

Models of separation, equivalence of treatment and the role of the supervisory committee

A study by
Cullen International
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Executive summary

This study compares the models of separation and equivalence related to the incumbents of eight European countries: Czech Republic, Denmark, Iceland, Ireland, Italy, Poland, Sweden, United Kingdom (UK), and for Australia and New Zealand.

These countries were chosen for the study based on current, past or potential future experience of separation applying to the vertically integrated operator. To Cullen's knowledge, these ten countries represent the best known international experiences relevant to vertical separation and related wholesale service provision. At present, nine out of the ten researched countries adopted separation at the wholesale level, while one stopped implementing separation after 2017.

The study also has a special focus on the role played by the governance structure and the supervisory committee in assuring non-discrimination and a level playing field among telecoms operators. In the countries researched, four out of ten countries have a supervisory committee and one had a supervisory committee before implementing the highest degree of separation, structural separation.

Vertical integration: equivalence of treatment and models of separation

Vertically integrated operators with significant market power (SMP) may have incentives to discriminate in favour of their own retail services. For example, by applying better wholesale prices internally or by giving their retail services access to more or better information or systems.

National regulatory authorities (NRAs) may impose a non-discrimination obligation to prevent such behaviour. This obligation can be based on equivalence of inputs (EoI) or equivalence of outputs (EoO). EoI implies that exactly the same products, prices and processes are offered to competitors as to the SMP operator's own retail arm. EoO means that the products offered by the SMP operator to alternative operators and to its own retail business are comparable in terms of functionality and price, although different systems and processes may be used.

To ensure compliance with non-discrimination, NRAs may also consider imposing some form of separation on the vertically integrated incumbent. When NRAs do so, they must ensure that the separation obligation remains proportionate to the identified competition problem.

In simple terms, the equivalence model adopted (EoI or EoO) sets out the level and form of non-discrimination protection available to competitors, whereas the model of separation should help to ensure the compliance and enforcement of the chosen equivalence model.

In the academic literature, Martin Cave [defined](#) in 2006 different models of separation, ranging from simple accounting separation to more complex ownership separation.

Martin Cave's separation options (Cullen International)

Model of separation	Description
Accounting separation	Costs and revenues of upstream and downstream products are allocated in different baskets. Preserves efficiency of vertical integration but does not provide equivalence of access.

Creation of a wholesale division	The incumbent has a separate wholesale division which supplies upstream inputs to competitors. The retail arm still has a preferential way to access products. No equivalence of access.
Virtual separation	First form of equivalence of access, as internal and external customers are treated equally. No physical separation of the businesses.
Business separation (BS)	Physical separation of businesses and new business practices, e.g. new office location, new brand, separate OSS, separate management information systems.
Business separation with localised incentives	As BS but it also involves incentives for senior managers in the separated entity
Business separation with separate governance arrangements	As BS with localised incentives but it requires also the creation of a divisional board with non-executive directors independent of the group
Legal separation	Separate legal entities under the same ownership
Ownership separation	Separate legal entity with different ownership

In 2016, the UK national regulatory authority (Ofcom) [published *Strengthening Openreach's strategic and operational independence*](#). In that document, Ofcom identified eight possible models of separation to apply to the vertically integrated incumbent BT.

Ofcom's models of separation (Cullen International)

Model of separation	Description
Accounting separation	Separate financial reporting, with costs and revenues of the upstream and downstream products allocated into different baskets
Creation of a wholesale division	A separate wholesale division established to supply inputs to competitors but without equivalence of access
Virtual separation	Services offered to internal and external customers on equal terms, without any physical separation of the businesses
Functional separation	Physical separation of the business and its processes, e.g. location, staff, branding, management information systems
Functional separation with local incentives	Functional separation with separate governance and different management incentives to those of the wider firm
Functional separation with independent governance	Creation of a divisional Board with non-executive members who act independently from the group Board
Legal separation	Upstream business is established as a separate legal entity within the wider group but remains under the same overall ownership
Structural separation	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

Under European law, the EU 2009 regulatory framework introduced separation as an "exceptional" regulatory remedy that might be imposed by NRAs, differentiating it from the standard remedy of accounting separation set out in the [Framework Directive](#). The EU 2009 regulatory framework also provides for the possibility of voluntary separation by an SMP operator. The two procedures are set out in articles [13a](#) and [13b](#) of the Access Directive.

Article 13a of the Access Directive gives to the NRAs the power to impose functional separation when they have demonstrated that it is the only way to achieve competition in the market after all other remedies from the regulatory framework have failed.

However, the term functional separation as used under European law is quite flexible and this flexibility can cause some confusion when seeking to clarify the different models of separation used. In particular, article 13a seems to incorporate different models of separation that can be imposed by an NRA, including both the creation of an independent operating business entity and legal separation. However, article 13a of the Access Directive, as further clarified by the [BEREC Guidance on functional separation](#) of 2011, does not refer either to accounting separation (a standard remedy under article 13 of the Framework Directive) or to structural separation, which could be in principle be imposed under competition law (by the national competition authority).

Even if structural separation cannot be mandated by NRAs as an “*exceptional*” remedy under article 13a, vertically integrated operators can propose it voluntarily under the procedure set out in article 13b of the Access Directive.

The terms of articles 13a and 13b are carried over to the new EU regulatory framework in articles 77 and 78 of the [European Electronic Communications Code](#) of 17 December 2018. These articles contain the provisions on functional and voluntary separation in very similar terms to those set out in the Access Directive.

Cullen International has categorised the countries researched based on three broad kinds of separation:

- Functional separation: physically separated staff, systems and processes.
- Legal separation: separate legal entity remaining under the same overall ownership, physically separated staff, systems and processes.
- Structural separation: separate legal entity with different ownership.

Main findings: equivalence of treatment model

Of the countries researched, Iceland and New Zealand have an equivalence access model based on EoI for fixed access services. UK has an equivalence access model based mainly on EoI.

A mixture of EoI and EoO obligations, depending on the fixed access service requested, applies in Ireland, Italy and Sweden.

Australia, Denmark and Poland currently have an EoO regime. However, the regulatory authorities mandated these types of equivalence of access obligations:

- for Denmark, before the NRA implemented legal separation in June 2019 (a new analysis on the wholesale broadband market after separation is in progress); and
- for Australia, before the completion of the structural separation of the Australian incumbent (Telstra), which is due to take place in July 2020.

In the Czech Republic, the NRA removed the EoI and KPI remedies imposed in 2015, following its fourth round review of market 3a and market 3b in 2018, introducing a more general obligation of non-discrimination.

Main findings: models of separation

In the countries researched, nine out of ten adopted separation at the wholesale level.

Ireland, Italy, Poland and Australia implement functional separation. The Italian incumbent (Telecom Italia) also notified to the NRA its project of voluntary legal separation on 27 March 2018. This was taken into consideration under the last fixed market review of markets 3a and 3b, published on 6 August 2019. In Australia, the functionally separated incumbent Telstra committed to achieve structural separation by July 2020.

Czech Republic, Denmark, Iceland and UK implement legal separation. The Swedish incumbent, Telia, voluntarily implemented legal separation from 2007 to 2017 through its fully owned subsidiary [Skanova Access AB](#) before reintegrating it as a part of a larger wholesale unit (Telia Infra) on 1 January 2018.

To Cullen's knowledge, at present the only country which has already implemented structural separation is New Zealand, where the vertically integrated incumbent decided to split itself into two separately listed companies under different ownership in 2011. As stated above, Australia should follow the example of New Zealand in July 2020.

Organisational and governance structure

The different models of separation involve decisions on how the separated wholesale division will work, including on matters such as reporting obligations, Chinese walls, and on which IT systems can be shared and which ones require a separated access.

In addition, the governance structure of the separated wholesale division might be subject to a supervisory committee and/or a monitoring unit that oversees the compliance of the SMP operator with its non-discrimination commitments.

Of the countries researched, four out of ten countries have a supervisory committee, Iceland, Ireland, Italy and UK. In New Zealand, there was a supervisory committee (IOG) from 2008 to 2011, the period when the incumbent operator had been implementing functional separation. However, the committee ceased to exist after the implementation of structural separation in 2011.

Australia and Poland do not have a supervisory committee per se that monitors compliance with non-discrimination commitments but they have other entities playing a role in helping to ensure equivalence.

In Australia, the Independent Telecommunications Adjudicator (ITA) provides a voluntary fast-track dispute resolution to investigate and resolve complaints on equivalence between wholesale customers and the incumbent. In Poland, the system of KPIs is subject to independent audits to verify its functioning.

Case studies

Summary of the main findings of the study (Cullen International)

✔ Yes

✘ No

○ Past/projects

Country										
	CZ	DK	IS	IRL	IT	PL	SE	UK	AUS	NZ
Separation applied at wholesale level?	✔	✔	✔	✔	✔	✔	✘	✔	✔	✔
Functional				✔	✔	✔			✔	
Legal	✔	✔	✔		○ 2018 Project of voluntary legal separation notified to NRA		○ 2008-2017 Skanova Access AB established as a legally separate entity, 100% owned by Telia	✔		
Structural									○ 2020 Structural separation	✔
Supervisory committee?	✘	✘	✔	✔	✔	✘	✘	✔	✘	○ 2008-2011 The IOG ceased to exist after the 2011 structural separation
Equivalence of access obligations	General non-discrimination	EoO	Eol	Both Eol and EoO	Both Eol and EoO	EoO	Both Eol and EoO	Eol	EoO	Eol

In the description of the European examples, reference is often made to the regulator's review of the wholesale broadband markets. The broad definition of these markets is defined at the EU level, with these definitions changing in 2007 and 2014:

2007 market definitions		2014 market definitions	
4	wholesale (physical) network infrastructure access	3a	wholesale local access at a fixed location
5	wholesale broadband access	3b	wholesale central access for mass-market products