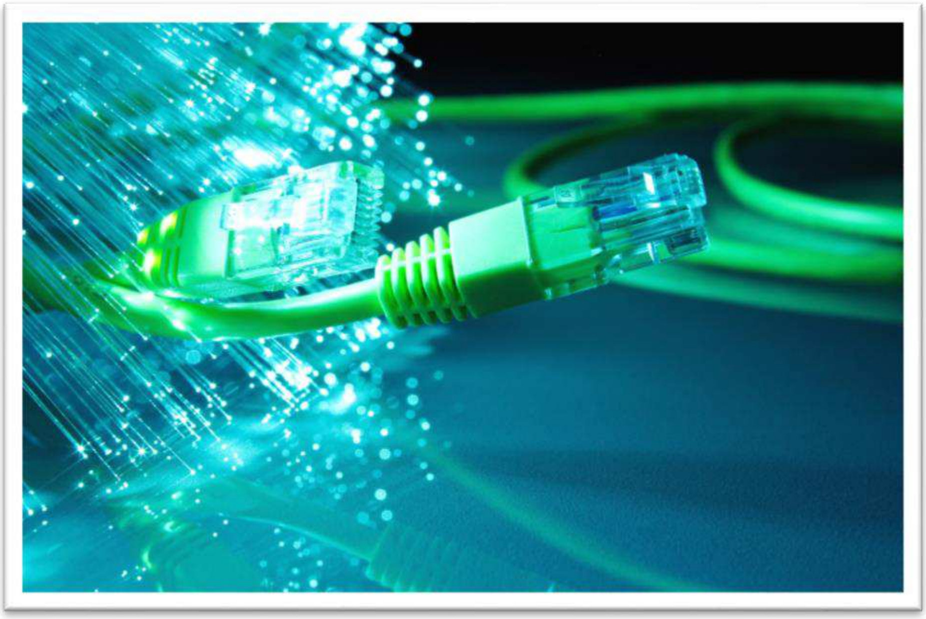
Number 73

17 February 2016

Economic Bulletin

BREAK BT'S MONOPOLY ON BROADBAND INFRASTRUCTURE



- Ofcom to report on BT Openreach's Broadband Provision later this month.
- UK ranks 12th in Europe for broadband speeds and 42% of SMEs report problems with internet connectivity, costing an estimated £11 billion for the UK.
- Some evidence to suggest that faster internet speeds will add £17 billion to UK GVA by 2024 – equivalent to over £600 per household.
- Ofcom should refer UK broadband infrastructure provider BT Openreach to the Competition and Markets Authority to investigate structural separation option.
- Structural separation in New Zealand has been a success. Ultra-fast broadband connections increased from less than 5% to 31% since July 2011.

1. BACKGROUND

In 2014 Ofcom set up a Digital Communications Review, which will examine – among other issues – the role of BT Openreach in the provision of broadband in the UK. Ofcom is due to report on this review later this month.

BT Openreach is required by law to allow UK broadband service providers to access its wholesale broadband infrastructure, which maintains broadband access for 30 million customers. Some argue that the broadband to home services provided by BT Openreach are effectively operating in a market that is a natural monopoly. Our economic bulletin seeks to highlight how best to increase competition into this natural monopoly.

Service providers using BT Openreach's infrastructure for broadband packages include BT, Sky, Talktalk and Vodafone. Many of these service providers have lodged complaints to Ofcom. These complaints include evidence of poor quality customer service, problems arising from a conflict of interest between BT and BT Openreach and concerns relating to the future investment in UK broadband infrastructure. Companies including Vodafone and Sky have made representations to Ofcom for there to be "structural separation" between BT and BT Openreach.

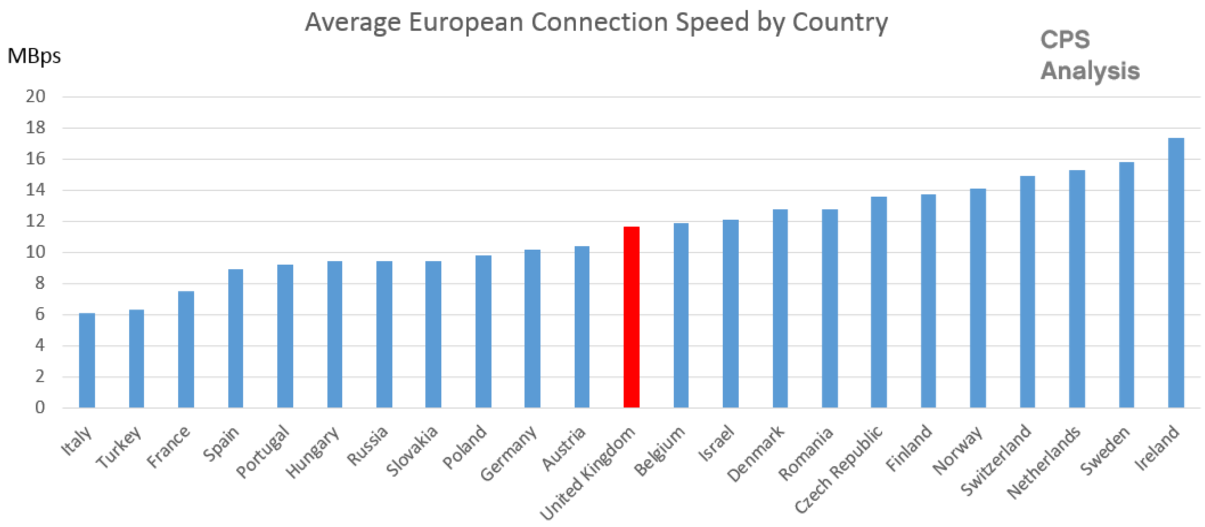
Ofcom does not have the power to split BT from BT Openreach – despite this being implied by the British Infrastructure Group. Ofcom could, however, refer this issue to the Competition and Markets Authority if it feels appropriate to do so.

2. IS OFCOM TOO COMPLACENT ON UK BROADBAND INFRASTRUCTURE?

UK broadband provision compares favourably to that provided in the some other European countries, according to data from Ofcom. Compared to Europe's five biggest economies, the UK ranks top for standard, new generation access and mobile broadband coverage. The UK also has the highest per capita high speed broadband speeds among these countries.

However, evidence from the House of Lords Economic Affairs Committee suggests that the UK is falling behind many other developed countries on broadband speeds. It found that the UK ranked 19th in the world and 12th in Europe for broadband speed *(see Figure 1)*, and that average speeds are less than half that observed in South Korea.

Figure 1: UK and European Country Broadband Speed



Source: Akamai link

3. THE IMPORTANCE OF FUTURE UK BROADBAND INVESTMENT

The UK's productivity is a major constraint on the UK economy, with the Office for National Statistics estimating that output per hour in the UK is 20 percentage points below the average for the rest of the G7. Investment in broadband could be a vital component in tackling the UK's chronic productivity problem. For example, the Broadband Infrastructure Group estimates that 42% of Small and Medium sized businesses currently report experiencing problems with their internet connectivity, costing the British economy an estimated £11 billion. A Government study estimates that the availability and take-up of faster broadband speeds could add about £17 billion to the UK's annual Gross Value Added by 2024, with the majority of the economic impact arising from improvements in the productivity of broadband-using firms.

4. INFRASTRUCTURE INVESTMENT – A LINK WITH PRODUCTIVITY?

Spending on UK infrastructure is not necessarily correlated with increased productivity of the UK economy. The Centre for Policy Studies Pointmaker 'Not Paved With Gold' cited the example that spending on road infrastructure has an insignificant relationship with real GDP growth for 29 OECD countries from 1996 – 2010 period. However, there is evidence to suggest a strong link between faster broadband speeds and productivity. A study from the United States, for example, suggests that cities with faster internet speeds currently report a 1.1% higher per-capita GDP.

5. THE CASE FOR STRUCTURAL SEPARATION OF BT OPENREACH

Many internet service providers have long complained that BT Openreach abuses its monopoly position by providing poor quality and customer service. Vodafone, for example, has argued that BT Openreach has failed to meet its obligations to them by delaying provision of Ethernet services and then failing to offer the appropriate compensation. The company claims that half of the lines it has taken from BT Openreach were delayed.

Other service providers have also highlighted the potential conflict of interest issues between BT and BT Openreach. For example, Sky argues that BT Openreach's ownership structure means that companies using broadband infrastructure are unable to work with BT Openreach on innovations that could increase broadband speeds, such as more fibre networks to the home (FTTH). The national network run by BT Openreach relies heavily on copper wires to the home, which provide comparatively slower speeds. Sky argues that Openreach would be highly attractive to investors as a structural separated entity and could lead to a boost in ultra-fast broadband investment in FTTH.

There are also concerns about whether BT's current structure is optimal for the expansion in broadband infrastructure provision. BT is becoming an increasingly diverse company, after the takeover of EE and its purchase of television rights. This highlights the potential for BT Openreach to divert investment away from broadband provision into other areas of BT's business.

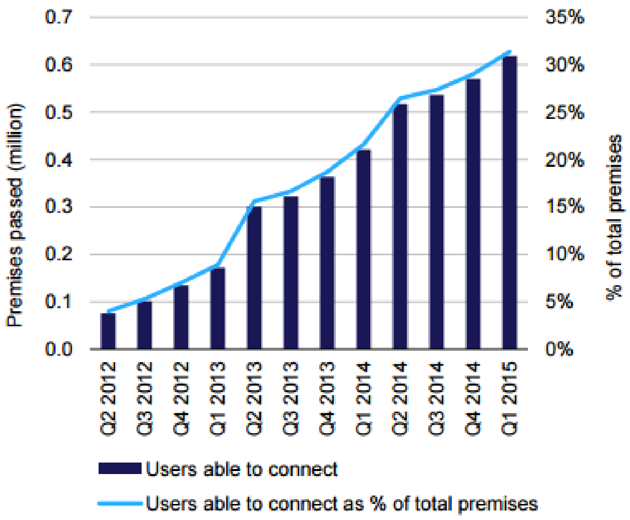
6. INTERNATIONAL PRECEDENTS

International case studies conducted by Ofcom suggest that structural separation could spur investment in FTTH. A model of structural separation applies in both Singapore and New Zealand. Ofcom concluded that Singapore's approach *"can be said to have been successful given the rapid migration to FTTH by all retail service providers, the very high take-up of passive products and high retail take-up of FTTH services."*

New Zealand's structurally separated entity Chorus cannot sell broadband services directly to customers and the company works with different phone and broadband providers to develop new services. Chorus acts as a monopoly, but it is owned by a number of private investors.

The roll out of ultra-fast FTTH broadband since structural separation in New Zealand has made considerable progress, having grown rapidly to 31% from less than 5% in July 2011 (see Figure 2). Ofcom also highlights that high levels of retail competition suggest that the approach has been a success. This could provide a useful blueprint for a structurally separated entity in the UK.

Figure 2: New Zealand Rollout of Ultra-Fast Broadband



Source: Ofcom link

7. THE CASE FOR THE STATUS QUO

BT Openreach has defended its strategy in boosting broadband services across the UK. Despite some service providers advocating investment in faster FTTH infrastructure, BT Openreach has argued that their strategy of improving existing copper assets will increase broadband speeds for consumers and provide better value for money.

On the proposal of "structurally separating" BT from BT Openreach, there are also concerns about the legal implications. Ed Vaisey MP, the Minister for the Digital Economy, says that *"full separation would be an enormous undertaking, incredibly time consuming [and have] lots of potential to backfire"*.

Virgin Media, BT Openreach's competitor, has also publically backed BT Openreach against calls for structural separation made by Sky, Vodafone and TalkTalk, arguing that structurally separating BT Openreach would deter investment in broadband improvements. It is important to note, however, that Virgin Media has its own broadband infrastructure and does not need to use BT Openreach's assets to provide services to customers.

8. CONCLUSION

The UK's broadband infrastructure is falling behind international competitors. BT has abandoned attempts to rollout ultra-fast fibre to premises broadband infrastructure. Instead, BT's focus is on fibre to the network and sweating copper assets, which will provide comparatively slower speeds.

Structural separation of BT Openreach must therefore be considered for the UK's broadband infrastructure. Regardless of whether there is merit in complaints about BT Openreach's service provision, the current broadband infrastructure market appears anti-competitive.

Click here to subscribe to the CPS eNewsletter

The current broadband infrastructure system leads to a conflict of interest in two key ways. BT runs the UK's broadband infrastructure and service providers are forced to use this infrastructure. Furthermore, BT uses its own infrastructure to provide internet services to customers, which is a major disadvantage to its retail broadband competitors.

Structural separation, however, could provide a market with a level playing field between all players, where the infrastructure that service providers rely on would not be owned by one company. This would be good for competition and good for consumers. There is every indication to suggest that a structurally separated BT Openreach – with various investors – might be more likely to invest in higher speed broadband provision. International precedents from Singapore and New Zealand provide favourable evidence for the structurally separated model.

Ofcom should refer the issue of structural separation of BT Openreach to the Competition and Markets Authority later this month. The Competition and Markets Authority can then investigate the matter and suggest the best ways of increasing competitive pressures in this market.

A delayed decision on this issue will be bad for broadband consumers and bad for the UK economy's productivity. Previous delayed decisions on improving the UK's infrastructure – such as that on Heathrow expansion – have been detrimental to the UK economy. Ofcom must not follow in these footsteps.

Daniel Mahoney and Tim Knox
Centre for Policy Studies

Follow us on:

Twitter **Facebook**

Forward to a friend

Click here to subscribe to the CPS eNewsletter