SKY'S RESPONSE TO OFCOM'S PROPOSALS FOR STRENGTHENING OPENREACH'S STRATEGIC AND OPERATIONAL INDEPENDENCE

EXECUTIVE SUMMARY

1. Genuine Openreach independence from BT could unlock and accelerate the development of fixed broadband investment, innovation and competition to the benefit of UK consumers and businesses. Ofcom's decision on how to deliver this independence will be critical to whether or not it succeeds. It is vital to the future of digital communications in the UK that Ofcom gets it right.

2. What is clear is that the status quo is not working. Over ten years on from the decision to establish Openreach as a division within the BT Group, Ofcom's Strategic Review of Digital Communications ("SRDC") has exposed pervasive and persistent concerns arising from BT's vertical integration. Ofcom has highlighted that the current framework of behavioural undertakings from BT cannot adequately restrain BT's ability and incentive to use control of the Openreach network to undermine retail competition in favour of BT's own retail divisions.1

3. Above all, BT's continued control of Openreach is acting to hold back investment in fibre to the premise ("FTTP") networks in the UK.

4. The time for tinkering around the edges of this failing regulatory structure has long since passed. Ofcom must act boldly and urgently.

5. The wider impact of inaction is already evident – the UK is falling behind international comparators in fixed broadband:
   - The UK has slipped to 20th in the average fixed broadband speed table and is now below the Czech Republic, Bulgaria and Romania.2
   - FTTP is only available to 2% of UK households today. Openreach’s current investment plans will not address this. Its next planned investment upgrade is G.Fast. However, this still relies on BT's legacy copper network and will provide uneven coverage, speed and reliability. Only FTTP networks can consistently, reliably and securely deliver high upload speeds, low latency and ultrafast download speeds.
   - By contrast there is over 50% FTTP coverage in Spain and Portugal already; New Zealand is building an FTTP network which will cover 80% of the population by 2022, using public and private funding; and France will become the second largest market for FTTP in Europe after Russia by 2019.

6. Against this backdrop, Ofcom has committed to "a strategic shift to encourage large-scale deployment of new ultrafast networks including fibre direct to homes and businesses, as an alternative to the copper-based technologies currently being planned by BT".3

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2 Akamai, ‘State of the Internet Report’, Q 2 2016, Figure 28, available here.
3 Initial Conclusions, page 5.
7. Sky supports Ofcom’s fibre investment objective and agrees with Ofcom that in order to deliver it “Openreach should behave like, and be seen to behave like, an independent company.”

Genuine Openreach independence could reverse the UK’s decline in fixed broadband competitiveness and remove a key barrier to large-scale UK FTTP investment.

8. An independent Openreach would make more objective investment decisions and could mobilise private investment. It would be a FTSE100 company generating over £5 billion in revenue and therefore able to attract its own capital for large infrastructure projects. It would also generate confidence from potential co-investment partners.

9. The most clear-cut and enduring option for securing effective Openreach independence is structural separation. This would remove BT’s ability and incentive to influence Openreach’s decision-making in favour of BT’s retail divisions, and at the expense of competing communication providers who are wholesale customers and potential co-investment partners of Openreach.

10. In its latest proposals for strengthening Openreach’s strategic and operational independence (the “Ofcom Proposals”), Ofcom stops short of recommending immediate structural separation of Openreach. Rather, it proposes legal separation of Openreach, where Openreach would be incorporated as a legal entity, but remain a wholly-owned subsidiary of BT.

11. Legal separation of Openreach offers less certainty of achieving Ofcom’s fibre investment objective. It will not deliver the clear, enduring independence that would emerge from structural separation, as it merely aims to circumscribe BT’s ability to influence Openreach, rather than removing BT’s ability and incentive to do so.

12. However, in the right form, legal separation could generate meaningful change within the sector. Legal separation would introduce an objective governance framework, underpinned by well-established and widely understood principles of company law, thereby providing legal certainty and transparency over Openreach’s independence. Legal separation is also an efficient way for Ofcom to address the concerns it has identified: it would be inefficient for Ofcom to make further adjustments to the BT undertakings (which Ofcom recognises have failed) in an effort to replicate what company law already does. As such, the Ofcom Proposals are a welcome starting point for achieving Ofcom’s objectives.

13. However, an effective solution to achieve Ofcom’s objectives would need to go further than the Ofcom Proposals. Anything less than full legal separation of Openreach is unlikely to deliver the step-change required.

14. Full legal separation would require:

(i) The transfer of assets and employees to Openreach: This is an essential element for securing Openreach independence. Openreach ownership of essential infrastructure assets and direct employment of its staff removes a direct route for unnecessary BT Group influence over a reformed Openreach. It also delivers the autonomy over core resources that Openreach requires to deliver on its company purpose and to implement significant investment decisions that would be in the interests of its downstream customers as a whole, rather than being skewed in favour of BT’s retail divisions.

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4 Initial Conclusions, paragraph 1.43.
(ii) **Genuine independent Openreach governance:** The Openreach board will be responsible for delivering behavioural change within the new Openreach organisation. Board independence from BT is therefore critical. This would require:

- **A process for appointing the Openreach board which is free of BT influence:**

  Rather than Openreach board appointments being made by BT (as Ofcom recommends), they should be managed under a formal, transparent and rigorous arms-length appointment process via an independent nominations committee. In addition, the remuneration of Openreach directors should be linked to Openreach performance, rather than BT Group performance.

- **The elimination or reduction of BT Group presence on the Openreach board:**

  There should be no BT director on the Openreach board. This creates a means for BT Group to directly influence Openreach decision-making and is likely to detract from the board’s focus on delivering Openreach’s company purpose to further its own company interests and treat all wholesale customers equally. A BT director would need to be recused from such a high number of confidential discussions regarding downstream competitors that he or she would not be able properly to perform their role. In addition, a BT directorship is superfluous, given that a list of reserved matters would be established to give BT Group appropriate oversight.

- **The limitation of Openreach reserved matters to fundamental ownership protections:**

  The establishment of reserved matters directly undermines Openreach independence by transferring decision-making powers from Openreach to BT Group. As such, the Openreach reserved matters should be transparent and narrowly defined to cover fundamental ownership protections only. This would include, for example, the acquisition and disposal of shares in or by Openreach. There should also be transparency of BT decision-making on the reserved matters. In particular for those going to the heart of Openreach decision-making, such as approval requests for investments outside the financial envelope, BT should be required to provide reasons for any rejection decision.

(iii) **Genuine financial independence:** To deliver Ofcom’s fibre investment objectives, Openreach must have the freedom to make the large investments it sees as desirable. This would require:

- The financial envelope set by BT to be large enough to allow freedom of Openreach decision-making on all but exceptional issues.
- Openreach to have its own capital raising powers. This would avoid BT using control over Openreach funding requests as a lever for blocking investments which may not be in the interests of BT’s retail divisions.
- Openreach to publish separate audited accounts. This would assist Ofcom’s regulatory monitoring and enforcement, as well as providing useful financial transparency to enhance the confidence of potential co-investment partners.

15. In addition, Ofcom should recognise that securing its fibre investment objectives does not depend on Openreach reform alone, but also rests on related measures within the 10-point plan put forward to Ofcom by industry. In particular, Ofcom is wrong to dismiss measures that enhance the contestability of wholesale supply of communications services to BT’s retail divisions as irrelevant to its objectives in reforming Openreach. Without these

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6 Towerhouse, ‘Legal separation of Openreach from BT: necessary steps to secure effective independence, transparency and to promote competition and investment’, 6 May 2016 (the “Industry 10-Point Plan”).
measures, the current skew of Openreach’s decision-making in favour of its captive customer is likely to continue. Contestability measures are therefore an important supplement to Openreach reform if Ofcom’s objective of timely large-scale fibre investment from a range of providers is to be secured without structural separation.

16. For these reasons, the Ofcom Proposals must go further and not be weakened. Ofcom should not accept dilution of full legal separation in negotiations with BT. Whilst voluntary agreement on separation with BT is no doubt procedurally attractive, if it does not secure genuine Openreach independence, Ofcom will inevitably fail to deliver its fibre investment objective and address the deep-seated competition concerns highlighted by the SRDC. Legal separation in name only, through incorporation of a shell company with no resources or meaningful independent decision-making powers will not address Ofcom’s concerns.

17. Indeed, it would be inappropriate for Openreach reform to be designed wholly or predominately by BT, whose incentive is to maintain the status quo and retain control of Openreach. Sky welcomes Ofcom’s rejection of BT’s voluntary proposals for changes to Openreach governance which comprise incremental changes to the BT undertakings and avoid legal separation of Openreach.

18. In the absence of structural separation, the package of full legal separation and additional measures outlined here is most likely to deliver meaningful change and achieve progress towards Ofcom’s objectives. It can also be achieved with minimal cost. Openreach is already functionally separate, which contributes significantly to the additional cost of incorporation being low.

19. BT has argued that there are numerous insurmountable barriers to legal separation, notably issues concerning implications for its pension scheme. These claims are vastly exaggerated. On the issue of pensions, together with TalkTalk and Vodafone, we have sought independent advice from pensions specialist, Mercer, on the impact of full legal separation on the BT pension scheme, which supplements the expert report on this issue produced by Sackers and provided to Ofcom earlier in this process.

20. Mercer concludes that any negative impact from full legal separation can be substantially mitigated through straightforward measures that are commonplace in the pensions industry. Both Sackers and Mercer also conclude that pension-related issues associated with legal separation would be significantly alleviated if the Government were to extend the Crown Guarantee attached to BT’s pension scheme to a new Openreach pension scheme – a simple and straightforward move that would involve no additional liability for the Government.

21. Finally, Ofcom is proposing to attempt legal (rather than structural) separation as an initial step in Openreach reform and it should establish measurable targets to monitor the success of this approach. Should full legal separation not prove to be effective in practice, Ofcom should not hesitate in swiftly ordering structural separation of Openreach. The future delivery of digital communications for UK consumers and businesses depends upon it.