Tels

Telstra Inquiry

Submission No. 61

AAPT

Submission by AAPT Limited

The House of Representatives, Standing Committee on Communications, Information Technology and the Arts

Inquiry into Structure of Telstra

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1. Executive Summary

AAPT believes the importance of an efficient competitive telecommunications sector to the Australian economy is well accepted by government, the community and industry participants. The extent to which such competition will be forthcoming depends on the industry structure of telecommunications. Service providers will only offer services where they can expect to get a return for their shareholders from offering compelling value propositions to their customers. In addition to the price customers are willing to pay for such services, it is the cost of the infrastructure required to deliver the services that will determine the extent of competition.

AAPT believes it is essential that the Government exit its position of ownership as part of its continuing reform of the telecommunications industry. We see this as a component of the ongoing reforms, which includes the appropriate regulatory arrangements that will permit genuine competition that is beneficial to end use consumers.

In the context of exiting its ownership role, we consider that the Government should reinforce its ongoing role in reviewing the structure of the industry as a whole. This includes the appropriate relationship between ownership of infrastructure and provision of services. AAPT is encouraged that the House of Representatives Standing Committee on Communications, Information Technology and the Arts is conducting this inquiry into the structural separation of Telstra. However, we do not believe the Committee has the resources to reasonably conclude the matter. Proper analysis is required of the consumer, investment and Government impacts of the structure of the industry, and recognition that this is a matter for dynamic not static consideration.

AAPT proposes that the Committee recommend that the Government fully consider the future structure of the telecommunications industry. This review should address the appropriate legislative measures that might be introduced as part of the full privatisation of Telstra to ensure that the responsibility of Government to monitor industry outcomes, and the power to undertake any further industry re-arrangements, are assured.

2. History

The Australian telecommunications industry has been the subject of repeated review and inquiry ever since the creation of Commonwealth's the postal and telecommunications power in the Constitution. The NSW Post-Master General and subsequent Prime Minister Joseph Cook declared on the eve of Federation that though it had always been assumed that the post office should be taken over at the Commonwealth's formation, he himself "had not heard a single effective argument in favour of doing so."[1]

The more recent major reviews included the Vernon Commission of 1974 which resulted in the creation of the separate statutory authorities of Telecom Australia and Australia Post, and the Davidson Inquiry of 1982 which was not directly implemented but started much of the later re-regulation from 1987 to 1997. As part of those changes the Government conducted an extensive review known as the Review of Structural Arrangements (ROSA) in the early 1990s, and more recently a major review of Telecommunications Competition Regulation by the Productivity Commission in 2002.

The first two inquiries were major public independent inquiries able to commission their own research. The ROSA inquiry took public submissions but was otherwise conducted within the confines of Government. The Productivity Commission was specifically excluded from considering issues of structural separation.

While public, the Parliamentary Committee is conducting the current inquiry with none of the

[1] Moyal, Ann *Clear Across Australia: A history of telecommunications* Thomas Nelson Australia 1984. P. 88

resources available to an independent inquiry. The Committee will be presented with detailed argumentation in submissions from interested parties. And the submissions of those parties will reflect their self-interest. So the positions that will be advocated by other carriers and consumers will contain no surprises for the Committee. Further, Telstra's role as the single largest consumer of legal services, consulting services and banking and financial services, is likely to see a litany of submissions advocating positions designed more to gain favour with a potential client rather than genuinely address issues of public policy.

The Terms of Reference themselves are artificially restrictive. They are:

> 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:
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> - 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.

These Terms of Reference tend to encourage a politically oriented debate about the ownership of Telstra. This distracts attention from the far more important question – what are the appropriate industry structures to generate the maximum benefit to Australia and its economy from the operation of competition in the provision of telecommunications services.

The fact that a debate about the structure of one firm can act as a proxy for a debate about industry structure is reflective of the concerns expressed by many about the ongoing viability of the operation of a competitive telecommunications market. Telecommunications operators will be reluctant to make any significant further investment in the Australian industry until key questions about the future industry structure are satisfactorily addressed. Current investment patterns reflect this fact.

Ideally the inquiry should address a simpler consideration. This is, what is the appropriate industry structure for telecommunications, what impact will this structure have on the interests of various stakeholders including investors, consumers and Government.

3. Industry Structure

It is not uncommon for the Commonwealth Government to consider appropriate industry structures in the interests of economic efficiency, nor for it to intervene to restructure industries where appropriate. A current example is structural adjustment of the sugar industry, where the Commonwealth is seeking to intervene to ensure the competitiveness of the industry by ensuring individual firms operate efficiently.

In the case of telecommunications the Commonwealth has a specific head of power to make laws for the operation of the industry. While some consideration has been given to structural arrangements of other utility industries, including some separation of infrastructure and retail components, these have been negotiated through a combination of Commonwealth corporation powers and State Government co-operation. In the case of telecommunications the consideration and responsibility is the Commonwealth's alone.

The post 1997 regime to introduce competition in telecommunications is based on the simple principles that to enable competitors to emerge all that is necessary is to remove the barriers to entry for new firms and to provide protection from anti-competitive conduct by the incumbent. The former is addressed by opening up licencing arrangements and the operation of an access regime to certain essential services via the provisions of Part XIC of the Trade Practices Act, the latter through extensions to the protections against anti-competitive conduct by the operation of Part XIB of the TPA.

However, it is apparent that the scale and scope economies of the incumbent are significant, and that even without behaving anti-competitively the integrated incumbent can maintain a superior cost structure that new firms can <u>never</u> match. At issue here is a fundamental unanswered question of telecommunications economics, and that is whether the customer access network in telecommunications is a natural monopoly or not. The best Australian analysis of this question was included in an Industry Commission staff paper.[2] That paper considered that there were two alternative errors in the regulation of telecommunications, the first would be to wrongly assume that they were natural monopolies and to regulate accordingly, the alternative error would be that they are natural monopolies and to regulate as if they are not. They concluded that the consequence of error of the first type were significantly greater than the consequences of error of the second type

It is time for this analysis to be reconsidered. There is little evidence globally of sustained infrastructure competition at the local network level after over ten years of experience. Where there has been limited success it has been created through limiting the ability of the incumbent to invest in new technologies, typically Pay TV and mobile networks. In circumstances like Australia where the incumbent faces no constraints there is even less reason to believe in the likelihood of access network competition. It is like a yacht race, the boat in front in the tacking dual merely needs to cover all his opponent's tacks and he steals the wind. The overbuild of the Optus hybrid fibre-coax network is an example of such a strategy.

It appears that there are only three possible future scenarios for the structure of the telecommunications industry. The first is a full reversion to a single integrated monopoly with some minor competition provided by niche service providers. The second is a duopoly structure with a fairly sickly vertically integrated competitor. The third is a fully vertically separated industry with a small number of infrastructure owners, and a small but larger group of service providers. A structure of a multitude of fully integrated carriers does not appear to be sustainable.

The question is which of these scenarios is the most desirable. Related to this question is what impediments are there to the achievement of any of these scenarios. These are questions of substance that need to be addressed through rigorous analysis. Regrettably in a parliamentary inquiry process submissions from participants are motivated primarily – if not entirely - by their own self-interest.

What does seem to be beyond doubt is that this matters. There have been a number of reports from NOIE and the Productivity Commission that identify the importance of an efficient telecommunications industry for a range of other industries for which telecommunications is a major input service. More recently the Australian Communications Authority in its

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[2] Albon et al. *Telecommunications Economics and Policy Issues* Industry Commission. 1997.

Telecommunications Performance Report for 2001-02 has estimated that GDP growth has been 1.62% greater than it would have been without telecommunications reform, that is, the economy is $10 billion larger than it would have been without the reforms..

Finally, as the structure of Telstra is a major determinant of the industry structure, it is essential to question whether it is possible at this stage for Government to decide to restructure Telstra. On the one hand there is a set of arguments, expressed by many, that while structural separation is possibly a good policy it is now "too late" – that it should have been done before any privatisation. On the other hand this appears to overlook the Commonwealth's power - or responsibility - in this area. A decision by the Commonwealth to change the industry structure can be achieved by legislation, not by exercising its rights as a shareholder. As an example, it is entirely possible for the Commonwealth to limit the market share that any one firm may have of sub-markets of the telecommunications industry. Under such a provision it would still be up to the management of Telstra to elect how it would meet these requirements, just as the media industry very successfully restructured itself following changes to cross-ownership laws.

4. Service Development and Impact on Consumers

The advent of competition in telecommunications globally was a consequence of the failure of incumbent monopoly telcos to provide the range and variety of telecommunications services to support developments in computing and customer switching that occurred in the late 1970s. The impact of industry structure on consumers is the variety of services available to them, and the prices of those services.

A concern about a structural separation model is that the same atrophied management approach may descend on the owners of the network infrastructure, that the worst elements of the old monopolies may return. This perhaps is at the core of the Committee's terms of reference in relation to the ability of Telstra to deliver new services under structural separation.

This issue invites another – perhaps more substantial - question. If Telstra is unable to develop new services in a structurally separated mode, then how is any competitor expected to be able to develop services under the current industry model. There are virtually no telecommunications services in operation in Australia that do not at some point rely on the use of some part of Telstra's network. If the Committee is to conclude that Telstra would be unable to develop new services as a consequence of structural separation, then the Committee is simultaneously concluding that the whole idea of a competitive telecommunications market is nonsensical. This would suggest the only appropriate policy response is a reversion to a fully integrated single regulated monopolist.

A related question is the ongoing investment in infrastructure as well as the quality of service. There is a perception that a single infrastructure owner will no longer have an incentive to invest in infrastructure, that the entity will be constrained to a low rate of return and thus be capital starved. There is a similar concern that the interface between network owner and service provider will create quality of service issues to do with hand-off of provisioning or fault management requirements.

These issues are magnified for telecommunications as the industry has a global history of 150 years (including the telegraph) of vertical integration. Consequently, the sophistication in contracting and in transaction management necessary to co-ordinate these activities is missing. Unfortunately, not changing the industry structure is not going to accelerate the development of these capabilities. And the absence of these capabilities continues to put pressure on competitive telcos who acquire some of their infrastructure from other players.

These are not intractable problems. Industries with large sunk cost investments like the mining industry have successfully dealt with these large contracting and co-ordination problems.

More recently the global automotive industry has significantly rearranged its sourcing and co-ordination models.

5. Impact on Shareholders

Justifiably the Committee has been asked to consider the implications of any industry arrangements on the interests of shareholders. There is some reasonable concern given that many of these shareholders acquired their shares from the Government. However, as part of both sales the Government as vendor expressly stated that the Government's approach to the regulation of the industry could change.

Additionally, there are other investors in the market. While Telstra likes to typify some of its largest competitors as being foreign owned, the two largest integrated competitors are listed on the Australian Stock Exchange, as are a number of smaller participants.

It would be inappropriate for more weight to be given to the interest of shareholders in Telstra than to the interests of shareholders in other telcos, especially since others have invested on the basis of government's regulatory and policy undertakings to support the growth of competition to benefit consumers. Any consideration of Telstra shareholders' interests can only be to the cost of investors in other companies.

The current valuation of Telstra is said to reflect disagreement in the market over whether Telstra should be valued as a growth stock or as a utility stock. This fundamental difficulty emerges because the returns that Telstra should expect from its Australian infrastructure are by nature those of a utility while the ventures in offshore markets and in content services are clearly for growth. Other firms faced with similar mixed asset classes separately offer their capital instruments to the market – for example Westfield has separate trusts for shopping centre ownership (utility) and development (growth). The consequence is that for Telstra the process of structural separation could increase shareholder value, not decrease it.

Telstra may not, however, see the benefit of such a separation for shareholder value. As discussed above the necessary sophistication in contracting and co-ordination for separation is lacking due to the history of integration. The merger of Telecom Australia and OTC created Telstra. This arrangement was chosen with the express purpose of delivering a world scale telco. Telstra's management seems to see the integrated domestic telco as an essential cash machine to fund this greater expansion. This is a transfer of wealth from Telstra consumers to Telstra shareholders.

There is no simple way to analyse the shareholder value effects of separation. What is apparent is that there are alternative forms of structuring that are worthy of consideration that may be shareholder value creating.

6. Impact on Government

The Terms of Reference ask the Committee to review the effects on the Budget of structural separation with Government retaining ownership of the network. This is presumably to reflect the loss of the opportunity to raise as much from a sale in the alternative model, and different future cash flows. In the context of privatisation discussions Access Economics prepared a paper on the Budget implications of the further sale of Telstra[3]. That paper identified the need to consider not only the implications for the Budget from the sale proceeds and lost dividend stream, but also the Budget consequences from economic growth contributed from the right regulatory regime.

[3] Report available at http://www.accesseconomics.com.au/reports/T3Budget.pdf

As mentioned above the Australian Communications Authority has calculated that the Australian economy is $10Billion bigger than it would have been without the reforms, and to sustain and further improve that benefit the appropriate industry structure arrangements are critical. As noted in the Access Economics report greater economic growth impacts the budget both through increased revenues and reduced outlays.

The Access Economics report identified ways in which the full budget impact could be more effectively modelled. This would appear to be a task that should be undertaken by Government not by industry participants.

7. Conclusion

The future structure of the telecommunications industry is a matter of great importance to Australia's future prosperity. The Commonwealth has the responsibility and power to reform the structure of the industry irrespective of its current or future ownership of Telstra. Its primary responsibility is to ensure that the industry structure supports the development of the industry in a manner that best promotes future economic growth. At the core of this issue is the question of whether competition is essential to deliver this outcome and how existing assets need to be used and future investments encouraged.

The issues in terms of whether structural separation enhances consumer outcomes, investment outcomes and budget outcomes require detailed and separate analysis. Getting the right outcomes is unlikely for a Committee that is responding to self-interested industry submissions. Was such analysis to determine that restructuring the industry would have significant benefit, the form of any separation and the means of its introduction are independent of the question of ownership.

AAPT believes it would be inappropriate to proceed with the full privatisation of Telstra without both analysing fully the structural issues, and addressing the ongoing monitoring of outcomes in the industry. This analysis should include assessing the regulatory provisions necessary to should future intervention be required to restructure the industry.