Australian Government
Department of Finance and Administration

Reference: 03/5917
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Mr Michael McLean
Committee Secretary
Senate Environment, Communications, Information Technology
and the Arts Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Mr McLean

Response to Questions on Notice - 7 October 2003 Hearings

I am pleased to provide to the Committee the Department of Finance and Administration responses to the questions placed on notice following Committee's Hearings on 7 October 2003.

In total there were 24 questions placed on notice that the Department agreed it would provide answers to by 17 October 2003.

Attachment A contains a set of seven questions, principally focussed on matters related to the Commonwealth Government Securities (CGS) market, together with responses to those questions. The responses in relation to the CGS market issues have been provided by the Treasury.

Attachment B contains the remaining 17 questions, together with answers. Telstra has provided the Department of Finance and Administration with the information in relation to Telstra securities and bonds on issue.

Should you have any queries, please do not hesitate to contact either myself on 6215 3620 or Mr Mark Heazlett on 6215 2090.

Yours sincerely

D. Yarra

David Yarra
General Manager (A/g)
Asset Management Group
17 October 2003

Attachment A

QUESTIONS ON NOTICE FROM HEARING OF SENATE COMMITTEE ON ENVIRONMENT, COMMUNICATION, INFORMATION TECHNOLOGY AND THE ARTS LEGISLATION COMMITTEE – 8 OCTOBER 2003

Question 1

The Government stated its intention in the 2003-04 Budget to maintain the Commonwealth Government Securities (CGS) market. As part of that decision the Budget Papers stated "the Commonwealth intends to continue to hold surplus funds in the form of term deposits [at the RBA] to meet short-term funding needs... In the event financial assets exceed $25 billion on an ongoing basis, the Commonwealth will consider allocating some funds to other liabilities, possibly superannuation." Treasury suggested (at the June 2003 Budget estimates) that approximately $40 billion worth of CGS would be maintained. I understand that at 30 September 2003 there was approximately $58 billion of CGS outstanding. Given the Government's commitment to maintaining the CGS market, the existing level of CGS and the expected sale price, is it the case that a significant proportion of the Telstra sale proceeds will be placed on term deposit at the RBA and/or used to purchase other financial assets such as shares?

Answer

As outlined in the 2003-04 Budget (Budget Paper No 1, Statement 7), the Government has decided to maintain a liquid market in Commonwealth Government Securities. In light of this decision, the Government will continue to hold surplus funds in the form of term deposits with the Reserve Bank of Australia (RBA) to assist with meeting short term funding requirements. This may require holding up to $25 billion in term deposits, given the magnitude of swings in within year funding needs.

Should the term deposit balance exceed $25 billion on an ongoing basis, the Government will consider allocating some funds to other liabilities, possibly Government employee superannuation liabilities. Such a decision will be announced well in advance and will be the subject of consultation with interested parties.

As noted in the 2001-02 Annual Report of the Australian Office of Financial Management, the term deposit balance at the RBA stood at just over $10 billion at the end of 2001-02.

Question 2

Do the 2003-04 Budget Papers assume the Telstra proceeds are used to retire debt and/or are the proceeds placed at the RBA on term deposit?

Answer

The Budget makes general assumptions regarding the forward estimates that do not specify the exact allocation of the proceeds to ensure that the budget is not significantly affected by future decisions about that allocation. The Budget papers provide details of forward estimates of net debt.

Question 3

If part or all of the Telstra proceeds are to be parked at the RBA on short term deposit, how is this treated in the Budget, for example how does this affect the underlying cash balance? What interest rate is assumed on these term deposits? How does the assumed term deposit interest rate compare to the expected foregone Telstra dividends for each financial year over the forward estimates beginning 2005-06?

Answer

Term deposits at the RBA are included in the Commonwealth general government balance sheet as 'investments, loans and placement'. Interest earned on the term deposits is included in 'interest income' and contributes to the underlying cash balance.

Issues raised such as interest saved compared to the expected foregone Telstra dividends are highly specific to the circumstances at the time of sale. The Government has made it clear that it will not proceed with the sale of Telstra until market conditions are conducive to taxpayers achieving an appropriate return from the sale.

Question 4

If the Budget assumes that all or some the Telstra proceeds are to be used to retire debt, what PDI savings are assumed? How do the expected PDI savings compare to the foregone Telstra dividends for each financial year over the forward estimates beginning 2005-06? Is it the case that placing the Telstra proceeds on short-term deposit at the RBA would benefit the budget balance less than if the Telstra proceeds were used to retire debt?

Answer

See answers to question 1, 2 and 3.

Question 5

For asset sales more generally, does placing the proceeds of asset sales on short term-deposit at the RBA instead of retiring CGS alter the cost-benefit analysis for determining whether asset sales proceed or not? Following the Government's decision to maintain the CGS market, has the Department re-examined the case for selling Telstra and more generally, other assets sales expected to take place in coming years.

Answer

For asset sales generally, the analysis of whether to proceed with a sale is based on a range of factors. The commitment to the further sale of Telstra equity reflects the Government's objective of promoting an efficient and vibrant telecommunications market in Australia. A privatised Telstra would be better able to adjust to the rapid changes in the telecommunications sector and more effectively compete both in domestic and international markets.

- Telstra would be able to act in a fully commercial fashion. Significantly, it would be able to raise equity, instead of relying on debt or retained earnings to fund projects.
- The sale of Telstra would also remove any potential conflicts of interest that may exist for the Government both as an owner and regulator of Telstra.

Question 6

The Budget Papers also indicate that should the amount on term deposit at the RBA exceed $25 billion on an ongoing basis, "the Commonwealth will consider allocating some funds to other liabilities, possibly superannuation". Can you explain what this statement means in practical terms? For example does it mean that the Commonwealth will be investing in other financial assets such as shares? Has any work been undertaken in Department of Finance and Administration relating to how the Government would manage its financial assets should the sale of Telstra proceed? For example, has any consideration been given to how the Commonwealth, if it were to purchase other financial assets such as shares, would manage potential conflicts of interest and other ethical issues that may arise? If so, can the Department advice the Committee on what work has been done to date?

Answer

The Government's commitments are outlined in Budget Paper No 1 2003-04, Statement 7.

Question 7

The National Party has called for the Telstra sale proceeds to be spent on infrastructure projects in country areas. If the Telstra proceeds are used to fund such expenditure, what is the impact on the Budget balance? Isn't it the case that additional Government expenditure on non-financial assets such as infrastructure projects, whether funded by assets sales or from recurrent revenue, would worsen the Budget balance?

Answer

The Government has stated that proceeds from the sale of the Commonwealth's remaining equity in Telstra will be used to reduce net debt and may also be allocated to fund other Commonwealth liabilities.

In the circumstance that there is direct Australian Government expenditure on non-financial assets, such as infrastructure projects, this would reduce the Budget balance.

Attachment B

SENATE HEARINGS ON SALE OF TELSTRA BILL 2003 QUESTIONS ON NOTICE TO DEPARTMENT OF FINANCE AND ADMINISTRATION 8/10/2003

1. What is the budgeted cost of a future sale of Telstra? Is this estimated cost included in the 2003-04 Budget? If so where does this appear? When was this cost estimate made?

Answer : The Government has not made any specific Budget provision for the sale costs associated with a further sale of Telstra. However, the Forward Estimates include an estimating assumption of the costs of conducting further sales, which is consistent with the estimating assumptions used in relation to sale proceeds.

However, the precise amounts which would be paid in relation to the sale costs associated with a further sale would be subject to a competitive tendering process. As a result, it has not been the practice of the Government to reveal estimates of sale costs ahead of that process.

Sale costs have been fully disclosed in relation to previous tranches of Telstra. For T1, the costs were $260 million or 1.8% of proceeds. For T2, they were $170 million or 1.1% of proceeds.

The Forward Estimates provisions are included in the Budget Papers under the functional classification Other Purposes as part of the Contingency Reserve. This is reflected in the explanation of the Contingency Reserve set out on page 6-62 of 2003-04 Budget Paper No 1. As is set out on that page items in the Contingency Reserve are not appropriated in the Budget. They are included to ensure that aggregate estimates are as close as possible to expected outcomes and will be appropriated closer to the time they eventuate. The Forward Estimates provisions are subject to review at each Budget and MYEFO.

2. How will the use of hybrids change the cost structure of a sale of Telstra? Does the budgeted cost (from question 1) take into account the costs associated with a Telstra sale using hybrid securities?

Answer: The Department of Finance and Administration advised the Committee in its evidence on 17 September 2003 that no decisions had been taken to use hybrid securities in future sales of Telstra or if they are used what the structure of any hybrid that was utilised would be.

As noted in the response to the previous question, the inclusion of sale cost provisions in the Contingency Reserve is done on the basis of ensuring that aggregate estimates are as close to final outcomes as possible. At the current level of development of those provisions it has not been necessary to make decisions concerning the inclusion or otherwise of hybrid securities.

At the hearing of 17 September 2003 the Department of Finance and Administration witnesses explained that hybrid securities combined elements of debt and equity and that there are a wide range of permutations that can be adopted for individual hybrids within that spectrum. The actual structure of the hybrid that is adopted (if any) will influence the costs that will arise.

Nevertheless, the costs and fees associated with debt securities tend to be lower than those applying for equity. Therefore, the potential exists for the use of hybrids to limit the costs associated with further sales of Telstra if the hybrids used were substantially debt like in character.

As outlined in response to other questions the use of hybrids was considered during the Telstra 2 offer. The costs incurred in the conduct of the Telstra 2 share offer included the costs involved in the consideration of hybrids and preparatory measures for their issue.

In the light of these considerations it is not apparent that the use or otherwise of hybrids, in further sales of Telstra, gives rise to substantial changes in the Contingency Reserve provisions for the costs of further sales of Telstra.

3. Would any liability incurred by issuing hybrids be classified as a contingent liability dependent upon whether the option to convert to Telstra was taken up or not?

Answer: Finance has outlined in evidence to the Committee and in responses to other questions that no decisions have been taken either to issue hybrid securities or if they are issued the form they will take. Within the spectrum between debt and equity securities there are many forms that hybrids could take. Any decision to use a hybrid would seek to structure the hybrid to best contribute to the achievement of offer objectives. These have not been set by the Government as yet.

To the extent that a structure that was adopted involved a contingent liability, that liability would be appropriately classified and reported as such in the relevant Budget papers.

It is unlikely that a bond that had the option of being exchanged at a specified price into a Telstra share would of itself involve a contingent liability. A liability to repay the bond would exist until the stage of exchange and would be classified in that circumstance in the same way as a Commonwealth Government debt security. To the extent that the arrangements for exchange varied then the classification and treatment may change.

4. Would the issuing of a hybrid security to facilitate the sale of Telstra be treated as a liability for the purposes of calculating Commonwealth General Government net debt? If not, doesn't this mean that bonds and hybrid securities are accounted for differently, with hybrids enabling the Government to artificially lower its estimate of net debt?

Answer: The Department of Finance and Administration has outlined in evidence to the Committee and in response to other questions that hybrid securities can take a wide range of forms and that they do not involve a homogenous product. The classification and treatment of the hybrid will be affected significantly by their structure.

A hybrid structure that involved the use of an interest bearing bond that had the option of being exchanged into a Telstra share at a specified future date is likely to be treated as a liability for the purposes of calculating net debt in respect of the bond component of the security. At the same time the value of the underlying Telstra shares that the bond could be exchanged into, would be recognised for the purposes of calculating net assets, until such time as the bond was converted.

If the exchange into Telstra shares was not optional, but mandatory, the treatment may vary. In such circumstances treatment would be determined having regard to the specific contractual conditions applying to the instrument. To the extent that treatment of such an instrument as debt varied, then the treatment of the underlying shares as an asset is also likely to vary.

5. Is it correct to say that by issuing hybrids, the Government is not selling its share in Telstra to pay off debt, but essentially issuing new debt which is backed by its shareholding in Telstra?

Answer: The Government has stated that the rationale for selling Telstra is based on a range of policy considerations. Included in these is the conflict between the Government being a regulator of telecommunication services and owner of a major service provider, the provision of greater certainty to the non-Government shareholders in Telstra, freeing up Telstra to manage its capital on a fully commercial basis and removing from taxpayers the commercial risks of Telstra's commercial operations.

The Government's policy is to use the proceeds from sale to reduce net debt.

As outlined in evidence to the Committee and in response to other questions, no decision has been taken to issue hybrids as part of a future sale of Telstra and that in the event that they are used no decision has been taken on the form of a hybrid that would be used.

As outlined above, the accounting treatment of hybrid instruments will vary according to the precise nature of the instrument.

If a hybrid involving optional exchange is utilised, the effect is likely to involve a refinancing of existing debt. For the period leading up to conversion, the instrument would most likely be treated as debt, with the Government maintaining ownership of the equity for that period. Following conversion, the debt would be eliminated and the equity would cease to be in Government ownership. The costs and benefits of such a debt refinancing will be taken into consideration when decisions are being made about whether a hybrid would be used.

However, it should be remembered that an equity offering will be the main component of further sales of Telstra shares with hybrids assuming a subsidiary role, if any. As the bulk of the sale would take the form of a direct equity offer, the overall impact of the sale would be to reduce the Commonwealth's equity holding in Telstra and to reduce net debt, even during the period leading up to any conversion of hybrid instruments.

6. If the share price does not rise, could the Government find itself still owning a significant part of Telstra in future years when the option to purchase Telstra shares expires and is not exercised?

Answer: As outlined previously no decision has been taken on whether hybrid securities will be issued as part of a future sale of Telstra and if they are issued the nature of the hybrid to be issued.

The extent to which, in the event a hybrid is issued, the Government could find itself still owning a significant part of Telstra would be highly dependent on the structure of the hybrid utilised. A structure which involved mandatory exchange, would not lead to any residual shareholding following the term of the security. A hybrid which involved the use of resettable terms (a common characteristic in the Australian retail market) has potential flexibility for exchange into Telstra shares in the event that the share price does not rise. Management of the exchange process is a feature in the design of a hybrid that would be specifically addressed in the detailed considerations that would occur in the lead up to a future sale.

7. The JP Morgan submission to the Telstra Senate Committee refers to the fact that hybrids were considered as part of the T2 sale, and notes that these:

   '...were not proceeded with in the view of the high level of retail demand for the ordinary instalment receipts, and because of other technical legislative issues that are now addressed by the Bill'.

   Can the Department clarify what these 'technical legislative issues' are and how these have been addressed in the 2003 Bill?

Answer: The possibility of issuing hybrid securities was considered as part of the Telstra 2 share offer. This consideration included a range of potential hybrid structures together with consideration of different issuing entities for the hybrid.

During that consideration an issue was identified that it was not totally beyond doubt that the Commonwealth was able to directly issue a hybrid security as part of a Telstra sale. The 2003 Bill makes specific provision authorising the issue of hybrids to remove any residual doubts. This will ensure that the Government has available to it the full range of options for issuing a hybrid, if a decision is taken that their use would be beneficial to the sale.

8. Can the Department explain how the concerns of the ANAO with regard to the use of hybrids (in their audit of the conduct of T2 Report No.20 of 2000-2001 section 2.31 p.35) have been addressed?

Answer: The ANAO Report No. 20 of 2000-2001 of the Performance Audit of the Second Tranche Sale of Telstra Shares notes that "the Government's criterion in relation to fiscal or net debt implications" of the hybrid was not able to be overcome.

That statement is not a general concern by the ANAO over the use of hybrids. It records the fact that a Government requirement for the Telstra 2 offer in 1999 could not be satisfied and therefore the hybrid was not pursued.

Any decision to utilise hybrids in future sales of Telstra will be taken in the context of the ability of the structure proposed to satisfy the sale objectives that will be determined by the Government and any other requirements that the Government may have at the time of the sale.

9. If the Government decides to set up a third party company to issue hybrid securities on the Commonwealth's behalf, will the Commonwealth be forfeiting its dividend stream throughout the duration of the hybrid?

Answer: As set out in evidence to the Committee and in responses to other questions there are a wide variety of structures that can be developed for hybrid securities. No decisions have been taken to issue hybrids, the type of structure that would be used if one was issued or what the issuing entity would be.

The determination of the recipient of the dividends payable on the shares associated with any hybrid would be dependent on the structure and terms and conditions attaching to those hybrids. The costs and benefits of varying structures would be considered as part of any decision to utilise a hybrid issued by a third party company.

However, there would clearly be some possible hybrid structures which would involve the Commonwealth retaining ownership of the underlying shares in the period leading up to conversion, and which would thus entitle the Government to receive the applicable dividends for that period.

10. If not, isn't this an inconsistent accounting treatment by moving debt off the budget but maintaining the benefits from Telstra dividends?

Answer: The accounting treatment of a hybrid, if issued, would be consistent with external accounting standards.

11. Will the hybrid be guaranteed by the Commonwealth and priced according to the Commonwealth Government CGS yield curve or will it be guaranteed by Telstra?

Answer: Issues relating to the pricing of any hybrids and whether they would be guaranteed by the Australian Government, Telstra or any other entity would form part of the detailed consideration of the development of a hybrid if a decision is made to pursue hybrid issues. The costs and benefits of the various alternatives would form part of the consideration of their use.

No decisions have been taken at this time on the use of a guarantee or otherwise.

12. Does Telstra currently have any corporate bonds on issue? What coupon rate do they pay? What is their current yield to maturity?

Answer: Telstra has advised the following information in response to this question.

"Yes Telstra does have corporate bonds on issue. A list of these is provided in Appendix 1. There are a range of coupon rates which reflect the currency of the raising, the market rates at the time, the maturity at the time, and Telstra's credit quality.

A large proportion of these bonds are in foreign currency which, apart from a few special raisings used to hedge investments, swapped into A$ at drawdown through to maturity. In other words they are synthetic A$ borrowings, since the majority of Telstra's activities are in A$.

Finally Telstra has a policy with its debt that sets a benchmark of 50% fixed and 50% variable. This percentage can be adjusted within set bands with senior management approval. Currently the setting is 55% and it has been within 50%-60% for the past 5 years."

13. Does Telstra have any convertible or hybrid securities on issue? What coupon rate do they pay? What is their current yield to maturity?

Answer: Telstra has advised the following information in response to this question.

" No Telstra does not have any convertible or hybrids."

14. Will coupon payments on any hybrid be included as an interest expense as per Table B-3 on page 2-16 of BP No.1?

Answer: The treatment of coupon payments on any hybrid in the Budget Papers will be dependent on the structure of the specific hybrid, the nature of the issuing party and the form of any coupon payments.

In the circumstance that the hybrid took the form of a debt security issued directly by the Commonwealth of Australia, which had the option of exchange into a Telstra share at maturity, it would be expected that coupon payments would be included as an interest expense in the relevant Budget papers. Where different structures were adopted for the hybrid consideration would need to be given to the most appropriate treatment in the Budget papers consistent with the prevailing standards for the preparation of Budget papers.

15. Will any change in the market value of the security be included in interest expense???? Will it be treated as a financing transaction below the line?

Answer: As indicated in responses to other questions the Budget and accounting treatment of hybrids and individual components of those hybrids is highly dependent on the specific structure of any hybrid that may be utilised.

The structure of the hybrid together with its contractual terms and conditions would determine what expenses would be incurred.

The Budget papers would reflect any expenses involved.

16. To what extent (in percentage terms) will the use of hybrids broaden the demand base for T3? How do the current foreign ownership limits impact upon overseas demand for Telstra?

Answer: As has been outlined in evidence to the Committee and in response to other questions hybrid securities cover the spectrum between debt and equity and there are many forms that they can take. The level of demand will be highly influenced by the particular structure employed and the market segment it appeals to.

The submissions and evidence by JP Morgan and ABN AMRO Rothschild provided indicative amounts that could be generated by particular styles of hybrids. Finance is not in a position to comment on the achievability of those estimates. Those figures would need to be re-examined in the light of prevailing market circumstances at the time future sales were to occur.

The current Telstra Act contains provisions that restrict total foreign ownership to an aggregate 35% and any individual foreign ownership to not greater than 5% of issued capital.

The current level of foreign ownership, at around one third of the allowable limits does not lead to any practical limitations on the ability of foreign investors to trade in Telstra shares.

17. Would a loosening of foreign ownership limits on Telstra make Telstra a more attractive company for overseas investors, such as those in the US or Europe?

Answer: The sale legislation does not vary the current 35% foreign ownership limit. As set out in the answer to Question 16, the current level of foreign ownership, at around one third of the allowable limits does not lead to any practical limitations on the ability of foreign investors to trade in Telstra shares.

Appendix 1

TELSTRA BONDS OUTSTANDING

Currency	Amount (m)	Coupon (% pa)	Issue Date	Maturity
*$A	500	12.00	Pre-1993	May 2006
*$A	250	8.00	March 1996	September 2004
*$A	500	7.25	March 2000	March 2010
*$A	500	7.00	July 2001	July 2008
*$A	500	7.25	May 2002	November 2012
$A	250	5.93	November 2002	November 2007
Deutschemark	1,000	5.125	April 1998	April 2008
EUR	1,000	5.875	June 2000	June 2005
EUR	1,500	6.375	June 2001	June 2011
French Franc	1,500	6.00	December 1996	December 2006
GBP	200	6.125	August 2002	August 2014
JPY	5,000	1.65	July 2000	July 2007
JPY	3,000	3 mth Libor + 0.25	May 2001	May 2008
JPY	3,000	1.65	September 2001	September 2010
JPY	2,000	1.25	September 2001	September 2008
JPY	5,000	1.25	October 2001	October 2008
Singapore Dollar	100	3.80	March 2001	March 2008
Swiss Franc	300	3.375	August 1998	June 2005
$US	250	6.50	November 1995	November 2005
$US	150	6.50	April 1996	November 2005
$US	55	3 mth Libor + 0.50	January 2002	January 2012
$US	500	6.375	April 2002	April 2012

* Refer below for yield to maturity

TELSTRA BONDS YIELD TO MATURITY

Telstra's issues bonds in domestic and offshore markets and uses the yield to maturity on our domestic bonds as the pricing benchmark before undertaking any offshore borrowings which are fully swapped (hedged) to Australian Dollars at issue. This converts our foreign currency bond issues into domestic borrowings that are economically equivalent to $A borrowing rates at the time.

Yields on our domestic bonds (and swapped foreign currency bonds) vary with monetary conditions and domestic and offshore investor appetite for credit risk. Indicative yields as at 30 September on our domestic borrowings and the margins to Commonwealth Government Securities (CGS) are shown below. (Inclusion of the yield to maturity on our foreign currency bonds has been omitted as this would create a misleading comparison.)

Bond Maturity	Coupon (% pa)	Yield to Maturity (% pa)	Margin to CGS (% pa)
September 2004	8.00	5.14	0.27
May 2006	12.00	5.50	0.45
July 2008	7.00	5.78	0.58
March 2010	7.25	5.89	0.64
November 2012	7.25	6.08	0.71