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Structural Separation in Canada Is the Cure Worse than the Disease?

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NETWORK SEPARATION:

Models, Economics and Regulatory Implications

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A. Background

1. Canada has two nearly ubiquitous wirelines into the home:
   - Telcos – 99% coverage
   - Cablecos – 97% coverage
2. Resellers of telecom services exist.
   - But are declining in market share in face of cable VoIP entry.
   - Services resold include local voice, L.D. and DSL high speed.
3. Cables are supposed to resell high speed internet, but minimal take up for a variety of reasons.

B. Regulatory Consideration of Network Separation

1. Not seriously considered in recent years.
2. Considered by Regulator in early 1990's after LD competition was opened and when government wanted more competition in local voice.
3. CRTC rejected separation in 1994 because:
   - Behavioural safeguards, including open access and unbundling, should be sufficient to prevent discrimination.
   - Telcos should not be prohibited from taking advantage of economies of scope, since doing so would reduce the benefits of competition.

4. Behavioural rules in wholesale market include:
   - Separate wholesale division
   - Prohibition on sharing certain information with retail division
   - Equal treatment
   - Co-location
   - Number portability
   - Access to support structures
   - Access to directory databases
   - Access rules for MDU's

5. CRTC stated policy has favoured “facilities” based competition over “resale” competition.
6. Mandated wholesale services based on “essentiality” and then “near essentiality”.

C. Current Situation in Canada

1. No likelihood of structural separation.
2. Scope of mandated wholesale services is declining, if slowly.
3. Issues still remain related to NGN.
   - Recent CRTC decision when copper is used in any service.
   - Incumbents have appealed to the Cabinet because they argue:
     - decision will impair further investment in FTTN; and
     - will weaken competition in favour of cablecos.
4. Even without mandatory requirements, wholesale market still exists.
   - About 50% of Bell Canada's wholesale revenues are now not mandated.

D. A Non-Regulatory Case Study - The Creation of Bell Aliant

1. Background

i. Bell Aliant was a combination of a regional incumbent with the rural, less dense areas in Bell Canada territory.

ii. It was not mandated by the regulator.

iii. The purpose was to unlock value, enhance local services and to take advantage of favourable tax rules for “income trusts”.

iv. The new entity was the largest regional telco in North America.

v. Bell Canada owned 45% of shares and controlled a majority of the Board.

vi. Public float represented 55%.

2. Implementation

i. As part of the arrangement, Bell Canada and Bell Aliant entered into a complex outsourcing agreement worth $350 million annually.

ii. As a result, Bell Aliant became Bell Canada's largest customer, in a sense.

iii. Agreement was very complex with over 75 statements of work.

iv. Disputes over purpose, objectives and legal meaning of agreement arose quickly.

v. Dispute resolution provisions were complex, including escalation to CEOs and arbitration.

3. Issues with Bell Aliant experience.

i) From the beginning incentives were not aligned and conflicts were endemic

- Bell Aliant focussed on cost controls and shareholder concerns.
- Bell Canada focussed on delivering only defined services inside contract.
- Bell Canada also had no culture or experience as an “outsourcer”.

ii) Bell Aliant wanted more customized, granular services, whereas Bell Canada wanted uniformity with its own services.

iii) Employees had different financial incentives and rewards.

4. The Results.

Implementation had very high transaction costs arising from:

i) Uncertainty in legal language.

ii) Extensive senior management time.

iii) Action Board discussion, particularly at Bell Aliant.

iv) Active engagement with auditors and finance departments due to settlement impacts.

v) Protracted discussions on capex and network planning.

vi) Frequent marketing issues/disputes.

In summary it was much more complicated than had been anticipated.

- Incentives/conflicts
- Personality issues
- Slowed decision-making
- And Bell Canada controlled the Board of Directors of Bell Aliant.

D. Network Separation – Is the Cure worse than the Disease?

What is the public interest harm that structural/functional separation is supposed to cure?

i. Ofcom said very recently it is rooted in discriminatory conduct based on the "ability" and "incentive" to discriminate.

Alex Blowers, March 6, 2009

ii) Agcom cites "competitive structural problems" and a desire to promote "effective competition" in the fixed access market.

iii) Other regulators also discuss discrimination issues, as well as a desire to promote competition.

What are the risks and rewards of pursuing increasingly complex forms of separation?

1. Risks

a) Will the remedy produce real sustainable competition?

- Facilities based vs. resale based competition
  - Only facilities based is sustainable
    - US UNEP experience
    - Canada
    - UK - Openreach produced less facilities based competition, relying more on LLU.

b) Will separation materially affect capital investment?

- U.S. - UNEP was a failure
- - Hands off approach to NGN
- Canada - Always a key factor
- - Recent adverse decision on wholesale internet access.
- Italy - LECG paper quantifies impact of delayed investment
  - *March 6, 2009*
- UK - Capex has increased only marginally, even with heavy compliance costs of undertakings.

c) How significant are the transaction costs?

- Higher than one would think.
  - Bell Aliant experience
  - Complexity of legal agreements
    - Canada
    - Australia

d) How easy is it to align incentives / avoid conflicts

- Almost impossible
  - Even in “control” situations (Bell Aliant)
- The greater the separation, the greater the risk of conflicts/misalignment

e) How adaptable is separation model to technological change?

- Problem of predictability
  - Particularly for NGA
  - Bundled services
  - IP applications
- Pricing complexity adds to rigidities
  - Hard to change once in place.
  - Never reflect the “real” world.
  - Recent example of access rules for the Royal Mail.

2. Rewards

a) Will “separation” reduce or eliminate discrimination?

- Most likely, but not certain
  - Some comments on UK experience.

b) Will “separation” produce effective competition?

- Much more debatable if it only encourages “me too” competitors.
- Too much dependency on access provider is likely counter productive, even from a regulatory cost/benefit analysis.

E. Summary

This debate boils down to whether the role of government is to promote “fairness” or “efficiency” in both operations and investments.

In my view, the government role should be the latter.