TELSTRA INQUIRY
Submission No. ....51........ .....

Level 38, the Chifley Tower
2 Chifley Square
Sydney NSW 2000 Australia

Morgan Stanley

tel (612) 9770-1111
fax (612) 9770-1129

31 January 2003

The Secretary
House of Representatives Communications, Information Technology and the Arts Committee
R1, Suite 116
Canberra ACT 2600

Dear Sir:

Structural Separation & Reduction of Commonwealth Interest in Telstra's Non-Network Businesses

This submission is made by Morgan Stanley to the House of Representatives Standing Committee on Communications, Information Technology and the Arts in relation to its inquiry into 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."

The Committee has been asked to 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 tele communications industry;
- The telecommunications regulatory regime;
- Telstra's shareholder value and its shareholders; and
- The Commonwealth Budget.

Morgan Stanley is one of the world's largest diversified financial services companies, with a reputation for excellence in advice and execution on a global scale. The firm enjoys leading franchises in three businesses:

- Global Securities, where Morgan Stanley serves individual and institutional investors and investment banking clients;
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- Global Credit Card Services, primarily the Discover Card, held by 40% of U.S. households, as well as a growing Morgan Stanley card business in the United Kingdom.

Today Morgan Stanley has over 700 offices in 28 countries and employs more than 55,000 people worldwide.

Morgan Stanley has been active in Australia for over 40 years and operates from offices in Sydney and Melbourne. Since 1990, Morgan Stanley has provided advice on over A$100 billion of investment banking assignments including major securities offerings, mergers, acquisitions, joint ventures, takeover defences and corporate restructurings. In 1997, Morgan Stanley became a member of the ASX Limited and today employs more than 100 people.

In our role as an adviser to institutional investors and investment banking clients worldwide, we have gained significant experience working with companies operating in industries where consolidation amongst major industry participants has had a significant impact on the competitive forces within that industry. In providing advice to these clients Morgan Stanley has gained experience regarding proposals for vertical and horizontal structural reform within a number of network based industries (for example, electricity, gas, rail transport and telecommunications) where the competitive environment has come under significant legislative and regulatory scrutiny.

In preparing this submission Morgan Stanley has undertaken a review of the available precedents and proposals for horizontal and vertical structural separation globally, including an analysis of a significant amount of publicly available material, and discussions with colleagues who have been involved with both public and non-public separation debates across a wide range of network industries globally, including telecommunications.

The U.S. Experience

The debate about structural separation in the U.S. telecommunications industry is extensive. The decision to horizontally separate AT&T into the "Baby Bells" in 1982 gave rise to the current U.S. industry structure, which today operates largely within a framework governed by the Telecommunications Act 1996.

The Telecommunications Act was developed in response to calls for greater competition in the telecommunications industry, particularly at the local exchange level where facilities-based competition is often impractical. While the U.S. industry benefits from vibrant competition in services like wireless, long distance and certain data products, the key focus of reforms under the Telecommunications Act was, and is, to promote competition in the local loop through unbundling network elements.

Despite capital markets conditions having recently limited the scope for competition from new market entrants, long distance carriers have begun to build reasonable presences as local exchange carriers. In fact, vigorous competition for local customers in the U.S. has recently accelerated dramatically in the absence of any structural separation. In 2002 the Bell companies lost several million access lines to carriers including AT&T, Worldcom, Sprint and others, as regulatory initiatives have fostered the capture of profitable market share at the expense of the incumbent Baby Bells.

Despite this pro-competitive regulatory framework, the prospect of structural vertical separation of the Baby Bell network and service operations has been raised on numerous occasions. Most recently, the Pennsylvania Public Utility Commission considered a proposal to require Verizon (formerly Bell Atlantic) to separate its network and service operations in Pennsylvania.

To date no proposal to separate network assets from the service operations of any of the Baby Bells has been implemented. Despite eighteen States having considered, or being in the process of considering, structural separation, there has been no congressional legislation filed in support of structural separation. Of these eighteen States, three States have rejected structural separation, fourteen are still considering proposals and one (Pennsylvania) has endorsed structural separation. Despite endorsing structural separation the Pennsylvania Public Utility Commission stopped short of implementing full structural separation and instead issued orders implementing a functional separation. The functional separation requires, among other things, that the incumbent telecommunications operator operate its wholesale and retail operations on an arms-length basis.

The fact that only one U.S. State has ultimately required any form of structural separation and the fact that the separation required in that instance was functional in nature only is, in Morgan Stanley's opinion, evidence of the risks and costs associated with implementation of a proposal to separate Telstra's core network from its other businesses. Moreover, we believe that the clear guidance for Telstra from the extensive debate in the U.S. is that the process of developing and implementing structural separation comes at a very real and significant cost, which manifests itself across all areas within scope of the Committee's review.

The European Experience

The European telecommunications industries have had a similar experience with structural separation. A number of incumbent operators have considered structural separation, most notably British Telecom (BT), Telecom Italia, and Telia of Sweden. To date only Telia has moved towards separation, and again this separation took the form of a functional division only.

The BT separation proposal is of particular interest as it involved a proposal made by a fully privatised incumbent operator without any regulatory intervention. As such, the BT proposal could seemingly be advanced to support an argument for structural separation unlocking value for shareholders in a fully privatised incumbent telecommunications company. However, it is important context that the BT proposal was announced in 2001 during BT's efforts to restructure its balance sheet in the face of significant financial pressures and rapidly declining equity valuations for communications stocks. Over the preceding 5 years BT had raised substantial amounts of debt to fund its international expansion strategy, and it is Morgan Stanley's opinion that the proposal for separation was floated chiefly in an attempt to alleviate immediate financial concerns. To the end we do not believe an argument for separation is supported by BT's circumstances.

It is also notable that after announcing this proposal it was rumoured that BT received a number of approaches to sell its network. BT ultimately did not proceed with any transaction, preferring instead to reduce its debt by divesting certain non-core offshore assets. It is Morgan Stanley's opinion that this course of action was ultimately pursued as it was regarded as the best mechanism for management to preserve shareholder value.

Morgan Stanley's Opinion

In the context of our analysis and experience Morgan Stanley has formed a number of opinions. Generally, we are of the opinion that:

- The theoretical arguments in favour of perfect competition in any industry are clear and compelling;
- However, the practical challenges associated with implementing structural reforms, particularly where these involve wholesale changes to industry structures, is extremely complex; and
- The degree of complexity is directly related to the degree to which an industry naturally favours monopoly.

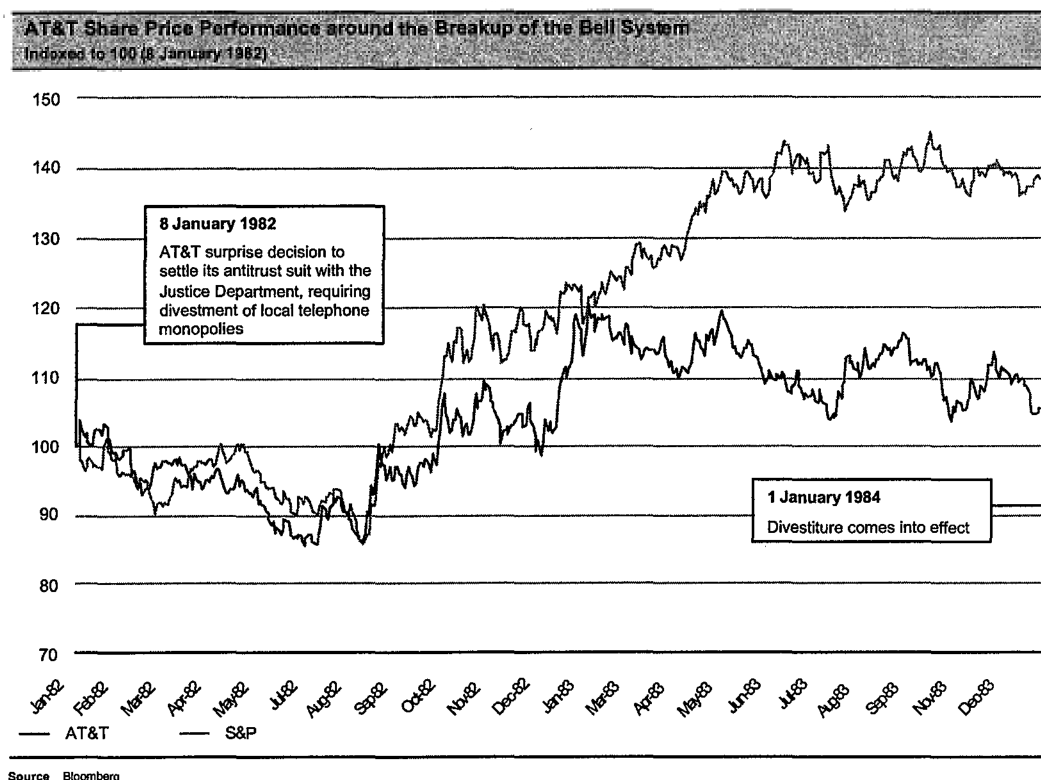
In the case of Telstra, specifically, it is difficult to make a detailed assessment of the actual impact of separating Telstra's core network from its other businesses given the information and timeframe available. It is also not clear given the scope of the Committee's inquiry whether reference to Telstra's *core network* means only those parts of the business exhibiting natural monopoly characteristics (most notably the local loop), or whether *core network* also includes other network elements which face contestability (such as Telstra's wireless, long distance, and cable businesses). Certainly in our opinion there seems little basis for grouping all of Telstra's network elements together:

- The fact of existing contestability in certain network businesses clearly illustrates that market forces are operating within the existing telecommunications regulatory framework;
- Grouping these contestable network businesses with monopoly network businesses for purposes of separation leaves Telstra's residual non-network businesses at a relative disadvantage:
  - Making them simply resellers of network services against existing competitors who themselves are often facilities-based; and
- In the medium term, these residual non-network businesses will likely have sufficient scale and incentive to build their own facilities, which could potentially lead to duplication and over-investment.

Furthermore, even in the parts of Telstra's network businesses that do exhibit monopoly characteristics, we are of the opinion that greater economic and social benefits can be achieved without the need for structural separation. In our opinion the practical risks of a structural separation significantly outweigh the practical benefits. Such risks include:

- The cost of implementation, including the cost of significantly diverting management, political and regulatory attention for what could be a lengthy process;
- The cost of maintaining separate business operations, including separate company overheads and regulatory compliance costs;
- The risk that the network business will attempt to leverage its position into other value-added services over time, further complicating the regulatory and compliance process;

- The risk that the rate of return regulated network business will be motivated to either under- or over-invest in its existing network over time, depending upon its allowed and earnable rate of return;
  - This risk presents the greatest practical threat to end-users in areas where the density of traffic on the network is low, notably regional, rural and remote areas of Australia;
- The risk that the network business will have limited incentive to invest in new network where there is a risk that it may not return its cost of capital over time;
  - This risk presents its greatest threat to the innovation of new network services, and again in areas where network traffic is low; and
- The risk that Telstra's share price will under-perform during any (potentially lengthy) transition period, adversely impacting any attempt by the Commonwealth to reduce its shareholding in Telstra's non-network businesses;
  - AT&T, for example, underperformed the Standard & Poors index by 33% during the period of its transition to the Baby Bell system.



Source Bloomberg

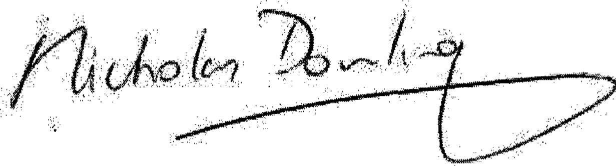
Conclusion

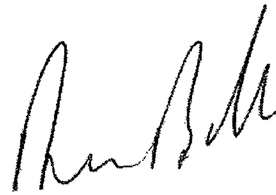
In conclusion therefore, it is Morgan Stanley's opinion that:

- The most appropriate path forward is to allow Telstra to remain as an integrated telecommunications service provider; and
- To the extent there are competitive concerns that need to be addressed within Telstra's existing operations, these concerns are most valuably addressed by incremental change to existing regulation rather than through wholesale changes to the way in which Telstra is structured.

We would be happy to provide further commentary on these opinions as required.

Yours sincerely,





for **Christopher Harland**
Managing Director
Global Head of Communications
Investment Banking

Rick Ball
Managing Director
Head of Australian Investment Banking