

## Chapter 2

### Issues to do with separation of Telstra

#### Provisions of the bill on separation of Telstra

##### *Addressing Telstra's vertical integration*

2.1 The bill provides that Telstra must separate either functionally or structurally. The Government argues that separation of Telstra is needed because:

- Telstra is one of the most integrated telecommunications companies in the world;
- partly because of this integration, it has been able to maintain a dominant position in virtually all aspects of the market despite more than 10 years of open competition; and
- Telstra's high level of integration has hindered the development of effective competition.<sup>1</sup>

2.2 The default position is that Telstra must functionally separate according to a functional separation undertaking approved by the Minister. The bill requires Telstra to comply with 'functional separation principles' listed in the bill, including that there should be equivalence in relation to the supply by Telstra of regulated services to its wholesale customers and its retail business units, and related matters.<sup>2</sup>

2.3 Alternatively, Telstra may voluntarily structurally separate: that is, the ACCC may accept an undertaking from Telstra that -

- Telstra will not supply fixed-line carriage services to retail customers using a telecommunications network over which Telstra is in a position to exercise control; and
- Telstra will not be in a position to exercise control of a company that supplies fixed-line carriage services to retail customers using a telecommunications network over which Telstra is in a position to exercise control.<sup>3</sup>

2.4 If a structural separation undertaking is in force, Telstra does not have to comply with the provisions about functional separation.<sup>4</sup> The Government's stated preference is that Telstra should voluntarily structurally separate.<sup>5</sup>

2.5 According to the explanatory memorandum, Telstra could undertake structural separation in several ways:

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1 Explanatory Memorandum, p. 1.

2 Item 22, proposed additions to Schedule 1 of the *Telecommunications Act 1997*.

3 Item 21, proposed section 577A of the *Telecommunications Act 1997*.

4 Item 22, proposed section 82 of Schedule 1 of the *Telecommunications Act 1997*.

5 Explanatory Memorandum, p. 8.

A few examples are:

- Telstra may elect to facilitate the transfer of the provision of fixed-line carriage services to its retail customers to another carriage service provider, over which Telstra is not in a position to exercise control.
- Telstra may establish a new company to supply fixed-line carriage services to its retail customers and divest enough of its interests in that company to ensure that it is no longer in a position to exercise control of that company.
- Telstra may elect to progressively migrate the traffic of its retail customers to another national network for the provision of fixed-line carriage services, such network being a network over which Telstra is not in a position to exercise control.<sup>6</sup>

### ***Addressing Telstra's horizontal integration***

2.6 The bill prevents Telstra from acquiring specified bands of spectrum, which could be used for advanced wireless broadband services, unless it structurally separates and divests its hybrid fibre coaxial (HFC) cable network and its interests in subscription television broadcasting licences (ie Foxtel). However the Minister may exempt Telstra from the requirements in relation to HFC networks and subscription television broadcasting licences if the Minister is satisfied that Telstra's structural separation undertaking is sufficient to address concerns about the degree of Telstra's power in telecommunications markets.<sup>7</sup>

2.7 The Government supports this measure on the grounds that:

Telstra's level of horizontal integration across the different delivery platforms—copper, cable and mobile—is in contrast to many countries where there are restrictions on incumbents owning both cable and traditional fixed-line telephone networks.... Telstra's horizontal integration has significantly contributed to Telstra's ongoing dominance in the Australian telecommunications market.<sup>8</sup>

## **Submissions on separation of Telstra**

### ***Submissions supporting the bill***

2.8 Most submissions from stakeholder companies or consumer interest groups supported separation of Telstra.<sup>9</sup> Their core argument supports the government's view that Telstra's level of vertical integration has allowed Telstra to behave

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6 Explanatory Memorandum, p. 92.

7 Item 22, proposed additions to Schedule 1 of the *Telecommunications Act 1997*. Explanatory Memorandum, p. 2.

8 Explanatory Memorandum, p. 2.

9 For example Vodaphone Hutchison Australia, *Submission 40*. Australian Telecommunications Users Group, *Submission 44*. Optus, *Submission 47*. Macquarie Telecom, *Submission 69*. iiNet, *Submission 70*. Austar, *Submission 71*. Internode, *Submission 73*. Primus Telecom, *Submission 76*. Infrastructure Partnerships Australia, *Submission 93*. Telecommunications Expert Group, *Submission 97*.

monopolistically, to the detriment of competition and Australian consumers. For example:

A number of international comparisons show Australia with higher prices, less innovative offerings and poorer service levels including broadband speeds and switching practices. ATUG believes this is due to lack of effective competition in the telco sector. Examples include OECD Communications Outlook 2009 and Oxford Business School Broadband Quality Score 2009.<sup>10</sup>

Telstra continues to identify the number of new carrier licences and ongoing price reductions as indicators of a vibrant, competitive marketplace, completely ignoring the figures included in the explanatory memorandum which show the extraordinarily high figures for the HHI, the Herfindahl-Hirschman Index, for this industry. That is a standard measure of concentration in industry that shows this industry is basically as concentrated as a dysfunctional duopoly.<sup>11</sup>

2.9 Some noted that Telstra's market dominance has increased in recent years; for example:

Data from recent Telstra annual reports further shows how quickly competition has retreated in recent years. In the past three years there has been a fall of 290,000 individual consumers lines connected to competitors. This is a fall of 12.75% compared to a loss of 0.6% of basic access lines by Telstra Retail in the same period.<sup>12</sup>

2.10 Submissions argued that functional separation has been successful in the United Kingdom:

Perhaps the most compelling endorsement of separation is provided by Ofcom which, following a recent assessment of the impact of the separation arrangements introduced by BT, has concluded that separation has been successful in delivering improved competition in the UK.<sup>13</sup>

2.11 Infrastructure Partnerships Australia noted the benefits of structural separation listed in a 2003 OECD report and supported by the 1993 Hilmer report on national competition policy:

The [Hilmer] report advocated the separation of natural monopoly components (such as fixed copper network) from competitive functions (such as retail services).<sup>14</sup>

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10 Australian Telecommunications Users Group, *Submission 44*, p. 5. Similarly Competitive Carriers Coalition, *Submission 48*, p.2. Optus, *Submission 47*, p. 5.

11 Mr D. Havyatt (Unwired Australia), *Proof Committee Hansard*, 13 October 2009, p.20.

12 Competitive Carriers Coalition, *Submission 48*, p. 3. Similarly Unwired Australia, *Submission 55*, p. 3. The Explanatory Memorandum discusses market concentration and notes that it is increasing (except in retail mobile services): p. 21.

13 Optus, *Submission 47*, p. 7. Similarly Infrastructure Partnerships Australia, *Submission 93*, p. 12.

14 Infrastructure Partnerships Australia, *Submission 93*, p. 11.

2.12 Optus submitted that criticisms of separation 'do not stand up to scrutiny':

These criticisms fail to acknowledge that the reforms have been well signalled and that they are aimed squarely at delivering improved outcomes for all Australians by putting the industry on to a more competitive basis. The experience of the UK and New Zealand demonstrate the benefits that separation brings in terms of delivering pro-competitive outcomes.<sup>15</sup>

2.13 The department argued that the dominance of one player in the market was such that action was required:

In the explanatory memorandum is a quote by Lord David Currie in the UK:

All that is needed is for the incumbent not to try their hardest to achieve reliability, timeliness and predictability to disrupt significantly the launch by competitors of a rival retail proposition.

... It is at that end, not who is the largest mobile phone player, the largest wireless player or the largest fixed-line player. It is about that competition angle. Are you able to disrupt someone's ability simply by not trying hard because across your set of businesses that part of your business that does infrastructure supply can simply say, 'I think I'll just be passive in the face of this person's needs. I might delay it or lose it or sleep on it.' None of that is unusual behaviour in marketplaces, and we all know it. The question in this is: has it arrived at a point where it sufficiently impedes supply of innovative services to consumers and businesses? The conclusion we have reached is that it does.<sup>16</sup>

***Other suggestions from supporters of the bill***

2.14 Supporters of separation made some detailed suggestions for amendments. The Competitive Carriers Coalition (CCC) argued that the principles for functional separation should be legislated in more detail.<sup>17</sup> The CCC argued that it should be legislated that Telstra must at once implement changes to remove its incentives to discriminate against other retailers, although structural separation may take some years.<sup>18</sup> Unwired Australia argued that the legislation should provide more detail about the grounds on which the Minister may exempt Telstra from the pay TV and HFC network divestment provisions.<sup>19</sup> Unwired Australia suggested that if Telstra

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15 Optus, *Submission 47*, p. 4.

16 Mr P. Harris, Department of Broadband, Communications and the Digital Economy, *Proof Committee Hansard*, 14 October 2009, p. 27.

17 Competitive Carriers Coalition, *Submission 48*, p. 5. Similarly Macquarie Telecom, *Submission 69*, p. 2.

18 Competitive Carriers Coalition, *Submission 48*, p. 7. Similarly Primus Telecom: 'Separation plans or undertakings should be required to achieve significant pro-competitive milestones along the way.' *Submission 76*, p. 2.

19 Unwired Australia, *Submission 55*, p. 7. Similarly Austar, *Submission 71*, p. 5.

breaches a functional separation undertaking, the ACCC should be able to apply to the Federal Court to force divestiture.<sup>20</sup>

### ***Submissions opposing the bill***

2.15 Stakeholder groups who opposed the separation provisions were Telstra and a number of investment managers or shareholder interest groups concerned about the likely effect of the changes on the value of Telstra shares.<sup>21</sup> Their main arguments were:

- separation will discourage investment or cause efficiency losses;
- separation will have high transitional costs for Telstra;
- separation will reduce Telstra's share value.

2.16 Submissions from individual Telstra shareholders mostly focussed on the third point.

### ***Effects on efficiency and investment***

2.17 Investors Mutual argued that economic literature supports vertical integration:

In industries that face significant uncertainties only vertically integrated firms are the most economically efficient allocator of resources.<sup>22</sup>

2.18 Telstra argued similarly that vertical integration 'reduces costs and facilitates innovation and is supported by international studies'.<sup>23</sup> In reply Unwired Australia said:

...Telstra also claims that separation is not required if it makes a series of changes in the wholesale regime to provide transparency and equivalence. I do not know how you can reconcile those two views: that you can get equivalency and transparency in a wholesale structure with a vertically integrated firm, yet the vertically integrated firm has a lower cost structure and a greater ability to innovate than any other firm in the market. Quite frankly, if the first statement is true, that vertical integration reduces costs and facilitates innovation, then we should not attempt to have a competitive telco regime.<sup>24</sup>

2.19 The Australian Shareholders Association argued that the bill will discourage investment:

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20 Unwired Australia, *Submission 55*, p. 10.

21 Maple Brown Abbott, *Submission 4*; Australian Foundation Investment Company, *Submission 53*; Investors Mutual Ltd, *Submission 68*; BT Investment Management, *Submission 74*; Australian Shareholders Association, *Submission 77*. Barmen, telecommunications consultants, also opposed 'forced separation': *Submission 96*, p. 5.

22 Investors Mutual, *Submission 68*, p. 5. Similarly Telstra, *Submission 88*, p. 6.

23 Telstra, *Submission 88*, p. 5.

24 Mr D. Havyatt (Unwired Australia), *Proof Committee Hansard*, 13 October 2009, p. 20.

International investors in particular will consider Australia to have a much higher level of sovereign risk if this Bill is passed and the Government allowed to impose its will on a private company.<sup>25</sup>

2.20 BT Investment Management submitted that:

It's a circular argument to suggest that because Telstra owns the only regulated bottleneck asset that it makes the bulk of fixed line market profit and should be broken up...

Whoever owns it will make such a regulated profit.... We consider that Telstra's profit is high because it is a well run integrated business and because of its high level of investment relative to its competitors.<sup>26</sup>

2.21 Telstra argued the changes 'have the potential to significantly increase regulatory uncertainty and hence reduce investment in telecommunications markets.' Telstra noted that it has a 62 per cent share of the market but makes 70 per cent of telecommunications sector capital investment (implying that this is a desirable result of the status quo). In reply Unwired Australia argued that the right comparison is with profit, not market share; Telstra still has 90 per cent of the industry's profit; thus Telstra is under-investing: 'Only people with market power can withhold investments'.<sup>27</sup>

***Transitional costs***

2.22 Telstra argued that the cost of separation would be in the range \$500 million to \$1.2 billion.<sup>28</sup> In the Government's view 'it is unclear what assumptions Telstra's claimed implementation costs or effects on its share price are based on... Telstra's claims can be assumed to represent the upper bounds of possible costs.'<sup>29</sup>

2.23 Others disputed the likely cost of separation. Optus said:

These costs are unlikely to be anywhere near as much as Telstra has claimed. Optus notes that BT, which is a considerably larger company than Telstra, incurred costs of £153 Million in implementing a very detailed and robust form of functional separation... In many respects the costs to be incurred in implementing separation will simply be displacing costs the industry incurs to date operating under the present regulatory arrangements. In recent years the industry will have incurred costs of no less than \$200 million operating within the present regulatory arrangements.<sup>30</sup>

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25 Australian Shareholders Association, *Submission 77*, p.3. Similarly Maple Brown Abbott, *Submission 41*, p. 2.

26 BT Investment Management, *Submission 74*, p. 3.

27 Telstra, *Submission 88*, pp. 2,10. Mr D. Havyatt (Unwired Australia), *Proof Committee Hansard*, 13 October 2009, p. 20.

28 Telstra, *Submission 88*, p. 8. See discussion at *Proof Committee Hansard*, 13 October 2009, p. 4.

29 Explanatory Memorandum, p. 28.

30 Optus, *Submission 47*, p. 11. Similarly Mr A. Sheridan (Optus), *Proof Committee Hansard*, 13 October 2009, p. 18.

2.24 The Government has argued that:

Telstra's vertical integration affects all Australians and the economy more generally through higher telecommunications prices and reduced innovation and investment in the sector.... It is the Australian Government's considered view that the medium- and longer-term competition benefits for the economy, business and end-users of implementing functional separation outweigh the short-term costs to Telstra of implementing functional separation if Telstra decides not to voluntarily structurally separate.<sup>31</sup>

*Effect on Telstra's share value*

2.25 Telstra and some other stakeholder groups argued that separation would reduce Telstra's share value. These submissions were mostly from investment managers.<sup>32 33</sup> Their concern about share value was usually coupled with an argument that the separation envisaged by the bill was unfair as it was not foreshadowed at the time of privatisation.<sup>34</sup>

In all three public offers Telstra was marketed as a strong investment on the basis of its large size and its position as the Australia's only integrated telecommunications company. The same assets that the Government as now insisting Telstra divest were promoted strongly as reasons for investment in the company... Obtaining full value for those assets in the situation of a forced sale will be difficult.<sup>35</sup>

We believe that the proposed structural separation if it occurs would result in a permanent reduction in shareholder value... the Government will be penalising Telstra for being successful and thereby penalising the many Telstra shareholders who relied on Government representations.<sup>36</sup>

2.26 It was sometimes unclear whether the claim was that the increased competition caused by separation would cause a transfer of profit from Telstra to its competitors in a zero-sum game, or that the community as a whole would lose because they believe Telstra's market dominance is economically efficient.

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31 Explanatory Memorandum, p. 33.

32 The Committee notes that the two investment managers who gave evidence opposing the bill hold shares in Telstra but not in Telstra's Australian competitors. Mr A. Tagliaferro (Investors Mutual Ltd), *Proof Committee Hansard*, 13 October 2009, p. 42. Mr R. Barker (Australian Foundation Investment Company), *Proof Committee Hansard*, 13 October 2009, p. 35.

33 The 224 form letters which the committee received were mostly about this issue.

34 Telstra focussed on economic arguments, and mentioned fairness arguments only passingly; for example: 'Telstra's shareholders have invested significant sums in these assets. To require them to divest their interests in these assets just as they are becoming profitable is unjust and raises questions of sovereign risk.' *Submission 88*, pp. 3, 8.

35 Australian Shareholders Association, *Submission 77*, p. 1. Similarly Maple Brown Abbott, *Submission 41*, pp. 1-2. Mr R. Barker (Australian Foundation Investment Company), *Proof Committee Hansard*, 13 October 2009, p. 33.

36 Australian Foundation Investment Company, *Submission 53*, p. 2.

2.27 Supporters of the bill argued that 'the government must stand firm and put the long term interests of all 22 million Australians ahead of the short term interests of less than 2 million Telstra shareholders.'<sup>37</sup>

2.28 On the question of whether the bill is fair to Telstra shareholders, the department argued that the three Telstra privatisation prospectuses mentioned regulatory risk adequately:

I have a list here of the quite generic warnings that went in every Telstra share offer: 1997, 1999 and 2006.

The 1997 offer said: 'There can be no assurance that the current or future governments will not take further steps which alter Telstra's competitive position or the manner in which the Australian telecommunications industry is regulated.'

In the 1999 offer: 'There is also a risk that current or future governments will take steps that further alter Telstra's competitive position or the manner in which the Australian telecommunications industry is regulated.'<sup>38</sup>

2.29 The T3 prospectus in 2006 said:

Regulation impacts the way Telstra does business and Telstra believes it is the most significant ongoing risk to Telstra. There can be no assurance as to future policies and regulatory outcomes. Regulatory outcomes may be significantly adverse to Telstra shareholders.<sup>39</sup>

2.30 The Competitive Carriers Coalition argued that complaints that Telstra shareholders have been betrayed should not be taken seriously, since:

- Every Telstra sale tranche acknowledged the simple reality that the regulation of telecommunications was subject to change;
- Telstra shareholders are asking to have interests protected that are immeasurable. It is impossible to know what regulatory action might result in Telstra share movements over time. Functional separation of BT was followed by share growth, while Telstra's value has declined precipitously in recent years while it was brutally exercising market power;
- It is not the Government's responsibility to protect the interests of the shareholders of one company over the interests of other companies' shareholders, and certainly not ahead of the interests of all citizens who have paid inflated prices for crucial communications services because of Telstra's unconstrained monopoly power....<sup>40</sup>

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37 Internode, *Submission 73*, p. 2.

38 Mr P. Harris (Department of Broadband, Communications and the Digital Economy), *Proof Committee Hansard*, 14 October 2009, p. 29. Similarly Unwired Australia, *Submission 55*, p. 15.

39 Telstra 3 Share Offer Prospectus, October 2006, p. 42.

40 Competitive Carriers Coalition, *Submission 48*, p. 4. Similarly Internode, *Submission 73*, p. 2.



2.31 Supporters of the bill argued that in any case the likely detriment to Telstra's share price is uncertain or overstated. For example:

The market reaction to the announced package of reforms has been fairly muted with Telstra's share price recovering after an initial small drop. More significantly, Optus notes that many industry analysts have retained their "Buy" recommendations on the Telstra stock following the Government's announcement and predict share price accretion over the next twelve months as these reforms are implemented.<sup>41</sup>

A more considered view is that these reforms address the inherent regulatory uncertainty within the industry, and once the reforms are implemented they will open up enormous potential for Telstra and other industry participants to pursue significant growth opportunities.<sup>42</sup>

If you look at what happened in the UK, BT share price actually improved relative to both the rest of the UK share market and to some of its standout competitors on the European continent. It improved because a lot of the uncertainty was removed and there was the promise that, over time, other aspects of regulation that constrained them in retail markets would be removed.<sup>43</sup>

2.32 The ACCC, in its submission to the Government's April 2009 National Broadband Network discussion paper, stated that vertical separation can enhance the value of separated firms. It reasoned that there may be some vertical diseconomies of scope which may arise as a firm takes on additional functions which are outside the scope of its core functions and which the firm is not well equipped to perform. It gave examples of previous voluntary separations to support these claims.<sup>44</sup>

***Comments on horizontal separation of Telstra***

2.33 Generally, stakeholders who supported structurally separating Telstra also supported horizontal separation:

Access to valuable content is likely to become an important force driving the take-up of higher speed broadband services. This creates a very real risk that a monopoly in premium content could be used to undermine future competition in broadband services.<sup>45</sup>

The level of Telstra's horizontal integration across all Australian telecommunications platforms, including fixed line, mobile, coaxial fibre cable and Foxtel cable, is unusual if not unique among advanced

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41 Optus, *Submission 47*, p. 11.

42 Primus Telecom, *Submission 76*, p. 2. Similarly Mr D. Foreman (Competitive Carriers Coalition), *Proof Committee Hansard*, 14 October 2009, p. 9.

43 Mr D. Forman (Competitive Carriers Coalition), *Proof Committee Hansard*, 14 October 2009, p. 9.

44 Australian Gas Light Company 2005, Toll 2007, Time Warner 2008. Explanatory Memorandum, p. 10.

45 Optus, *Submission 47*, p. 7.

economies. Telstra's integration across all telecommunications technologies has significantly contributed to the organisation's ongoing dominance in the Australian telecommunications market and has allowed the organisation to utilise undue influence to block market participants.<sup>46</sup>

The fact that FOXTEL has not extended its product portfolio to offer a competing broadband access product, unlike other major pay TV providers in the developed world, is a clear indication that the services and products available to consumers are being limited by the integration of Telstra and FOXTEL. AUSTAR believes that the divestiture of FOXTEL is a critical step in addressing competition concerns raised by Telstra's horizontal integration.<sup>47</sup>

2.34 Optus noted that the horizontal separation provisions are ultimately discretionary and can be waived if the Minister is satisfied with the terms of Telstra's structural separation plan: 'On balance this approach appears reasonable.'<sup>48</sup>

2.35 Opponents of the bill were often critical of horizontal separation. These included:

- Australian Foundation Investment Company: 'shareholders have borne the risk of the [Foxtel and HFC] investments and should be allowed to reap the rewards'; and
- BT Investment Management: 'restricting Telstra's access to 4G spectrum is counter-productive to effective industry development.'<sup>49</sup>

### **ACCC's role in structural or functional separation of Telstra**

2.36 The provisions concerning structural separation give the ACCC the role of accepting Telstra's undertaking concerning separation. If the ACCC considers that Telstra has breached the undertaking it may apply to the Federal Court for a remedy.<sup>50</sup>

2.37 The provisions concerning functional separation give the ACCC the role of advising the Minister whether to accept a functional separation undertaking.<sup>51</sup> The ACCC must monitor and report annually on Telstra's compliance with a functional separation undertaking.<sup>52</sup>

2.38 Submissions were generally supportive of this role. The Competitive Carriers Coalition urged that the process by which the ACCC considers structural separation

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46 Infrastructure Partnerships Australia, *Submission 93*, p. 13.

47 Austar, *Submission 71*, p. 4.

48 Optus, *Submission 47*, p. 7. Similarly Australian Telecommunications Users Group, *Submission 44*, p. 6.

49 Australian Foundation Investment Company, *Submission 53*, p. 2. BT Investment Management, *Submission 74*, p. 2.

50 Item 21, amendments to the *Telecommunications Act 1997*, proposed section 577A ff.

51 Item 22, amendments to the *Telecommunications Act 1997*, proposed sections 77, 80.

52 Item 39, amendments to the *Telecommunications Act 1997*, proposed section 105B.

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should have the highest level of public consultation, and there should be more guidance to the ACCC on what would be acceptable in an undertaking by Telstra.<sup>53</sup>

2.39 Foxtel argued that the ACCC's discretion regarding Telstra's undertaking to structurally separate would be too broad, and matters that the ACCC should consider should be set out in the bill.<sup>54</sup>

### **Committee comment**

2.40 The object of telecommunications policy is to promote innovation in telecommunications, and more efficient and competitive services for the community as a whole. The Committee accepts the view of the Government and most industry stakeholders that the separation of Telstra will bring long term benefits.

2.41 In the committee's view the three Telstra sale prospectuses were clear enough about the potential of regulatory changes in the telecommunication sector that might affect Telstra's competitive position. The committee notes that in any case there is a lack of consensus around what might be the long terms effects of separation on Telstra's share price.

2.42 It is not the government's role to support the share value of one telecommunications company in preference to its competitors, however the committee does not believe that sufficient evidence has been presented that these regulatory reforms will be detrimental to Telstra's share price. The enhanced consumer protections offered in the bill, the greater regulatory certainty that will be brought about by its passage, and the improved efficiency and competition in the sector as a result, should together ensure a sound future for all Australia's telecommunications providers.

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53 Competitive Carriers Coalition, *Submission 48*, p. 7-8. Similarly on consultation Unwired Australia, *Submission 55*, p. 9; Macquarie Telecom, *Submission 69*, p. 2.

54 Foxtel, *Submission 98*, p. 6.

