

# Functional separation – A backgrounder

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# Outline

- Introduction
- Economics: why separate or not?
- Law
  - > What are we talking about?
  - > What powers are there?
  - > What is the experience so far?
- Bringing the two together
  - > A sober view of separation
  - > Towards a test ??
- Conclusion: current proposals

# Introduction

- Separation (or unbundling) hot topic
  - > Energy
  - > Electronic communications
  - > Precedents: rail, cable TV, etc.
- Aim of presentation
  - > Step back from the debate
  - > Take a critical and sceptical view in the light of academic literature and practical experience

- Why separate?
  - > Classical problem of vertical integration, with
    - Foreclosure through discrimination, price squeeze, etc.
    - Other risks (exploitation, etc.) ?
  - > Starting point: Chicago analysis
    - No need to worry, even if bottleneck / dominance is present at one level
  - > Well, not that simple...
    - Depends on strict assumptions
    - Dynamic aspects

- What is gained by separation?
  - > Discrimination and price squeeze problems reduced (removed?) in a one-off fashion
  - > Potential reduction of transaction costs for regulation: information on the non-competitive activities is more easily gained, lesser need for constant behavioural supervision
- The costs of separation
  - > One-off: implementing the separation, i.e. moving from a firm to a contractual basis
  - > Longer-term: some regulation is still required !!

- What is lost in separation ?
  - > Vertical integration and its benefits
    - Signals are felt throughout the chain
    - Economies of scope
    - Firm instead of contract: transaction costs
  - > Dynamic aspects: incentives on the non-competitive part
  - > Opportunistic behaviour around the boundary

- Alternative to separation
  - > Access regulation
    - More behavioural
    - Harder to implement and police, potentially less effective
    - Costly over the long-term
- *Ex ante vs. ex post* dimensions

- What are we talking about?  
The six degrees of separation
  - > Accounting
  - > Functional
  - > Structural
  - > Legal
  - > Management
  - > Divestiture

- What powers are there?
  - > Under primary EC law
    - Article 95 EC
    - Article 86(3) EC
    - Article 82 EC
      - > With Article 9 of Regulation 1/2003
      - > With Article 7 of Regulation 1/2003
  - > Merger Control Regulation
  - > SMP regime under electronic communications regulation
- Significance of consent by firms / Member States

- What is the experience so far?
  - > Rail
  - > Directive 90/388 et seq.
  - > Cable TV
    - Directive 95/51: accounting separation, threat of legal separation
    - Directive 1999/64: legal separation, threat of divestiture
    - Divestiture achieved in *BiB/Open*, *Telia/Telenor - Telia/Sonera*, German cases
  - > Difference between general instruments and individual cases

# Bringing the two together

- A sober view of separation
  - > Looks too good to be true !!
    - Based on simple models, where drawing lines is assumed to be feasible and relatively inexpensive
    - Assumes that an adequate regulatory regime can be devised for the non-competitive part
  - > Historical evidence less compelling

# Bringing the two together

- Towards a test?
  - > Separation (> accounting) sensible only if
    - benefits outweigh costs
      - > complete test, including benefits of vertical integration, dynamic aspects, transaction and regulatory costs
    - a stable and clear boundary can be drawn
      - > avoid opportunistic behaviour

# Conclusion

- Current discussion at EC level
  - > Reding proposals unclear
    - infrastructure / service OR
    - local networks / rest OR
    - passive / active elements OR
    - layers ?

# Conclusion

- Serious risks if no action is taken
  - > Move to NGNs and the position of service-based competitors
  - > Addressable *ex post* ??
- Yet very serious implications of separation
  - > Regulation taking centre stage for the foreseeable future
  - > Regulation as part of the business process
  - > Return to technology-based regulation
  - > Dynamic implications !
- Consider carefully all alternatives !!