How integration within BT Group affects the management and performance of Openreach

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1. I have been asked by Talk Talk Group to consider how and whether the position of BT Openreach as a wholly owned subsidiary of BT Group plc is likely to affect its day to day management and performance. I am aware that there is already an extensive debate in this Digital Communications Review about how and whether the vertical integration of BT Group provides Openreach with the incentive and ability to discriminate in favour of its affiliated downstream operations, BT Consumer and BT Business (previously BT Retail). This is not the primary focus of this paper.

2. Instead, I consider the incentives which BT's management, at both at Openreach and BT Group, face when discharging their responsibilities and, in particular, when thinking about how to allocate resources amongst BT's various businesses. I conclude that whilst current regulatory arrangements are intended to, and may to some degree, ensure that Openreach's management act as if Openreach were independent from BT Group, they also mean that Openreach loses the internal battle for resources more often than not. I think this means that, even if Openreach's management were competent and committed to meeting the needs of their wholesale customers (which I presume them to be), their ability to do so will be always be compromised by the resources they can obtain from BT Group. Ironically, I think this problem gets worse the more effective Ofcom's existing regulatory arrangements (to prevent discrimination by Openreach) prove to be. Only a fully separated Openreach would be free of such internal constraints.

Conglomerates have both advantages and disadvantages over non-integrated rivals (and BT is no exception)

3. Large and complex conglomerate organisations such as BT Group are bound to be challenging organisations to manage. BT has had its share of adventures over the past 20 years, with expansion and retrenchment in areas such as Global Services (including joint ventures with AT&T and MCI, subsequently unwound, during the 1990s), UK mobile (with the demerger of O2 in 2001 and proposed acquisition of EE fifteen years later) and entry and then exit from a wide variety of overseas businesses throughout the period since privatisation (notably mobile interests in Europe and Japan). A substantial economic and business strategy literature has developed over the years to claim that complex conglomerates underperform their less diversified peers over the long term. This is

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reflected in the concept of a 'conglomerate discount' to reflect the fact that a large firm trades at a discount to the valuation of the sum of its constituent parts[2].

4. However, conglomerates may also hold certain advantages over less integrated businesses. There are many conglomerate businesses that do not trade at a discount, or which outperform the market of their peer group during certain periods but underperform during others. At first sight, BT Group appears to be in this category, having significantly outperformed the FTSE over the past 5 years, a period during which total returns for BT shareholders have increased by over 200%.

5. The various costs and benefits that might arise from a conglomerate structure are nicely illustrated by the demerger of Telecom New Zealand (TNZ) into separate network and retail businesses in late 2011. There are, of course, important differences between the position that company found itself in and the position BT Group finds itself in today. The most significant is the New Zealand Government's willingness to proceed with the construction of a publically funded fibre network to compete with TNZ if TNZ had not agreed to demerge its operations at the time. No such threat is being made by the UK Government today (so far as I am aware). Nonetheless, the notice issued to shareholders by the Board of TNZ in September 2011 provides a good summary of the various benefits and costs that BT Group (and most other conglomerates) might also be expected to derive from its existing structure[3].

6. In that notice the TNZ Board identify the following as **advantages** of an integrated structure (which they therefore consider to be costs of the proposed demerger):

    a. The integrated business has larger and more diversified earnings than the demerged business, which may allow for a lower cost of borrowing or borrowing on less stringent terms.

    b. The scale and diversification of the integrated business may provide greater stability in volatile financial market conditions

    c. The integrated business may obtain economies in joint purchasing which the smaller, demerged businesses may not be able to secure

    d. The integrated business may allow adverse events in one business to be offset by gains in another. In particular, losses of retail market share by Telecom New Zealand to competitors might be partially offset by wholesale revenues earned by the network business (the same argument might apply to the offsetting of regulatory shocks applied to the network business). The demerged businesses could not offset costs and losses in this way and their owners will be proportionately more exposed to such shocks as a result

[2] See, for example, John Kay in The Oxford Handbook of Strategy: A Strategy Overview and Competitive Strategy, Faulkner and Campbell (eds), section 2.2; Michael Porter, Chapter 12 in Managing the Multibusiness Company: Strategic Issues for Diversified Groups, Goold and Sommers Luchs (eds); Maksimovic and Phillips, 'Do Conglomerate Firms Allocate Resources Inefficiently Across Industries' at http://www-bcf.usc.edu/~gordonph/Papers/conglom.pdf
[3] https://www.chorus.co.nz/file/53605/scheme-booklet.pdf, sections 2.2 and 2.3

e. The network business will not make long term network investments with the underpinning support of cashflows from a wholly owned retail customer base. Conversely, the retail business will no longer have access to the more stable cashflows earned by the network.

7. The TNZ Board also recognise that there are important **disadvantages** with the current, integrated structure (which they describe as benefits from the demerger):

    a. The management of the integrated business may lack focus compared to the demerged operations, as the retail and network businesses each have very different business models, serve very different customers and face different competitive and regulatory conditions.

    b. The integrated business will have a capital structure and financial policies which may not best reflect the needs of its very different constituent parts. In particular, a demerged network business would be expected to be able to assume significantly greater leverage than the integrated firm might contemplate

    c. Management incentives for running an integrated business will differ from those required to manage each division well. It may be possible to devise more focussed and more effective management incentives in a demerged enterprise.

    d. Investors in an integrated business are unable to gain direct exposure to the underlying assets which may better suit their investment requirements. It is also difficult for investors to gain adequate information of and understanding about the constituent elements of a complex conglomerate and to hold management properly to account.

8. In the case of TNZ, the Board considered that any advantages of the integrated structure were outweighed by disadvantages and recommended that the demerger proceed. Shareholders agreed and appear to have earned solid returns from the demerged businesses in the period since then.[4]

9. BT has also exhibited many of the features identified in the TNZ documents– both positive and negative - over the years. For example:

    a. It seems likely that the cashflows earned by BT's domestic operations, and by Openreach in particular, have helped BT Group to survive a series of corporate mishaps, including losses incurred by Global Services in the late 2000s and in various overseas investments dating back to the 1990s. (On the other hand, it might also be argued that BT would not have made some of these investments if it had been a more tightly focussed business with greater financial discipline).

[4] Nick Delfas: '*there is nothing in the share price performance of Telecom New Zealand post separation to imply that separation has in itself been an investment negative*', 'Why BT should volunteer the split', p.4 Redburn 24 September 2015

b. It appears that BT's previous mobile business, BT Cellnet, operated at some disadvantage and thus underperformed relative to its more focussed UK rival, Vodafone during the 1980s and 1990s[5]. On the other hand, the O2 business that was demerged from BT in 2001 was generally regarded as having been better managed before being subsequently acquired by Telefonica in 2006 (and for a period of time thereafter)[6].

c. BT's current management claims that its recent investments in superfast broadband, made since 2010, have only been possible with the support of its downstream subsidiaries, particularly BT Consumer, selling superfast retail products to its own customer base.[7]

10. Whether or not BT's shareholders would have done better or worse, and how the various constituent parts of BT Group would have performed, had it been demerged as TNZ did is impossible to judge. All we can say is that BT Group's total shareholder returns over the past 5 years – which is the only way I know how to value BT Group's performance – do not suggest that BT is a poorly managed company or that it trades at a significant conglomerate discount today.

11. However, Ofcom's primary concern in this Review is not, and should not be, with the management or returns of BT Group as a whole. Ofcom's focus should instead be on Openreach, as the manager of the bottleneck assets to which BT Group rivals require access and upon which the prospects for effective downstream competition in the UK market and the overall development of the country's fixed infrastructure still substantially depends. The question we need to consider is whether and how BT's conglomerate structure affects the management and performance of Openreach specifically. I do this in the next section.

Current regulatory arrangements seek to incentivise Openreach management to act as if it were separate from the rest of BT Group

12. The current regulatory arrangements agreed between BT and Ofcom in 2005 are generally intended to make Openreach's management behave as if Openreach were being run as an independent business rather than a subsidiary of BT Group. For example:

a. The Undertakings governing the management and operation of Openreach include arrangements that are intended to tie the remuneration of Openreach's employees to the performance of Openreach rather than that of BT Group. This is

[5] For example, I understand that in the early days of the development of its network Cellnet was required by the parent to locate its masts on existing BT properties, even if this was not the preferred location from a mobile network planning perspective. Vodafone, which was not encumbered by such limitations, was generally regarded as having built a better network as a result. This is an example of where a subsidiary of a conglomerate is required to obtain inputs from other members of the group rather than being able to procure them on the open market.

[6] BT Cellnet had been overtaken by Orange, a later entrant, to be the second largest operator in the UK (after Vodafone) by 2001, just prior to the demerger. By 2008, O2 had itself overtaken Vodafone to become the largest operator.

[7] Although others argue that the co-ordination required to make such investments could also have been achieved through arms length contracting between third parties, see Charles Rivers Associates 'The Hold Up Problem in Vertically Integrated Industries', report for Sky

intended to ensure that the management and employees of Openreach behave is if Openreach were an independent firm and without regard to the interests or performance of other parts of BT Group or of BT Group as a whole.

b. The Equal Access Board, intended to oversee Openreach's compliance with the Undertakings, introduces a formal means of holding Openreach's management accountable in a way which supplements (and probably also adds complexity to) the conventional reporting lines and Board functions we otherwise find in any publically listed company. In this case, it is as if Openreach has its own discrete regulator to supplement the oversight which Ofcom provides for BT Group as a whole.

13. However, even if we assume these measures are effective in terms of setting distinct incentives for Openreach management, there remains at least one aspect of Openreach's business where the management cannot behave as if they are running a fully independent business[8]. This relates to the resources –financial, human and other - which they will have at their disposal and which are allocated to them by BT Group. Since resources obviously impose limits on what any management can achieve, this is the critical issue.

14. Any independent business is able to retain its own cashflows and compete with other firms and other uses of capital to secure additional funds in financial markets or from its lenders to finance its business needs. In contrast, Openreach (as a subsidiary of BT Group) and the Openreach CEO (reporting to the Group CEO) have to compete with other BT Group interests for their share of the conglomerate's resources. In my experience, these battles are hard fought. One of most critical functions of any conglomerate management - and presumably for BT Group too - is to adjudicate between these competing demands and to determine how resources are allocated amongst the various internal interests in order to best meet the interests of the Group and its shareholders overall.

15. The pooling of resources by the various constituent businesses of a conglomerate can, as noted earlier, produce both benefits and costs for the shareholders of BT Group. But, more importantly for Ofcom and for those of BT's rivals who depend upon Openreach, they can create benefits and costs for particular subsidiaries. In the next section I explain why I think today's regulatory arrangements have created a bias in the way in which BT Group allocates resources between its various subsidiaries, and that this bias can be expected to (and does in fact) operate against Openreach's interests. Since Ofcom is primarily concerned with the performance of Openreach, this ought to be a matter of concern to Ofcom. Since this bias arises because of the way in which today's regulatory regime operates, it ought to be of even greater concern. And since any measures to further reduce Openreach's ability to discriminate in favour of other BT Group businesses are

[8] I note that Ofcom is considering changes to existing arrangements which might give Openreach greater control over the financing of its own operations whilst remaining a subsidiary of BT Group, citing examples from Singapore and the Scottish Water Industry. See para 11.55 at http://stakeholders.ofcom.org.uk/binaries/consultations/dcr_discussion/summary/digital-comms-review.pdf. I find it difficult to envisage how any Board could agree to forfeit control over how resources are allocated to a business and yet still retain fiduciary duties for the performance of that business.

only likely to exacerbate this bias, it ought, in my view, to be a key consideration in this Review.

Current regulatory arrangements mean BT Group has a rational bias against Openreach

16. When today's functional separation arrangements were adopted in 2005 they were intended to ensure that BT Retail (subsequently divided into two units, BT Consumer and BT Business in 2013) would face more effective competition in its retail markets. At the same time, it was expected that there would be little change to the competitive conditions faced by Openreach, which remains the monopoly supplier of wholesale services to the rest of the industry in most cases.

17. Whether or not retail competition has been more effective as a result of the regulatory arrangements adopted in 2005, the fact remains that BT's retail market share of broadband services has grown during this period - from 23% in 2005 to 31% by 2013. Part of the explanation for BT's success might, as many claim, be the continued ability of Openreach to discriminate in favour of BT Consumer or to engage in conduct which has such effect. I do not assess the validity of those claims in this note. However, it also seems likely to me that BT Consumer's success can be attributed, at least to some degree, to the efforts and incentives of the management of BT Group to achieve such an outcome.

18. Whilst current regulatory arrangements mean that Openreach's management might be indifferent as to whether its wholesale services are retailed through BT's own retail channels or through those of rivals, BT Group's management are most certainly not. Since functional separation limits BT Group's ability to ensure that Openreach favours BT's own retail operations unfairly, BT Group has been forced to adopt other strategies in order to defend BT's position in retail markets. These 'other strategies' include allocating a greater proportion of BT's collective resources to BT Consumer and less to Openreach (than might otherwise be the case in a demerged environment).

19. BT Group's determination to defend and grow its retail market share since 2005 could be said to represent an attempt by BT to meet competition. This ought to benefit UK consumers even if it is unwelcome to BT's retail rivals. However, it is not the whole story when Openreach and BT Consumer (and BT Business) also compete for the finite financial and other resources that are controlled by BT Group. Decisions to allocate resources to defend BT's retail position therefore also have consequences for Openreach's performance as well.

20. BT's financial statements show that it has held capital expenditure broadly flat at around £2.5 bn p.a. during the period since 2010 (having been over £3bn in years prior to that). Openreach's share of that capital has remained stable at around £1bn p.a. Openreach's revenues and profits have also remained broadly unchanged during the period, reflecting its position as a monopoly supplier of services with utility-like characteristics and predictable costs.

21. In contrast, revenues at BT Consumer have grown by around £200m p.a. year since 2011, making it the only part of BT Group to achieve revenue growth during this period. Profits have also grown by £200m over the period as a whole[9].

22. Resource allocation inside large firms like BT is complex and influenced by a wide variety of factors, both financial and non-financial. A great deal of strategizing and internal politics can be applied to the process. But at the end of the day it is reasonable to suppose that management will generally seek to allocate resources to those parts of their business which exhibit the best growth potential, in terms of revenues, profits and/or market valuation. In BT's case it is clear that BT Consumer has been the Group's best - indeed only - revenue growth opportunity in recent years. Any growth in profits at BT Consumer will then have a significant impact on the value of BT since its retail activities are typically being valued by financial analysts at around 10x EBITDA[10], a much higher multiple than that applied when valuing network businesses like Openreach (at around 5x EBITDA). This means, crudely, that any profits which BT Group can extract from the Consumer business are worth twice as much as growth in Openreach to anyone who is remunerated in BT shares, as BT Group's management are[11].

23. BT's latest results appear consistent with this analysis. Operating costs at BT Consumer have grown by 2% over the year to March 2015 and by 11% in the prior year to March 2014 - the only division where they were allowed to do so. Operating cost fell by 2% and 1% at Openreach in the same periods and by substantially more in the other BT divisions (Global Services, Wholesale and Business)[12]. More materially, BT Group has spent at least £2 bn on exclusive sports rights in order to strengthen its retail broadband propositions since 2012, with the most significant acquisitions representing annual programme charges of £300m p.a. for Champions League and £250m p.a. (rising to £320 m from 2016/17) for Premier League[13]. Taken together, this dwarfs the non-sports capex budget for BT Consumer of around £200m p.a..

24. In addition, BT Group is currently in the process of seeking to acquire the UK's largest mobile business, EE, for an enterprise value of £12.5bn. Although BT Group has identified some modest network cost synergies in the transaction which might benefit Openreach as well, it is clear that the main strategic rationale for the transaction (and the majority of the synergies) is to enable the cross-selling of retail services to the respective retail customer bases of BT and EE and the development of 'converged' retail products. Again, this represents a very significant financial commitment by BT Group (involving

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[9] All financial data from BT at https://www.btplc.com/Sharesandperformance/Quarterlyresults/KPIs6yrIncomeStatement-FCF-Q11516.pdf

[10] See,e.g., Delfas at fig 1 p.2

[11] For example, in May 2012, the top 1000 BT managers received £90m under a 3 year share plan, with the BT Group CEO receiving £4.7m. In common with many companies, BT's Incentive Share Plan targets Total Shareholder Returns and free cash flow, which (properly) incentivises management to maximise profits and minimise capital expenditure, See p.80 at http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/2012_AnnualReport_DirRem.pdf

[12] See http://www.btplc.com/Sharesandperformance/Quarterlyresults/2015-2016/Q1/Downloads/Newsrelease/q115-release.pdf, p.12 and 14

[13] http://www.btplc.com/Sharesandperformance/Presentations/downloads/UEFA-release.pdf and http://www.btplc.com/Sharesandperformance/Presentations/downloads/FAPLfinal.pdf

the issue of new shares to Orange and Deutsche Telecom, a new share placing and the assumption of additional debt by the Group), the benefits of which will be substantially realised by BT Consumer and BT Business rather than by Openreach[14].

25. It might be argued that BT Consumer may itself need resources be allocated to Openreach in order for BT Consumer to grow. Ofcom appear to have relied on this assumption to discipline Openreach and sustain the quality of its outputs after functional separation in 2005[15]. BT's management often claim this was indeed the case when the decision to invest in superfast broadband in 2010 was underpinned by sales forecasts from BT Consumer. It is difficult to judge from the outside. Overall, however, I see little evidence to suggest that BT Consumer has required or that BT Group has made significant additional investments in Openreach in order for BT grow its retail market share over the past 5 years. On the contrary, BT Consumer appears to have prospered during periods in which Openreach's performance, by its own admission and in Ofcom's view, has deteriorated significantly.

26. Even if that were not the case, it seems unlikely that BT Consumer will be placed at any significant competitive disadvantage to its rivals if BT Group continues to underinvest in Openreach. At worse everyone who buys from Openreach will be disadvantaged in equal measure[16]. In contrast, BT Consumer would be much more likely to find itself at a significant disadvantage if BT Group were to decline to invest in assets such as TV sports rights or mobile. These are assets which BT Consumer (and BT Group) seem to consider essential for BT to defend and grow its retail market position (particularly against rivals like Sky). As a result, BT Group has powerful incentives to favour BT Consumer over Openreach when allocating resources.

27. The current regulatory arrangements powerfully reinforce these incentives. Any investments made in assets outside of Openreach clearly avoid regulatory conditions which are attached to investments made inside Openreach. This means:

    a. Any returns earned on investments made outside Openreach are unlikely to be affected by regulation, whereas returns on assets held by Openreach either will be limited by regulation or will carry the risk of being regulated in future[17]

    b. The benefits of any investments in Openreach will have to be made available to BT's retail rivals on non-discriminatory terms. Even if Openreach is still able to discriminate in favour of BT Consumer, at least to some degree, it will remain far easier for BT Group to use investments made outside of Openreach to

[14] See http://www.btplc.com/Sharesandperformance/Presentations/downloads/EEAnnouncementPresentationFINAL.pdf

[15] *'We had hoped that equivalence would lead to Openreach delivering equally good service to all downstream providers, since BT would itself suffer if this did not happen'*, para 11.45 at Ofcom

[16] I accept that BT Consumer may still find itself at some disadvantage to Virgin Media in these circumstances.

[17] BT's costs of acquiring TV sports rights are considered in the VULA margin squeeze test adopted by Ofcom, but BT has no obligation to offer these assets on a wholesale basis to rivals.

differentiate BT's retail propositions from those of its competitors than to use resources deployed by Openreach to achieve the same result

28. If this is right, I would expect BT Group management to continue to exhibit a strong bias in favour of allocating resources to defend and grow BT Consumer (or other unregulated businesses), even if this comes at the expense of investment which might otherwise be required to allow Openreach management to meet their objectives. Such resource allocation policy is both rational and will likely maximise returns for both BT Group shareholders and BT Group management. These both seem to me strong reasons to expect it to continue. This result arises from the interaction between BT's conglomerate structure and the incentives which are created by the current regulatory arrangements under which BT's various constituent businesses are then managed.

29. Critically, the more effective the regulatory arrangements to prevent discrimination by BT are, the stronger these biases in terms of resource allocation will be. This is what prompts the concern that if Ofcom now takes steps to strengthen the current functional separation arrangements in an attempt to more effectively deter discrimination, this would do nothing to improve Openreach's ability to capture BT Group resources and may instead make it even more difficult to do so. Openreach's performance could further deteriorate as a result, not because Openreach management lack appropriate incentives or competence, but because they simply lack resources to do the job.