TELSTRA INQUIRY

Submission No. 40

This version: 30 January 2003

The ownership and structure of Telstra

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AUSTRALIA

Submission to: House of Representative Standing Committee on Communications, IT and the Arts, Inquiry into structural separation of Telstra

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The ownership and structure of Telstra

Ever since its creation from the merger of Telecom Australia and the Overseas Telecommunications Corporation in 1992, Telstra has inhabited something of a no-man's land. From 1992 to 1997, policy towards Telstra was premised on the assumption that, after the advent of unrestricted competition in mid-1997, Telstra would rapidly lose all vestiges its historical role as a monopoly provider of telecommunications services and would become, at most, first among equals in a competitive marketplace.

In preparation for this event, Telstra launched an ambitious expansion program, which is still continuing. The expansion included both ventures into overseas markets and vertical integration from Telstra's traditional role as a telecommunications carrier to a new role as a content provider for markets such as pay-TV and Internet services.

When competition failed to make significant inroads in Telstra's dominance of most of the markets it served, the 'no-man's land' problem became evident. In part, Telstra is a regulated supplier of natural monopoly services, and likely to remain so for the foreseeable future. Equally, Telstra seeks to be an entrepreneurial and innovative competitor in a wide range of unregulated markets. The tension between the two roles is severe.

Telstra's status was further compromised by its partial privatisation under the *Telstra (Dilution of Public Ownership) Act* 1996. As the Act's title indicates, it was stated that partial privatisation was an appropriate policy option for Telstra, and not a mere stepping stone to full privatisation. With the recent announcement that full privatisation will not proceed in the absence of higher share prices, it is once again government policy that Telstra should remain part-private and part-public for the indefinite future. In the intervening period, however, numerous government ministers have described, in the strongest terms, the absurdity and untenability of the ownership structure created by their own past policies.

In this submission, it is argued that the only coherent response to Telstra's unsatisfactory structure is one based on a split between Telstra's core telephony operations and the peripheral activities arising from the expansion of the 1990s, combined with a return of the core operation to full public ownership and full privatisation of the peripheral operations.

Ownership

Clearly the issue of Telstra's structure cannot be separated from the question of ownership. Although Telstra's current structure is the product of government policy, its unsatisfactory nature is generally recognised. Telstra is an unstable mixture, half public and half private, half monopoly supplier of infrastructure service and half media enterprise. A resolution of the present difficulties must begin with the question of Telstra's ownership.

The case for partial privatisation

Privatisation of publicly-owned assets has been undertaken in most Western countries. In many cases, the preferred approach has been to sell a minority stake initially, with no firm commitment regarding full privatisation (as in the case of Telstra), or even with a commitment to retention of majority public ownership (as in the case of the Commonwealth Bank). In this phase of the process, arguments have frequently been presented to support the claim that a mixture of public and private ownership can be sustained indefinitely.

It has sometimes been argued that partial privatisation is superior to complete privatisation. A typical statement of the case is that presented by the Government members of the Senate Environment, Communications, Information Technology and the Arts Committee inquiry into the *Telstra (Dilution of Public Ownership) Bill* 1996

On partial privatisation, the Minority Report of Senators Baume, Knowles, O'Chee and Tierney stated (Section 2.2.1.3)

> We believe it is significant that the Government is proposing to retain two thirds ownership of Telstra. The constant references, during the course of the Inquiry, by the Opposition Senators and some witnesses to total privatisation were misleading and untrue. The same untruth is repeated throughout the Majority Report. Many witnesses who made such claims were asked by Government Senators who they believed would take the decision to permit 100% privatisation, given that the Government does not have a majority in the Senate. They were quite unable to provide a satisfactory answer to this question.
>
> Unlike some full privatisations overseas where a significant proportion of the efficiency gains went to the new private sector owners, the Commonwealth, as the major shareholder of Telstra, will share in the efficiency gains produced from privatisation. On this point, the Department of Finance submitted:
>
>> *While the Government will forego future dividend payments in proportion to the shareholding it sells, Telstra's current and expected dividend payments are significantly less than the expected interest savings associated with the likely reduction in Commonwealth debt (equivalent to the estimated value of the Company). If the potential for increased profitability is realised following the stimulus of private investment, this would further increase the value of the Commonwealth's residual two thirds equity in later years, and may be expected to increase dividend payments on a pro-rata basis. [25]*

> ... As the partial privatisation increases Telstra's efficiency and hence its ability to prosper in a competitive environment, the government, and the people of Australia, as the majority shareholders, will more than likely stand to gain from the enhanced value of their investment in Telstra.

Claims about the sustainability of partial privatisation has rarely been sustained once the first stage of privatisation has been implemented. The Australian government's position on Telstra was no exception. Numerous government ministers and other officials have made statements to the effect that 'Telstra cannot remain half-pregnant' and that the current status of partial privatisation leaves Telstra in 'no mans land'. Treasurer Peter Costello observed (*Australian* 18/3/00) 'Telstra should all be either privately owned, or if people really think that nationalisation and government ownership is necessary they ought to have the courage of their convictions and nationalise it'.

In some cases, indeed, there has been an exchange of positions, with some opponents of privatisation arguing that a mixture of public and private ownership is sustainable. However, Mr Costello is correct in observing that claims of this kind typically represent a failure to follow beliefs about the desirability of public ownership through to their logical conclusions.

The case against partial privatisation

In my submission to the 1996 inquiry, and in a number of subsequent publications, I argued that partial privatisation was in fact the worst of all policy options, reducing the return from the sale of publicly-owned assets without creating an offsetting benefit for purchasers. As I observed '***The best option, therefore, is either to retain the asset or sell it in one go.***' The relevant section of my submission is presented as Appendix 1.

In addition to the problems with loss of asset value, it has become increasingly evident that the management of enterprises with a public majority shareholding and a private minority poses serious problems of corporate governance. As I observed in the Australian Financial Review (Labor's dilemma on Telstra, 31 January 1997):

> The continued maintenance of a private minority shareholding in an enterprise like Telstra is an untenable position. The directors of the enterprise would be in an invidious position, as would the minority shareholders. Directors responsible to a government majority shareholder could not possibly disregard public policy imperatives in an area as important as telecommunications, but in doing so they would violate their fiduciary obligations to disregard the interests of everyone except their shareholders. Minority shareholders would be locked into whatever services and pricing polices, and whatever pattern of dividend distribution, the government chose to impose on them.

Six years later, these concerns have been amply vindicated. Many of the difficulties may be seen in considering the response of Telstra's management to concerns about the quality of services in rural Australia, and the perceived linkage between improvements in the quality of service and the political feasibility of privatisation. On almost any theory of corporate governance, the handling of this issue has been unsatisfactory.

Under the departmental and statutory authority models that prevailed until the 1980s, the quality of telecommunications services was a matter of government policy. Under the departmental model that prevailed until 1975, the Postmaster-General was directly responsible for determining the quality of service, under the usual Westminster conventions of ministerial responsibility. Under the statutory authority model introduced in 1975, responsibility for day-to-day management of the telecommunications network was devolved to the board of Telecom Australia, but the ultimate responsibility of government remained clear.

Under the corporatisation model, introduced with the formation of Telstra in 1989, the boards of corporatised government business enterprises are supposed to pursue a profit-maximisation objective, subject to the satisfaction of explicitly stated community service obligations (CSOs). Clearly, this approach has not been adopted in relation to concerns about the quality of rural services. Rather, the management of Telstra has been forced into an explicitly political role, trading off the profitability of the enterprise against the desire to secure political support for privatisation in rural areas.

The government's handling of its status as majority owner of Telstra has been highly unsatisfactory. On the one hand, the relevant Minister, Senator Alston, has declined to use the majority public shareholding to direct the board to adopt policies that would benefit the Australian community where this might conflict with Telstra's stated objective of 'maximising shareholder value'. On the other hand, it has been widely reported that Senator Alston used his influence to secure the appointment of a personal friend, Dr. Switkowski, as CEO (*Financial Review* 17/2/99). Under current interpretations of the Westminster system, those appointed to public office owe a personal allegiance to the minister responsible to their appointment rather than to the government as a whole or the Australian public. Moreover, Dr. Switkowski has openly urged his majority owner, the Australian public, to sell its shareholding, and public comment on his actions has frequently focused on its political usefulness, or otherwise, to the present government. Thus, Dr. Switkowski may be seen as having obligations to manage Telstra in the interests of any or all of:

- The private shareholders of Telstra;
- The Australian public, as the ultimate majority shareholders;
- The Commonwealth government as the majority shareholder;
- The relevant ministers as formal shareholders;
- The Coalition parties as political allies; and
- Senator Alston personally.

In this context, it is reasonable to describe Telstra as facing a crisis of governance.

Full privatisation of Telstra would resolve some of the present conflicts but would exacerbate others. Although the difficulties arising directly from government ownership of shares would be eliminated, the fundamental fact that Telstra, in its role as the dominant provider of universal service, is too important to be regarded as an independent private business would be unchanged. Direct government ownership would have to be replaced with more intrusive regulation of Telstra's performance than already exists.

Telstra faces a basic conflict between the fiduciary obligation of its management to secure the best return possible for shareholders by all legal means, and the needs of the Australian community for socially optimal provision of telecommunications services. The conflict is particularly acute when it is observed that Telstra's management is obliged, among other things, to lobby governments for favourable regulatory outcomes. In particular, for any given set of community service obligations, Telstra's management is obliged to lobby for the largest possible CSO payment from government. Conversely, for any given payment, Telstra's management is obliged to lobby for the least costly set of service requirements. In particular, there is an inherent conflict between Telstra's stated goal of maximising shareholder value and the interests of telecommunications users in rural and regional Australia.

The conflict is exacerbated by the desire of Telstra management to pursue a strategy based on international markets for Internet services. In the context of this strategy, the only relevance of Telstra's Australian infrastructure business is its capacity to serve as a 'cash cow' to finance loss-making Internet ventures overseas. Partial public ownership provides a limited constraint on this kind of internal cross-subsidy. Full privatisation would exacerbate the conflict between the objectives of Telstra's managers and shareholders and the needs of the Australian public as a whole.

A final observation in this context is that it is bad policy to deliberately introduce an unsustainable policy change, such as partial privatisation, in the hope that the resulting chaos will enforce the adoption of a desired radical reform, in this case, full privatisation. Yet on Mr. Costello's own admission, this is what has been done in the case of Telstra. Given the admission that the partial privatisation was undertaken on the basis of false or mistaken claims about the sustainability of this halfway house, the most appropriate response is to return to the *status quo ante* of full public ownership, then consider whether full privatisation can be justified.

The case for public ownership of the core network

Until the 1980s, infrastructure systems such as telecommunications networks were publicly-owned, vertically integrated monopolies in most countries. The main exception was the United States, but even there, the combination of regulated monopolies, pricing based guaranteed rates of return and heavy reliance on bonds for financing produced outcomes very similar to those under public ownership.

There were two main reasons for public ownership of infrastructure. First, it was generally accepted that infrastructure networks constituted natural monopolies, in which services were most efficiently supplied by a single integrated enterprise. In such cases, regulation of prices was necessary. Although it was possible, as in the United States, to award the relevant monopoly rights to private or quasi-private firms, long experience with regulated monopolies of this kind suggested to most observers that this was a less satisfactory solution than public ownership. For services that are consumed broadly by the community as a whole, public ownership internalises the conflict that would otherwise arise between the interests of the regulated firm's owners, who benefit from higher prices, and those of consumers and voters, who benefit from lower prices.

In an infrastructure network, natural monopoly arises from a combination of efficiencies of scope, scale and density. The precise demarcation of these terms is not standardised, but the substantive sources of natural monopoly are well-understood. Efficiencies of scope arise when multiple services are provided over the same network (for example voice and data communications). Efficiencies of scale arise when the service area of the network is expanded (for example, when a number of local networks are integrated to form a national network). Efficiencies of density arise when the numbers served in a given area increase, either because more customers connect to the service or because competing suppliers merge.

The second major grounds for public ownership was the belief that adequate investment in infrastructure would only be undertaken by the public sector. This belief was based in part on observation of the combination of wasteful duplication with inadequate services to outlying areas that had arisen when competitive firms engaged in infrastructure investment, as in the case of 19th century. A second crucial factor was the fact that private equity investors demanded higher rates of return than did purchasers of government bonds. This 'equity premium' could not be accounted for by standard economic models, but appeared to reflect inadequacies in capital markets.

This equity premium problem was the basis of the key finding of the Royal Commission set up in 1948 by the conservative Playford government in South Australia to examine the performance of the privately-owned Adelaide Electric Supply Company

> Over the period of the last 24 years [to 1948], the Company has paid in dividends and interest nearly 2 million pounds more than if the Treasury rate had been paid. Future capital costs at Treasury rates would result in reduced capital costs and lower charges.

On the basis of this and other findings of inadequate performance, Playford nationalised the industry. For the following fifty years, the Electricity Trust of South Australia (ETSA) supplied electricity efficiently, met a range of social objectives and yielded returns greater than or equal to the cost of capital to the Treasury.

From the 1980s onwards, public ownership was replaced by privatisation in many countries. Although the political imperative for privatisation was frequently driven by the spurious fiscal benefits apparently generated by asset sales, there was also a newly developed economic case for privatisation, which rested on two main arguments. In essence, these arguments turned traditional views about natural monopoly and the public role in long-term capital investment on their heads.

The first argument was that technological changes had rendered the concept of natural monopoly obsolete. In the future, it was claimed, large-scale integrated infrastructure enterprises would be replaced by competitive markets dominated by small, nimble players employing the Internet to avoid the need for ownership of large-scale capital assets. In the electricity industry, the most prominent representatives of this trend were 'asset-light' energy trading firms such as Enron and Dynegy. In telecommunications, most attention was given to 'competitive local exchange carriers (CLECs)' such as PSINet in the United States, and OneTel in Australia. The 1996 Telecommunications Act was supposed to facilitate the rise of CLECs.

The corollary of this view was the claim that old-style telecommunications enterprises, such as Telstra, based on the ownership of local telecommunications networks, were doomed at best to stagnation and more probably to extinction. In 1998, for example, Communications Minister Alston asserted that "Telstra's best years may lie behind it".

The second argument for privatisation was based on the 'efficient capital markets hypothesis'. Drawing on the exaggerated respect for the wisdom of capital markets that developed during the 1980s and 1990s, advocates of the efficient capital markets hypothesis claimed that the best guide to decisions about investment in infrastructure (or any other industry for that matter) were the asset prices generated in markets for financial assets such as shares and bonds.

Experience since 1998 has refuted both elements of the case for privatisation. It has become clear that natural monopoly is more important than ever before. Entrants to the telecommunications and energy trading industries have gone bankrupt in large numbers, Incumbent local exchange carriers have retained dominance and are seeking mergers to generate economies of scale. In the United States, the failure of the 1996 reforms is generally acknowledged. On current trends, mergers between local exchange carriers (Baby Bells) and the return of these carriers to the long-distance market looks set to reverse the breakup of the old AT&T monopoly, which took place in the 1970s.

The failure of the efficient markets hypothesis has been even more dramatic, particularly in the telecommunications sector. It has become clear that, in deregulated financial markets, asset prices and the investment signals they generate bear little or no relation to any underlying economic reality. During the 'bubble economy' of 1996-2000, the value attributed by stockmarkets to Internet-based and telecommunications businesses rose to around 5 trillion US dollars. In most cases, the associated enterprises are now bankrupt or else have shares trading at less than 10 per cent of their bubble era valuations.

The losses associated with the collapse in sharemarket values are 'paper losses', representing transfers of wealth rather than losses to society as a whole, though this is little consolation for retired workers who have lost their life savings while insiders have sold their shares for massive profits. However, absurd asset valuations necessarily lead to absurd investment decisions. During the bubble from 1996 to 1999, investments in Internet businesses and telecommunications infrastructure amounted to between 500 billion and 1 trillion US dollars. Virtually all of the money invested in Internet business has been dissipated, as has the majority of the money invested in the construction of multiple optical fibre networks, each with massive overcapacity. On current estimates, less then 5 per cent of optical fibre laid down during the bubble era is currently in use. It is likely that 80 to 90 per cent of excess capacity will be rendered useless by technical obsolescence and lack of maintenance before demand rises to meet capacity.

Australia shared in this experience, most notably in the 'cable race' between Optus and Telstra from 1994 to 1997. The networks rolled out by the two carriers have approximately 90 per cent overlap, but serve only about half the country. The combination of wasteful duplication in some areas with inadequate service in others is typical of the outcome when infrastructure investment decisions are driven by the short-term focus of capital markets. Fortunately, and in part because Telstra's activities were constrained by public ownership, the loss of wealth in Australia (around 1 per cent of GDP) was small in comparison to that incurred in the United States and elsewhere.

The demonstrable failure of capital markets to generate sensible asset prices or investment decisions was accompanied by a series of revelations about the actual operations of capital market participants including corporate executives, stockbrokers, sharemarket analysts, accounting firms and bond rating agencies. These revelations showed that none of the main participants in financial markets was performing their role adequately and that some sectors of the market, such as the research undertaken by stockbroking firms were systematically corrupt. Although these phenomena were exacerbated by the bubble, to which they contributed, many reflected tendencies that had been evident since the financial market deregulation of the 1970s, and had been exposed previously during the 1990-91 recession, but had been disregarded during the boom of the 1990s.

Experience of privatisation has also validated the views expressed by the 1948 Royal Commission in South Australia and many other advocates of public ownership of key infrastructure assets. As is shown in more detail below, privatisation has rarely yielded returns sufficient to offset the loss to the public sector of the dividends and retained earnings received under public ownership.

The case for privatisation of content assets

At any time since the introduction of television to Australia in 1956, a suggestion that the government should purchase a major television network, and operate it under conditions allowing direct ministerial control, would have rejected by almost all participants in the policy debate. Yet according to many news reports (for example, http://www.smh.com.au/articles/2002/03/22/1016777664634.html) proposals for the purchase of the Nine Network were put to the board of Telstra by the current chairman, Bob Mansfield, and CEO Ziggy Switkowski in 2000, and have remained under consideration.

Unlike the ABC which has a Charter, a system of parliamentary scrutiny and an effective guarantee of operational independence, a Telstra-owned Nine Network would be subject to the direct control of the shareholding ministers (the Minister for Finance and the Minister for Communications). These ministers have and routinely exercise, the power to nominate the members Telstra's board by virtue of their majority shareholding. They could, as owners of the Nine Network have done in the past, intervene in decisions affecting broadcasting and editorial policy without any accountability to Parliament and without even any clear requirement for disclosure.

There is no apparent constraint, for example, that would prevent a government-appointed board of a commercial channel from providing free advertising time to the governing political party or running pro-government editorial content. While such blatant abuses might prove counterproductive more subtle use of the power of the media to bias coverage and to grant a range of political favours might be harder to detect.

Such possibilities should raise grave concerns, particularly among participants in the policy debate concerned about the dangers of excessive state power. Regardless of the general outcome of any review of Telstra's structure, a clear statement that Telstra will not be permitted to acquire ownership of newspapers or television or radio stations while it remains publicly owned is highly desirable.

Although Telstra has not yet undertaken the purchase of a newspaper or TV station, its existing involvement in pay-TV and the provision of Internet content is a source of serious concern. In addition to concerns about the propriety of a government-controlled, but largely unaccountable, enterprise, being engaged as a player in the media industry, there are significant problems arising from

Summary

Telstra's current ownership structure is unsustainable. The persistence of a mixture of public and private ownership is undesirable in itself. In addition, it has led to a situation in which activities which ought to be undertaken by the public sector are being undertaken by an enterprise with fiduciary obligations to private shareholders while activities from which governments should be excluded are being undertaken by an enterprise with a majority public shareholding.

In general terms the appropriate solution is clear. Telstra should be split, with its 'core' activities being returned to full public ownership, while 'peripheral' activities are fully privatised. It is apparent that the core must include the local telecommunications network, and that the set of peripheral activities to be privatised must include Telstra's Australian and domestic media ventures. The question of where the line is to be drawn is more complex, and will be addressed in the remainder of this submission.

Structural separation

The public policy case for structural separation

Telstra is unique among telecommunications enterprises worldwide in the range of services in which it holds a dominant or market-leading position. Telstra maintains dominance in all the areas where its predecessor enterprises, Telecom Australia and OTC were formerly statutory monopolies, including not only local, long-distance and international phone services but also related activities such as the telephone directory business. In addition, as would be expected given its history, Telstra is the dominant provider mobile telephony.

In relation to the Internet, Telstra not only provides the connection services (phone lines or cable connections) for the vast majority of subscribers, but is also the biggest single Internet Service Provider (ISP), providing such services as web hosting, email accounts and Domain Name Service (DNS). Through its Foxtel partnership, Telstra also dominates pay-TV services.

Taken together, Telstra's range of activities is unparalleled. To assemble a comparable span of market dominance in the United States, it would be necessary to merge not only the 'Baby Bell' local telephone companies and the dominant long-distance enterprise AT&T but the major cable companies and AOL Time Warner, which is the dominant ISP and a significant producer of media content. Of course, no such merger would be permitted in the United States on grounds both of competition policy and concern over the implications for public debate of the creation of such a media colossus.

Yet, as has been noted, it is inevitable under current regulatory structures that the pay-TV business will be integrated with free-to-air TV. Neither cross-media ownership laws nor, it appears, competition policy would prohibit the previously mooted purchase of Channel 9. And there is no reason to suppose that cross-media ownership laws will remain unchanged indefinitely. Relaxation of those laws would make Telstra the leading candidate to purchase any radio or newspaper networks that came on the market.

The anti-competitive implications of Telstra's unparalleled horizontal and vertical integration have been noted on many occasions, both by its competitors and by independent commentators. Given dominance in a wide range of connected markets, it is almost impossible to prevent abuses of market power.

The greater dangers associated with Telstra's dominance of so many communications markets have been obscured by the weak and ineffectual governance inevitably associated with an unstable mixture of public and private ownership, and the continuous scrutiny associated with the ongoing privatisation debate.

A resolution of the privatisation debate which preserved Telstra's current structure intact would quickly be revealed to have created a monster, whether the outcome was full privatisation or, less probably, renationalisation. Concern has long been expressed in Australia about the political power of media magnates such as Kerry Packer and Rupert Murdoch, especially when viewed in combination with the broad range of non-media business interests held by these magnates. Yet the power of Consolidated Press or News

Limited would pale into insignificance when compared with that of a fully privatised Telstra. And of course, given the complex business relationships already in place, there is no reason why individual magnates such as Packer or Murdoch should not be able to obtain effective dominance of a privatised Telstra.

The implications of full renationalisation would be equally disturbing. As has already been noted, under its corporatised structure, Telstra is subject to none of the checks and balances imposed on the ABC. Under full renationalisation, Australia would have a higher degree of direct political control over the content of communications, and particularly the Internet, than any other democratic country.

The business case for structural separation

The uniqueness of Telstra's structure is not solely the result of constraints imposed in other countries as a result of public policy concerns. 'Conglomerate' enterprises like Telstra have generally performed poorly in the long term, although they have invariably been popular in periods of manic speculation such as the telecommunications and Internet 'bubble' of the late 1990s. In these periods, rising asset prices have produced automatic gains to those willing to buy assets of any kind. A range of spurious rationales has been manufactured in every such period.

The poor performance of investments driven by a supposed need for expansion is most evident in relation to Telstra's Asian investments. These include a number of joint ventures focused on Hong Kong. It was grossly improper for a company majority-owned by the Australia public to engage in speculative foreign investments of this kind. Some consolation might have been yielded if the speculation had proved profitable but, as is usually the case, it did not. However, it is clear from the complaints of Telstra's management at the time about the constraints imposed by public ownership, and from the greater disasters suffered by fully privatised firms, that public ownership served to limit the waste of Australian resources during the bubble period.

The case for preserving Telstra's current structure

Having observed that there is a strong case for structural separation, it is of interest to examine the case for maintaining the current structure. In particular, it might be expected that successive governments, in adopting the policies that led to the current structure, would have assessed its advantages and disadvantages. In fact, however, the current outcome has arisen through a combination of accidents, inattention, short-term political imperatives and mistaken beliefs about the telecommunications market.

The original decision to merge Telecom Australia and the Australian Overseas Telecommunications Corporation into a single enterprise, Telstra, was the product of a complex compromise within the Labor Cabinet, rather than being the product of a reasoned analysis. Although, as will be argued below, it is not sensible to unwind this merger now, it is clear that the Cabinet overestimated the strength of the competition Telstra would face, and that this overestimation has been a persistent feature of telecommunications policy.

Telstra's dominance of the market for cable-based Internet and pay-TV services was similarly the accidental product of an ideologically-based unwillingness to intervene to produce sensible outcomes, even when the actions of the main players, Telstra and Optus, were clearly driven more by strategic and regulatory considerations than by any attention to market imperatives. Policymakers assumed that a laissez-faire approach would give rise to a situation where Telstra and Optus each had local cable monopolies, between them covering most of urban Australia, and with only modest overlap.

Instead, overlap was nearly 90 per cent, and the rollout ceased with the move to 'full competition' in 1997 leaving only about half the country with access to the network. Given Telstra's dominance in other areas of the market, it naturally emerged as the dominant provider, with Optus falling into its familiar position as follower.

Telstra's emergence as a dominant provider of Internet Services, and the disappearance of most of the independent firms that initially provided these services, was similarly the product of inattention. No consideration was given as to the desirability or otherwise of requiring a separation between content and carriage.

Throughout this process, governments and their advisers persistently underestimated Telstra's strength and overestimated the competition faced by Telstra. It is now apparent that most of Telstra's competitors based their business models either on the over-optimism of the late 1990s, or on 'regulatory arbitrage'. Examples of regulatory arbitrage include exploitation of advantages provided by the regulatory system to buy Telstra's services and resell them at a profit and 'Stackelberg follower' policies involving prices that are sufficiently below Telstra's to attract a modest market share, but not low enough to provoke a vigorous competitive response. Those in the former category, most notably, OneTel, have already failed. Those in the latter category are unlikely, by their nature, to pose a threat to Telstra's continued market dominance.

Although Telstra's managers, not surprisingly, favor preservation of an integrated structure, their delicate political position makes it difficult for them to engage in open public debate on the topic. As a result, the most coherent case for preservation of Telstra's structure is that put forward by the Communications, Electrical and Plumbing Union.

Telstra's optimal structure

The local telephone network

Despite claims to the contrary, the local telephone network is a natural monopoly and is likely to remain so for the foreseeable future, barring a drastic decline in the cost of mobile telephony, the main competing technology. It is increasingly evident that attempts to manage privatised natural monopolies through regulation are untenable in the long term. In the short run, evidence from the period prior to privatisation can be used as a basis for incentive-based regulation. In the long run, however, regulation of a monopoly business is inevitably based on cost plus rate of return.

Under private ownership, there is an inherent conflict between the interests of the regulated enterprise, which benefits from higher prices, and the interests of the public, which benefits from lower prices. If prices are set too low, the regulated firm can respond by cutting investment. However, in the context of a regulatory game, the firm has the incentive to threaten such cuts, even if the regulated price is in fact consistent with a market return to efficient investments. Hence, resources will be dissipated both in lobbying and in inefficient investment decisions designed to secure regulatory advantages. All of these processes are already evident in Victoria where privatised firms are seeking to renegotiate the rules under which they acquired assets in the electricity and public transport industries.

The same conflicts are potentially present under public ownership, but they are internalised by virtue of the fact that owners and consumers are, for practical purposes, the same people, namely the residents or citizens of the jurisdiction in question. Whereas under private ownership a decision to set prices to high results in a transfer of wealth from producers to consumers, under public ownership such transfers wash out. What households lose as consumers of the service in question they gain as taxpayers and consumers of government services.

In summary, the starting point for analysis is that the local telephone network should form the core of a fully publicly owned telecommunications enterprise, which I will refer to as Telstra Public

Retail services

It would be possible, in principle, to allow Telstra Public to own and operate the local telephone network, but not to allow it to deal directly with household and business customers. Under this model, Telstra would act purely as a wholesaler. Typically, it is assumed, a competitive market in retail services would rapidly emerge.

The thinking behind this argument reflects the technological assumptions that have been the basis of mistaken policies in the past. There is every reason to suppose that there are strong economies of scale between operation of the local telephone network and the provision of retail services such as connections, repairs and billing. The idea that these services can simply be separated is simply wishful thinking.

This proposition is not merely theoretical. Under the third-party access regime to which Telstra is subject, consumers are free to purchase their retail services from competing firms. The majority, however, have chosen to purchase directly from the actual service provider, Telstra. The imposition of structural separation between network ownership and retail services would deprive consumers of the option that most clearly prefer.

It is also doubtful that this model would produce a competitive outcome. It is far more likely that Telstra's privatised successor would dominate the market. However, in the absence of an obvious technical basis for market dominance, the private retailer would probably be subject to less stringent regulation than is currently applied to Telstra, making consumers worse off once again.

In summary, retail services should remain integrated with the provision of the local telephone network as part of Telstra, but the requirement to allow access to competing retailers should be retained.

Long-distance and international services

The imposition of compulsory separation between local and long-distance services was the centrepiece of the 1982 consent decree which resolved an antitrust action brought by the US Department of Justice against the dominant telecommunications enterprise AT&T. Under the degree AT&T retained its long-distance and other businesses, while a number of geographically separate local telephone companies (Regional Bell Operating Companies or 'Baby Bells') were created.

Although this policy produced some favorable outcomes initially, it is increasingly regarded as untenable. The seven RBOCs have been merged into four (Verizon, SBC, BellSouth, and Qwest), with the elimination of at least one (probably Qwest) being viewed as virtually inevitable within the next couple of years.

More importantly, the RBOCs are very likely to be allowed to re-enter the long-distance telephony market in the near future. AT&T is likely to merge with one of them as part of this process. Thus, the net impact of the 1982 decree will have been to break the old AT&T monopoly up into three or four geographically separate pieces.

There are substantial economies of scope in allowing consumers to deal with a single provider for both local and long-distance services from a given network, especially when, as in Australia, it is not always possible for consumers to determine which numbers are local and which are long-distance. Once again, a compulsory separation would foreclose an option most consumers clearly prefer.

Similar points apply to international services. Although it is possible to argue that a more competitive outcome could have been achieved if Telecom and AOTC had never been merged, leaving the domestic and international markets completely separate, the question has been resolved. The market that has emerged is one in which consumers expect domestic and international services to be supplied as part of a single package.

ADSL connection services

Asynchronous Digital Subscriber Line (ADSL) technology is one of the two main methods used to provide broadband Internet access (the other being hybrid fibre-coax cable, discussed below). ADSL services are provided using the local (copper wire) telephone network, of which Telstra is the sole provider.

The provision of Internet connections using ADSL technology therefore involves three potentially distinct services

(i) the provision and maintenance of the local telephone network connection;

(ii) the provision of the ADSL connection over the local network;

(iii) the provision of ISP services;

The approach taken in the United States, following the 1996 Communications Act, was to provide all three components separately, with an RBOC providing (i), a DSL ''wholesaler' providing (ii) and an ISP providing (iii). The resulting division of responsibilities was a recipe for disaster. Technical problems produced an epidemic of buckpassing in which each component provider blamed the other two. In particular, the RBOCs had no interest in assisting third-party providers of a service that they could potentially deliver in the future.

By contrast, the older model in which a range of competing ISPs provided services to consumers using modems designed to operate over 'plain old telephone service' (POTS) lines never encountered severe difficulties. This model allows for a fairly clear distinction between 'carriage' and 'content', making it relatively straightforward for consumers to assign responsibility for different aspects of service quality.

This analysis suggests that the feasible policy options are either a fully integrated ADSL service, like that currently offered by Telstra, or a common carrier model in which Telstra provides the ADSL connection for a range of competing ISPs. As has been argued already, the second model is to be preferred.

ISP services and Web content

The main arguments for separating Telstra's ISP and Web content businesses from its core telecommunications business have already been set out. To summarise, the main positive argument arises from the anti-democratic and anti-competitive effects of allowing a regulated monopoly provider of essential services to be a content provider and media enterprise. The negative argument is based on the absence of any obvious social benefits such as economies of scale and scope arising from allowing Telstra to undertake such a high degree of vertical integration. As has already been noted, Telstra is unique in its level of vertical and horizontal integration.

The HFC network and pay-TV

Applying the analysis presented for other components of Telstra's network, it is straightforward to conclude that the content services currently provided over Telstra's hybrid-fibre coax (HFC) cable system, including pay-TV and broadband ISP services, should be separated from the core business. A more difficult question relates to the allocation of the network itself. The general principle of separating carriage from content implies that the HFC network should be retained as part of the core business, as does the possibility of using the network for voice telephony. On the other hand, if a model of 'competition between technologies', discussed by Quiggin (...) is adopted, separation between copper-wire and HFC networks would be a natural consequence.

The problem is further complicated by the residual effects of the 'cable race' between Telstra and Optus. The problems arising from the existing of two half-built and largely duplicate networks must be resolved before any real progress can be made in this area. The nature of this resolution will impinge on the appropriate structure for Telstra.

Mobile telephony

The situation of mobile telephony is similar to that with HFC cable. The choice between retention and divestiture must be made in the light of a more general reorientation of policy regarding mobile telephony. Concerns about competition must be balanced against the clear desire of many consumers to deal with a single provider for telephone services of all kinds.

In addition, it is necessary to consider the general public preference for Telstra to be retained, as far as possible, intact and in full public ownership. A clearly articulated proposal to strengthen Telstra's core business by disposing of peripheral operations could gain public support. However, it seems likely that many Australians would regard the mobile telephony business as part of Telstra's core operations and their views should be respected.

WhitePages and Yellow Pages

A number of RBOCs in the United States have used the sale of White Pages and Yellow Pages operations to assist in capital restructuring. Although there is no compelling case for the divestment of Telstra's White Pages operation, there is equally no compelling case for its retention. The sale of assets of this kind could be used to finance various capital restructuring options, such as the repurchase of private shareholdings.

Other peripheral assets

Telstra's expansionist drive has resulted in the acquisition of a wide range of peripheral assets, most of which have performed poorly. The most notable is the joint venture with Hong Kong Telecom. While it is too late to retrieve the loss imposed on Australian taxpayers by this irresponsible venture, it is essentially that assets of this kind be separated from the publicly-owned core network.

Implementation

Since the current wave of privatisation began it has frequently been argued that, once an enterprise has been privatised it can never be returned to public ownership. This is a curious claim in view of the fact that a wide range of enterprises in many countries, including Australia, were nationalised in the first three-quarters of the 20th century. It has been conclusively refuted in the 21st century as a number of privatised enterprises have been renationalised (Railtrack in the United Kingdom, accident compensation in New Zealand), new public enterprises have been established (the Post Office bank in New Zealand) and some activities previously undertaken by private enterprises have been nationalised (airport security in the United States).

The proposal to fully privatise Telstra's peripheral activities while nationalising the core business greatly enhances the range of options available for the process of nationalisation.

First, there is a choice regarding which, if either, of the successor enterprise would retain Telstra's formal identity and which would be 'spun off'. If the core business were maintained as Telstra, the peripheral assets could be sold off or floated off and the proceeds used to repurchase privately owned shares. Alternatively, Telstra could sell its core telephony assets to a new publicly owned enterprises, with the government's Telstra shareholding being sold off at the same time. The new privately-owned firm would then be free to pursue the expansionist plans of the current management, if they retained the support of shareholders.

Two other issues, closely related concern the choice between immediate and gradual renationalisation and the willingness of government to take on some debt to finance renationalisation. Given a commitment to eventual renationalisation, there is no particular reason for governments to seek an immediate return to full public ownership. Rather the proceeds of the sale of peripheral assets could be used to finance the repurchase of shares from those willing to sell at the current market price. The remaining minority shareholders would continue to receive dividends, but would not exercise significant control over the board or have any prospect of receiving a takeover bonus. Their shares could be repurchased gradually over time, using Telstra's internally generated funds.

Alternatively, the government could take on some additional debt to make what would be, in effect a takeover offer. Assuming a sufficiently high acceptance rate, standard takeover rules could be used to compulsorily acquire the shares of the remaining locked-in minority.

A final option would be a formal renationalisation, with appropriate compensation under the takings clause of the constitution. Although feasible, this seems less attractive than the market solutions discussed above.

Financial implications

Financial outcomes of past privatisations

Following the passage of the *Telstra (Dilution of Public Ownership) Act* 1996, one third of the public shareholding in Telstra, One third of the government's shareholding, consisting of approximately 4.3 million shares, was sold at an average price of $3.40 yielding sale proceeds of $14 billion, all but $1 billion of which was used to repay debt. This privatisation was claimed as a success because strong demand for shares ensured a sale price at the upper end of the range of expectations, because purchasers of shares enjoyed strong capital gains reflecting the oversubscription of the share issue, and because the retirement of debt permitted interest savings of around $900 million per year.

From the viewpoint of taxpayers, however, the existence of capital gains for buyers was not an indication of success, any more than the shareholders of a private firm would regarded as successful the sale of an asset at a price which allowed buyers to make immediate profits on resale. The partial privatisation of Telstra exemplified the tendency for public assets to be sold for less than their market value, which in turn is usually less than the value of the stream of profits accruing to the public sector.

The fundamental question in evaluating the partial sale of Telstra is the comparison between the earnings foregone as a result if privatisation and the interest saving from the repayment of debt. A series of previous analyses have shown that, assessed on this basis, the first-stage privatisation of Telstra produced a substantial loss to the public, which has grown over time. The estimates of Telstra's earnings growth and value in public ownership presented in my submission to the 1996 Senate inquiry (Appendix) have, if anything, proved conservative.

The second-stage privatisation, conducted at a time when share prices for telecommunications enterprises were inflated by the technology bubble was roughly neutral in terms of its impact on the public fiscal position. The analysis may be presented conveniently in terms of earnings per share.

For the last couple of years, the combined value of post-tax earnings and imputation credits has been around 40 cents per share, enough to service \$6.70 of debt at an interest rate of 6 per cent. That is, on the conservative assumption that Telstra's profits will remain stable in nominal terms, the value of shares in public ownership is \$6.70. On the more reasonable assumption of stable real profits, the value of shares in public ownership is around \$10.

The government has already recognised that, at current share prices, the proceeds from the sale of the public shareholding in Telstra would not be sufficient to justify forgoing the associated stream of earnings. The converse is true. At the current share price, the repurchase of the private minority shareholding would improve the public fiscal position.

Concluding comments

Until recently, policy debate surrounding Telstra has been dominated by the presumption that full privatisation is inevitable and that renationalisation is unthinkable. Any debate in which crucial policy options are ruled out as unthinkable is unlikely to produce sensible outcomes and this has clearly been the case in relation to Telstra.

Fortunately, the option of renationalisation has become a practical reality in numerous recent instances around the world. It is clear that the only coherent response to Telstra's unsatisfactory structure and governance is a combination of renationalisation and divestiture.

Appendix - Extracts from 1996 submission

Partial privatisation

If the new private owners of an enterprise can introduce substantial efficiency improvements, the increase in the flow of profits may offset the higher rate of return demanded by private equity holders. If this is so, the public will benefit from privatisation. But in the case of a partial sale, as proposed in the Telstra (Dilution of Ownership) Bill, there is no change of management and hence no possibility of efficiency improvements beyond those that would have taken place anyway. The public suffers the loss associated with the equity premium but gets no efficiency benefit.

The best option, therefore, is either to retain the asset or sell it in one go. If it is believed that equity markets are too thin to absorb the asset in one go, the best way of selling is to commit in advance to a sale staged over several years. However, where equity markets are thin the equity premium is likely to be larger than usual, and the case for privatisation correspondingly weaker.

The position of minority shareholders in a publicly owned enterprise of the kind proposed by the government is such as to guarantee a low sale price. Should the Liberals lose the next election, the shareholders would be at the mercy of the incoming Labor government. If that government should be genuinely hostile to privatisation, the minority shareholders would be unlikely to make large returns on their investment. In these circumstances, it would be a foolish investor who offered the same price for shares in a partly privatised Telstra as they would offer in the case of a full privatisation.

(emphasis added)

The valuation of Telstra in public ownership

In this section, the principles set out above will be applied to derive a range of values for Telstra in public ownership. Three scenarios will be considered. In Scenario 1, profits grow in line with real GDP, that is, at a real rate of 3.5 per cent per year, until 2001, and stabilise thereafter. In Scenario 2, profits grow at a real rate of 20 per cent until 2001, and stabilise thereafter. In the low scenario, real profits decline by 25 per cent in 1996 and stabilise thereafter. The resulting profit streams are presented in Table 2.

In Table 3, the streams of profits under the three scenarios are valued using four different discount rates. The preferred rate, based on the analysis presented above, is 4 per cent. For the purpose of sensitivity analysis, rates of 2 per cent and 6 per cent are considered.

Table 1 Profit scenarios for Telstra

Projected Telstra real post-tax profit $m (1995-96 values)

	Scenario 1	Scenario 2	Scenario 3
1995	1755	1755	1755
1996	1816	2106	1316
1997	1880	2527	1316
1998	1946	3033	1316
1999	2014	3639	1316
2000	2084	4367	1316
post-2001	2084	4367	1316

Table 2 Valuation of Telstra in public ownership

	Present value of Telstra earnings ($ billion 1995-96)		
Discount rate	Scenario 1	Scenario 2	Scenario 3
4 per cent	54.4	107.9	35.3
2 per cent	106.9	217.7	68.6
6 per cent	36.7	71.1	24.2

The preferred estimate for the valuation of Telstra in public ownership is $54.4 billion, obtained by applying a 4 per cent real discount rate to the stream of profits in Scenario 1. This is approximately twice the value envisaged in most discussion of the possible sale of Telstra. Assuming a realised sale price of Telstra of $24 billion, privatisation would reduce the net worth of taxpayers by around $30 billion.

Under Scenario 2, where the past rate of profit growth is sustained for a further five years, the value of Telstra in public ownership rises to $107.9 billion. This is approximately equal to the value of all outstanding Commonwealth government debt. That is, at current interest and inflation rates, the profits of Telstra under Scenario 2 would cover the entire real interest on Commonwealth government debt.[1] The remaining nominal component of interest could be rolled over while keeping the real value of public debt constant and allowing the ratio of public debt to GDP to decline steadily. Thus, the debt burden on taxpayers would effectively be eliminated, since no contribution to debt service would be

[1] For simplicity, all the scenarios assume that Telstra's real revenue, profits and capital stocks stabilise from 2001 onwards. In a stable situation of this kind, the entire post-tax profit may be paid out as dividends. A more realistic set of scenarios, involving continued growth after 2001 would only reinforce the conclusions derived here.

required from general revenue. There is no guarantee that Telstra's past profit growth will continue as envisaged in Scenario 2. But by undertaking privatisation now, the government guarantees that taxpayers will bear a substantial burden of public debt for years to come.

In the least favorable Scenario 3, Telstra suffers a substantial loss of market share and profitability as a result of competition. Even in this scenario, however, the stream of earnings generated by Telstra is greater than the saving that would arise by privatising Telstra and using the proceeds to repay debt.

Variations in the real interest rate used in the analysis within the range from 2 to 6 per cent do not change the basic conclusion. For all three scenarios and all three discount rates, the value of Telstra in public ownership is greater than the sale price envisaged by most analysts. The costs of regulatory uncertainty and the premium rate of return demanded by holders of private equity outweigh any efficiency gains that might be expected under private ownership.