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

23 September 2003

ABN·AMRO ROTHSCHILD

Executive summary

The purpose of this document is to provide the Senate Environment, Communications, Information Technology and the Arts Legislation Committee (" the Committee") with the views of ABN AMRO Rothschild ("AAR") on various aspects of the sale of the Commonwealth's residual shareholding in Telstra.

This submission seeks to assess the direct benefits of the full privatisation of Telstra for consumers, the Australian economy, the telecommunications industry in Australia and Telstra, as well as the likely indirect benefits of wider share ownership. In addition, the submission addresses the effect of the proposed full sale of Telstra on the ability of the Government to effectively regulate the telecoms market in Australia, and assesses whether the proposed legislation will allow the Commonwealth the necessary flexibility to execute a sale that meets its objectives.

The submission provides empirical evidence to demonstrate that privatisation, in combination with a sound regulatory framework and a competitive market place, does generate improved economic performance and benefits to the community. In other words, privatisation cannot be considered in isolation from the regulatory framework and the nature of the competition. Critics of privatisation need to demonstrate why the policy and regulatory framework is inadequate, why any identified deficiencies cannot be addressed by changes to the framework and why public ownership is the only solution to the identified problems.

The argument that the Government should continue to own a majority shareholding in Telstra because it would not be possible to effectively regulate a fully privatised company is, in our view, flawed:

- It fails to appreciate that there is the potential for, and at a minimum the perception of, conflict in the Government having the role of both regulator and owner of the regulated entity
- It logically leads to the implication that the Government should perhaps own the other participants in the telecommunications sector
- More generally it is an argument for the Government to assume a majority ownership role wherever it has a regulatory function such as insurance, banking, airports etc. where regulation and competition do not completely address industry problems

Objectives of the sale

We assume that there are a number of key objectives for the Government in proceeding with the full privatisation of Telstra, including:

- To achieve an optimal financial return from the sale
- To provide Telstra with the full commercial flexibility to adapt most effectively to the high-growth, fast-moving and highly competitive telecommunications sector
- To promote an internationally competitive, efficient, innovative telecommunications industry as an important component of the Australian economy and as means to deliver benefits to companies and the public generally

Implementation

The Commonwealth's objective of maximising sale proceeds can be met through offer structure features that take into account the inter-relationship that exists between:

- Issue size
- Size and source of investor demand
- Structural components of the transaction
- Their respective and combined implications for the issue price

In order to maximise demand at the time of the offer, and hence proceeds, the Commonwealth should maintain maximum flexibility when it comes to the structure of the offer and the markets in which it may offer the securities. Each of the above factors are inter-related and also potentially affect the achievable issue price. They therefore cannot be fully considered in isolation. For example, a larger issue size may to lead to a lower issue price unless incremental demand is stimulated by the larger issue size (e.g. due to higher indexation and the removal of the perceived overhang) and/or by additional structural components such as the inclusion in the offer of a hybrid security and/or a buyback. Issue structure and size need to be assessed closer to the time of a possible selldown.

Executive summary

Benefits of full privatisation

The combination of the full privatisation, a rigorous and transparent regulatory regime and a competitive market place will provide maximum benefits to Australia and its citizens. Australia has the latter two elements: a leading regulatory regime and a highly competitive market by world standards. However the final element is lacking. The effectiveness of regulation and competition will be enhanced by the full privatisation of Telstra for the benefit of consumers, business and the economy in general.

Privatisation will eliminate any actual or perceived conflict in the roles of the Commonwealth, for example, by:

- Removing any potential conflict of interest between being the regulator and determining such matters as the approach to access, competition and regulated prices, while being the majority owner of Telstra
- Sending an unambiguous message to industry participant, consumers and investors that there is a separation between (i) government and social policy, and (ii) Commonwealth ownership of the largest company in the sector. This is important for domestic and international credibility.

Improved competition and regulation will assist in ensuring that, on the whole, enhanced products and services are provided to consumers nationwide at competitive prices.

Failure to privatise is likely to send the opposite, negative signals to industry and the community.

Benefits for consumers

The evidence from overseas experience, in particular that of British Telecom ("BT"), suggests that full privatisation provides a range of benefits in terms of lower prices, improved service and reliability, expanded customer choice and a wide range of new services. These improvements in product service quality and customer choice have been accompanied by improved financial performance.

In the UK, BT dramatically improved its performance and quality of service post full privatisation, reducing tariffs for local, long distance and international calls; reducing failure rates for phone calls; significantly increasing in the proportion of pay phones in operation; and the introducing a wide range of new services.

Benefits for the economy

Empirical evidence points to net benefits to the economy as a result of full privatisation. These benefits generally accrue as a result of improved economic efficiencies delivering gains to consumers (via lower prices), to industry (via a more efficient industry sector) and to government (via increased tax receipts from a more efficient and better performing industry sector).

Enhanced competition and lower prices

Full privatisation will increase private sector shareholder pressures to improve operational performance and this will create scope for competition to exert downward pressure on prices to the benefit of consumers and business in general. This combination of privatisation, competition and regulation will have flow through benefits to the Australian economy.

Innovation, product range and industry development

The combination of privatisation and measures to enhance competition will, on available evidence, produce a broader range of products that consumers want and are willing to pay for. Optimal performance of the telecommunications sector is vital for the overall competitiveness and performance of the Australian economy. Full privatisation provides the added commercial pressure and incentives for this to occur.

Increased employment and improved employee relations

Evidence from overseas privatisations indicates that where privatisation involves the proper alignment of interests of employers and employees there is an improvement in employee relations and productivity. Furthermore, the general effect of privatisation on competition and efficiency will tend over time to enhance economic performance and thus improve employment prospects across the economy.

Executive summary

Fiscal benefits for the Commonwealth

The market disciplines and investment risk profile of the private sector tend to improve the financial performance of the business. The result of this is that the private sector is likely to attach a higher value to a privatised entity than the value that the entity can provide to the owner under continuing public ownership.

The proceeds of privatisation would be made available to reduce net debt and therefore improve the Government's budgetary position and its financial capability to provide services. In addition, full privatisation reduces the risk profile of the Commonwealth by replacing higher risk equity income with low risk debt savings and tax revenue. Finally, by improving overall economic performance, there are indirect financial benefits, as the improved economic performance feeds into higher taxation receipts.

Broader share ownership

Full privatisation of Telstra could enhance the scale and coverage of share ownership in the Australian population by providing a wider range of choice to the community if they want to have a direct or indirect, or indeed no exposure to Telstra's financial performance.

Regulatory framework

Australia has in place a comprehensive legislative framework for the telecommunications sector. It is designed with the aim that the entire community obtains the highest practicable standard of telecommunications services and to ensure that there is a high level of competition in the sector. The policy framework includes the Australian Communications Authority ("ACA"), the Telecommunications Act 1997 and the Telstra Corporation Act 1991, and operates together with the Trade Practices Act 1974 and the Australian Competition and Consumer Commission ("ACCC").

Contents

1. Terms of Reference

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1.1 Terms of Reference

The Senate has referred the provisions of the Telstra (Transition to Full Private Ownership) Bill 2003 to the Senate Environment, Communications, Information Technology and the Arts Legislation Committee ("the Committee"). The Committee has invited submissions from interested parties and will report its findings to the Senate by 30 October 2003.

Senator Eggleston said today [19th August 2003]:

> "It has been longstanding Government policy that Telstra should be transferred to full private ownership while being subject to a continuing regulatory framework that protects consumers and promotes competition. The purpose of the Bill is to repeal the provisions in the Telstra Corporation Act 1991 that require the Commonwealth to retail its 50.1 per cent equity in Telstra. The change in Telstra's ownership status will not affect the Government's ability to protect the interests of consumers, competitors and the public generally - and especially those living in regional Australia as a result of safeguards written into the Bill."
>
> The Committee has been asked by the Senate to examine the provisions of the Bill and to report back by 30 October 2003. The Committee invites interested individuals and organisations to make their views known in relation to this important issue by placing a submission before the Committee's inquiry by its deadline of [Tuesday 23 September 2003].

1.2 ABN AMRO Rothschild expertise

ABN AMRO Rothschild is the international equity capital markets joint venture between the ABN AMRO and Rothschild groups. Formed in July 1996, ABN AMRO Rothschild is one of the world leading equity capital market houses and was ranked in the top 5 for lead managers of international equity offerings in 2002. Since 1996, we have lead managed international equity offerings worth in excess of US$140 billion.

We have access to some of the world's most skilled corporate financiers from both the Rothschild and ABN AMRO international and domestic networks. Together with our dedicated team of equity capital markets professionals, we have advised on valuations and capital raisings for many of the largest and most successful equity offerings internationally.

We have strong advisory and execution experience in the telecommunications sector. We have advised either the vendor or issuer on telecoms sector equity markets transactions worth in excess of US$165 billion, significantly more than any other house in the world.

- In Australia AAR was Global Co-ordinator for both the Telstra IPO and Telstra 2 privatisation offering, as well as acting as the Business Adviser in the Telstra IPO and Scoping Study Adviser in Telstra 2. This experiences gives us unrivalled insight into both the company and Australian sector
- In Asia we were Global Co-ordinator and Bookrunner on three of the largest telecommunications IPOs in 2002 (MobileOne, Maxis Communications and Bharti Tele-Ventures)
- Internationally we have advised on the majority of the landmark incumbent telecommunications IPO and sell-down transactions, including British Telecom I and II, Deutsche Telecom I, II and III, KPN I, II, III, IV and V, France Telecom / STM and Swisscom, in addition to the extensive corporate advisory work our parent banks have undertaken with all of these companies and respective Governments
- In 2003 ABN AMRO Rothschild was the lead bank in the US$16bn France Telecom share capital increase, acting as Financial Adviser to France Telecom, Joint Special Co-ordinator in the warrant offer and Joint Global Co-ordinator in the rump placement
- In September 2003 Rothschild acted as adviser to the Dutch Government in a E2.3bn selldown of its shareholding in KPN, the incumbent telecoms operator in the Netherlands

2. Policy Arguments for the Full Sale of Telstra

2. Policy Arguments for the Full Sale of Telstra

2.1 Introduction

Privatisation can benefit all stakeholders including individuals, governments, businesses and their customers. Privatisation allows governments to raise funds and reduce their exposure to commercial risks better managed by the private sector. This in turn allows governments to focus on their core responsibilities of policy and regulation. In the case of telecommunications, this includes regulations such as Universal Service Obligations ("USOs") and price caps, which ensure price control of services for consumers, as well as providing specific protections for regional, rural and remote users.

Private ownership of business improves a firm's commercial focus, encouraging them to lower operating costs, utilise capital more efficiently and expand revenues. A competitive environment and appropriate laws and regulations will enable consumers to further benefit through lower prices and wider product offerings.

Australian taxpayers are currently forcibly exposed to the volatility of global equity markets, which has seen the value of the Governments shareholding in Telstra fall by 37.5% since the second partial privatisation in 1999 (based on the institutional offer price of $7.80, and the market price of $4.87 of Telstra shares as at close of trade on 23 September 2003).

The constraints on Telstra's ability to raise equity capital on a par with its local and international competitors is an example of a legislated equity restriction which limits the company's competitive position, financial returns and constrains its capital management.

2.2 Benefits for consumers

International and domestic experience demonstrates that the Australian economy and Australian consumers will benefit from the sale of the Commonwealth's holdings in Telstra.

In recent years, over 40 major countries have privatised their previously government-owned telecommunications companies and 17 of these companies have been fully privatised (see Appendix 1). In addition, the USA and Canada have a history of private ownership of telecommunication companies.

In the telecommunications sector, the UK provides the most relevant empirical evidence. Like Australia, the UK has a liberalised, competitive market and a generally well regarded legal and regulatory environment. British Telecom ("BT") was first partially privatised and then subsequently fully privatised. The strong performance of BT combined with improved services and reduced prices for consumers in the years following the company's full privatisation clearly demonstrate the benefits of a move to full private ownership.

Case Study: Privatisation of British Telecom

The UK experienced dramatic improvements in BT's competitiveness, range of product offerings and its quality of service post full privatisation. This included:

- A decrease in tariffs for local, long distance and international calls by an average 47% in real terms between 1984 and 1997
- A decrease in failure rates for phone calls from 4% for trunk calls and 12% for local calls to below 0.5% for all domestic calls (all non international calls are now categorised as domestic)
- An increase in the proportion of pay phones in operation from below 80% in 1987 to approximately 98% currently
- Complaints of line congestion fell from 20% to below 2%
- A plethora of new services, for example, BT was one of the first telecommunications companies in the world to offer frame relay services

Source **Oftel**

Generally, evidence indicates that the quality of service improves under the disciplines of private ownership, a fully competitive market place and appropriate regulatory safeguards such as Community Service Obligations ("CSOs"). For example, BT dramatically improved customer service levels between 1987 and 1997 as the company moved from partial to full privatisation.

Indicator	Measure	BT 1987	BT 1997
Service Provision	% of orders completed "on time"	28.4%	97.4%
Fault Repairs	% of faults cleared in target time (9 hrs)	74.3%	87.5%

Source **Oftel**

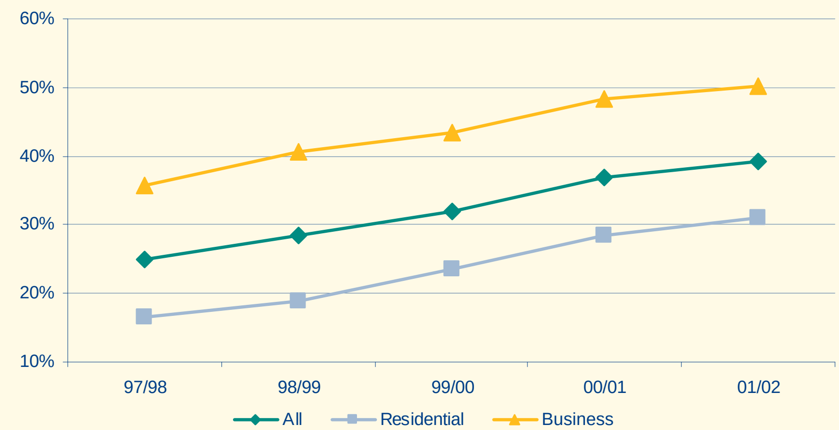
2. Policy Arguments for the Full Sale of Telstra

2.2 Benefits for consumers (cont'd)

This trend has continued in the years since full privatisation. According to the most recent Oftel report on the UK telecommunications industry (2003), over the last three years "increasing competition helped to contribute to further price reductions, and in the year to March 2002 average fixed telecoms prices fell by 5%. Oftel market research also shows that 96% of UK residential customers are satisfied with their overall telephony service".

Effective competition in the UK since full privatisation is evident by the increase in the market share of BT's competitors over the past six years in both residential and business sectors.

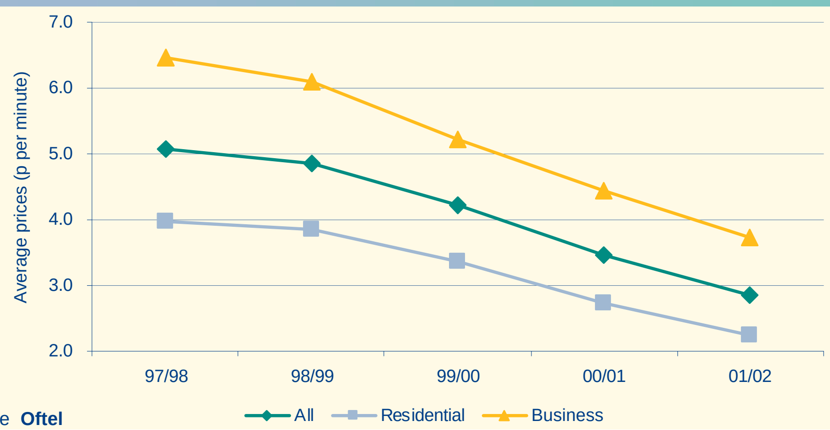
Increase in competitors' market share (by revenue)



Source **Oftel**

Average fixed line call costs in the UK have fallen by over 40% for business customers and approximately 45% for residential customers over the period.

Average fixed line call costs in the UK



Source **Oftel**

2. Policy Arguments for the Full Sale of Telstra

2.2 Benefits for consumers (cont'd)

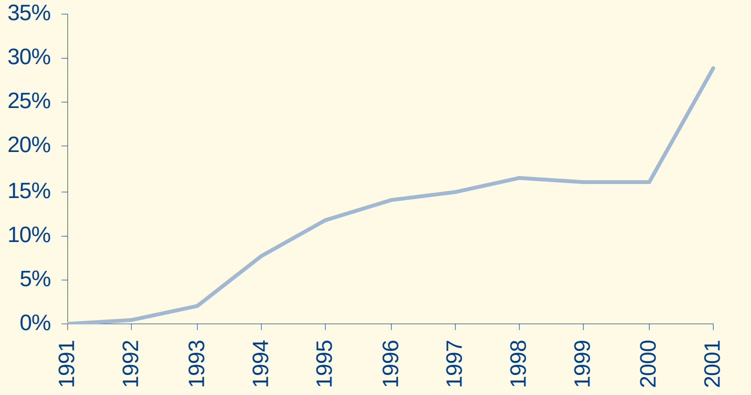
Lindsay Tanner suggests that "a private Telstra would be a giant private monopoly that would totally dominate the communications sector". The British empirical evidence suggests otherwise, and that the British Government (through Oftel) has been able to effectively regulate BT since full privatisation, resulting in continued improvements to services, reduced prices for the consumer and increased competition.

Since 1997, and the IPO of Telstra, the Australian market has been open to full competition, which has resulted in new suppliers and services, lower prices and greater choice for consumers. The quality of services has improved, investment opportunities in the sector have expanded and service provision to regional and rural Australia, as well as the main population centres, has accelerated.

- International call prices have decreased by an average if 21.1% each year
- National long distance call prices have decreased by an average of 8.4% each year
- Local calls prices have decreased by an average of 8.3% each year
- Estimated decrease in the cost of mobile phone services of 27.4% between 1997 and 2001
- Virtually all Australians can now dial up to at least one ISP at untimed call rates

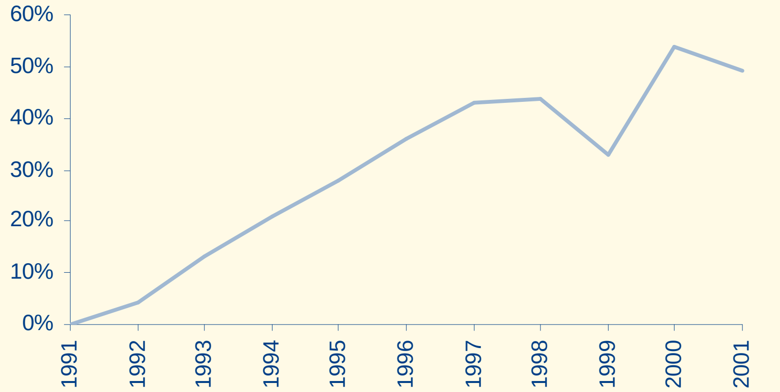
The increased competition in the Australian market is highlighted by the significant increase in the market share of new entrants in long distance national calls and international calls.

New entrants' market share (national long distance calls)



Source **OECD Communications Outlook 2003**

New entrants' market share (international calls)



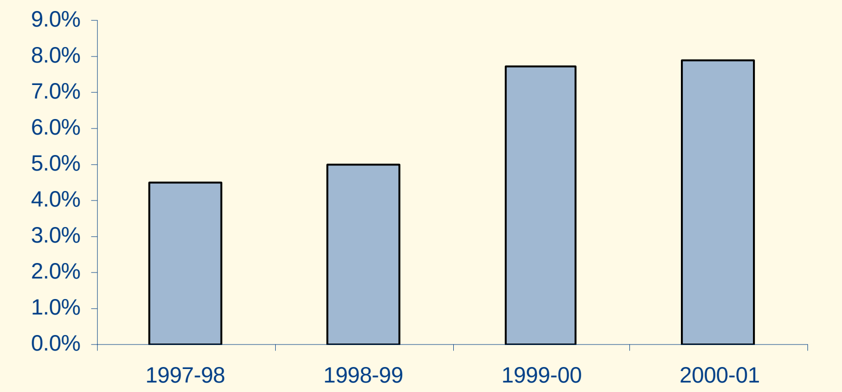
Source **OECD Communications Outlook 2003**

2. Policy Arguments for the Full Sale of Telstra

2.2 Benefits for consumers (cont'd)

This competition has resulted in steady decreases in the average cost of fixed line calls for Australian consumers.

Annual decrease in the price of Australian fixed line calls



Source **Australian Communications Authority**

Since 1997 a wider range of services is being offered to Australian consumers than ever before across fixed and mobile services, internet and other data services. There have been reductions in prices across many services and improvements in service quality and features.

These positive changes have been brought about via regulation and not the Commonwealth's role as a shareholder of Telstra.

Recent reports by the International Telecommunications Union shows Telstra and Australia still trail in broadband penetration and pricing compared to countries with a roughly similar geographic profile (e.g. the US) where fully private telecoms compete to offer ADSL services. The better broadband penetration rates in the US are not as a result of more stringent regulation, but more effective competition. It is the fostering of further competition in Australia (and not regulation nor Government ownership of Telstra) that will continue to drive improvements in areas such as broadband.

2.3 Benefits for the economy

The UK has had one of the most extensive privatisation programs during the last two decades and in 1995 Professor Alan Miller published a survey of 24 studies of the British privatisation program in the Columbia Journal of World Business. (Miller (1995) British Privatisation - Evaluating the Results).

Professor Miller found that for nine of the Government's objectives of privatisation, the studies were unanimous in finding evidence to support the objectives:

- Reducing the size and scope of government involvement
- Freeing government funds so they can be used in sectors of the economy other than state-owned business
- Creating a free market economy in which decisions about consumption and production of goods and services are made by individual consumers and enterprises in the marketplace
- Promoting domestic investment
- Benefiting the economy through higher returns on capital in privatised business
- Generating new sources of tax revenue
- Broadening domestic equity ownership in order to promote more equal distribution of wealth among the population and to create a positive attitude towards private ownership of industry
- Promoting equity ownership among employees of privatised business in order to give them a greater stake in their firms, resulting in higher motivation and productivity

2.3 Benefits for the economy (cont'd)

Three of the objectives found majority support in the studies surveyed:

- Reducing the government's budget deficit
- Providing customers with improved service, better quality, more choices, new products and lower prices
- Improving the efficiency and performance of privatised firms through competition or other means

Net welfare gains

As was extensively canvassed in the Senate Inquiry that preceded the Telstra Dilution of Public Ownership Act in 1996, the World Bank study by Gala, Jones, Tandon and Vogelsang (1992) Welfare Consequences of Selling Public Enterprises, looked in detail at 12 privatisations, four of which were in the telecommunications sector (Chile, Mexico, Malaysia and the UK), taking care to isolate the effects of private ownership. While individually some of these cases may be open to various interpretations, the overall weight of the study is that it found net welfare gains in eleven of the twelve cases and on average the present value of these gains equalled 26% of the firm's predivestiture sales revenue.

The study found that the initial sale of British Telecom in 1984 made the UK better off by over £10 billion expressed in terms of 1985 prices (approximately £2.2 billion to government, £3.9 billion to shareholders and £4.0 billion to consumers).

According to a 1997 study by UK based National Economic Research Associates (NERA), in the first year of Margaret Thatcher's government (1979) 33 state enterprises, all later to be privatised, absorbed £500m of public funds as well as more than £1bn in loan finance. By 1987 these same (but now privatised) companies were contributing £8bn a year to the Treasury in share sales, tax receipts and dividends.

Allocative efficiency gains

The examination of the overall allocative efficiency of a sample of 164 electricity plants from a range of countries found that investment decisions which decide the factor mix of government owned utilities are less efficient than those in privately owned plants. The author stated "we were led to conclude that government interference in the investment decisions of publicly owned electricity generators does significantly increase costs." *[Pollitt (1995) Ownership and Performance in Electric Utilities Oxford University Press]*

Productivity gains

In a study focused on the privatisation of British Airways, it was found that the stock prices of US competitors fell 7% on announcement of privatisation, implying the expectation of a more competitive British Airways. Measures of productivity also improved significantly in the three years after privatisation. *[Eckel, Eckel and Singal (1997) Privatisation and Efficiency, Industry Effects of the Sale of British Airways, Journal of Financial Economics]*

Fund managers Guinness Flight Hambro published a study of global privatisations in 1998, concluding that privatised companies significantly outperformed comparable companies listed on the same stock market for ten years after privatisation, suggesting the achievement of above average efficiencies and profitability improvements. An index of privatised companies generated a return between 1991 and 1997 of 145%, compared to a return on comparable private companies of 89%. *[Guinness Flight Hambro (1998) Measuring the Privatisation Effect in Privatisation International, March]*

2.4 Effects on Australia's telecommunications industry

The telecommunications sector in Australia, as elsewhere in the world, is highly dynamic and critical to the industrial development of the country. Recent changes have been driven to a significant degree by rapid technological advances, including the convergence of telecommunications, broadcasting and information technologies and an increasingly competitive international marketplace. It is important for the industry and the country that Telstra operates as efficiently as possible, and can pass efficiencies onto all Australians. The ability to foster competition and regulate (as opposed to direct through equity ownership) is the most important element in maximising the benefits of developments in the industry to all parts of the economy.

2. Policy Arguments for the Full Sale of Telstra

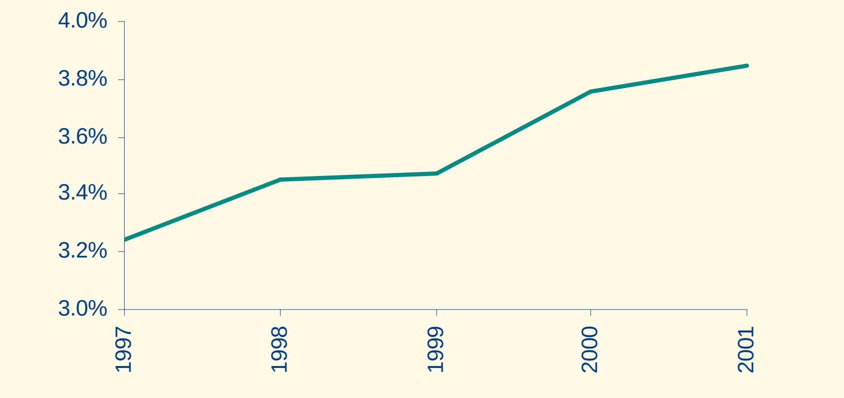
2.4 Effects on Australia's telecommunications industry (cont'd)

Since 1997, the time of the IPO of Telstra, the Australian market has been open to competition, which has resulted in new suppliers and services, lower prices and greater choice for consumers.

- New investment in the telecommunications sector had totalled more than $19.7bn (up to 2002)
- 88 carriers in the market using a range of new technologies
- Over 850 service providers have entered the market (with 40% of these carriers focussing on regional areas)
- Prices for consumers have fallen by an average of 6.9% per annum

The telecommunications industry has become an increasingly important component of national GDP over recent years, driven by the increased competition made possible by effective regulation.

Telecommunications revenue as a percentage of GDP



Source **OECD Communications Outlook 2003**

2.5 Benefits to Telstra

Telstra is Australia's largest company and plays a vital role in Australia's economic, industrial and social future.

The company has benefited from market scrutiny of its performance that has come from partial privatisation. Despite falling since the time of the Telstra 2 offer, the Telstra share price has outperformed the Australian market since its IPO in 1997, and the global telecommunications sector since Telstra 2.

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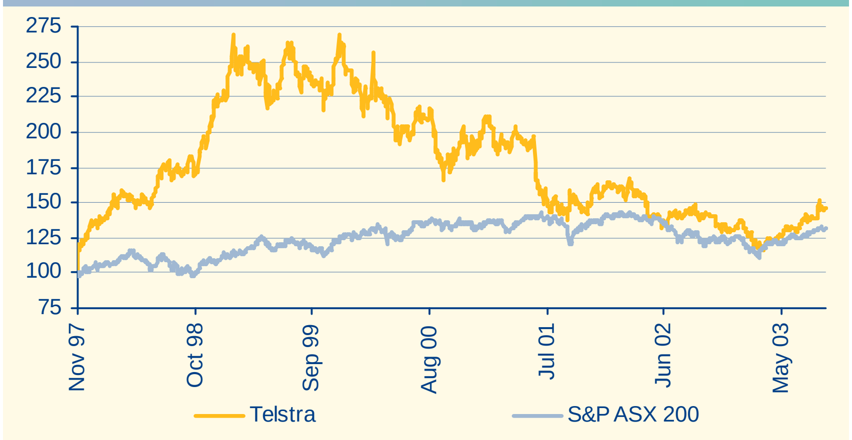
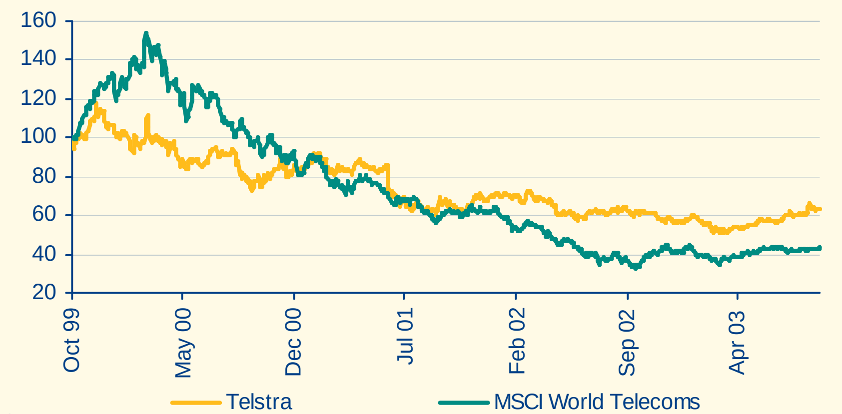
Telstra share price performance relative to the S&P/ASX 200 since IPO



Source **Datastream**

2.5 Benefits to Telstra (cont'd)

Telstra share price performance relative to the MSCI World Telecoms Industry



Source **Datastream**

Competition has forced Telstra to focus on its customers, productivity and costs in order to match its competitors in the Australian market.

However, Telstra remains constrained in its ability to raise equity capital to compete on a par with its fully privatised global competitors. Without the ability to raise additional equity (due to the current requirement that the Commonwealth not be diluted to an ownership position of less than 50.1%), Telstra may find itself in a position whereby it becomes constrained to fund new technologies, infrastructure and earnings accretive acquisitions.

Unless Telstra is able to access the global capital markets for equity, its ability to compete in an increasingly dynamic and technologically driven environment will inevitably reduce its market position and consequently its value. Full privatisation will enhance the company's competitive position by enabling it to have the flexibility to appropriately fund new technologies and infrastructure.

2.6 Increased employment and improved employee relations

A study of privatisations in 18 countries and 32 industries between 1961 and 1990 found no evidence that privatisation leads to lower employment in the relevant industries over a medium to long term basis. This study found "strong performance improvements, achieved surprisingly without sacrificing employment security". While some privatisations were accompanied by large reductions in employment, on average employment went up during the three years after privatisation. The findings state that "after being privatised, firms increase real sales, become more profitable, increase their capital investment spending, improve their operating efficiency, and increase their work forces." *[Megginson, Nash and Randenborgh (1995) The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis, Journal of Finance]*

In the UK, whilst BT's privatisation was associated with reduced employment of 100,000, nearly 95,000 jobs were created in the industry over the same period.

While broad-based studies of this nature are of interest, the specific circumstances of a privatisation and the market in which the entity operates will influence the result. A clear distinction also needs to be made between the effect of privatisation and the impact of a broad range of factors that will affect Telstra and the telecommunications sector regardless of the issue of ownership.

2. Policy Arguments for the Full Sale of Telstra

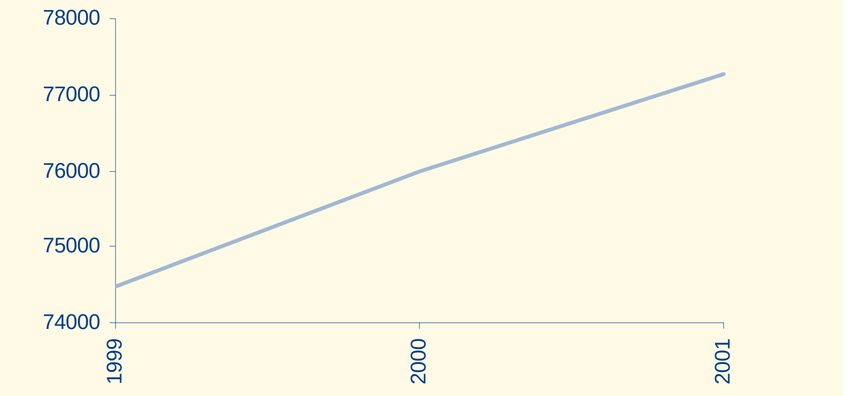
2.6 Increased employment and improved employee relations (cont'd)

It is possible that Telstra, owing to pressure on market share and the need to achieve best practice efficiency, may experience some further decline in employment. However such an outcome will occur under either public or private ownership. The commercial flexibility afforded by full privatisation will, however, provide Telstra with the best opportunity to maximise its performance and employment prospects.

Positive flow-ons from increased profitability in telecoms should increase employment elsewhere. Given that telecommunications is a major enabling technology for all other sectors of the Australian economy, productivity increases are likely to lead to lower prices which in turn lead to reduced costs and increased profits across the economy, providing an impetus for growth and increased employment in the economy as a whole.

Although difficult to assess on an economy wide basis, the employment levels in the Australian telecommunications industry have risen since the partial privatisation of Telstra.

Employment in the Australian telecommunications industry



Source **OECD Communications Outlook 2003**

2.7 Financial benefits

The full privatisation of Telstra is expected to yield overall financial benefits to the Commonwealth.

First there is the direct financial benefit through sale proceeds being used to reduce net debt and hence reduce ongoing debt servicing costs, albeit with some offset from forgone dividend receipts.

The market disciplines of privatisation are expected to produce operating cost improvements and assist in increasing revenues, leading to an improved bottom line performance and competitiveness. This expected improvement in performance should be reflected positively in the sale price that the Government will receive, which should exceed the expected value of Telstra under continued public ownership as discussed previously.

Second, the sale of Telstra reduces the risk profile for the Commonwealth Government by replacing an uncertain equity income with a certain debt cost reduction. The Commonwealth will continue to share in performance improvements made by Telstra after selldown, through taxation receipts that accompany any higher profitability. This will be an out-turn effect that will not be factored into prior Budget estimates, in line with conventional Budgetary processes.

Finally, there is an indirect financial benefit to the Commonwealth through the fact that the full privatisation of Telstra is expected to generate ongoing economic benefits for the overall economy through improved telecommunications performance, feeding into a whole range of other industry sectors that are users of these services and whose real cost will decline and quality of service improve. This improvement in economic performance will in turn be reflected in the overall tax base of the Commonwealth.

Some parties have suggested that the Commonwealth should retain majority ownership of Telstra because they expect that the future value of the shareholding (from dividends and capital gains) may exceed the sale proceeds and any savings in payment of public debt.

2.7 Financial benefits (cont'd)

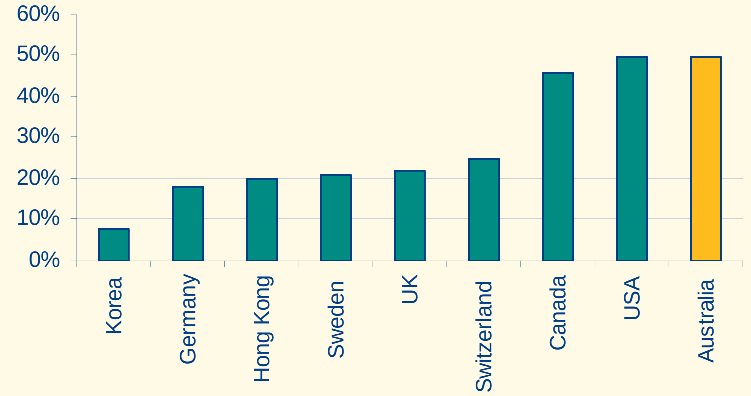
The sale price of the remaining Telstra shares will be based on continuous secondary market valuations that reflect investors' commercial assessments of the present value of the expected future cash flows from the company's operations. It is generally held that under full private ownership the scope for cost reductions and revenue gain from, inter alia, more efficient corporate strategy and operations, will mean that these expected future cash flows under full privatisation will be higher than under partial privatisation. In addition, rather than a single point estimate of expected future cash flows, adopted by the Government as a single shareholder, the market will demonstrate a range of expectations (and hence values), and it is the upper portion of this range that will determine the market valuation.

Some commentators have suggested that the present value of the company under Government ownership should be assessed at a low discount rate to reflect the relative cost of Commonwealth borrowing, but the proper commercial assessment of the present value requires the use of a discount rate related to the risk profile of the entity generating the cash flow - in this case the company. While that may be marginally higher under full privatisation, this is unlikely to materially offset the expectations of higher cash flows under private ownership.

2.8 Wider share ownership

The previous Telstra share offers have had a significant impact on the level of shareholding in the Australian community. Recent ASX data shows that Australia now has 50% of the adult population owning shares directly (shares in a company listed on the stock exchange, listed property trust, derivatives or listed interest rate securities) or indirectly (managed fund, personal superannuation fund) shares. This ranks as the highest level of retail share ownership in the world, alongside the US and significantly above the UK.

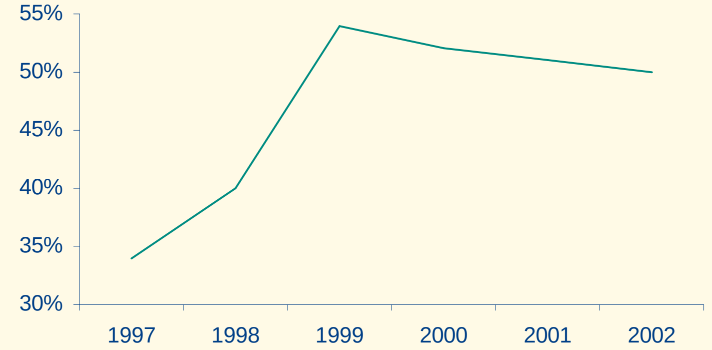
Level of retail share ownership in Australia



Source **ASX International Share Ownership Survey (2002)**

The level of share ownership in Australia increased significantly since T1, when 1.88m retail investors applied for shares, 560,000 of them buying shares for the first time. In 1999 share ownership in Australia peaked, with 54% of the adult population owning shares (directly or indirectly). This followed the Telstra 2 share offer, where 1.66m retail investors applied for shares, 400,000 of them first time shareholders.

Share ownership levels in Australia since 1997



Source **ASX International Share Ownership Survey (2002)**

2.8 Wider share ownership (cont'd)

Key observations and benefits of the rising incidence of share ownership across all strata of Australian society are:

- **Increasing share ownership represents delayed consumption**. Increasing household investment in shares (both direct and indirect) represents increased "savings" for future consumption, including retirement
- **Increasing share ownership is proportionately higher for lower income groups, older adults and is geographically diverse**. The increase in share ownership, and the associated long term increase to the wealth of shareowners, is increasingly widespread and not confined to the affluent or to metropolitan areas. Although relatively more middle and lower income households are becoming shareowners, it still remains that higher income households are more likely to own shares than lower income households, and metropolitan households are more likely to own shares than country/ regional households
- **Increasing awareness of the long term performance and flexibility of shares versus other asset classes**. Households are increasingly adding share investments to their other financial assets, such as term deposits, rental properties and listed trusts. Diversification of a household's investments will, in general, decrease the overall risk of the household's investment portfolio
- **Increasing ease of access to the share market and increasing financial awareness**. This has been the result of increased information leading to a more sophisticated and financially aware investing public, successful floats of well known Australian companies (like Telstra, Commonwealth Bank, Qantas and GIO), and a wider range of broking choices (e.g. online brokers and banks offering discount broking services)

A more financially astute public has many advantages for both the individuals and for society as a whole, derived from a better understanding of personal and social financial matters upon which to make informed decisions.

2.9 Fiscal arguments for privatisation

Several parties have suggested that the reduction in public debt that will flow from the sale proceeds will be seriously outweighed by the loss of dividends that the government currently receives from Telstra. They calculate this through a comparison of the net effect of the Government's foregone share of profits and its interest savings both discounted at the same rate.

The analysis used to reach this conclusion is fundamentally flawed. It looks at the benefit/cost of privatisation by comparing the present value of the Government's present share of Telstra's future net profit streams to the present value of interest savings using the same discount rate for each of these financial flows. Any investment/divestment decision can be examined from a risk and return perspective when considering present values. It is inappropriate to use the risk free rate in valuing Telstra.

There will, of course, be a range of estimates of that value. These will differ because different analysts (and academics) will have different views of the expected future cash flows, and different views about what the risk profile of the business implies for the discount rate. But these are merely different estimates of the same expected value. It is not appropriate to use the Commonwealth's cost of borrowing as the discount rate applicable under Government ownership.

Detailed in the table below is the weighted average cost of capital ("WACC") that various analysts are currently applying to Telstra. Their WACCs ranged between 8.6% and 10.5%, with an average of 9.4%. The risk free rate assumed in the analysts' WACCs range between 5.5% and 6.5%.

2.9 Fiscal arguments for privatisation (cont'd)

Broker	Risk free rate (%)	Market risk premium (%)	Target gearing ratio (%)	Beta	Cost of debt (%)	Cost of equity (%)	WACC
Deutsche Bank	6.25	6.00	17.50	0.80	7.79	11.05	10.07
SSB	5.75	5.00	20.00	1.16	7.25	11.55	8.90
JB Were	6.50	6.00	16.67	0.85	7.14	11.60	10.50
UBS	5.55	4.00	20.00	1.00	7.05	9.55	8.63
ABN AMRO	5.70	4.50	20.00	1.00	7.00	10.20	9.11
Average	5.95	5.1	18.83	0.96	7.25	10.79	9.44

Source **Broker reports**
Notes: 1 Beta represents levered beta at the target gearing ratio

- The theory that the party that has most control over risk should be the owner of an asset implies that this party would have an incentive to minimise the risk the asset is subject to, thus maximising its value. In this case, it implies that the Government might deliberately set a regulatory regime that will maximise the value of Telstra by limiting the scope for competition in the market. This theory highlights the potential conflict between the Government's regulatory role and the Government being the owner of regulated entities. The Government has, however, made it clear that it will not compromise regulatory policy in the interests of preserving its ownership value
- The argument, if valid, would also imply that the Government should own the other entities in the telecommunications sector. To do otherwise would create an uneven playing field, not consistent with the principles of competitive neutrality. Extending this logic beyond the telecommunications sector, the argument equally implies that in other sectors where the Government has a substantial regulatory role, it should also own the entities that are subject to the regulation. This would mean that, if accepted, the Government should own the banking and insurance sectors and should repurchase the airport sector, amongst other examples

An appropriate methodology involves a comprehensive evaluation and comparison of the full range of cashflows for Government where Telstra is partly privatised (current ownership structure) and fully privatised.

3. Effect of Full Sale on Regulation

3. Effect of Full Sale on Regulation

3.1 Introduction

The combination of (i) full privatisation, (ii) a rigorous and transparent regulatory regime, and (iii) a competitive market place will provide maximum benefits to Australia and its citizens. Australia has the latter two elements: a leading regulatory regime and a highly competitive market by world standards. But lacks the final element; Telstra is only partly privatised.

The effectiveness of regulation will be enhanced by the full privatisation of Telstra for the benefit of consumers, business and the economy in general. They will also be enhanced by the specific legislative changes proposed in the Telstra (Transition to Full Private Ownership) Bill 2003.

Australia has in place a comprehensive legislative framework for the telecommunications sector. It aims to ensure that (i) so far as reasonable, the entire community obtains the highest practicable standard of telecommunications services, and (ii) there is a high level of competition in the sector. The policy framework includes limbs specific to the telecommunications sector with the Australian Communications Authority ("ACA"), the Telecommunications Act 1997 and the Telstra Corporation Act 1991, and operates together with the Trade Practices Act 1974 and the Australian Competition and Consumer Commission ("ACCC").

Key aspects of the policy framework include the following:

- **Ownership**. In order to retain Telstra as an independent Australian entity, there are provisions that restrict total foreign ownership to an aggregate of 35% of issued capital, with no individual foreign entity permitted to hold greater than 5% of issued capital. There are requirements that Telstra's head office, place of incorporation and base of operations are to be in Australia. In addition the Chair and the majority of the Board must be Australian citizens. Furthermore, there is a requirement for at least two of Telstra's directors to have knowledge of, or experience in, the communications needs of regional, rural and remote areas of Australia.
- **Competition and Access**. The ACCC has powers to address any anti-competitive conduct and to require operators to provide access to the network to competitors on reasonable terms and conditions. In addition, there are a number of pro-competition measures that have been pursued, including addressing pre-selection issues and number portability requirements.
- **Consumer Protection, including in regional, rural and remote Australia**. The Universal Service Obligation ("USO") aims to ensure that virtually all people in Australia, wherever they live or work, will continue to have reasonable and equitable access to the standard telephone service and payphones. Telstra has been designated as the national universal service provider and will continue to have lead responsibility to meet the service provision requirements under the USO.

  The customer service guarantee scheme ("CSG"), which commenced in January 1998, provides for financial compensation to customers where the performance requirements set out in the standard developed by the ACA are not met. Not only will customers receive rebates for deficient service, but the ACA will require the service provider to take remedial action to correct any systemic problems in meeting these standards.

  Initiatives such as the Network Reliability Framework ("NRF") will help ensure that areas of greatest need are targeted for improvement.

  Furthermore, the proposed privatisation Bill will increase Telstra's legal responsibility to provide telecommunications services to people living in regional/rural and remote areas of Australia.
- **Price Control, including in regional, rural and remote Australia**. For certain Telstra services there is a price cap regime in place under the provisions of the Telstra Corporation Act. This price cap regime passes onto customers substantial real reductions in prices over time on the core services.

  There are also two specific pricing measures to protect regional, rural and remote customers. These are the Local Call Price Parity Measure and the Rebate Scheme for Remote Customers.

These regulations have been augmented in the proposed legislation by requiring Telstra to maintain a local presence in regional, rural and remote parts of Australia, empowering the Minister of Communications, Information Technology and the Arts or the Australian Communications Authority ("ACA"), to make decisions of an administrative nature and the advent of the Regional Telecommunications Independent Review Committee ("RTIRC"). These regulatory elements focus on the regional, rural and remote communities to give them additional protections. Beyond this legislation, in future, the government can also provide transparent and direct assistance to particular groups. This is arguably more socially and economically efficient than causing cross-subsidies to exist within a competitive entity like Telstra.

3. Effect of Full Sale on Regulation

3.1 Introduction (cont'd)

Improved competition and regulation will assist in ensuring that, on the whole, better products and services are provided to consumer at better prices nationwide. Regulation will continue to evolve as required to protect consumers and promote competition. But ultimately, it is competition and general competition regulation, not Telstra specific regulation, which will be most efficient and effective in attaining consumer protections, fostering higher levels of competition and investment into the industry.

3.2 Is regulation without ownership possible?

Clearly, other sectors of the economy are effectively regulated without Government ownership. In fact, it is arguable that one can regulate more effectively by not having, and not being perceived to have, any conflict of interest which may arise through ownership.

Full privatisation will eliminate any actual or perceived conflict in the roles of the Commonwealth, for example, by:

- Removing any potential conflict of interest between being the regulator (determining the approach to access, competition and regulated prices), while being the owner of Telstra (and as a potential vendor of its stake in Telstra seeking to achieve the maximum sale price achievable)
- Sending an unambiguous message to industry participant, consumers and international investors into Australia that there is a separation between (i) Government and social policy, and (ii) Commonwealth ownership of the largest company in the sector. This is important for domestic and international credibility

3.3 Protection of consumer and fostering competition

The evidence from overseas experience, in particular that of British Telecom (discussed in Section 2), suggests that full privatisation provides a range of benefits in terms of lower prices, improved service and reliability, expanded customer choice and a wide range of new services. These improvements in product service quality and customer choice have been accompanied by improved financial performance.

Relying on specific regulation to protect consumers, such as retail price controls, can be harmful to competition (and therefore consumers) in the long run by artificially forcing down retail prices, when competition can achieve this more efficiently and effectively. The competitors who most effectively compete, gain benefits of winning customers as they drive down retail prices. Retail price regulation tends to result in consumers remaining with Telstra. Eventually, for long term maximisation of consumer benefits, competition is needed and is more likely to provide these benefits than, for example, government imposed price setting. The full privatisation will also greatly reduce the risk that future governments (e.g. by specific directive) will restrict Telstra's ability to compete rationally and freely under general competition laws.

3.4 Investment in the industry

In addition to specific substance of regulation, the lack of predicability of the regulatory regime is one of the most serious impediments to investment. Removing the overhang of government ownership in Telstra and the improved perception that the Government's regulatory policy is objective, will likely improve the investment climate for telecommunications in Australia. Ultimately, through competition, Australia needs to let consumer demand (what consumers are willing to pay for) determine investment. Full privatisation will assist this, and will certainly not hamper it. There does not appear to be a lack of investment in the UK. e.g. BT's current initiative on massively increasing broadband penetration.

Another advantage of full privatisation is removing the perception of preferential support of Telstra amongst investors and Telstra's competitors. An example is that Telstra arguably enjoys a lower cost of debt capital as ratings agencies take comfort from the Commonwealth being a major shareholder and presumably, less likely to accept Telstra becoming bankrupt. A recent example was the French Government's participation in the France Telecom recapitalisation. On the other hand, Telstra can not optimise its capital structure (e.g. by borrowing more) due to its inability to raise equity capital thus raising its overall cost of debt. These distortions would be removed when considering investment decisions with a fully privatised Telstra.

4. Implementation

4. Implementation

4.1 Introduction

The Commonwealth's objective of maximising sale proceeds can be met through offer structure features that take into account the inter-relationship that exists between:

- Issue size
- Size and source of investor demand
- Structural components of the transaction
- Their respective and combined implications for the issue price

In order to maximise demand at the time of the offer, and hence proceeds, the Commonwealth should maintain maximum flexibility when it comes to the structure of the offer and the markets in which it may offer the securities. Each of the above factors are inter-related and also potentially affect the achievable issue price. They therefore cannot be fully considered in isolation. For example, a larger issue size may to lead to a lower issue price unless incremental demand is stimulated by the larger issue size (e.g. due to higher indexation and the removal of the perceived overhang) and/or by additional structural components such as the inclusion of a hybrid security or a buyback as part of the offer.

4.2 Offer structure

Given the potential size of an offering and the inherent uncertainty of making demand estimates for any market offering at an undetermined time in the future, it is prudent for the Commonwealth to explore the extent to which it is possible to maximise demand. Introducing additional structural components to the transaction should access additional incremental, non-traditional sources of demand. These components could include the use of hybrid instruments, which can have the benefit of:

- Reducing the size of the main equity offering, increasing price tension
- Providing offer flexibility through being able to vary tranche size, timing and pricing
- Creating the potential to sell shares at a premium to current market
- Accessing capital markets not available in an offer of ordinary shares or instalment receipts
- Enabling a sell down to be initiated in one major step

Delivery of these benefits comes through being able to access capital unavailable for the main offer. Investors who would not acquire ordinary shares often buy hybrid securities, making available new sources of demand. An appropriately structured and sized hybrid can access these new markets without cannibalising demand for the ordinary shares. This capital principally comes from specialist convertible funds, fixed income funds, hedge funds and, to a limited extent, incremental retail demand.

4.3 Issuance of hybrid securities under the Bill

The legislation under which the previous Telstra sell-downs were conducted contained restrictions on how the sale could be structured. In order to provide the Commonwealth with maximum flexibility to implement offer features to maximise proceeds, provisions to enable the use of hybrid instruments should be made.

Over the past three years, the Australian and New Zealand hybrid market has undergone dramatic growth and development. At a time when equity markets were volatile and uncertain, the hybrid market provided both issuers and investors a flexible and more certain alternative. Hybrid securities rose in popularity for issuers as share price slumps and falling earnings resulted in an increased cost of pure equity and reduced issuer credit quality.

At the same time, there were abundant buyers of hybrids, mainly from fixed income accounts and the retail sector, looking for capital stable investments with a high yield in a falling interest rate environment. Retail investors in particular, responded to falling equities markets by switching into cash and actively investing in new products, particularly within the hybrid market.

Hybrids have three key attractions for retail investors:

- High degree of capital protection
- Relative certainty of income
- Some potential for equity upside

4. Implementation

4.3 Issuance of hybrid securities under the Bill (cont'd)

The retail hybrid market in Australia is amongst the most sophisticated in the world. Retail investors have been investing in hybrids for a number of years, with both the appetite and level of issuance increasing significantly over time. This is highlighted by the retail take up in recent Australian hybrid issuance.

Selection of Australian hybrid issues (2001 to date)

Issuer	Issue Size (m)	Issue Date	Maturity / Reset Date	Company Rating	Credit Rating	Est. Insto	Est. Retail	Amt Insto	Amt Retail
St George Bank (PRYMES)	300	22-Feb-01	21-Feb-06	A	BBB	55%	45%	165	135
Santos	350	5-Dec-01	3-Sep-06	BBB+	BBB-	50%	50%	175	175
Fairfax (PRESSES)	250	12-Dec-01	12-Dec-06	BBB+	BBB-	65%	35%	163	88
Computershare	75	18-Dec-01	30-Nov-06	N/A	N/A	55%	45%	41	34
IAG (RPS)	350	4-Jun-02	15-Jun-07	AA+	A	60%	40%	210	140
David Jones	65	2-Jul-02	1-Aug-07	N/A	N/A	40%	60%	26	39
Seven (TELYS)	189	18-Oct-02	30-Nov-07	N/A	N/A	30%	70%	57	132
AMP	1,150	24-Oct-02	24-Oct-07	BBB+	BB+	65%	35%	748	403
Adelaide Bank	100	27-Nov-02	30-Jul-07	BBB	N/A	10%	90%	10	90
Transurban	430	14-Apr-03	14-Apr-07	A-	BBB	65%	35%	280	151
Seven (TELYS2)	135	15-May-03	30-Nov-08	N/A	N/A	35%	65%	47	88

Source **ABN AMRO Rothschild, IRESS, company reports**

4.3.1 Flexibility essential

The Bill defines a "sale-scheme hybrid security" broadly and enables such a security, if issued, to be issued in any jurisdiction and in any denomination. This ensures that the Commonwealth has the flexibility to structure any future sell downs of Telstra in the most appropriate way given the sale objectives at the time. It is important to note that any issue of a hybrid security would be made in accordance with the Corporations Act, the Australian Stock Exchange's Listing Rules and the securities laws of any relevant foreign jurisdictions.

4.3.2 Suggested amendments to Bill

In consultation with the law firm, Freehills, we propose some changes to the Bill. The proposed changes are mostly by way of clarification and removing potential ambiguity.

4.3.2.1 Proposed section 8AJ(4)(l)(ii)

We recommend the deletion of sub-paragraph (ii) of new paragraph (l) of section 8AJ(4). It would be preferable if sub-paragraph (ii) were deleted as its inclusion makes it potentially unclear as to whether the issue of hybrids by a wholly owned Commonwealth company will only qualify as a Telstra sale scheme (so the facilitative provisions eg. section 8AQ apply etc) where the Commonwealth also transfers Telstra shares to the company. For example, the provisions need to cover a situation whereby the hybrid is issued by a wholly owned Commonwealth company but that the company only has an option over the shares to support its exchange obligations rather than the shares being delivered to the company.

However, even though the position is not entirely clear we assume that the fact that the definition of "hybrid-security issuer company" comes up in sub-paragraph (i) does not prevent the definition applying if there is no transfer per sub-paragraph (ii). If it did prevent the definition from applying, then the guarantee provision in paragraph (m), as well as the various provisions elsewhere to the effect that such a company counts as the Commonwealth for various purposes, would not apply unless there was a transfer of shares to the company, which would seem rather limiting.

4.3.2.1 Proposed section 8AYA(4)

We recommend that this subsection be amended by adding words to the effect that the 30 day notice period may be waived or shortened by the Commonwealth in its absolute discretion.

It is possible that Telstra may take the view that they would need to announce any notice given under this section. With the Commonwealth's permission, this could be shortened so as to enable Telstra to "hit the market" immediately post announcement, rather than giving the market 30 days warning as trading "cum" rights issue for a lengthy period can depress the share price. This would not be a problem in terms of Telstra having private discussions with the Commonwealth before reaching a decision to proceed (as those could be had before the notice is given).

Appendix

I. Levels of Government ownership of international carriers

Appendix 1

Fully privatised carriers

Country	Carrier
Argentina	Telefonica de Argentina, Telecom Argentina
Chile	CTC, ENTel (International)
Denmark	TDC
Hong Kong	Hong Kong Telecom (PCCW)
Hungary	Matav
Ireland	eircom
Italy	Telecom Italia
Japan	KDD (International)
Korea	Korea Telecom
Mexico	Telex
New Zealand	TCNZ
Peru	Telefonica de Peru
Philippines	PLDT
Portugal	Portugal Telecom (1)
Spain	Telefonica
South Korea	Korea Telecom
UK	BT

Source **ABN AMRO Rothschild, OECD Communications Outlook 2003**

Partially privatised carriers (>50%)

Country	Carrier	% Privatised
Germany	Deutsche Telekom	69
Greece	OTE	66.2
India	VSNL (International)	73.9
Indonesia	PT Indosat (International)	77
Japan	NTT	54.1
Malaysia	Telkom Malaysia	79
Netherlands	KPN	80.6
Poland	Telekomunikacja Polska	77.4
South Africa	Telkom	60.7
Venezuela	CANTV	93.4

Source **ABN AMRO Rothschild, OECD Communications Outlook 2003**

Partially privatised carriers (<50%)

Country	Carrier	% Privatised
Belgium	Belgacom	50 – 1 share
Czech Republic	Cesky Telecom	48.9
Finland	Sonera	46.9
France	France Telecom (2)	41.1
Iceland	Iceland Telecom	5
India	MTNL (Domestic)	43.8
Indonesia	PT Telkom (Domestic)	45.7
Israel	Bezeq	48.5
Norway	Telenor	22.3
Pakistan	PTCL	12
Singapore	Singapore Telecom	[23%]
Sweden	Telia	29.4
Switzerland	Swisscom	37.3

(1) 1.8% owned by government institutions
(2) Buyout of Orange minorities will increase figure to 46%

Source **ABN AMRO Rothschild, OECD Communications Outlook 2003**