



**SUBMISSION TO THE SENATE ENVIRONMENT, COMMUNICATIONS,
INFORMATION TECHNOLOGY AND THE ARTS LEGISLATION COMMITTEE**

**INQUIRY INTO THE PROVISIONS OF THE *TELSTRA (TRANSITION TO FULL
PRIVATE OWNERSHIP) BILL 2003***

EXECUTIVE SUMMARY

- Telstra should be sold now, but subject to several conditions that are far more important than the sale *per se*. Privatisation is important, but competition is more important.
- The bill's provisions may not be sufficient to ensure a competitive industry post-privatisation because there are currently fundamental structural problems in the Australian telecommunications industry. These problems may be difficult to solve once Telstra is sold unless the bill is amended to enable these problems to be addressed.
- AAPT does not recommend structural separation of Telstra at this stage. There may be benefits in allowing new industry structures to unfold. New network technology may make it possible and perhaps desirable for Telstra to operate in a less integrated manner, and may also make it possible for other network operators to operate more independently of Telstra.
- It is important for the T3 prospectus to specifically refer to the number of current and prospective inquiries into telecommunications, and foreshadow that while some of the recommendations of those inquiries and review have been implemented, other recommendations may be implemented in the future.
- Having regard to the importance of competition, and its nascent and fragile state, the bill must provide for regular reviews into the adequacy of the telecommunications regime to control Telstra's behaviour in *all* parts of Australia. An independent body such as the Productivity Commission (or the ACCC) should be required to conduct such reviews at least every five years, so that Telstra is subject to rigorous monitoring and so that competition can be maintained and improved. The Commission should be required to report to the Minister on its findings and recommendations, and the report should be required to be tabled in the Parliament.

INTRODUCTION

The issue of Telstra ownership has dominated debate about the direction of telecommunications policy for far too long. Telstra must be sold now, but subject to several conditions that are far more important than the sale *per se*.

Telstra's transition to full private ownership is a logical continuation of a series of competition reforms. It is important that this transition is recognised as but one component of an ongoing process of market liberalisation. This committee, and ultimately the Parliament, needs to give very careful consideration to whether all the elements of the telecommunications regulatory regime are sufficient for the post-privatisation environment. This must be considered now, rather than after the sale, when some alternatives may be more difficult or perhaps even impossible to achieve.

There are three parts to this submission. The first part discusses whether Telstra should be fully privatised. The second part discusses whether the provisions of the bill are sufficient to ensure a competitive industry post-privatisation. The third part suggests some solutions to deficiencies in the bill.

AAPT looks forward to the opportunity to elaborate on the matters outlined in the submission, and to address Committee members' questions in relation to the submission, at the public hearing in Sydney in 30 September 2003.

Issue One – Should Telstra be fully privatised?

The question of whether Telstra should be fully privatised must be addressed by considering four inter-related issues. The first is the importance of competition. The second is the appropriate role of Government in the regulation of telecommunications. The third is the extent to which Government currently exercises control over Telstra. The fourth involves consideration of the benefits of competition versus the benefits of privatisation.

The Role of Competition

For the last two decades telecommunications policy has focused on the need to ensure that Australia's telecommunications services are internationally competitive. It is now hard to remember the days prior to any liberalisation of the telecommunications regime. In that era Australian businesses and residential customers were dependent on the service provided by Telecom Australia. They were subjected to a number of incredibly damaging industrial disputes that brought Australian business to a near standstill. They suffered long delays in receiving new and innovative services, and customer service was very poor.

It is also important to recall that Telecom Australia enjoyed its position of absolute monopoly not through any expertise in marketing or delivery of services, but through a history of more than 100 years of government mandate.

More recently we have seen a great deal of emphasis on the roles that information and communications technologies play in modern economies, and on the importance of introducing competition to these sectors. This emphasis has come from many sources including reports of the OECD¹ and the Productivity Commission². We have seen comments to the effect that a quarter of Australia's productivity growth can be attributed to utilisation of information and communications technologies. In more stark terms, the Allen Consulting Group has estimated the Australian economy is 1.62 per cent (or \$10 billion) bigger than it would have been without the telecommunications reforms introduced in 1997.³ (The benefits are outlined in more detail in Appendix 1).

¹ OECD *Seizing the Benefits of ICT in a Digital Economy*. As referred to in a Media Release by Senator Alston on 2 May 2003 in this report "Australia is cited as a key example of ICT-led growth". Minister's release available at http://www.dcita.gov.au/Article/0,,0_1-2_15-4_114166,00.html. OECD report available at <http://www.oecd.org/dataoecd/43/42/2507572.pdf>

² Productivity Commission. *Information Technology and Australia's Productivity Surge 2001*. A key message of the report was "The adoption of information technology (hardware and software) contributed to Australia's productivity surge in the 1990s. Australia was very quick on the uptake of information and communications technologies (ICTs) in the 1990s by international standards." P.XII. Available at <http://www.pc.gov.au/research/staffres/itaaps/itaaps.pdf>

³ The ACA commissioned the Allen Consulting Group (ACG) to report on the economic benefits that accrue to residential and small business consumers resulting from changes in the telecommunications market since 1997. ACG's full report, *Benefits Resulting from Changes in Telecommunications Services*, is on the ACA's website at: www.aca.gov.au/aca_home/publications/reports/reports/performance/2001-02/cbreport.htm. A summary of ACG's findings is annexed to this submission (Appendix 1).

Notwithstanding the impressive results in the development in competition in telecommunications, there is still not effective competition in most market segments and the rate of development appears to have slowed. The 2001 Productivity Commission review of competition in telecommunications concludes that while the state of competition is greater than some years ago, in the absence of regulatory oversight it is likely it would be weakened significantly.⁴ More recently the Australian Competition and Consumer Commission has reported “During 2001-02 progress in achieving effectively competitive telecommunications markets slowed” and “competition has not developed as extensively as expected after full competition was introduced in 1997”⁵.

Role of Government

As competition in telecommunications and use of ICT (Information and Communication Technologies) services are such major drivers of economic growth, as outlined in the previous section, the role of Government must be to focus on facilitating this outcome. Such economic growth will be beneficial for all Australians including, as discussed later, the Commonwealth Government through its receipts from taxation.

There is a significant impediment to competition between private sector firms and government owned enterprises. This is sometimes referred to in shorthand as the problem of the Government being both poacher and gamekeeper. A private sector firm seeking to make an investment, the outcome of which may restrict the ability of the government owned enterprise to return profit, always risks Government intervention to favour the Government firm.

In the environment of a part-privatised government firm the dimension of this problem changes somewhat. The Government can no longer completely control the firm to determine the profit to be returned to Government. However, the interest in the financial well being of the firm remains strong while the Government is in a position to sell down its stake.

⁴ Productivity Commission, *Telecommunications Competition Regulation*, Inquiry Report, 2001. p. 99
Available at <http://www.pc.gov.au/inquiry/telecommunications/finalreport/index.html>

⁵ Australian Competition and Consumer Commission, *ACCC Telecommunications Report 2001-02* pp. 8 and 12.
Available at
http://www.accc.gov.au/pubs/publications/utilities/telecommunications/Telco_report_Part_1_2001_02.pdf

That is the current position with Telstra. While the Government has appeared to be hands-off in the management of Telstra, there is nevertheless concern among industry participants that telecommunications policy may be unduly influenced by the Government's desire to enhance the price of Telstra shares and to return dividends to Telstra shareholders (including itself) over and above the returns to shareholders of other firms investing in telecommunications.

The focus on new investment in telecommunications has been at the expense of an understanding of the efficient utilisation of investment that has already occurred. One of the main reasons for regulating monopolies is that a monopolist's profit-maximising behaviour is to constrain production below efficient competitive levels. This means that the first goal of competition in the delivery of services should be the efficient utilisation of infrastructure that is already in place. Competition between providers will help grow demand to justify further investment in that infrastructure and new infrastructure.

These are the essential concerns on which Government should focus. The Australian Competition and Consumer Commission report referred to above⁶ highlights that the current state of competition and its future is not something about which we can afford to be complacent.⁷ The focus on who should own Telstra has diverted attention from these essential policy considerations.

How the Government controls Telstra

Opponents of Telstra privatisation argue that a public controlling interest in Telstra is necessary to curb undesirable behaviour of Telstra. Yet there is no evidence that over the last six years the Government has influenced the behaviour of Telstra any more than it has influenced any private sector corporation.

The Government's control of Telstra has been exercised principally through legislation and the normal processes of engagement with large

⁶ Australian Competition and Consumer Commission, *ACCC Telecommunications Report 2001-02* pp. 8 and 12. Available at http://www.accc.gov.au/pubs/publications/utilities/telecommunications/Telco_report_Part_1_2001_02.pdf

⁷ The Parliament amended the competition provisions in 1999 at the time of introduction of the legislation dealing with the sale of the second tranche of Telstra, and in both 2001 and 2002 in response to the Productivity Commission report referred to above (note 4).

firms within any industry. Legislation has controlled aspects of Telstra's behaviour (and other carriers' behaviour) such as the ongoing requirement for universal service, customer service guarantees, and some price controls. As will be mentioned later, much of this legislation is in need of some review. However, the fact that legislative changes may be necessary does not belie the fact that legislation has been the principal means of government control of Telstra.

In addition, Government regularly influences the behaviour of private sector corporations by engaging those organisations in discussion about how the Government perceives the future. In many cases, large organisations will adopt a specific behaviour as a consequence of such discussions often to forestall a threat or perceived threat of intrusive government regulation, or otherwise to curry favour.

Further, the Government has a strong disincentive to control Telstra's behaviour, either as owner or regulator, because it must always have regard to the opinions of 1.3 million private investors in Telstra to whom it sold shares.

For example, discussion of structural separation has arguably been suppressed by consideration of the likely hostile response of minority shareholders. The prospectuses for T1 and T2 included a provision that Government at all times retained the role of regulator and that nothing in the sale of the shares should be interpreted as a guarantee that the regulatory regime would not change. However, such disclaimers do not in any way affect that fact that the Government's position as owner as well as regulator creates a potential for conflict of interest.

Finally, the extent to which the Government has been able to extract behaviours from Telstra without regulation, for example the introduction of Telstra Country Wide, has been largely due to the operation of incentive on the part of Telstra to free its management from Government ownership. That is, the prospect of privatisation has worked as an incentive for Telstra to do the Government's bidding. The recent undertaking given by Telstra in relation to a number of recommendations of the Estens Inquiry is a good example of how this incentive operates.

Recognising these facts raises two issues. The first is the issue of how to control Telstra effectively after the full privatisation of Telstra, a matter that

will be addressed later in this submission. The second is the issue of the consequences of not proceeding immediately to the full privatisation of Telstra. It is likely that any further delay in full privatisation would result in Telstra management putting the sale issue on the back burner for quite some time. That is, Telstra's likely behaviour following a failure to be fully privatised would be to get on with business and attempt to ignore the role of the Government as part owner. Telstra has already devoted too many resources to unprofitable projects aimed solely at persuading Government backbenchers, opposition parties and consumers that the sale should go ahead.

It is doubly important not to privatise Telstra until the Government has sorted out the post-privatisation regulatory construct for another reason. There are securities law requirements that have the effect that any major regulatory proposals that are not dealt with prior to the sale must be disclosed in detail in the prospectus. The industry, and particularly Telstra, has been under close review – through the ACCC, the Productivity Commission, and the Estens and Besley Inquiries. If there is nothing in the prospectus to indicate that the recommendations of these and future inquiries will be implemented, there is a strong inference that the Government will not do anything in relation to these matters for some time.

Benefits of competition versus benefits of privatisation

Selling Telstra merely involves exchanging one asset for another, and the impact on the budget is the changed cash flows from each of those assets. The correct consideration of the financial impact therefore begins with a consideration of the current cash flow, which is the dividend stream the Commonwealth receives. If we value the current Government stake at \$5 per share it is worth just over \$32 billion. Assuming a dividend yield of 4.9 per cent, then the dividend stream to the Commonwealth is currently in the order of \$1.555 billion. At the same time, we can value the benefit to the Government of converting that equity into cash through a sale, assuming the same share price of \$5 and assuming the sale costs \$500 million in various fees. Assuming a 5.64 per cent bond rate, the Government would save \$1.790 billion in interest payments if the proceeds were used to retire debt. The net gain therefore is \$235 million per annum. Some of these figures are obviously fungible, and would be able to be

calculated more accurately by the Department of Finance and Administration, but AAPT submits they are close to the mark.

Against this change in cash flow, one needs to compare the gain in receipts that has occurred as a consequence of reform of telecommunications since 1997. As noted above, the ACA has estimated that annual GDP is 1.62 per cent higher than it would have been without the 1997 reforms to telecommunications. Access Economics⁸ uses a rule of thumb of \$1.530 billion of budget revenue receipts for every 1 per cent additional GDP. This means that telecommunications reform has thus far increased tax receipts by \$2.479 billion.

So it is not only business and consumers who benefit from a focus on competition in telecommunications. It is also the Government's budget that is directly affected by the impact of competition. Privatisation clearly has potentially large financial benefits if the funds released by the sale are applied to reduction of public debt. But competition reforms are generating far greater benefits than can be expected from reducing public debt with the proceeds of the sale.

And as we progress from 2003, it is worth noting that these benefits as quantified are the benefits of reform of an industry that the ACCC describes as not yet effectively competitive. In the local call market competition has had very little impact.⁹ Despite the appearance of strong competition in the national long distance and international call markets, Telstra still has about 48 per cent of this market.¹⁰ There is limited competition in mobile termination services, which is distorting pricing of fixed-to-mobile services.¹¹ This strongly suggests that there are potentially far greater gains to be made than those reported by the ACA. However

⁸ Access Economics, *Further Reform of Australian Telecommunications Regulation and the Budgetary Impact of the Privatisation of Telstra 2002*. This paper was prepared for the Competitive Carriers Coalition and outlined a methodology for fully analysing the budget impact of T3. Estimate at p. 13. Report available at <http://www.accesseconomics.com.au/reports/T3Budget.pdf>

⁹ Professor Allan Fels, *Regulating Competition in Converging Markets: Telecommunications and Broadcasting*, Speech, ABN AMRO, 30 April 2003, p. 3. Available at http://www.accc.gov.au/speeches/2003/Fels_ABN_AMRO_300403.pdf

¹⁰ Professor Allan Fels, *Regulating Competition in Converging Markets: Telecommunications and Broadcasting*, Speech, ABN AMRO, 30 April 2003, p. 4.

¹¹ Professor Allan Fels, *Regulating Competition in Converging Markets: Telecommunications and Broadcasting*, Speech, ABN AMRO, 30 April 2003, p. 5.

given that the industry is not yet effectively competitive, it is equally possible that the source of such gains is fragile.

Accordingly, the focus of government policy should not be on the matter that has consumed more hours of parliamentary debate and more column inches of newspaper than any other telecommunications matter, namely Telstra privatisation. The focus of government and public debate should be on how to ensure competitive outcomes in telecommunications.

Issue Two – Are the bill's provision's sufficient to ensure a competitive industry post-privatisation?

Having recognised that the full privatisation of Telstra should occur, we now need to address the provisions of the bill. The bill responds to several of the Estens Report recommendations relating to the need for Telstra to maintain a local presence in regional, rural and remote parts of Australia and requiring regular independent reviews into the adequacy of telecommunications in those areas. The remainder of the bill makes amendments to various Acts and regulations as a consequence of Telstra ceasing to be Commonwealth controlled. There are a number of reasons why these provisions are insufficient to ensure a competitive industry post-privatisation.

There is a structural problem in the Australian telecommunications industry

It is generally acknowledged that access regimes have inherent problems. They do not provide timely outcomes. They lead to gaming, both by access providers and access seekers. They are a source of great uncertainty. They involve significant regulatory costs.¹²

As noted by Professor Allan Fels recently:

“These problems stem from one of the main deficiencies of access arrangements — they do not change underlying incentives of a firm to provide fair, timely and non-discriminatory access to its upstream inputs where it also competes in downstream markets.”¹³

¹² Professor Allan Fels, *Regulating Competition in Converging Markets: Telecommunications and Broadcasting*, Speech, ABN AMRO, 30 April 2003, p. 14.

¹³ Professor Allan Fels, *Regulating Competition in Converging Markets: Telecommunications and Broadcasting*, Speech, ABN AMRO, 30 April 2003, p. 14.

The core or kernel of the market failure identified by Professor Fels is that there is a fundamental structural problem in the Australian telecommunications industry. Some of the issues related to this problem were acknowledged by the ACCC in its recent report *Emerging Market Structures in the Communications Sector*.¹⁴ Detailed economic analysis of these structural issues can be found in submissions to the ACCC by many parties through the course of consideration of Telstra's access undertakings.¹⁵ The fundamental issue is that the integrated firm internalises all the benefits of market growth in the prices it charges itself, while charging its external downstream participants a price that is based upon averages derived from existing market volumes.

The provision of accounting separation will not change this structural problem. It will merely make it more visible.¹⁶

Recognising that more fundamental structural changes are often necessary if the full benefits of competition are to be achieved, the OECD Council has adopted a Recommendation on Structural Separation of Regulated Industries urging member countries to consider separating the monopoly and the competitive parts of regulated industries, especially during the process of privatisation or liberalisation.¹⁷

AAPT does not recommend structural separation of Telstra at this stage. Separating Telstra into privately owned and publicly owned companies, or any other form of structural separation, would be an extremely complex task. The OECD Recommendation encourages member states

¹⁴ Australian Competition & Consumer Commission, *Emerging Market Structures in the Communications Sector*, Report to Senator Alston, Minister for Communications, Information Technology and the Arts, June 2003. Available at http://www.accc.gov.au/pubs/publications/utilities/telecommunications/Emerging_market_structures.pdf

¹⁵ Submissions by Core Research (Professors Stephen King and Joshua Gans) at http://www.accc.gov.au/telco/sub_model/AAPT_CoRe_Comp.pdf and by n/e/r/a (Dr Tom Hird) at http://www.accc.gov.au/telco/sub_model/Optus_23July.pdf

¹⁶ Australian Competition and Consumer Commission, *ACCC Telecommunications Reports 2001-02*. "The new accounting separation regime for Telstra's wholesale and retail operations may, depending on how it is specified and what use is made of additional monitoring provisions, create a more transparent environment that assists such monitoring. It may also help in identifying emerging competition issues, as well as investigating current concerns that arise regarding the level of Telstra's vertical integration. However, as accounting separation does not change a carrier's underlying incentives or conduct it will not necessarily address the limitations created by the current industry structure." P.23 Available at http://www.accc.gov.au/pubs/publications/utilities/telecommunications/Telco_report_Part_1_2001_02.pdf

¹⁷ OECD, *Restructuring Public Utilities for Competition*, Paris, 2001

to carefully balance the benefits and costs of separation versus the economic and public benefits of vertical integration in the course of regulatory decisions. AAPT acknowledges that there would be high transaction costs. It would be extremely difficult to conduct a cost/benefit analysis merely on the basis of the superficial level of consideration that has been given to structural separation in Australia to date.

Further, AAPT believes there may be benefits in allowing new industry structures to unfold as new network technology makes it possible and perhaps desirable for Telstra to operate in a less integrated manner, and which may also make it possible for other network operators to operate more independently of Telstra.

However, there is a strong possibility that the current structural problem will persist well into the post-privatisation era, and remedies to address the issue must therefore be considered.

Current penalties are inadequate to control Telstra

The primary penalty that can apply to Telstra for breach of the *Telecommunications Act 1997* is removal or loss of its carrier licence. It is highly unlikely this penalty would ever be imposed, having regard to the consequence that 10 million telephones would be disconnected upon revocation of the licence.

Notionally the threat of loss of Telstra's carrier licence might cause the corporation to modify its behaviour to some extent. However as there is no real likelihood of loss of its licence, the extent to which this threat would cause Telstra to modify its behaviour is probably minimal.

The other main remedies under the *Telecommunications Act* are injunctions and pecuniary penalties.

Injunctions are often an inadequate remedy because the remedy is only able to affect specific future conduct. Monopolists are generally very skilled at modifying their behaviour to make it difficult to draft an effective injunction.

Pecuniary penalties are also far from adequate. The maximum pecuniary penalty for a breach of the *Telecommunications Act* is \$10 million for

each contravention. A similar penalty applies in relation to breaches of the Trade Practices Act. Generally the maximum pecuniary penalty under that Act is \$10 million for each contravention. In the case of a contravention of the competition rule, the penalty for each contravention is \$10 million and a further \$1 million for each day that the contravention continued.

While these penalties seem high, they are nevertheless inadequate in the context of an organisation that makes over \$3 billion profit per annum. Were Telstra to see the potential to win a significant point in regulation or market structuring, or a significant profit-making opportunity, these penalties would not necessarily deter the conduct even if the conduct amounted to a clear breach of either Act.

The bill needs to provide new structural remedies to deal with future circumstances

There are three reasons why it is appropriate to provide additional remedies for anti-competitive behaviour by Telstra.

The first is the possibility that competition in telecommunications may not continue to unfold, or that the level of competition will decline. As discussed above, the current structural problems in the industry suggest that this is a real prospect. It may well be that in the post-privatisation era, the only effective way to develop sustainable competition in telecommunications will be through some form of structural separation of Telstra.

The second is that Telstra's performance in regional and rural Australia may decline below its current level once the company is privatised. As noted previously, Telstra's responses to both the Besley and Estens inquiries could be perceived as being primarily motivated by its desire to be privatised. Accordingly there is a very real question as to how to enforce Telstra's compliance with the recommendations of such inquiries in the post-privatisation era.

The third reason involves consideration of a worst-case scenario. Telstra may currently be constrained from taking advantage of some new market opportunities because it is unable to raise equity due to the current Government ownership requirement. As Senator Alston has remarked, this may have been a benefit to Telstra as it has been unable

to get itself into the troubles that some other global telcos have brought upon themselves.¹⁸ There have been cases where other privatised utilities such as British Rail and Air New Zealand have had to return to full or part Government ownership as a consequence of management difficulties. Were a fully privatised Telstra to go on a radically expansionary phase and then suffer serious financial distress, it would be essential for the Australian Government to take action to ensure the provision of essential telecommunications services in Australia. It would, however, be highly inappropriate for the Government to prop up the whole of Telstra including its competitive businesses.

Each of these reasons suggests that it is desirable that the bill provide for additional remedies to be available in those circumstances.

Issue Three – What can be done to ensure a competitive industry post-privatisation?

As discussed in the previous section, AAPT is concerned that the bill pays insufficient regard to the potential need for structural remedies in the post-privatisation era. It is appropriate that the bill include remedies for dealing with worst-case scenarios, both as a safety net for telecommunications consumers and so that investors in Telstra are well-informed of the potential for future regulatory action of a structural nature.

AAPT is also concerned that the Government has put a number of regulatory issues on the back burner for some time now, as a result of excessive focus on the privatisation of Telstra. It is important that the prospectus specifically refer to the recent Productivity Commission review, and also the Besley and Estens inquiries. The prospectus should also refer to the reviews of the CSG and USO regimes required under s159A of the *Telecommunications (Consumer Protection and Service Standards) Act 1999*. The prospectus should foreshadow the possible need to implement legislative responses to all these reviews.

But most importantly, having regard to the importance of competition, and its nascent and fragile state, the bill must provide for regular reviews into the adequacy of the regime to control Telstra's behaviour in *all* parts

¹⁸ Senator the Hon Richard Alston, SPAN 10th Anniversary Dinner, speech, 5 September 2003.

of Australia rather than being confined to regional, rural and remote communities. AAPT submits that an independent body such as the Productivity Commission (or the ACCC) should be required to conduct such reviews at least every five years, so that Telstra is subject to rigorous monitoring and so that competition can be maintained and improved. The Commission should be required to report to the Minister on its findings and recommendations, and the report should be required to be tabled in the Parliament.

APPENDIX 1 - Estimated incremental benefits in 2001–02 attributable to 1997 changes

Benefit type	Value/growth
Benefits per household	Between \$595 and \$878
Total household benefits	Between \$4,398 million and \$6,490 million
Growth in economic output	More than \$10 billion (1.62 per cent of GDP)
Benefits to small business	About \$900 million (1.67 per cent growth)
Growth in employment	1.14 per cent
Real consumer wage growth	1.76 per cent
Growth in real consumption	1.37 per cent

(Source: Australian Communications Authority *Telecommunications Performance Report 2001-2002* p.33. Available at: http://www.aca.gov.au/aca_home/publications/reports/reports/performance/2001-02/report.htm . The ACA's figures are taken from a report of the Allen Consulting Group, *Benefits Resulting from Changes in Telecommunications Services*, also available on the ACA website at: www.aca.gov.au/aca_home/publications/reports/reports/performance/2001-02/cbreport.htm