



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.

¹ Ofcom, 'Making communications work for everyone – Initial Conclusions from the Strategic Review of Digital Communications', 25 February 2016 (the "Initial Conclusions"), paragraphs 6.47 and 6.48.

² Akamai, 'State of the Internet Report', Q2 2016, Figure 28, available [here](#).

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
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.”*⁴ 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”),⁵ 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

³ Initial Conclusions, page 5.

⁴ Initial Conclusions, paragraph 1.43.

⁵ Ofcom, ‘Strengthening Openreach’s strategic and operational independence – Proposal for comment’, 26 July 2016.

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.

(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 arm's-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.⁶ 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 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 there is a negative impact from full legal separation but that this can be substantially mitigated through measures that are frequently used and accepted in the pensions industry. Both Sackers and Mercer also conclude that other 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 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.

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").

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

INTRODUCTION AND CONTEXT

1. Sky welcomes the opportunity to respond to these important proposals.
2. Ofcom's overarching goal in the Strategic Review of Digital Communications ("SRDC") is to:

*"promote investment and competition to ensure that people and businesses get the phone, broadband and mobile services they need in coming years, wherever they live and work."*⁷
3. To achieve this, Ofcom committed to a number of strategic objectives.⁸ Most significantly, Ofcom highlighted a new direction for its strategy:

*"We will make 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. New deployments will deliver increased choice of broadband services for people and businesses over the next decade, while reducing the UK's reliance on the Openreach network."*⁹
4. A major obstacle to Ofcom successfully encouraging large-scale FTTP investment in the UK is the lack of independence between Openreach and BT Group, arising from BT's vertical integration. Ofcom has found that the current model of functional separation fails to deliver the market outcomes that Ofcom thinks it should:

"The competition concerns we have identified as a result of BT's vertically integrated structure are, in many ways, similar to those we identified in 2005. As a result, whatever the market successes the Undertakings have been able to deliver, we are concerned that they – together with the SMP regulation that sits alongside them – have failed fully to achieve the market outcomes that we think they should. This is because the vertically-integrated structure of BT inherently affects the way in which BT makes significant decisions. It is therefore our view that the important and persistent competition problems and market failures identified in 2005 have not been fully addressed by the current functional separation model.

*Consequently, the status quo is not acceptable; change is needed."*¹⁰
5. Sky agrees. The existing regulatory model has enabled a number of positive developments since its introduction. But it does not sufficiently limit the influence that BT Group exerts over Openreach or the ability and incentive of BT to favour its own downstream division over other competing communications providers. Nor does it create any confidence among Openreach's downstream customers and potential co-investment partners that Openreach will treat them fairly and equally. In particular, as Ofcom identifies, under the current structure major strategic and operational decisions relating to Openreach are

⁷ Initial Conclusions, paragraph 1.1.

⁸ As set out in the Executive Summary of the Initial Conclusions, the six objectives are: a strategic shift to large-scale investment in more fibre; a step change in quality of service; reforming Openreach; the right to broadband; empowering consumers to make informed choices and to deregulate and simplify whilst protecting consumers.

⁹ Initial Conclusions, page 5.

¹⁰ Initial Conclusions, paragraphs 6.47 and 6.48.

subject to oversight by BT Group¹¹ and there is insufficient consultation with Openreach's downstream customers who compete with BT, in particular when taking major network investment decisions.¹²

6. Ofcom recognises that as a result of BT Group's influence over Openreach, significant competition problems continue to persist in fixed broadband, leading to poor outcomes for consumers and businesses in terms of price, choice, investment, innovation and quality of service. As Ofcom correctly notes, *"where BT acts on [its] incentive[s], 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"*.¹³
7. It is important that Ofcom's measures for Openreach separation are sufficiently broad and robust to address the long-standing concerns arising from BT's vertical integration, and therefore remove the obstacles to achieving Ofcom's fibre investment objective, and ultimately its overarching goal.
8. Such investment is an important step in delivering modern digital communications services to UK consumers and businesses. However, Ofcom's fibre investment objective cannot be realised in a timely manner under the status quo.
9. In the Ofcom Proposals, Ofcom stops short of recommending immediate full structural separation of Openreach. Rather, Ofcom recommends, as a first step, legal separation of Openreach, where Openreach would be incorporated as a legal entity, but remain a wholly-owned subsidiary of BT. Ofcom notes that legal separation of Openreach could take various forms - in particular it may or may not include the transfer of assets and employees to Openreach - and seeks views on the appropriate form of legal separation. Ofcom retains the option of introducing structural separation, should legal separation prove ineffective.
10. In parallel, BT has notified Ofcom of voluntary proposals for further functional separation of Openreach (the "BT Proposals"). Under these proposals, legal and structural separation of Openreach would be avoided. Openreach would remain a division of BT, governed under a revised version of the existing BT undertakings (the "Undertakings").
11. In circumstances where Ofcom has identified that a step-change is needed, it is manifestly inappropriate for any solution to Ofcom's concerns to be designed solely or predominantly by BT, whose incentive is to preserve the status quo and retain as much influence over Openreach's strategic decision-making as possible. The future of modern digital communications services for UK consumers and businesses should not be determined by 'horse trading'.
12. Rather than tinkering around the edges of the current failing structure, a new and distinct structure, underpinned by an objective and transparent framework, is required to secure Ofcom's objectives. This will ensure that Openreach makes strategic decisions in a manner that reflects the interests of all its customers, not just BT Group. Any model that does not achieve this will fail to resolve the concerns arising from BT's vertical integration and will not secure Ofcom's fibre investment objective.

¹¹ Openreach's annual operating plan is reviewed by the BT Group CEO and then requires approval by the BT Group Board; and a number of BT Group committees and divisions are involved in Openreach's decision-making processes.

¹² Ofcom Proposals, paragraphs 3.18-3.31.

¹³ Ofcom Proposals, paragraph 3.14.

13. The success of Ofcom’s final measures should be judged against measurable targets which assess whether the concerns Ofcom has identified in the SRDC have been adequately addressed. The benchmark is not merely whether Openreach demonstrates independence which is greater than at present; rather the target is whether the form of independence decided upon by Ofcom proves to be successful in countering Ofcom’s concerns and delivering its fibre investment objective.
14. This response in four parts:
- **Part A** reiterates that structural separation is the solution most likely to be effective in addressing the concerns arising from BT’s vertical integration.
 - **Part B** explains that if Ofcom does not impose structural separation, full legal separation of Openreach is the solution most likely to deliver meaningful change.
 - **Part C** outlines the specific improvements needed to the form of legal separation proposed by Ofcom in order to minimise undue influence from BT Group.
 - **Part D** explains that the costs associated with full legal separation are not disproportionate.

PART A – STRUCTURAL SEPARATION IS THE SOLUTION MOST LIKELY TO BE EFFECTIVE IN ADDRESSING OFCOM’S CONCERNS AND ACHIEVING OFCOM’S OBJECTIVES

Structural separation is the most effective solution

15. The Ofcom Proposals conclude that whilst structural separation is a “*credible option*” for addressing Ofcom’s concerns, BT should first be given the opportunity to make legal separation work.¹⁴
16. Sky remains of the view that structural separation is the most effective and enduring solution to address the adverse effects that arise from BT’s vertical integration in a timely manner. As Ofcom has recognised, full separation is “*the cleanest and most clear-cut long term solution*” to address Openreach’s underlying incentives.¹⁵
17. BT’s ownership, through Openreach, of the only ubiquitous national network infrastructure and its influence over Openreach lie at the heart of the competition issues Ofcom has identified. Establishing Openreach as a structurally independent company, outside the BT corporate group, would remove BT’s influence and vertical incentives. Any solution falling short of structural separation (for example, legal separation) risks being ineffective because it does not remove BT’s influence and vertical incentives; rather BT’s influence and ability to act on its incentives is merely circumscribed (to lesser or greater degrees depending on the precise solution adopted).
18. Government has encouraged Ofcom to:
- “tak[e] whatever action is needed to correct the competition problems identified and to promote the growth of the digital economy, however radical a change that might be” (emphasis added).*¹⁶

¹⁴ Initial Conclusions, paragraph 4.10.

¹⁵ Initial Conclusions, paragraph 6.57.

¹⁶ Government response to the Ofcom Strategic Review of Digital Communications and Business Connectivity Markets reviews, paragraph 8.

Structural separation is an appropriate response relative to the magnitude and enduring nature of the problems Ofcom has identified and to the importance of Ofcom's overarching goal and fibre investment objective for communications services in the UK in the coming years. Structural separation would make a significant contribution to achieving Ofcom's overarching goal.

Structural separation would increase competition

19. Structural separation would liberate all market players (particularly Openreach and BT's downstream divisions) and would unlock a series of positive, pro-competitive outcomes. In particular, BT Retail's business, with its large subscriber base, would become contestable, with all upstream suppliers competing on a more level playing field to win that business. This could transform the viability of these competing suppliers, leading to benefits for all downstream communications providers. This new competitive dynamic would have a significant effect on Openreach, which would face competition for the business of its largest customer as well as that of other downstream retailers, thereby incentivising it to compete more effectively and improve its service quality. This would maximise the scope for effective competition in the provision of high speed broadband services. Absent additional measures, this would not be achieved through legal separation alone.

Structural separation would increase investment

20. The increased competition that would flow from the contestability of demand from BT's retail divisions and increased demand from other downstream retailers would also likely lead to an increase in overall investment levels: upstream operators (including Openreach) would invest more in their existing networks and investments in new networks would become more economic and less risky. Openreach would also become free to work with all of its customers (not just BT) to finance significant new network investments. Increased investment in infrastructure goes to the core of Ofcom's overarching goal and fibre investment objective.

Structural separation would allow Openreach to focus solely on its core business

21. Establishing Openreach as a separate company would give it full control over its business strategy and remove the pressure on Openreach to take decisions that are designed to serve the broader interests of BT Group. If Openreach had the sole aim of optimising its wholesale revenues and profits for its shareholders, Openreach would be forced to place greater emphasis on serving the interests of all its customers and end-users equally.

Structural separation would be a significant deregulatory step

22. Structural separation would render redundant much of the complex and substantial regulation aimed at preventing BT from acting on its incentive to favour its downstream divisions. For example, many of the Undertakings and other behavioural regulation could be removed. This would free up Ofcom's resources to focus on implementing and enforcing more streamlined and focussed regulation targeted at addressing concerns arising from Openreach's upstream market power,¹⁷ which is key to Ofcom's objective of ensuring that the UK's communications sector meets the needs of end-users in coming years.

¹⁷ For example, as Ofcom notes at paragraph 1.44 of its Initial Conclusions, regulation would still be needed on price and quality.

The perceived barriers to structural separation are overstated

23. Plainly, BT strongly opposes structural separation, and has put forward a number of assertions about why it would either result in poor outcomes, or be excessively costly to undertake. These are without merit. For example, assertions that being part of BT Group provides Openreach with access to investment capital are risible. An independent Openreach would be a major FTSE-listed company, with ready access to investment capital via the markets. And in relation to the costs and complexity of separation, such claims are overblown. Companies de-merge all the time – indeed as recently as 2002 BT spun off its mobile telecoms business (BT Cellnet) – and the recent successful vertical separation of Telecom New Zealand shows how relatively straightforward such de-mergers can be.

PART B – ABSENT STRUCTURAL SEPARATION, FULL LEGAL SEPARATION OF OPENREACH IS THE SOLUTION MOST LIKELY TO DELIVER MEANINGFUL CHANGE

24. Ofcom has concluded that it would be disproportionate to move to structural separation as an immediate step. Although Sky considers that structural separation is the most effective and only clear-cut solution to achieving Ofcom’s policy goals and addressing the competition problems identified, legal separation, in the right form, could potentially be effective in delivering meaningful change (albeit to a lesser extent than structural separation). In this context, the Ofcom Proposals to establish Openreach as a legally separate entity are a useful stepping stone towards a genuinely independent Openreach.

Anything less than full legal separation is unlikely to be effective

25. The Ofcom Proposals need to go further in order to be effective at delivering the step-change required. In short, Openreach must be *fully* legally separate, with greater financial independence, its own infrastructure assets and its own staff. Even then, Sky does not consider that full legal separation will deliver all the benefits of structural separation and there is a risk that it will not fully achieve Ofcom’s objectives. Anything less than full legal separation (including the ‘light’ version of legal separation proposed by Ofcom, without, for example, Openreach asset ownership and direct employment of Openreach staff) however is extremely unlikely to secure Ofcom’s objectives.
26. Ofcom has indicated that it would move to structural separation (i.e. a more interventionist solution) if BT could not make legal separation work.¹⁸ In these circumstances, it would be wholly inappropriate and a wasted opportunity for Ofcom to accept the self-serving and ineffective measures proposed by BT. Under the BT Proposals (which merely entail amendments to the existing Undertakings and do not constitute legal separation), Openreach would remain a business unit of BT, with BT maintaining a high degree of involvement in Openreach’s management. Openreach would not have its own Articles of Association defining its specific purpose and the Openreach committee would continue to owe a duty to act in the best interests of BT plc and its shareholders. The BT Proposals would therefore not deliver meaningful change.
27. Sky agrees with Ofcom that the BT Proposals are wholly insufficient to address Ofcom’s concerns, because they do not achieve Ofcom’s objective of giving Openreach greater independence and autonomy.¹⁹ For this reason, they are also unlikely to achieve Ofcom’s objective to deliver timely enhanced fibre investment or its overarching goal for UK digital communications.

¹⁸ Ofcom Proposals, paragraphs 1.20, 1.23, 1.50, 2.13, 4.10 and 6.20.

¹⁹ Ofcom Proposals, paragraph 7.31.

Full legal separation has the potential to deliver considerable benefits

28. Whilst not as clear-cut as structural separation, full legal separation would be a more predictable and effective model than the status quo and has the potential to deliver considerable benefits. A legally separate Openreach, with its own purposes and board of directors with legal duties to act in the interests of Openreach, would be inherently more independent than under the current structure or under the revised structure proposed by BT. Full legal separation would introduce an objective governance framework, underpinned by well-established and widely understood principles of company law, thereby providing legal certainty and assurance about Openreach's independence.
29. Full legal separation is also an efficient way for Ofcom to address the competition problems and market failures it has identified. It would be inefficient for Ofcom to make further adjustments to the Undertakings (which Ofcom recognises have failed) in an effort to replicate what company law already does.
30. The key advantages of full legal separation are that it would:
- (i) enable Openreach's objects, purposes, powers and structure to be clearly circumscribed in Openreach's constitutional documents, including details of the rights and restrictions on BT Group when acting as a shareholder of the company as well as the responsibilities of the directors of the new entity;
 - (ii) ensure that Openreach has its own independent Board with the power to manage the company's affairs and with directors' duties to act in the best interests of and to promote the success of Openreach, rather than BT Group: the Openreach Board would be *"insulated... from the direct interests of the wider BT Group's other divisions"*,²⁰
 - (iii) lead to much greater transparency resulting in particular from the new governance processes and reporting obligations, which in turn would provide comfort and certainty to the industry and improve the ability of communications providers to engage with Openreach's plans and strategy;
 - (iv) give Openreach the ability to take legal steps in its own name, for example owning assets, borrowing money or putting in place legal instruments such as binding, arm's-length contracts between Openreach and BT Group;
 - (v) allow Openreach to be operationally independent, i.e. to be free from influence in its day-to-day operations, with greater resources, giving it the technical and commercial capability to manage its operational delivery without relying on BT Group;
 - (vi) allow Openreach to make strategic decisions for the benefit of the market as a whole; and
 - (vii) ensure that (at least at a senior level) Openreach employees' duties are to Openreach and that their remuneration is not aligned with the performance of BT Group.
31. Ofcom states that one of the most important measures of success of its proposal is its ability to assess whether Openreach board decisions are made independently, without

²⁰ Ofcom Proposals, paragraph 4.5.

undue influence from BT Group.²¹ The increased transparency that would flow from Openreach's legal incorporation would provide a clear and established framework, underpinned by statute, for Ofcom to monitor whether Openreach is in fact operating independently of BT Group. This would be much more effective and transparent than the current set of complex behavioural remedies to which BT is subject.

32. A requirement for legal separation has an established precedent in competition and regulatory policy. In other sectors such as energy, transport and banking, wholly-owned subsidiaries are required or enabled to act with a substantial amount of freedom from their parent companies. Legal separation has also been implemented in the telecoms sector in a number of countries, including Sweden, Singapore, Australia and New Zealand.²²
33. Many examples are described in the Industry 10-Point Plan which Sky, TalkTalk and Vodafone provided to Ofcom in May this year. To highlight one, when Centrica acquired the Rough Gas Storage Facility ("Rough") from Dynegy in 2003, it gave undertakings to the Secretary of State for Trade and Industry which required it to establish legal, financial and physical separation between the entity with market power and all other parts of Centrica's business.²³ This was because the Competition Commission (the "CC") had found that vertical integration with Rough would give Centrica the ability and incentive to behave in ways that would disadvantage its downstream rivals. In the absence of these undertakings, the CC considered that other industry participants and potential entrants would experience a significant increase in uncertainty, both as to their future access to the storage facility and as to the effect that the merger might have on Centrica's conduct in the wholesale market. The CC considered that one of the likely effects of such uncertainty was a distortion in investment in gas storage, including a reduction in investment caused by increased uncertainty over expected returns, as well as inefficient investment in other storage facilities motivated by uncertainty over future access to Rough.
34. Applying the above principles to Ofcom's stated strategic objectives,²⁴ full legal separation has the potential to lead to more equal and transparent treatment of all Openreach's downstream customers. This in turn could foster greater investment in FTTP networks and improved service quality, because Openreach would be more attuned to the requirements of all its customers.
35. However, this outcome is not likely to be achieved through full legal separation alone: full legal separation is only one of a wider series of necessary measures. As discussed further in the sections below, additional regulatory measures need to be implemented to ensure:
 - (i) strong and effective functional separation between the operation of the new subsidiary and other parts of BT; and
 - (ii) enhanced contestability of wholesale supply of communications services to BT's retail divisions.
36. As discussed further in Part C below, these additional measures will increase competitive pressure on Openreach at the wholesale level and create conditions for a more level playing field (through greater and more robust use of the equality of inputs principle and by removing BT's ability to influence Openreach). The greater independence of BT's retail

²¹ Ofcom Proposals, paragraph 1.46.

²² Singapore, for example, operates a multi-tiered market structure consisting of: the network operator, several operating companies and retail service providers.

²³ See Section 5 of the undertakings, latest version available [here](#).

²⁴ The strategic objectives are set out in footnote 8 above.

divisions should mean that Openreach would face buyer-side pressure to invest in fibre rollout and improve quality of service. In turn, this should give Openreach increased incentives to improve and maintain better service provision to retain the business and also to ensure continued service improvements in the longer term.

37. In this way, the package of measures in totality will reinforce Openreach's independence and better equip Ofcom to achieve its fibre investment objective and overarching goal.

PART C – OFCOM'S PROPOSALS FOR LEGAL SEPARATION NEED TO GO FURTHER TO BE EFFECTIVE

38. As we have highlighted, the exact form of legal separation imposed on Openreach is critical for ensuring effective strategic and operational independence. Legal separation of Openreach in name only, through the incorporation of a shell company with no resources or meaningful independent decision-making powers, similar to BT's Plusnet subsidiary, will not address Ofcom's concerns. While Ofcom's proposals for legal separation are a starting point – as described below, Sky supports many of Ofcom's recommendations – they do not go far enough. Any dilution of full legal separation, would undermine Openreach independence and not address Ofcom's stated concerns or secure Ofcom's objectives.
39. The Ofcom Proposals are a light form of legal separation. In order to deliver full legal separation, the proposals require specific clarifications and improvements to enhance their effectiveness.
40. At every stage, BT Group's influence should be circumscribed to the minimum necessary to establish fundamental ownership protections.
41. The enhancements essential for securing effective Openreach independence are discussed further below and fall into four key areas:
- (i) improvements to enhance the independence of Openreach's governance;
 - (ii) improvements to enhance the financial independence of Openreach;
 - (iii) measures to ensure Openreach controls the core resources necessary for operational autonomy; and
 - (iv) measures to improve the contestability of wholesale supply of communications services to BT's retail divisions.
42. At the end of this section, we outline our recommendations for implementation and for monitoring the effectiveness of the final measures.

Measures to enhance the independence of Openreach's governance

43. Effective legal separation rests on the independence of the Openreach board and its ability to make unfettered decisions.

Some elements of the Ofcom Proposals are welcome

44. The Ofcom Proposals comprise some key elements necessary to establish independent Openreach governance. In particular, Sky welcomes the following aspects of Ofcom's proposals:
- (i) Openreach will have its own board of directors, subject to duties underpinned by company law;

- (ii) Openreach directors will owe primary duties to Openreach as a company and will have clearly defined delegations, within which the directors can operate independently of BT Group;
- (iii) Openreach's core company purposes will include furthering its own objectives and acting in the interests of all customers equally and Openreach directors must act in a way which, in good faith, is most likely to achieve those purposes. Openreach directors will also be subject to standard statutory duties, including the duty to promote the success of Openreach; and
- (iv) The Openreach CEO and Openreach senior executives will be appointed by the Openreach Board. No Openreach executives will have direct lines of reporting into BT Group. The Openreach CEO will report into the Openreach Chairman.

However, Ofcom's proposals need to go further in other key areas:

45. *Board appointments: a process must be established for appointing the Openreach board which is free of BT's influence.*

- (i) The Openreach board bears a heavy responsibility to lead the behavioural change needed to create a genuine break from the status quo. It is critical therefore that the individuals who make up the board are chosen independently.
- (ii) Ofcom proposes that the appointment of the new Openreach directors would be carried out by BT Group, in consultation with Ofcom. BT would also retain the ability under company law to remove directors by resolution. This ongoing BT involvement in key Openreach appointments creates a significant risk of BT Group continuing to exert material influence over the Openreach board.
- (iii) It would be more appropriate to utilise an arm's-length appointment process akin to that designed for listed companies under the UK Corporate Governance Code (the "Code").²⁵
- (iv) Under the Code, a nomination committee is expected to engage in a formal, transparent and rigorous appointment procedure in order to appoint new directors. The relevant provisions of the Code are set out in Annex 1. The committee itself could also have regard to other requirements, for example, the balance of female representation on the board or the need for directors to be security vetted.
- (v) In this case, Ofcom could establish an independent nomination-style committee to make the initial appointments to the Openreach Board. Subsequent appointments would be made by a nomination committee constituted of independent members from the established Openreach Board. Should BT Group consider it essential to retain some participation in the appointment process, it could have a veto right providing it with a limited number of vetoes over candidates proposed by the committee.
- (vi) Sky understands that BT has commenced recruitment for a Chairman of the Openreach Board, per the divisional structure set forward in the BT Proposals. Such recruitment is highly premature and should not be permitted to prejudice Ofcom's preferred package of final measures. In particular, it should not be a

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The UK Corporate Governance Code, Financial Reporting Council, April 2016.

barrier to fresh recruitment following the implementation of Ofcom's final measures.

(vii) Sky welcomes the criteria set out in paragraph 4.18 of the Ofcom Proposals for identifying a non-affiliated, non-executive director for the Openreach Board. However, these should be supplemented with additional criteria for identifying where an individual is not independent, as set out in the Code, provision B.1.1:

- if the director has, or has had within the last three years, a material business relationship with the company (i.e. BT or Openreach) either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- if the director holds cross-directorships or has significant links with other BT directors through involvement in other companies or bodies;
- has served on the board of Openreach for more than nine years from the date of their first election;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme; or
- if the director has close family ties with any of the relevant company's advisers.

(viii) To maintain a minimum standard of independence of the Openreach Board, the remuneration of the executive directors on the Openreach board (and indeed other senior Openreach executives and senior employees) should not be linked to the performance of the BT Group as a whole, nor should they receive hospitality, payments or services from BT.

46. *Board composition: BT Group presence on the Openreach Board should be eliminated or heavily circumscribed*

(i) Ofcom proposes that the Openreach Board would include a BT Group non-executive director. Provided appropriate reporting processes are in place from the Openreach Board to BT Group, the grounds for including a BT Group non-executive director are wholly unclear. Rather, the BT Group non-executive is likely to struggle to discharge his or her duties to Openreach effectively and may be a conduit for ongoing BT Group interference in Openreach board decision-making.

(ii) The reasons for this are as follows:

- the flow of information to the BT non-executive director on the Openreach Board (and potentially of information relevant to Openreach through the BT board) would be so restricted that he or she would be limited in their ability to discharge their duties as a director;
- more broadly, as Ofcom acknowledges,²⁶ the BT non-executive director would owe general duties to both BT Group and Openreach. In practice, it would be a challenge for any director to fulfil both sets of duties without

²⁶

Ofcom Proposals, paragraph 4.34.

finding themselves conflicted on a regular basis. Therefore, the benefit of having such director would be undermined;

- the purpose of reserved matters (see below) is to ensure that BT's rights as a shareholder are protected and should act as adequate protection for BT without the additional need for presence on the Openreach Board; and
- the presence of the BT non-executive director creates a route for unnecessary direct BT Group influence on Openreach which risks diluting Openreach independence. The individual would continue to bring a BT Group perspective to bear on Openreach decision-making and may influence Openreach board debates in a manner that does not reflect fully Openreach's company purpose.

47. In light of the above concerns, the cleanest solution is for BT Group presence to be completely eliminated from the Openreach board.²⁷ If a BT Group presence is considered essential, then this should be limited to a BT board observer position. Whilst a BT board observer would also face recusal from many of the Openreach board discussions of competitively sensitive issues, this would not be significant as the board observer would not have formal duties in the governance of Openreach.
48. *Board decision-making: Openreach reserved matters should be limited to fundamental ownership protections*
- (i) By definition the establishment of reserved matters removes decision-making from the Openreach Board and transfers it to BT Group. As such, this dilutes the effectiveness of Openreach's independence.
 - (ii) As the owner of Openreach, BT Group will consider it necessary to retain some decision-making for itself. However, the list of reserved matters should be narrowly defined and limited to issues of fundamental ownership protections, such as the issuing of shares and the liquidation of the company. A template list of reserved matters is set out in Annex 2.
 - (iii) There should be transparency of the list of Openreach reserved matters, which should be specified in advance. By contrast, the governance protocol proposed by BT refers to reserved matters at Part C. However, this section simply cross-refers to other BT documents and policies and the exact reserved matters are not visible from the proposed governance protocol itself. The risks associated with this type of approach are evident under the Undertakings, where a broadly defined Annex 2 has been used by BT to allow an extensive range of BT Group personnel and departments to have access to and influence Openreach's commercial strategy and thereby effectively circumvent the overall intent of the Undertakings.
 - (iv) There should also be transparency of the BT decision-making on the Openreach reserved matters. This is particularly important in relation to those matters which

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An elimination of board involvement of this type was implemented in the privatisation of the UK electricity sector, whereby the privately held regional electricity companies collectively owned a holding company – National Grid Holding plc – which, in turn, owned the National Grid Company plc – the owner and operator of the national electricity transmission grid. Under the articles of association of National Grid Company plc, no officer or employee of National Grid Holding plc, or any of its shareholders (or of a company related to one of the shareholders) may at the same time be a director or officer of the National Grid Company plc. A similar provision was included in the merger undertakings given by Centrica plc in relation to its acquisition of the Rough gas storage facility. A legally separate Centrica storage subsidiary was established to operate Rough – Centrica Storage Limited. No employee or director of any member of the Centrica Group is permitted to hold any office of employment or directorship in Centrica Storage Limited.

go to the heart of Openreach's strategic independence and its ability to make the large investments it sees as desirable (e.g. approval of requests outside of the 'financial envelope'). BT should be required to provide a reasoned explanation of any decisions to reject investment approval requests. A further safeguard in respect of BT's decision-making could be afforded by an obligation, for example in the Undertakings, requiring BT to act reasonably in its decision-making on reserved matters.

Measures to enhance Openreach's financial independence

49. To establish genuine independence from BT Group, Openreach must have significant financial independence. Without this, Openreach will be unable independently to make the large investments it identifies as desirable, nor be able to respond objectively and confidentially to investment requests or offers from large wholesale customers or co-investment partners.
50. Whilst Sky welcomes Ofcom's proposals to facilitate freedom of Openreach decision-making within a financial envelope specified by BT Group, Ofcom's final measures will need to go much further in detail and scope in order to establish effective financial independence for Openreach.
51. Openreach will need sufficient funds at its disposal, without continuous recourse to BT Group. At a fundamental level, this will require the financial envelope to be large enough to allow freedom of Openreach decision-making on all but exceptional issues. Ofcom's final measures should specify this, at least at a principled level. The financial envelope could set out high-level financial metrics in a number of areas, including capital expenditure and an acceptable project rate of return, in order to provide BT Group with appropriate insight as the owner of Openreach.
52. The capital expenditure allocation within the financial envelope should be large enough to enable Openreach to conduct the investment activities that are essential to it fulfilling Ofcom's strategic objectives, bearing in mind that many of its core investments will be capital-intensive. We agree with Ofcom that Openreach's independence would be significantly undermined under BT's proposal to require BT Group to approve Openreach's investments of 'strategic importance', in addition to investments above the specified financial approval threshold.²⁸ It would be impossible to define strategic importance in a precise way and as such, this approval process could be used as a route for unnecessary BT Group influence, undermining effective Openreach independence. The approval thresholds defined in Ofcom's final measures should contain no such obligation.
53. Within the indicative financial envelope, we agree with the Ofcom Proposals that Openreach should independently identify its priorities and develop its medium term strategic plan, as well as its annual operating plan. It is critical that the BT Group board has no formal approval role in this process, as Ofcom proposes.²⁹
54. As noted in the Industry 10-Point Plan, it is desirable for Openreach to have its own capital raising powers. The ability for Openreach to borrow in its own name in order to fund its business plan, will deliver further independence from BT Group. This could address concerns that if BT Group retains full control of Openreach funding, it may use this as a lever to ensure funding only for the projects which serve BT's overall interests. As an independent legal entity with over £5 billion of revenues per annum, there is no reason why Openreach would not be able to borrow cost-effectively. In addition, if considered

²⁸ Ofcom Proposals, paragraphs 7.41 to 7.42.

²⁹ Ofcom Proposals, paragraph 4.48.

necessary, this could be accompanied by an agreed ceiling on Openreach incurring debt beyond a certain level of leverage.

55. In order to enhance transparency, it is also essential for Openreach to publish separate audited accounts. In addition to its current obligations to provide regulated financial accounts and reporting to Ofcom, this obligation would ensure that Ofcom and other stakeholders (such as customers and potential co-investment partners) would be provided with transparent information about Openreach's financial performance. This would provide a sounder basis for assessing Openreach's costs and enable, for example, enhanced accuracy and enforcement of Ofcom's price controls, as well as being an important confidence-building measure for potential co-investment partners.

Measures to ensure Openreach controls the core resources necessary for operational autonomy

56. The Ofcom Proposals must go further to ensure both that Openreach can operate on an ongoing basis free of material dependency on BT Group and that genuine cultural change is brought about within Openreach.
57. This means that the following are essential:
- (i) Openreach must own the infrastructure assets needed for its operations; and
 - (ii) Openreach must directly employ its staff.
58. The Ofcom Proposals suggest that the above elements are a preference rather than a 'must-have'.³⁰ We disagree. Ofcom should have more than a 'strong preference' for these aspects of legal separation. They should be a fundamental part of Ofcom's final measures because without them legal separation is extremely unlikely to lead to meaningful change.
59. These measures were considered in detail in the Industry 10-point Plan previously provided to Ofcom (proposals 10 and 13, respectively). We do not repeat that detail here. For convenience, the proposals are reproduced at Annex 3 and the key aspects are summarised below.

Assets

60. Openreach should own the infrastructure assets it needs to fulfil its company purpose and its strategic and operational plans.
61. Such assets include (but are not limited to):
- (i) interests in land for network assets and for Openreach's commercial purposes (e.g. offices);
 - (ii) passive infrastructure, such as ducts, poles and copper and fibre connections;
 - (iii) some active assets, such as those used to provide Connectivity Services and fibre to the cabinet, as well as other elements of network access such as power and accommodation; and
 - (iv) customer supply contracts (which are currently between the customers and BT Group).

³⁰ Ofcom Proposals, paragraphs 4.71 – 4.81.

62. Ownership of these assets will enable Openreach to manage independently the delivery of its services. This should mean that it can deliver its services more reliably than at present, as well as ensuring that delivery is consistent with its regulatory obligations, for example, providing services on an equivalence of access basis. It will also remove a key aspect of Openreach's dependency on BT Group and therefore limit influence from BT Group.
63. Openreach would not be independent of BT if it relies on a service agreement with BT for access to essential infrastructure assets, which are core to Openreach's ability to fulfil its company purpose.
64. The important benefits of full legal separation should not be sacrificed over an exaggerated fear of practical difficulties in transferring assets, such as contracts with third parties. Such difficulties are unlikely to be material and can, in any event, be mitigated in a straightforward manner. For example, Ofcom could permit such transfers to be conducted over a longer transitional period and/or could carve out certain limited exceptions up to a threshold of, e.g. 20% of the asset base being accessed under arm's-length contracts.
65. [X][CONFIDENTIAL][X]

Employees

66. Workforce independence is a critical element in delivering genuine Openreach independence and cultural change.
67. Again, for similar reasons to those identified above for asset ownership, direct employment of Openreach staff is important to give Openreach the autonomy to fulfil its company purpose and deliver on its strategic and operational plans.
68. In addition, establishing direct employment relationships with Openreach staff is an important step in cultivating genuine cultural and behavioural change within Openreach. As noted above, it is important that the remuneration incentives for, at least the most senior Openreach staff are not predicated on BT Group performance, but rather driven by Openreach performance.
69. The transfer of Openreach employees from the existing Openreach division to the new wholly-owned Openreach subsidiary could be implemented in a straightforward manner under TUPE.³¹ Openreach would simply have to ensure that the employees were offered the same or equivalent contractual terms. In order to achieve genuine cultural and behavioural change, it is recommended that senior Openreach employees have remuneration packages (including incentive schemes) which are based on Openreach performance, rather than BT performance. This would assist in aligning the incentives of senior management to the performance of Openreach as a company, rather than BT Group as a whole. This could be achieved within a TUPE arrangement by offering those employees access to equivalent Openreach-related incentive schemes, where they were previously within a BT-related scheme.
70. [X][CONFIDENTIAL][X]

Measures to enhance contestability of wholesale supply of communications services to BT's retail divisions

71. One important benefit of structural separation is that both Openreach and BT's downstream retail businesses become fully independent from each other. This would have

³¹ 'TUPE' refers to 'The Transfer of Undertakings (Protection of Employment) Regulations 2006'.

an important benefit in relation to Ofcom's strategy of promoting investment in FTTP networks because other operators would, in principle, be able to compete to supply BT Retail with wholesale inputs, alongside Openreach provision.

72. As long as BT remains vertically integrated however, as it would with legal separation, BT has strong incentives to tie BT Consumer's business to the Openreach network (not least because, in doing so, BT ensures that Openreach maintains a dominant position in wholesale access markets and the benefits that accrue from that).
73. Under legal separation, the presence of this large captive customer on the Openreach network would undermine Ofcom's efforts to strengthen Openreach independence and as a result to promote the roll out of FTTP networks. This would occur in two ways:
- (i) Openreach would not be sufficiently independent for it to treat all its customers equally. All aspects of its strategic and operational decision-making would be significantly distorted by its knowledge that the custom of a group company – which is also the UK's largest broadband retailer – is assured. The treatment of Openreach's other customers would be made through that lens – this would not occur under structural separation.
 - (ii) The lack of contestability in the wholesale supply of communications services to BT Consumer also deprives any potential builders of FTTP networks of sufficient scale to make their investments economically viable. This lack of any potential network competition to Openreach also reduces its incentives to invest in FTTP itself.
74. It is for these reasons that Sky, along with other communications providers, proposed in the Industry 10 Point Plan that under legal separation BT should be obliged to take measures that enhance contestability in the wholesale supply of communications services to its retail divisions – for instance, through a mandatory, open tendering process, with independent oversight.
75. Ofcom's justification for not considering these points now was that “*requiring BT to tender for network providers for its retail operations*” does not relate directly to Openreach's strategic and operational independence. The key point, however, is that Ofcom is considering legal separation of Openreach as a way of achieving the objectives that have emerged from its strategic review, having taken the view that currently full structural separation may be disproportionate to the achievement of those objectives. If one of the key benefits of full structural separation is lost, namely independence of BT's retail divisions, in Sky's view it makes sense to consider additional options for promoting such independence alongside measures to make Openreach also behave more independently.

Implementation recommendations

76. In order to ensure the success of Ofcom's final measures, the following further steps are important:
- (i) The Openreach constitutional documents, such as the Articles of Association, will be critical in ensuring effective implementation of full legal separation. It is therefore essential that industry is appropriately consulted on the content of those documents.
 - (ii) As sole shareholder of Openreach, BT would have a number of statutory rights that would enable it to circumvent full legal separation. Importantly, BT would have the right to amend Openreach's Articles of Association which, as noted above, are key for implementation of full legal separation. Whilst immediate and overt reversal of the legal separation measures would be readily visible, it is also possible that BT

could make subtle changes to the articles which would gradually erode full legal separation. It is essential therefore that BT provides an undertaking to Ofcom not to engage in conduct, for example through use of its shareholder rights that would undermine the purpose and effect of the final measures implemented by Ofcom. In addition, BT should be required to notify Ofcom of any changes to the articles and the underlying rationale for such changes.

- (iii) A specific and short timeframe should be defined for transitioning to the new arrangements, e.g. a maximum of six months. This should not prove unduly onerous as BT has a proven ability for executing complex transactions in short order (for example, its recent acquisition of EE). It is critical that the concerns arising from the existing Openreach governance structure are addressed as swiftly as possible. Where there are certain non-strategic functions which cannot be transitioned in this timeframe (for example, payroll), an arm's-length, time-limited transitional services agreement could be put in place. The duration of such an agreement should not be excessive and in any event should not exceed 24 months.

Monitoring the effectiveness of these proposals

- 77. In Section 6 of the consultation Ofcom proposes to monitor the outcomes delivered by the proposed changes and, if they are found not to be working effectively, to carry out "*a more detailed review*" in which the "*core question*" 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.*"
- 78. Sky welcomes the proposal to monitor the outcomes of the proposed changes. However:
 - (i) rather than focus on a diffuse set of factors – many of which may not be linked directly to the proposed changes – as Ofcom proposes, Sky considers that Ofcom should instead monitor a small set of indicators of positive change in relation to Openreach independence. We discuss proposed indicators further below; and
 - (ii) it is unnecessary to propose a further – no doubt lengthy – review in the event that the proposed changes are found not to deliver. Ofcom has made it abundantly clear that the current proposals are an alternative to structural separation of Openreach. Ofcom should make it clear that if the current reforms are found not to be working, it will proceed directly to implementation of structural separation.

Proposed metrics of success

- 79. Ofcom's proposals are intended to change the behaviour of Openreach – to make it take decisions that are more independent of the wider interests of BT Group, and more in line with the types of decisions that an independent entity would take.
- 80. Accordingly, the best measure of whether the new regime is succeeding is whether Openreach takes decisions on key issues that are the types of decisions that an independent network operator would take.
- 81. There are three key areas in which Openreach decisions should be monitored, as follows.
 - (i) Charging for GEA services

The level and structure of GEA charges favour BT's retail business, at the expense of driving the additional volume that third parties, such as Sky and TalkTalk, could help to deliver. An independent Openreach would be likely to do some or all of the following: (a) lower GEA rental charges, (b) lower upgrade charges for customers

transferring from standard broadband to superfast broadband, and (c) be open to negotiation of agreements which provide lower charges for revenue guarantee commitments.

Delivery of these types of changes should be a key metric for evaluation of the success of the new regime.

(ii) Greater investment in FTTP

It is evident that a key driver of Openreach's current preference for incremental upgrades of its network is the overall preferences of the BT Group. An independent Openreach would be more likely to be willing to invest to a far greater extent in FTTP. Accordingly, additional investment of this type – above existing plans announced by BT – should be a key metric for evaluation of the success of the new regime.

(iii) Engagement with proposals for co-investment

An independent Openreach should be expected to be willing to engage constructively with proposals by third parties for co-investment opportunities. This does not mean that it should be expected to accept all such proposals. However, the hallmarks of constructive engagement with proposals include: (i) timely engagement in dialogue on proposals, (ii) provision of reasonable counter-proposals or amendments to proposals, (iii) acceptance of reasonable, profitable proposals and (iii) provision of sound reasons for rejecting proposals.

PART D – THE COSTS ASSOCIATED WITH FULL LEGAL SEPARATION ARE PROPORTIONATE

82. Given Ofcom's current focus on legal separation, in this section we address the costs associated with our recommended form of full legal separation.

The effectiveness of a solution is an essential element of proportionality

83. Before turning to the costs of full legal separation, we comment on Ofcom's assessment of the Ofcom Proposals. In Section 5 of its consultation, Ofcom assesses the costs of the Ofcom Proposals. It concludes at the end of the consultation document that its proposals are proportionate.³² However, the effectiveness of a solution is an essential element of any proportionality assessment and the Ofcom Proposals do not meet this criterion.³³

84. In the SRDC, Ofcom identified persistent and pervasive adverse effects arising from BT's vertical integration, that existing regulation has failed to address. This has resulted in poorer outcomes for consumers and businesses as regards price, choice, quality of service, investment and the speed of innovation coming to market.

85. In light of Ofcom's extensive concerns, structural separation is a proportionate solution, as, for the reasons explained in Part A above, it is the solution that can most effectively and comprehensively address Ofcom's concerns with the greatest certainty.

³² Section 5 and paragraph 9.1 of the Ofcom Proposals.

³³ See, for example, the Supreme Court in *R (Lumsdon) v Legal Services Board* [2015] UKSC 41, paragraph 33, reaffirming the jurisprudence of the European courts on the interpretation of the principle of proportionality.

86. There is less certainty that full legal separation will be effective in addressing Ofcom's concerns. Nevertheless, if implemented as recommended above, it could engender meaningful change in the independence of Openreach decision-making. If it proves to be effective, full legal separation could therefore also be a proportionate solution.
87. A solution which falls short of full legal separation, such as the weaker forms of legal separation described in the Ofcom Proposals (which do not involve Openreach control of assets and employees) or BT's proposal to avoid legal incorporation altogether and maintain Openreach as a division of BT Group, will not be effective in addressing Ofcom's concerns. These structures will not deliver the step-change required to secure genuine Openreach independence. In addition, the BT Proposals will not provide an objective and transparent framework for governance and for monitoring the effectiveness of the separation. As such, these solutions cannot meet the first limb of the proportionality test – effectiveness.

The costs of full legal separation are not disproportionate

88. We do not anticipate that the costs of the internal reorganisation necessary to achieve full legal separation would be disproportionate. By way of benchmark, BT anticipated spending £0.5 billion in integration costs for its recent merger with EE.³⁴
89. [REDACTED][CONFIDENTIAL][REDACTED]
90. Sky has sought independent advice from:
- (i) Sackers LLP (“Sackers”) on whether there is a bar from a pensions law perspective to separating Openreach (previously submitted to Ofcom and reproduced at Annex 5); and
 - (ii) Mercer Limited (“Mercer”) on the impact of full legal separation of Openreach on the employer covenant and possible mitigation (provided at Annex 4).
91. [REDACTED][CONFIDENTIAL][REDACTED]

Conclusion

92. In conclusion, to the extent that it is effective, full legal separation is a proportionate solution to the deep-seated concerns identified by Ofcom and the broad-ranging objectives it is seeking to achieve. If it ultimately proves ineffective, Ofcom should not hesitate in swiftly ordering structural separation in order to deliver the change needed in the UK digital communications sector.

Sky

October 2016

³⁴ See the BT Group presentation on its acquisition of EE, slide 18, available [here](#).

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

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ANNEX 1: PROVISIONS OF THE UK CORPORATE GOVERNANCE CODE RELEVANT TO APPOINTMENT OF NEW DIRECTORS

- A1.1 The full UK Corporate Governance Code is available [here](#).
- A1.2 Code Provision B.2 states that there should be a formal, rigorous and transparent procedure for the appointment of new directors. More specifically, the Code provides a detailed process for the appointment of directors as follows:
- (i) the nomination committee (with a majority of independent non-executive directors as members) should lead the process for board appointments and the majority of members should be independent non-executive directors (Code Provision B.2.1);
 - (ii) the nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board (Code Provision B.2.1); and
 - (iii) the work of the nomination committee should be reported upon in a separate section of the Annual Report with an explanation given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or non-executive director (Code Provision B.2.4).

ANNEX 2: PROPOSED LIST OF OPENREACH RESERVED MATTERS

A2.1 BT to provide its written consent prior to:

- (i) decisions that exceed a clearly defined 'financial envelope';
- (ii) the acquisition or disposal of any interest in the share capital of any other body corporate by Openreach or of the assets of another company;
- (iii) the issue of any shares in Openreach or the grant of any option or right to acquire or call for the issue of the same;
- (iv) the paying up of any share capital or debenture or debenture stock of Openreach;
- (v) any proposal for the winding-up or liquidation or other insolvency related arrangements of Openreach;
- (vi) the making of any change to the agreed accounting practices and policies of Openreach except where such change is required by law or recommended by the auditors;
- (vii) the recommendation of or proposals for any payment of any dividend or any other distribution by Openreach (noting that the Articles of Association of Openreach will only typically allow for dividends to be paid which are recommended by the Openreach Board);
- (viii) the entry into any partnership, joint venture or other profit sharing agreement; and
- (ix) the changing of the accounting reference date.

ANNEX 3: EXTRACT OF INDUSTRY 10-POINT PLAN REGARDING ASSET AND WORKFORCE INDEPENDENCE

The extract attached sets out Proposals 10 and 13 from the Industry 10-Point Plan, previously provided to Ofcom as part of the Industry 10-Point Plan.

ANNEX 4: MERCER PENSIONS REPORT ON THE OFCOM PROPOSALS FOR THE LEGAL SEPARATION OF OPENREACH FROM BT PLC

ANNEX 5: SACKERS REPORT ON THE PENSION ISSUES AND CONSIDERATIONS ARISING FROM THE OFCOM PROPOSALS FOR THE LEGAL SEPARATION OF OPENREACH FROM BRITISH TELECOMMUNICATIONS PLC