JANUARY 2003

TELSTRA INQUIRY

Submission No. 57

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON COMMUNICATIONS INFORMATION TECHNOLOGY AND THE ARTS: INQUIRY INTO TELSTRA

STRICTLY PRIVATE AND CONFIDENTIAL

JPMorgan Submission

JPMorgan

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1. Outline

Background

JPMorgan received an invitation to make a submission to this inquiry. We note the terms of reference as follows

- That the Committee inquire into and report on the economic and social impact of structurally separating Telstra's core network from its other businesses and reducing the Commonwealth's current shareholding in Telstra's non-network businesses.
- In conducting its inquiry, the Committee should consider the impacts of such a proposal on:
  - The efficient provision of services to end-users, including businesses and residential customers in regional, rural and remote Australia;
  - Telstra's ability to continue to provide a full array of telecommunications and advanced data services;
  - Ongoing investment in new network infrastructure;
  - The wider telecommunications industry;
  - The telecommunications regulatory regime;
  - Telstra's shareholder value and its shareholders; and
  - The Commonwealth Budget.
- The Committee shall consult widely in the conduct of the inquiry, including with the telecommunications industry, the investment community, representatives of regional Australia and the trade union movement.

JPMorgan has prepared this submission on the impact of a proposed Telstra structural separation from the perspective of Telstra's shareholder value and the views of Telstra's shareholders, investor clients and contacts.

JPMorgan's investor clients are domestic and international investors participating in Australian capital markets, including a large base of retail investors. They include many current and former Telstra shareholders and major investors who would be needed to support any further privatisation of Telstra or any of its principal components. They also include investors whose continuing general support is needed by the Australian economy as a whole.

In summary, given investor interests and the relevance of those interests to Australia's national interest, we counsel that it would be unwise for the Australian Government to mandate any structural separation of Telstra.

If, however, the Government nonetheless decided to do so, and was able to give practical effect to such a decision (which is very doubtful and may be unachievable), then the Government should move expeditiously to fully privatise any "non-network" business ("ServCo") that was thereby created.

This view does not detract from JPMorgan's (and investors') overwhelming view that completing the privatisation of Telstra in its existing structure should be a policy priority for the Commonwealth.

Who is JPMorgan?

JPMorgan Chase & Co., is an international financial services powerhouse with global assets of over US$741 billion (as at June 2002) and operations in more than 50 countries. The firm is a component of the Dow Jones Industrial Average, is headquartered in New York and serves more than 30 million consumer customers around the world.

JPMorgan is the investment banking arm of JPMorgan Chase & Co. and is one of the world's premier investment banks as measured by client franchise, product breadth, geographic reach and size. At the centre of its business model are its extensive client relationships with corporations, financial institutions, governments and institutional investors. The firm provides clients with a full range of investment banking and commercial banking products.

The firm has had a presence in Australia since 1872. After combining Ord Minnett, Chase Manhattan bank and J.P. Morgan, JPMorgan is one of the largest and most successful investment banks in the country. In Australia and New Zealand, the firm has over 1,000 employees (in Sydney, Melbourne, Adelaide and Auckland).

It is one of the few fully integrated investment banks in Australia with leadership positions across a wide spectrum of financial products - debt, debt capital markets, equity, equity capital markets, equities research, M&A, custody and investor services.

Globally, and in Australia, the firm is a leader in the provision of financial services to the telecommunications sector and investors in the sector.

Our Australian telecommunications equity research team is ranked 1st in the industry and is closely linked to our global research practice. The firm has close relationships with a number of the largest global and domestic investors into the Australian market and Telstra. We have provided equity research coverage on Telstra since its IPO through our highly respected Australian telecommunications research team, David Wilson and Lynn Canalese.

In addition, we also cover Telstra from a debt research perspective.

The firm, through Ord Minnett, acted as Joint Lead Manager (Australia and New Zealand) in both T1 and T2. The firm also provides investment banking services to a number of telecommunications clients and has played an important role in many of the large deals over the last few years. In this context, JPMorgan has acted as adviser to Telstra on a number of transactions.

Summary of investor position

In this document, we refer to the proposed separated network and service elements of Telstra as "NetCo" and "ServCo" respectively.

There is a strong investor view that the interests of both existing Telstra shareholders and the broader economy would be materially damaged by any forced structural separation. While structural separation of Telstra may arguably increase the scope for competition in the Australian telecommunications industry, any efficiency gain would be expected to be more than offset by adverse consequential effects. This would be true whether or not NetCo was re-nationalised following a structural separation, as has been proposed by some.

Key issues that militate against any structural separation of Telstra include

- The practical difficulty and cost of any mandated separation;
- The ongoing effect of any separation on Telstra's operational efficiency and profitability - and hence shareholder value;

- The level of compensation cost, and the difficulty of ensuring that Telstra shareholders were properly compensated and that change in ownership interests were effected on just terms;
- The effect of separation in increasing Telstra's cost of capital, which would reduce its capacity to invest in existing or new telecommunications infrastructure. In addition, the reduction in the scale of Telstra would inhibit its ability to take advantage of regional growth opportunities and to become a "regional champion";
- The detrimental effect of any government mandated separation of private investors' interests on Australia's international investment reputation;
- Uncertainty as to the value separated entities would attract, given that structural separation would be an unprecedented undertaking. Telstra is currently valued on a comparable basis to its global integrated telecom peers. No comparables exist for valuing ServCo; and
- The detrimental effect upon ServCo of NetCo's lower incentive to invest in its network, particularly if NetCo is re-nationalised.

2. Concerns of current Telstra shareholders

Practical difficulty and cost of separation

The "structural separation of Telstra's core network" is a concept open to a wide range of conceptual interpretations. Some commentators have mooted separation of "services" from infrastructure - although the technology for delivering many services is inextricably embedded in the technology of the infrastructure. Others have mooted the separation of Telstra's local loop infrastructure only - although provisions have long existed to afford Telstra's competitors regulated access to the local loop. Structural separation would seem a harsh alternative to timely and effective application of those provisions.

JPMorgan thus understands that there is no clear physical, commercial or technical definition that would enable either - or any - form of separation to be given practical effect. Any regulatory definition adopted would likely be transient - subject to rapid destabilisation as technologies, and the fundamental economics of those technologies, evolve in the future ("technological erosion").

The task of defining a basis for separation, and recreating the necessary multitude of links between the two entities by contractual agreement alone would be, at best, daunting.

Any structural separation of Telstra would also be an unprecedented undertaking. The 1984 separation of AT&T divided that company along the then discrete boundary between local and long distance networks - not between the local loop and the switches as would be required for local loop separation. AT&T and the new 'Baby Bells' all retained both retail and wholesale activities. The AT&T experience is therefore practically and technically very different from any proposed separation of Telstra along NetCo/ServCo lines.

Points of reference that are available - including the public debate over BT's proposed self-separation in 2000 and JPMorgan's work with a range of corporate telecommunications clients globally - serve to reinforce the cost and time implications of any separation attempt, as well as the difficulty of implementing a workable, let alone efficient outcome.

Examples of difficulties that would be faced in a separation process include

- Difficulty of identifying the most appropriate and feasible 'line of separation' through the entire company;
- Legal and other costs of separating and assigning property rights that are currently used in more than that part of Telstra that would become "NetCo" (including intellectual property rights as well as real estate, rights of way, easements etc.) and assigning them respectively to NetCo or ServCo;
- Cost and time required to separate highly complex IT and billing systems;
- Drafting of arm's length commercial and legal agreements governing all interactions between NetCo and ServCo, as well as ongoing administration and interpretation of those agreements;
- Employee uncertainty about limited career prospects with more narrowly focussed separate entities, as well as with the process of change itself;
- Effective, efficient and equitable separation of superannuation arrangements for the two groups of employees;

- Inevitable 'turf wars' between managers;
- The diversion of attention in Telstra from its customer and shareholder value focus while it focused on the separation process and the establishment and consolidation of the new entities; and
- Difficulty of valuing the assets to be placed in NetCo.

Ongoing effects of separation on Telstra's operational efficiency and profitability

There are a number of structural models for competitive telcos in developed economies. These range from integrated full service firms such as Telstra, through to single technology or single service firms (such as Vodafone) and niche operators. Depending on their history, business strategy and commercial capacity, different firms can succeed commercially with different structures. It is not axiomatic that any one model is optimal for the whole market. The absence of structural regulation allows different firms and different investor groups to explore the scope for efficiency and commercial success among competing structural models.

Investors who hold equity in Telstra have invested in a firm that promotes a full-service, fully integrated, structural model. Those investors would have grave concerns if Telstra were prevented by regulation from developing that model competitively within prevailing regulatory requirements. Most investors acquired their stakes in Telstra pursuant to two privatisation transactions, in both of which the Commonwealth promoted the investment that was offered as being in a full service, integrated telco. They have a reasonable expectation that any post-privatisation change to that model would arise, if at all, in the usual course of business development by way of Board decision for accountable commercial reasons. No investor in T1 or T2 had any expectation that the structure of the company would change post-purchase by Government mandate.

Telstra's fully integrated structure is one of its key commercial advantages. Integration of network and service arms allows Telstra to deliver a higher quality, more seamless communications product to customers and drive costs - and prices - down through economies of scale and scope. The loss of these advantages upon separation would clearly reduce economic efficiency and reduce shareholder value.

The broad frameworks, and informal cooperation that currently govern relations between divisions of Telstra would be replaced by a multitude of detailed legal contracts that would inevitably give rise to ongoing disputes. The likelihood of disputes and uncertainty around the regulatory system would increase over time as technology develops, blurring the definition of any structural boundary between the two entities and changing the nature of interaction between NetCo and ServCo and, ultimately, the fundamental economics of the telecommunications sector.

Long-term value would also be destroyed within Telstra (and the Australian economy at large) by the negative effect separation would have upon innovation. Without full access to the resources of a retail arm, NetCo would be less well placed to forecast demand for new communications technologies and less willing to make the investments required to deploy them. NetCo would need to be heavily regulated and some have mooted re-nationalisation. Either course would exacerbate this isolation from market signals. Without the ability to foresee or reap upside returns from investment in innovation, NetCo would be reluctant to bear the investment risk needed by its downstream clients—ServCo and its competitors.

The value destructive effect of externally mandated separation is recognised by Telstra's Board and management, who strongly oppose the notion on the grounds of shareholder value. Also telling is the fact that no other privatised incumbent telco has separated its retail and network arms—despite the value premium that investors were willing to pay for pure telecom service businesses during the technology boom period. Both SingTel and Telecom New Zealand - two of Telstra's largest competitors, both regionally and domestically, remain free to pursue an integrated strategy in Australia and in their home markets.

In general, where structural regulation, or line of business restrictions, have been applied or contemplated, this was a pre-privatisation or pre-liberalisation measure.

Compensation

Any structural separation imposed on Telstra by Government would affect the property rights of its investors by reducing the value of their shares. The Commonwealth would be constitutionally required to pay compensation to those investors on just terms.

With Telstra's share price having fallen about 40% since T2 in October 1999 and about 50% since its post T2 peak in November 1999 Telstra investors (and, in particular, retail investors) are very sensitive to further diminution in the value of their investment. They would inevitably demand and be entitled to compensation. Shareholders would rightly understand that the Commonwealth (part) privatised Telstra at prices that reflected the value of an integrated entity. Any subsequent change to the fundamental nature of that investment would require full compensation.

Given that Telstra's market value positively reflects its integrated and full service character, the combined shareholder values of separated entities would axiomatically be less that that of an integrated Telstra. Therefore, even the pro-rata distribution of equity in each of NetCo and ServCo to current Telstra shareholders would not amount to full or just terms compensation.

Should the Commonwealth re-nationalise NetCo as some have mooted, the compensation case would be more complex and problematic. The Commonwealth would presumably acquire NetCo from Telstra, and would be constitutionally obliged to make such an acquisition on just terms[1]. It is inconceivable that the terms of such a large, opposed, compulsory acquisition would be settled without protracted litigation. Even then, the payment to Telstra for the acquisition of NetCo would probably still not compensate the shareholders in the residual Telstra/ServCo fully. The true values of NetCo and ServCo would not become clear for a number of years, leading to delay and misallocation of resources.

Re-nationalisation of NetCo would also deprive shareholders of an opportunity to profit from their historical investment in network technology. Since privatisation in 1997, Telstra has increased its capital expenditure from an historical level of approximately $3 billion per annum to approximately $4 billion per annum, with the extra funds largely spent on network upgrades. A total of around $5 billion of shareholders' funds, which could have been paid out as dividends, have instead been used to improve the quality of Telstra's network over the past five years.

It is not readily possible to accurately model the likely value effects of such a major structural change. It is, therefore, not possible to ascertain whether the proceeds to the Commonwealth of fully privatising ServCo post-separation would be sufficient to meet the costs of compensation and/or the costs of acquiring 100% of NetCo.

[1] *Commonwealth Constitution, cl 51(xxxi)*

Having acknowledged the practical difficulty of valuing NetCo, the ultimate cost of re-nationalisation would be high. As an indicative measure, if NetCo were to represent 60% of the current market value of Telstra, the Commonwealth would be obliged to pay A$17.8 billion to Telstra shareholders for that acquisition alone.

If the value of NetCo exceeds the value of the Commonwealth's current stake in Telstra, then separation plus the re-nationalisation of NetCo would cost the Commonwealth more than the proceeds from fully privatising ServCo. In addition, the Commonwealth would have to pay compensation for the total amount of the shareholder value destroyed by the separation decision and process.

No matter how separation was implemented or what compensation was offered, it is highly likely that elements of Telstra's shareholder base would remain dissatisfied and would respond with litigation and public advocacy.

3. Broader capital market concerns

Detrimental effect of separation on Telstra's cost of capital and on re-investment in the network

As noted above, NetCo would have less incentive than Telstra to invest in network improvements because of a reduced ability to forecast demand for those products and to reap rewards from successful investments. This would increase the discount rate used to assess future investments—to reflect the higher risk—leading to a reduction in the volume of investments that would be viable. This would increase Telstra's cost of capital.

Both NetCo and ServCo would enjoy less predictable cashflows, lower economies of scale and scope and lower margins than Telstra. These changes would weaken the credit rating of the separated entities, increasing the interest rate at which they could raise debt and reducing the level of debt that they could prudently carry. These factors, combined with a diminished growth profile, would also decrease the attractiveness of NetCo to equity investors, if it were not re-nationalised.

If NetCo were re-nationalised, any proposed new investments in the network would need to compete for the allocation of scarce Government resources as one of a multitude of competing public needs. Any debt raised by a re-nationalised NetCo would be seen to add to the debt burden of the Commonwealth.

The increased cost of both equity and debt would be particularly evident in the years immediately after separation, due to the high levels of uncertainty that would surround NetCo and ServCo's respective sustainable levels of profitability.

Detrimental effect on Australia's international investment reputation

A government mandated structural separation of the largest listed Australian company would harm the country's international investment reputation. By fundamentally changing the nature of an asset that was recently privatised—with substantial participation by foreign investors—Australia's credentials as a reliable and stable capital market would be damaged.

This damage could increase the cost of capital of other major Australian companies by increasing the country risk premium that investors apply to Australia. This would increase the difficulty (and cost) of raising new debt or equity from international investors and of retaining existing investors. It would also affect international demand for further asset sales by Australian governments, State or Federal and, more generally, for investment participation in regulated assets and public-private partnership investments.

4. Ownership of ServCo

JPMorgan does not accept that it is either desirable or feasible to create a NetCo/ServCo structure. But if such a structure was created, the interest of investors would lie in it operating without continuing Commonwealth ownership. This is because, *inter alia*

- Once of the purposes of separation would have been to place ServCo on a competitively neutral basis in the market. Ongoing Government ownership would be inconsistent with this purpose, not least by affecting access to capital;
- It has been largely bipartisan policy that Government ownership in one market participant in a fully competitive market (banks, airlines) is not appropriate;
- Some may hold the view that Government ownership in ServCo is necessary in order to ensure it continues to provide affordable and reliable services to target customer groups - such as some in rural and remote areas. But one of the purported reasons for separation, is to bring back into controlled Government ownership, in NetCo, the infrastructure necessary to ensure this objective. If separation could not be designed to secure that outcome, then separation would be unwarranted on that score; and
- The partially privatised nature of ServCo would impel its board to pursue solely commercial objectives in the interests of all shareholders - as is the case with Telstra today. The Government could not properly use its influence as a shareholder to compel ServCo to engage in other, socially motivated activities. To the extent that such intervention is necessary, it can and should be achieved through appropriate contract and/or by regulation.

JPMorgan
31 January 2003

file

Brien, Andrew (REPS)

From: Stephen.D.Chipkin@jpmorgan.com
Sent: Friday, 31 January 2003 5:37 PM
To: Committee, CITA (REPS)
Subject: Inquiry into the Structure of Telstra

JPMorgan Final Submission 31-J...

Paul McMahon
The Secretary
House of Representatives Communications, Information Technology and the Arts Committee

Dear Mr McMahon

Thank you for your letter of 6 January 2003, inviting submissions to this inquiry.

We have pleasure in enclosing JPMorgan's submission to the Committee.

If you have any queries in relation to our submission, please feel free to contact us.

Yours sincerely

Stephen Chipkin

4.2.03
Agreed to Sub. being public
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pm
AJB

(See attached file: JPMorgan Final Submission 31-Jan-03.pdf)

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