Is Structural Separation the Right Response to New Digital Era Challenges?

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3 June 2015 – Last month, we brought a group of investors to meet the CEO of O2 Czech Republic, the world’s first integrated incumbent telecom operator to choose to structurally separate its infrastructure from its service business. Although the concept of infrastructure separation in telecoms and utilities is not new and global experience, for example from the UK and New Zealand telecoms, suggests that fears of value loss from such moves may be exaggerated, no incumbent other than O2 Czech Republic has yet chosen to voluntarily become a ‘digital service company’, spinning off its entire basic telecom infrastructure into a separate legal entity (‘the infrastructure company’). The separated assets include fixed-line access network, fiber backbone, mobile towers, and mobile radio equipment.

Although there is no immediate plan for the private controlling shareholder to cease control in either of the two companies, those companies may have different shareholder bases, the service company will be managed on an arms-length basis, and future control changes cannot be ruled out. The only reason why management decided to implement such a model is because it believes that in the context of present and future regulatory trends in the Czech Republic — a European Union member country — this move will create value for shareholders.

In this note we look at a shareholder value creation case from voluntary (i.e. shareholder and management-driven) structural separation in telecoms. Since regulation is the crucial driver, we first outline our high-level thoughts about technology, media & telecom (TMT) regulation.

The key question in TMT regulation: When should superior returns be tolerated?

The desire to generate superior returns by building a sustainable competitive advantage is the key driver of most free-market enterprises. Success in building such advantages, however, naturally creates quasi-monopolies, which may curtail free competition. For example, mobile operators with superior networks, unless those are fully open, are in fact lightly regulated quasi-monopolistic high-end service providers. Scale economies have always made TMT industries prone to creating such quasi-monopolies with superior returns. Policymakers sometimes tolerate them on the basis of broader economic and society interests such as:

1. **Support for innovation** in order to boost local economies and their global competitiveness.
2. **Revenue extraction** from the industry for governments and for good causes (e.g. taxes, licence fees, dividends, or donations).
3. **Support for basic infrastructure investments**, for example into mobile and fiber networks.

Successful innovation requires the best talent and capital willing to take high risk, both of which are difficult to attract without opportunities to be rewarded with superior returns. Hence, as with intellectual property, we think that the benefits of innovation may in some
cases justify tolerance of superior returns.

Whether such superior returns should also be tolerated in order to extract revenue for state budgets is a political question. On the one hand, it is possible to see the political appeal of conducting highly competitive spectrum tenders to raise substantial revenue as opposed to, for example, hiking general taxes. On the other hand, tolerance of superior returns for this purpose tends to lead to economic inefficiencies and conflicts of interest. Conceptually, special industry taxes or fees should, in our view, be linked to specific externalities such as environmental impact of the business. In such cases, they can be treated as a cost to the industry with no need to tolerate superior returns for selected operators.

Finally, the concept of tolerating superior returns to encourage investment in basic (utility-like) infrastructure may, in our view, not be economically efficient. Such investments, which often involve significant scale economies but limited innovation, may be better approached by allowing infrastructure consolidation. Dominant infrastructure companies could then be regulated, similar to utilities, using a Regulated Asset Base (RAB) model, which allows fair return on investments into basic infrastructure and gives regulators tools to encourage investment. Which part of telecom infrastructure should be seen as the ‘basic utility’ for this purpose, however, remains a major question.

**Opportunities for TMT innovation have changed, giving regulators new incentive to promote competition in innovative digital services and tolerate consolidation in basic infrastructure.**

Innovation opportunities in TMT are clearly evolving. Rapid developments in the Internet industry over the past ten years, along with future opportunities in interactive video content, Internet of Things, e-health, e-finance, robotics, artificial intelligence and similar areas, have arguably shifted opportunities to innovate from basic infrastructure, such as towers and fiber networks, to a diverse area of digital services. Although most of the innovative third-party digital services running on telecom operators’ networks are yet to be developed, some of them already exist. Services such as connected cars, Apple’s Soft SIM, Amazon’s Kindle, Google’s mobile service Fi in the US, and Sky’s interactive TV and broadband services in the UK in our view indicate future trends in the industry. We have also addressed this topic in our GPS reports *Re-birth of telecom monopoly: Is the industry broken and heading towards its monopolistic roots?* from November 2014 and *Is the current telecom regulation helping economic growth?* from February 2015.

We think that in their effort to promote innovation, regulators may in the future become more lenient towards companies attempting to build a sustainable competitive advantage (and hence generate superior returns) in innovative digital services, particularly if these are local companies with potential to boost local employment, economic growth, and competitiveness of local economies in the global markets. Meanwhile, regulators may, in our view, have less tolerance for superior returns generated by lightly regulated vertically integrated fixed-line, mobile, or converged operators. This is because such infrastructure leadership could inhibit development of a diverse digital service economy by limiting the access of innovative digital service companies, including local ones, into top-class quality, but in its nature basic, infrastructure.

Telecom infrastructure is sometimes described as the backbone of the digital economy. Leaving aside the fact that living organisms usually have one as opposed to several competing backbones, it is clear that a model of several overlapping infrastructure networks, which is prone to producing quasi-monopolistic ‘leaders’, is not the only way to encourage investment into basic infrastructure. Vertical integration is hardly the most efficient way to encourage diverse and innovative competition for digital service either. If regulators follow the above-mentioned concept, owning basic infrastructure could become a burden to generating high returns for the telecom operators as opposed to a differentiating factor. This may lead to a situation when structurally separating certain basic infrastructure assets becomes value accretive for telecom operators.
What is structural separate of telecom operators?

By structural separation we mean legal ownership separation, i.e. the disposal, of basic telecom infrastructure assets possibly including fixed-line access networks, fiber backbones, mobile towers, or mobile radio equipment etc. by major telecom operators. The trigger for such decisions is usually related to regulation in two possible ways. Firstly, operator management may conclude that given the regulatory outlook, ownership of some infrastructure assets does not form a basis for major competitive advantages anymore, while their disposals may boost returns and value. Secondly, the regulator could impose such structural separation by law.

The former way, also called voluntary structural separation, gives the telecom operators a range of advantages. They could, for example, choose which assets they dispose depending on their view of future regulation, future competitive advantages, and other business reasons. They also determine the initial buyers of the infrastructure assets and potentially can benefit from leveraging the infrastructure company. However, each operator and market faces different conditions so there is no industry-wide answer about which assets should ideally be separated. Large numbers of mobile operators have, for example, already chosen to dispose of some or all of their towers or they are contemplating such a move. While large telecom operators have so far been mostly reluctant to voluntarily separate their infrastructure assets, there are examples of newly established infrastructure/wholesale-only local fiber companies in Europe and Asia.

The latter way, also called involuntary structural separation, is based on a legislative process aimed at forcefully breaking up the telecom operators to create open basic infrastructure networks, like in the fixed-line case in New Zealand. Policy-makers, who support this approach, believe that open networks are superior for the broader economy and for the consumer. Out of the major regions, the European Union appears ideologically closest to the open network concept. The European Commission (EC), for example, enforced similar involuntary structural separation in the electricity industry in 2006 on the basis this would prevent the industry suffering from vertical integration. The EC has also been focused on creating and regulating telecom wholesale markets and opening passive telecom infrastructure more persistently than regulators in most other regions. In 2006, the UK functionally separated its incumbent fixed-line network (i.e., separated operations without ownership change). In our view, the EC sees open infrastructure as being supportive of its ultimate objective of creating European common markets in electricity, digital services, etc. Creation of the Digital Single Market is No. 2 on the EU’s current top ten priorities list. All that said, there are currently no proposals to enforce structural separation in European telecoms by law, and we do not expect this to change very soon. Apart from a lack of consensus on this issue, we believe structural separation is much harder to design and enforce for telecoms than it is for utilities, for example, because definition of basic infrastructure is more ambiguous in telecoms.

Cutting the Gordian knot: Why some telecom incumbents may choose to structurally separate voluntarily

Let’s now think about whether other incumbents in Europe and globally could follow O2 Czech Republic’s lead and voluntarily separate some, or all, of their infrastructure. Regulation is without doubt the key factor in such decisions. Even without enforcing involuntary structural separation by law, regulators can encourage voluntary structural separation by promoting open access infrastructure, allowing infrastructure consolidation, and promoting innovative competition for digital services, for example. Operators with independent and rational controlling shareholders in markets where one can reasonably assume that regulators would behave in the described way may start seeing the following value accretive benefits in voluntary structural separation:

- Freedom from regulation and lower legal risk. The idea behind structural separation is that the service company, which is freed from owning infrastructure, should also be freed from most telecom regulation. It should, for example, be able to bundle digital and other services and products. Such commercial freedom is a crucial condition for successful innovation. Meanwhile, lack of restrictive regulation also
reduces legal risks faced by the operators.

- **Superior strategy based on simplicity.** Separating the infrastructure and service simplifies business models of the telecom operators, giving the two separated companies the opportunity to develop clearer and simpler strategies and corporate culture than vertically integrated operators would have. This can lead to better execution, management motivation, and ultimately increased overall efficiency.

- **M&A, funding and financial engineering.** Each of the two separated companies has an opportunity to better focus its M&A strategy as well as find more suitable funding to match its business model (cheap long-term infrastructure capital, government infrastructure subsidies, growth-focused capital, etc.). The infrastructure company may in many cases have the opportunity to create equity value through taking additional leverage.

- **Infrastructure consolidation.** The separated model may benefit from higher regulatory tolerance of in-market consolidation in infrastructure.

- **First-mover and flexibility benefits.** Telecom operators, which choose to voluntarily structurally separate their infrastructure in an early stage, may enjoy a first-mover advantage in building their digital services business as well as some degree of flexibility to choose which strategic assets they keep in the unregulated service company and who will initially own the infrastructure company.

**Why have most telecoms so far resisted voluntary structural separation?**

Telecom executives usually see fundamental industry challenges ahead, which among other things, drive the current M&A activity in the industry. However, a view that voluntary structural separation is the right strategic response has so far been rare. After all, structural separation in its extreme form means the end of the telecom industry as we know it today. This would be followed by the emergence of a utility-type infrastructure industry and a riskier, but also more innovative, digital services industry. Each of these industries may need different management focus and different types of investors. It is clear that supporting structural separation would require a high degree of risk taking (by the current operators' management and shareholders) as well as strong interest alignment between management and shareholders. Such a move also needs to be based on a conviction that it is in the best interest of shareholders. Finding examples of major telecom operators which fulfil all these criteria has so far been difficult. Some operators are taking a view that moves less radical than ownership separation are more appropriate. Such models include, for example, imposing internal barriers within the existing incumbent operators similar to those applied at BT and its fully owned infrastructure division Openreach.

Many telecom executives believe that sustainable network advantages also bring superior returns in the service business — in other words they see synergies between owning the network and providing services on it. Moreover, many vertically integrated operators believe that they deserve special regulatory treatment, for example because they are helping to generate a special tax or dividend revenue for the government or they lead strategically important infrastructure investment projects in their countries. Under the current regulation, it is hard to disregard such arguments in most countries.

Furthermore, telecom executives may be concerned about the duplication-driven cost increase caused by structural separation as well as the risks of not identifying the right assets for the separation, execution risks, negative perception of the separation by largely dividend-focused investors, and potential regulatory risk (e.g. regulators failing to free up the service companies from regulation) as well as major competitive, commercial and strategic risks facing the service companies. Any case for voluntary structural separation hence needs to be strongly justified by confidence that the new regulatory environment will be supportive of it. We think that most large telecom operators currently do not have such confidence.
Change of mindset: From complexity to simplicity; from risk aversion to taking risk for a reward

The most successful TMT companies such as Apple and Google have several things in common, but two stand out. Firstly, despite their technological sophistication, their products and pricing tend to be relatively simple. They also have the ability to constantly innovate and at some point totally reinvent their products. Secondly, with their focus on a small number of simple-to-use products, they often take significant commercial risks. Vertically integrated telecom incumbents and large mobile operators have historically approached their business differently. Their product offerings have often been quite complex, and risk aversion has usually played a major role in their business strategies. This should not be surprising given the fact that most investors see telecoms as dividend yielding low-risk utility-like companies. Moreover, a significant number of telecom operators worldwide have large free floats (i.e. risk averse dividend-focused investors are important for them) and direct or indirect government-related major shareholders. This naturally discourages them from taking excessive business risk including moves such as structural separation, even if potential returns were high.

That said regulators in countries such as New Zealand and the UK have already enforced structural and functional separation of telecom infrastructure based on principal reasons. We have also already mentioned private companies in Europe and Asia rolling out fiber as a pure wholesale infrastructure-only business, and Apple’s soft SIM, Google’s Fi, or Amazon’s Kindle are high-profile examples of the concept of separated infrastructure and service. The most basic form of structural separation, disposals of mobile towers, is already wide-spread and is gaining further momentum globally.

In our view, the best conditions under which structural separation of major telecom operators may create value for shareholders are as follows:

- **Pro-separation regulation.** Regulators would need to clearly demonstrate their desire to turn basic telecom infrastructure into an open access utility in order to encourage the most effective competition in innovative digital services, ideally with a bias toward supporting innovative local service companies by giving the successful ones an opportunity to generate superior returns.

- **Privately controlled operators.** Telecom operators controlled by private entities, not directly linked with governments or other operators’ interests, are in our view more likely to show flexibility and take the risks necessary for adopting new business models.

- **Simple operators and telecom markets in smaller countries without excessively complicated legal framework.** Size and complexity of the operators’ businesses, complexity of the telecom markets in which they operate, and the complexity of legal framework and inefficiencies of the overall business environment in their countries all represent challenges for the business case of voluntary structural separation.

- **Successful precedent.** Precedents from New Zealand and the UK did not confirm earlier fears that functional or structural separation of telecom infrastructure must cause shareholder value destruction. That said, these cases occurred at a time when the digital economy and Internet of Things arguments were less relevant than they are now, and hence the transformational effect on their local telecom industries and economies may have been less profound than it could be in the future. It will be very interesting to watch the O2 Czech Republic case in the following months and years, including the mix of assets being separated, execution of the separation, strategic moves of the service company, regulatory response, competitors’ response, and the ultimate value creation.

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