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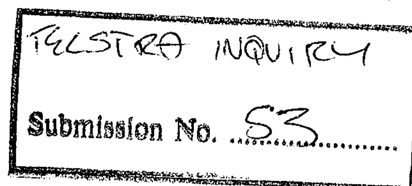


Inquiry into the structure of Telstra

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

Submission of UBS Warburg

JANUARY 2003

❖ Executive summary

This submission is made by UBS Warburg Australia (UBS Warburg) and sets out our views on the potential separation of Telstra into two components: a network-owning company (NetCo) and a service company (ServCo). We have not sought to address difficulties that may affect implementation of separation, but rather to focus on underlying issues relating to valuation and policy.

In our opinion, the separation of Telstra would result in a substantial value loss for all Telstra shareholders. This would reflect the loss of the inherent value of integration of the network and service elements of a telecommunications company that is produced by the high level of inter-connection between telecommunications services and the underlying network. A telecommunications network, unlike some other utilities, is not simply a transmission network. It includes additional equipment and software assets that are required to provide end-services to the customer. The Telstra network is also not one network but a number of networks that overlay and interact to provide efficient carriage and other telecommunications services.

Integration value is well recognised by global capital markets. Telecommunications business models that do not involve network ownership or depend on only one network technology have largely been unsuccessful and enjoyed weaker investor support compared with their integrated peers. Separation would also result in a smaller market capitalisation of any resultant listed entity. This of itself tends to lead to diminished investor interest and an increased cost of capital.

A detailed review of the experience of privatisation falls beyond the scope of this submission. However, in our opinion, private ownership of the network assets is preferable to state ownership as it subjects the network owner to market disciplines (both in terms of operating efficiencies and capital allocation) and encourages the owner to focus on growth and meeting its customers' needs.

In this submission, we discuss two mechanisms that could be used to effect separation: sale of NetCo to the Commonwealth; or separation by way of a demerger under a scheme of arrangement into two separately listed companies, each owned as to 50.1% by the Commonwealth. Either mechanism would require the approval of non-Commonwealth shareholders. This would, in effect, mean that the Commonwealth would need to compensate shareholders for any value loss on separation. In addition to funding this compensation, the Commonwealth may be required to pay an additional 'control premium' reflecting the benefits of 100% ownership should it desire to move to 100% ownership of NetCo. We note that the market price of any resultant listed entity would provide a ready benchmark against which to assess the adequacy of the consideration paid to non-Commonwealth shareholders.

We believe that existing regulatory frameworks are best-suited to achieving the anticipated major benefits of separation: ensuring adequate access to telecommunications infrastructure by 'uneconomic' populations; and fostering service-level competition.

❖ Definition of 'structural separation'?

'Structural separation' of Telstra could take a variety of forms. We note, however, that the Committee's view envisages separation of Telstra's core network from its non-network businesses. It also entails reduction of the Commonwealth's current majority shareholding in the non-network businesses. In this respect, the understanding of the term is similar to the proposal in the Australian Labor Party's formulation in its policy paper *Reforming Telstra* (ALP Policy), where non-network businesses are separated into a privately held company, and the Commonwealth assumes ownership of the network.

For the purposes of this submission, we have assumed that the result of structural separation is separation of the ownership of Telstra's network and non-network operations into NetCo and ServCo respectively. Our submission considers two scenarios: in the first, the Commonwealth moves to 100% ownership of NetCo; and in the second, the Commonwealth remains the 50.1% shareholder of a listed NetCo entity.

❖ Potential value loss on separation

We believe that the separation of Telstra would result in substantial value loss for all Telstra shareholders.

INTEGRATION VALUE LOSS

Integration value recognises the inherent benefits of a vertically integrated telecommunications business. The value captured through such integration is likely to be more significant in the case of telecommunications service providers than other infrastructure-based service providers, given the extent of the inter-connection between the network and the services provided to customers.

Integrated telecommunications companies operate multiple networks with multiple layers of operations nested on top of the basic transport layer. The provision of a broad range of consumer products increasingly depends on the ability of the company to determine the integration of the network layers and a growing proportion of telecommunications service delivery relates to the provision of network services. Indeed, in many cases, the network *is* the service. For example, the customer choice relating to DSL connection or cable modem fibre.

With clients demanding 'whole of business' solutions the need for integrated product offerings has increased. As a result, a large proportion of customer service quality and value is attributable to the network technologies and software that are applied to their demands.

Further loss of value on separation is likely to occur as a result of additional costs flowing from the duplication of administrative functions such as finance, customer management, legal, tax and other corporate functions. The value loss in this regard is relatively minor in comparison with the extent of value loss attributable to integration.

Market support for integrated network/service telecommunications enterprises is stronger than support for non-infrastructure telecommunications enterprises. Market disenchantment with second-tier telecommunications operators – specifically those that are non-infrastructure-based– has been accompanied by a growing belief in the value of integration and superior prospects for integrated telecommunications companies. Indeed, non-infrastructure-based telecommunications operators and alternative carriers have a very chequered track record in global capital markets, for example the history of mobile resellers in this country and of alternative carriers in the US.

We believe that the integration value loss would be reflected in the market value of the remaining components of Telstra (NetCo and ServCo).

POTENTIAL VALUE LOSS DUE TO DECREASED MARKET CAPITALISATION

A feature of investment patterns in Australia and other developed capital markets, is the trend to index-based investment. We estimate that index-based investment now accounts for around 15% of total Australian funds under management, up from around 10% five years ago.

A proportion of investor support for Telstra in its current form is attributable to its large market capitalisation relative to other companies listed on ASX. Its inclusion in every large market-capitalisation index makes it a 'must-hold' stock for most index-based investors. This is particularly true of foreign index-based investors who tend to have investment mandates limited to a smaller number of Australian stocks.

Diminished investor support and the smaller market capitalisation of ServCo (and NetCo were the Commonwealth not to move to 100% ownership) would be reflected in an increase in the cost of capital from Telstra's current level. This would further increase the potential value loss on separation.

❖ Private ownership and market disciplines promote efficiency and innovation

A philosophy that the private sector is better equipped than the government sector to efficiently provide key services has seen governments throughout the western world devolve former state-

owned service monopolies to varying levels of private ownership. This has occurred in Australia in certain jurisdictions in respect of gas and electricity and, to an extent, telecommunications, and has had parallels in the transport and financial services sectors. It has been accompanied by the development of regulatory regimes designed to increase competition amongst service providers to foster technical innovation, broaden the availability of services and reduce the overall costs to consumers.

It is beyond the scope of the current Inquiry and this submission to fully reflect on the experience of privatisation and deregulation in Australia. It is, in any case, a process that is still far from complete. However, it is unquestionably the case that efficiency, competition and technical innovation have been enhanced under private management of formerly state-owned and managed infrastructure. As a result, the Australian economy has benefited from lower costs across a broader range of services, contributing significantly to overall economic flexibility and productivity.

Ownership of large, complex infrastructure by the Commonwealth is, in our view, inappropriate. It runs counter to the trend of devolution of government ownership of assets and would increase the likelihood of inefficiency in the operation of the backbone of the wider telecommunications industry. It would isolate NetCo from market disciplines and the consequent benefits for the broader economy and consumers.

The relative competitiveness of Australia's telecommunications sector relies substantially on continuous innovation and technological development at the infrastructure level. An increase in service-level competition would not compensate for inadequate access to infrastructure services. The pace of technological change has been transforming of telecommunications in the last five years, and this is likely to continue. Developments in network technology will place significant pressure on the strategies and processes of infrastructure investment and management. Failure to effectively manage this change would substantially impair the relative efficiency and effectiveness of overall telecommunications services.

Were NetCo to be fully owned by the Commonwealth, the market may be concerned that maintenance, development and innovation would be constrained by the vagaries of the Commonwealth budget process. The Commonwealth is subject to a range of considerations external to NetCo that may lead to inadequate resourcing and ongoing investment when government choices favour alternate allocations.

The risk that NetCo may be inadequately resourced into the future would add to the risk that a state-owned NetCo would be unable to provide, at reasonable cost, the range and quality of services required by a successful telecommunications sector. This could introduce additional risk to the sector profile, and have a detrimental impact on participants' costs of capital.

In summary, we would be concerned that the outcome of a fully state-owned NetCo would be increased inefficiency at the network level (due to a lack of skills and resources and its separation from ServCo), with consequent increases in customer pricing and a diminution in service quality and innovation.

❖ Shareholder support required for separation

We see that there are two principal ways in which separation could be achieved:

- sale of NetCo assets to the Commonwealth; or
- demerger of Telstra into NetCo and ServCo.

It is not altogether clear from the terms of reference for the Inquiry, whether the process of separation would entail the complete exit by the Commonwealth from ServCo, and a move to full ownership of NetCo. However, we note that this seems to be the result favoured in the ALP Policy, and the assumption behind much of the debate on this issue since its release.

SEPARATION BY SALE OF NETCO ASSETS TO THE COMMONWEALTH

This would involve the acquisition of the assets of NetCo by the Commonwealth from Telstra. For the purposes of the ASX Listing Rules and the Corporations Act, this would be regarded as a related party transaction and would require shareholder approval.

Related party transaction provisions

ASX Listing Rule 10 prevents the disposal of a substantial asset (eg NetCo) of a company (eg Telstra) to a substantial shareholder of that company (eg the Commonwealth), without the approval of shareholders. This approval requires the votes of the substantial shareholder (eg the Commonwealth) to be disregarded. Similar shareholder approval requirements may be required by the Corporations Act.

This would mean that for the Commonwealth to acquire NetCo, it must obtain the support of more than 50% of non-Commonwealth shareholders. Listing Rule 10 would also require the provision of an independent expert's report stating an opinion as to the fairness of consideration paid to non-Commonwealth shareholders. The Corporations Act may also require the provision of material that may reasonably be considered material to a shareholder in determining whether the sale was in the best interests of Telstra.

Change of business provisions

ASX Listing Rule 11 could also be applied at the discretion of the ASX. This Listing Rule enables the ASX to prevent a company (eg Telstra) from making a significant change to the scale or nature of its business (eg separation), without the approval of shareholders. This would also require the votes of the Commonwealth to be disregarded.

CONSIDERATION FOR NON-COMMONWEALTH SHAREHOLDERS

The value of the consideration offered by the Commonwealth and the likely value of ServCo would, in our opinion, be the principal consideration of the majority of non-Commonwealth shareholders in deciding whether or not to vote to approve the transaction. In making this assessment, shareholders would be influenced by the independent expert's opinion, analysts and market commentators as well as their own analysis.

The independent expert's report would be likely to find that a fair and reasonable value for non-Commonwealth shareholder interests in NetCo would 'compensate' non-Commonwealth shareholders for the value loss upon separation.

Control premium

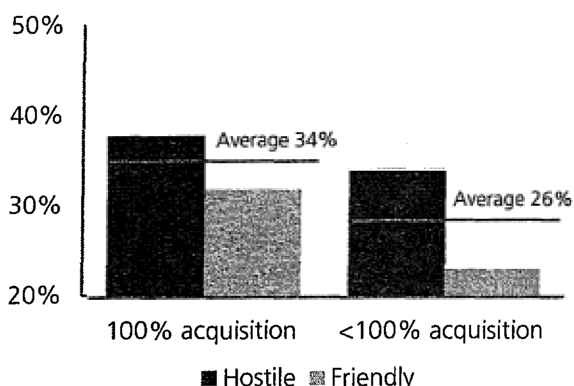
At a practical level, it is also likely that the value of the consideration offered to non-Commonwealth shareholders to acquire their interests in NetCo would need to be 'sweetened' to an extent to ensure non-Commonwealth shareholder approval for separation. This 'control premium' would reflect the benefits that accrue to a 100% owner, even though it could be argued that the Commonwealth already controls the network. Precedent transactions and ASIC policy involving takeovers by controlling shareholders suggest that a 'control premium' is still required, as there are benefits in having 100% ownership over simply having a controlling shareholding. These can include the ability to deal with the assets without regard to the minority shareholders and a reduction in corporate overheads. Logically, the 'control premium' would be required in addition to the compensation for loss of integration value, although the two may overlap, as to some extent, only one overall premium will be observed.

We believe that the market - including non-Commonwealth shareholders - would expect the 'control premium' to be comparable with previously observed acquisition premia. The extent of the premium required would also be heavily influenced by the size of the value loss on separation and may exceed typical levels for this reason. The 'control premium' is therefore likely to result in a substantial cost to the Commonwealth in the process of effecting separation.

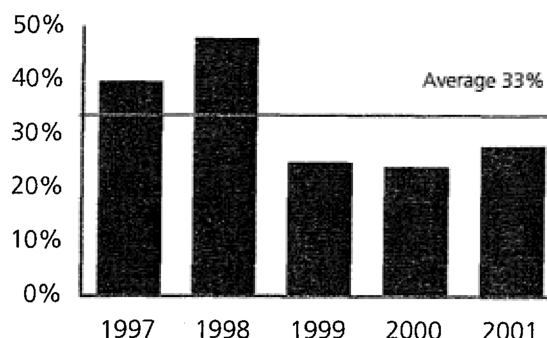
UBS Warburg's study of acquisition premia in the Australian context suggests that the average bid premium is the range 30% to 40%. Even at the lower end of this range, the 'control premium' would result in substantial additional costs to the Commonwealth.

Average bid premium tends to be around 30 to 40%

Hostile vs friendly



Historic premia



NOTES:
1 Takeover premium is for all bids announced on Australian targets over A$50m
2 Takeover premium represent highest bid over the share price 4 weeks prior to first bid announcement
3 Hostile and friendly averages based on takeovers announced since January 1997

SEPARATION BY WAY OF A DEMERGER

A demerger would involve the implementation of a scheme of arrangement, such that existing Telstra shareholders were granted interests in ServCo and NetCo that were identical to their pre-demerger interests in Telstra. This would see the Commonwealth retain a majority shareholding in the demerged entities – which could be sold down or added to a later date. Alternatively, a scheme of arrangement may achieve a complete exit by the Commonwealth from ServCo and 100% ownership of NetCo. This would imply acquisition by the Commonwealth of the minority non-Commonwealth interests in the assets of NetCo and the sell-down of its interest in the assets of ServCo.

Separation by way of a demerger would require satisfaction of the following shareholder approval thresholds:

- a majority of Telstra shareholders present and voting at the special meeting;
- who together hold at least 75% of the total number of Telstra shares voted.

As with an outright sale of the NetCo assets, the scheme would require an independent expert's report. The expert would be required to state an opinion as to whether the demerger of Telstra would be in the best interests of its shareholders. Given the extent of value loss that we would expect on separation, the opinion is unlikely to be favourable, unless the Commonwealth were to compensate non-Commonwealth shareholders for the value loss on separation.

We note that the post-separation share price of ServCo (and NetCo, if the Commonwealth were not to move to 100% ownership) would provide a ready measure of the value of the compensation paid to non-Commonwealth shareholders. The difference between the aggregate of ServCo's value as implied by its share price and NetCo's value and the pre-separation value of Telstra implied by its then share price, would represent the market's estimation of the value loss on separation.

❖ Implications for the Commonwealth

As discussed above, the process of separation is likely to leave the Commonwealth exposed to a 'value gap', being the difference between the stand-alone value of NetCo and the amounts paid to reflect the 'control premium' and as compensation for value loss of integration.

The key relationship between NetCo's value and its ongoing management, would be the expected return to be derived from providing access to its infrastructure. An acquirer of such assets would be expected to develop an access pricing framework that, as a minimum, sought to recover the full long-term costs of efficient access provision, including sunk costs.

The determination of an appropriate access pricing framework would be a complex task and is beyond the scope of this submission. However, it is in the interests of a competitive telecommunications market that access prices be neither excessively high nor excessively low. The balance must recognise that the owner of telecommunications infrastructure is entitled to generate revenue that is at least sufficient to meet the long-term costs of providing the infrastructure and that provides a return on its investment adequately reflecting the risks involved.

A key issue is whether the Commonwealth would be able to fund its exposure to the 'value gap' by setting access prices at higher levels than may otherwise be the case. In our opinion, this would not be feasible. To do so would introduce significant market distortions and would further disadvantage ServCo shareholders. Rather, the access pricing framework would be designed to provide a return sufficient to fund the continued efficient provision of access to NetCo services. The 'value gap' would remain unfunded by this means and the Commonwealth would be required to accept a sub-optimal return.

❖ Separation 'benefits' better obtained through regulation

Proponents of separation argue that it would:

- enable the Commonwealth to ensure adequate access to telecommunications infrastructure by regional Australians and other 'uneconomic' populations; and
- foster competition at the service level, thus reducing consumer costs and increasing the diversity of service offerings.

However, in both respects, we believe that regulation through existing regulatory frameworks, rather than separation, is best able to deliver on these underlying policy objectives.

The existing universal service arrangements are currently undertaken and funded by Telstra and other industry participants. We believe that private sector participants are best able to provide cost-efficient infrastructure access and see no reason for this to be a function assumed by a Commonwealth-owned enterprise. Telstra and other industry participants have an incentive to minimise their costs and to the extent that the service provided is inadequate, providers may be subject to penalties and licensing conditions.

Infrastructure access provision by a Commonwealth-owned NetCo is likely to be less efficient that that undertaken by private participants. This would place upward pressure on consumer pricing and may also prove a disincentive to providing more costly, but more technologically advanced, infrastructure services to remote populations.

The principal requirement for increased competition at the service level is the implementation of a transparent and equitable access pricing regime – the objective of the current regulatory framework. This challenge is not overcome through Commonwealth ownership of NetCo – service level participants and consumers would still have the same requirements for transparency as with Telstra in its current form. In any case, regulation is currently directed to this purpose and we believe has established the basis for a viable and competitive telecommunications service industry.

❖ About UBS Warburg

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