas where alternative network operators have invested is unrelated to the issue of securing more independent decision-making for Openreach. Indeed, a more independent Openreach would likely be incentivised to invest and upgrade networks in the face of competitive threats, and should have the opportunity to do so.
- 8.16 We have therefore not included a number of these more detailed ideas in our proposal.

## Section 9

# The way forward

## The statutory framework for our proposal

- 9.1 Building on our Initial Conclusions, we have set out in this document the details of our proposal to strengthen Openreach's strategic and operational independence. We have explained why we consider that our proposal will be an effective and proportionate means to address our concerns regarding Openreach's forward looking decision making and how this forms part of our wider strategy for the future of digital communications.
- 9.2 This is a forward-looking proposal, setting out our strategy for ensuring the quality and availability of world leading communications services for UK citizens and consumers over the next ten years
- 9.3 The Communications Act 2003 sets out the domestic statutory framework for such forward-looking regulation, based on the harmonised European Framework. In our February initial conclusions document we explained that our next step was to prepare a proposal for submission to the European Commission in accordance with procedures set out in the Communications Act.
- 9.4 Since then, the UK has voted in a referendum to leave the European Union. Whilst that vote did not itself have any immediate legal effect, it is clearly important that at a future point the relevant legislation in the UK may be amended. When and how this will be done is a matter for the UK Government and Parliament. Until any legislative change occurs, the Communications Act 2003 remains in force in its present form.

## The BT proposal

- 9.5 As set out in our February document, we remain open to the potential for agreeing voluntary proposals if they effectively address our concerns. BT has now submitted a proposal to Ofcom under the Communications Act 2003 detailing the actions it intends to take to implement its re-organisation of Openreach. This is summarised in Section 7, and can be found in full on our website<sup>52</sup>.
- 9.6 In any voluntary implementation of a new model for Openreach we would look to the members of the Openreach governing body to ensure that the new arrangements were operated properly and effectively. Ultimately, the BT Group Board will continue to be accountable for the effective operation of any voluntary proposal.
- 9.7 We have explained our view that, whilst there are several areas of common ground between our proposal and BT's plans, there are a number of areas where BT has not gone far enough and which, if unchanged, will not in our view achieve the goal of a more independent Openreach on strategic and operational issues. We invite stakeholders to provide their views on this question.

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<sup>52</sup> [BT Proposal](#), 18 July 2016.

## Next steps

- 9.8 We believe that action is required now to deliver better outcomes for consumers and citizens. Subject to considering any representations received in response to this document, we will proceed with our proposal as quickly as possible.
- 9.9 Once we have decided which model of Openreach to take forward, we will consider whether that model has any impact on existing SMP conditions. We will also consider the any revised model of separation when we set new SMP conditions in our future reviews of relevant markets.
- 9.10 We will also need to consider the extent to which the existing BT Undertakings are still required. As part of that process, we will consider the request we have received from BT to vary the Undertakings.
- 9.11 The deadline for making representations on the matters set out in this document is 4 October 2016.

## Annex 1

# Responding to this proposal

## How to respond

- A1.1 Ofcom invites written views and comments on the proposal set out in this document, to be made **by 5pm on 4 October 2016**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <http://stakeholders.ofcom.org.uk/consultations/strengthening-openreachs-independence/>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email [david.michels@ofcom.org.uk](mailto:david.michels@ofcom.org.uk) attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Alternatively, responses may be posted to the address below, marked with the title of the consultation.
- David Michels  
Ofcom  
Riverside House  
2A Southwark Bridge Road  
London SE1 9HA
- Fax: 020 7981 3333
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

## Further information

- A1.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Fergal Farragher on 0207 891 3000.

## Confidentiality

- A1.7 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, [www.ofcom.org.uk](http://www.ofcom.org.uk), ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.
- A1.8 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish

all responses, including those that are marked as confidential, in order to meet legal obligations.

- A1.9 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/terms-of-use/>

## Ofcom's consultation processes

- A1.10 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.11 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at [consult@ofcom.org.uk](mailto:consult@ofcom.org.uk) . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.12 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Steve Gettings, Secretary to the Corporation, who is Ofcom's consultation champion:

Steve Gettings  
Ofcom  
Riverside House  
2a Southwark Bridge Road  
London SE1 9HA

Tel: 020 7981 3601

Email [steve.gettings@ofcom.org.uk](mailto:steve.gettings@ofcom.org.uk)



## Annex 2

# Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

### Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

### During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

### After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

## Annex 3

# Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, [www.ofcom.org.uk](http://www.ofcom.org.uk).
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at <http://stakeholders.ofcom.org.uk/consultations/consultation-response-coversheet/>.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

## Cover sheet for response to an Ofcom consultation

### BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

### CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing  Name/contact details/job title

Whole response  Organisation

Part of the response  If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

### DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

## Annex 4

# Separation case studies

## Introduction

- A4.1 As we set out in Section 4, there is a range of options models of separation, from accounting separation to structural separation. Broadly, each model provides successively stronger constraints on the vertically integrated company's ability to discriminate. At the same time, the measures imposed become more intrusive for the regulated firm.
- A4.2 Different models of separation, and associated governance, have been proposed and implemented across various regulated sectors, including telecoms, electricity, water, and banking. In designing our proposal to ensure greater independence for Openreach we have considered whether any existing models that may share features with 'legal separation' in these markets could present useful lessons learned. The examples we have looked at include:
- 4.2.1 Swedish telecoms;
  - 4.2.2 Singapore telecoms;
  - 4.2.3 Scottish water;
  - 4.2.4 French electricity; and,
  - 4.2.5 UK banking.
- A4.3 We have examined these models in order to understand their objectives and structure, with the aim of informing our own proposals for Openreach. In doing so, we have considered publicly available information relating to the relevant legislation or regulation in place. Where appropriate we have spoken with relevant regulatory authorities, Government departments and regulated companies to confirm our understanding of each model.

## Case studies

### Swedish telecoms

- A4.4 In 2008, Swedish incumbent Telia Company formed a wholly-owned subsidiary (Skanova) to own and sell access to its copper and fibre infrastructure. Telia Company imposed this model unilaterally, without input from the Swedish regulator (PTS). However PTS had previously requested legal powers from the Swedish Government to make functional separation available as a remedy.<sup>53</sup>
- A4.5 Skanova is committed to providing equality of access to all downstream operators and has an Equality of Access board to monitor compliance. Based on our meetings with representatives of PTS and Telia Company, we understand that while Skanova is a legally separate company, it is not operationally separate from Telia Company:

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<sup>53</sup> [PTS, Improved Broadband Competition through Functional Separation, 14 June 2007.](#)

both companies share information, systems, and staff. Further, the model was not intended to provide for more independent governance of Skanova, which remains integrated with Telia Company. As the 100% shareholder, Telia Company appoints Skanova's Board of directors and there are no legal requirements that Skanova's directors are unaffiliated with Telia Company.

## Singapore telecoms

- A4.6 As part of its national broadband programme, the Singapore Government has invested public funds to build a national FTTP network. As part of this programme, it required the separation of the fibre network operator or 'NetCo' from the active infrastructure level and from retail service providers. In particular, the IDA (the Info-comm Development Authority of Singapore) specified that NetCo should not be controlled by a downstream operator.
- A4.7 In 2008, a consortium (called OpenNet), led by Axia NetMedia and which included the incumbent operator SingTel, won the NetCo contract. Since SingTel also operates at the retail level, in order to benefit from public funds to build the fibre access network, it set up a registered business trust structure and transferred its passive infrastructure assets (such as ducts and exchanges) to a wholly-owned business trust (the NetLink Trust).
- A4.8 A trustee-manager (CityNet) holds and manages the infrastructure assets on behalf of the NetLink Trust at arm's length from SingTel and provides wholesale access to its fibre network. SingTel receives the financial benefits from CityNet's activities through its ownership of the NetLink Trust. This structure was designed to ensure a level of management and operational independence for CityNet from SingTel, without undermining the financial benefits for SingTel of owning its network infrastructure.
- A4.9 In 2013, CityNet acquired all the shares in OpenNet, the consortium which won the NetCo contract. Other telecoms operators objected to the acquisition, commenting that CityNet was unlikely to act as a 'neutral' or 'independent' NetCo that would serve the best interests of the industry, given its relationship with SingTel.<sup>54</sup> The IDA approved the acquisition, accepting undertakings designed to ensure the NetCo's independence, and required SingTel to reduce its stake in the NetLink Trust to less than 25% by 2018.<sup>55</sup>
- A4.10 A Trust Deed governs the relationship between SingTel and CityNet. Under the Deed, SingTel appoints one of the five members of CityNet's Board. Directors to CityNet's Board can only be appointed after IDA's approval.<sup>56</sup> Moreover, a majority of the Board's members shall be independent of SingTel (meaning they do not have an employee or management relationship with SingTel).<sup>57</sup> CityNet decides on day-to-day operations and can invest, raise, or borrow funds for the purposes of rolling out its fibre network independently of SingTel, provided it does not exceed threshold

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<sup>54</sup> [IDA, Explanatory Memorandum on the Decision of the IDA in relation to the Consolidation Application, 21 November 2013, p. 23.](#)

<sup>55</sup> [IDA, Explanatory Memorandum on the Decision of the IDA in relation to the Consolidation Application, 21 November 2013.](#)

<sup>56</sup> [Licence to provide facilities-based operations granted by the IDA to CityNet, 1 October 2014.](#)

<sup>57</sup> See [Singapore Business Trusts Act, Business Trusts Regulations, 2006.](#)

amounts and engages in arm's length transactions (i.e. with independent contractual partners).

### Scottish water market

- A4.11 In 2005, the Scottish Government decided to open the water market for business customers to competition. It required Scottish Water (which operates the water infrastructure) to legally separate its retail arm. Scottish Water formed a legal subsidiary for its business market retail activities (Business Stream). Scottish Water (which is wholly owned by the Scottish Government) owns holding company Scottish Water Horizons Holdings, which in turn owns holding company Scottish Water Business Stream Holdings ('SWBSH'), which owns Business Stream.
- A4.12 In 2007, WICS (the Water Industry Commission for Scotland) and Scottish Water agreed a governance code for Business Stream.<sup>58</sup> In accordance with the governance code, SWBSH appoints the Business Stream Board on behalf of Scottish Water. The Business Stream Board can take operational and strategic decisions independently, but within defined limits. For example, any decisions which require new financing or the approval of the Scottish Government require the approval of SWBSH.<sup>59</sup>

### French electricity market

- A4.13 In 2003, the European Commission ('EC') issued a directive on the electricity market, requiring the legal separation of vertically-integrated entities that combine generation, transmission, and distribution.<sup>60</sup> In 2005, French incumbent EDF formed RTE as a wholly-owned subsidiary to operate its transmission network.
- A4.14 In 2007, the EC concluded that legal and functional separation had failed to sufficiently prevent vertical discrimination. In 2009, the EC issued a further directive, requiring vertically integrated electricity companies to either structurally separate, or implement governance rules which ensure the independence of legally separate transmission operators.<sup>61</sup>
- A4.15 In accordance with the 2009 EU Directive, RTE has two Boards:
- 4.15.1 The Management Board has a majority of members who are independent of EDF (meaning that they have no current or recent past professional position with or interest in EDF).<sup>62</sup> It decides on day-to-day activities and manages the network. The Management Board prepares an annual ten-year network development plan that it submits to CRE, the French energy regulator, for approval.
- 4.15.2 The Supervisory Board has a minority of members who are independent. A third of its members are appointed by EDF, a third represent staff, and the final third represent the French Government. It appoints members of the

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<sup>58</sup> [WICS, Governance Code, 2007.](#)

<sup>59</sup> [Scottish Government, The Scottish Water Governance Directions, 2009.](#)

<sup>60</sup> [EU, Directive 2003/54/EC concerning common rules for the internal market in electricity, 26 June 2003.](#)

<sup>61</sup> [EU, Directive 2009/72/EC concerning common rules for the internal market in electricity, 13 July 2009.](#)

<sup>62</sup> See also [EC, Commission Opinion on Certification of RTE, 25 November 2011.](#)

Management Board and decides on matters with a significant impact on the value of shareholders' assets. For example, these include major financial decisions such as debt levels and dividends.

## UK banking sector

- A4.16 In 2013, in response to the financial crisis, the UK Government required the Prudential Regulation Authority to make rules to ring-fence bodies within banks that provide core banking services (such as taking deposits) from other divisions.<sup>63</sup> The aim is to protect ring-fenced bodies from financial shocks to other, riskier divisions of a banking group.
- A4.17 In 2015, the PRA proposed rules to separate ring-fenced bodies in a sibling structure: the bodies and the other divisions are to be legal subsidiaries owned by the same holding company.<sup>64</sup> Under the proposed rules, at least half of the ring-fenced bodies' Board must be independent non-executive Directors and the Chair must be independent (meaning that they have no current or recent past professional position or business relationship with the parent company). The ring-fenced body should decide on core banking services independently, while the parent company exercises oversight and sets group strategy. The ring-fenced body should adopt group policies and make amendments or additions as necessary to comply with its obligations.

## Relationship between separation, governance and control

- A4.18 These case studies provide useful examples of the relationship between separation model, governance, control and accounting for subsidiary assets. This is summarised in the table below.

Case Study	Summary of separation principle	Company's descriptions of governance and control (from annual reports)	Group accounting status
TeliaTelia Company / Skanova – Swedish telecoms	Legal separation, no restrictions on board membership	TeliaSonera is assumed to have control if the group owns the majority of shares and the shares have equal voting rights attached, and a proportionate entitlement to a share of the returns of the entity and decisions about relevant activities are determined by majority votes. TeliaSonera is also assumed to have control if TeliaSonera selects the majority of the board contractually even if not holding the majority of the shares.	Subsidiary (consolidated)
SingTel/NetLink Trust – Singapore telecoms	Legally separate trust, managed and operated separately by CityNet	NetLink Trust is 100% owned by Singtel and is equity accounted as an associate in the Group as Singtel does not control it.	Associate (non-consolidated interest)
Scottish Water/Business Stream – Scottish water	Legal separation, owned through holding company structure	Scottish Water Business Stream Limited (Business Stream) is treated as a subsidiary although there are special governance arrangements which were established.  In conjunction with the Water Industry	Subsidiary (consolidated)

<sup>63</sup> [UK, Financial Services \(Banking Reform\) Act, 2013.](#)

<sup>64</sup> [Bank of England PRA, Policy Statement PS10/15 The Implementation of Ring-fencing, May 2015.](#)



Case Study	Summary of separation principle	Company's descriptions of governance and control (from annual reports)	Group accounting status
		Commission for Scotland and associated with the conditions attached to Business Stream's licence for the supply of water and waste water services. Scottish Water is, however, satisfied that the controls and governance in place are such that consolidation is appropriate.	
EDF/RTE – French electricity	Legal separation, independent management board but minority rights on the supervisory board (other members include government and employees)	The EDF group owns 100% of the capital of [RTE], but EDF ceased exercising control (exclusive or joint) over RTE in 2010 when its governance was brought into line with EU Directive 2009/72 (13 July 2009) as transposed into French law. However, the Group has significant influence over RTE since it appoints one third of its Supervisory Board members. RTE is therefore an associate for the EDF group, and is accounted for by the equity method in accordance with the instructions of IAS 28 (revised)	Associate (non-consolidated interest)

Source: Ofcom, company accounts

## Conclusions

- A4.19 Although the case studies we have considered are not identical to our draft proposal for Openreach, many feature governance arrangements designed to increase independence for the regulated subsidiary company. Such governance arrangements cover Board membership and determine which bodies are able to decide on day-to-day operations, strategy, and financing. Often regulators have sought to balance greater independence for the subsidiary company with the need to enable the parent company to protect its legitimate business interests.
- A4.20 The case studies provide relevant examples of models of legal separation that have been helpful to inform our analysis. However, they also reveal several contextual differences. These include different objectives, levels of regulator and Government involvement, the effect of direct funding as a mechanism to facilitate separation, and market conditions (including levels of competition). In conclusion, there is not a direct read across to the specific situation faced in the UK today or features of our proposal for Openreach.