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Telstra: privatisation, renationalisation or restructuring ?

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Summary

This submission is organised as follows. Section 1 deals with fiscal arguments for privatisation, and shows that the sale of the public equity share in Telstra at current and likely future prices would substantially reduce the net worth of the public sector. Section 2 deals with other arguments for privatisation and shows how the case for privatisation that was built up in the 1980s and 1990s has been invalidated by events. Section 3 deals with alternatives to privatisation and argues that the appropriate policy involves divestiture of peripheral assets and renationalisation of the core business, ending the unsustainable policy of partial privatisation.

Telstra: privatisation, renationalisation or restructuring

Proposals for the privatisation of Telstra have been publicly debated in Australia since the publication in 1992 of the *Fightback!* package, which advocated the sale of Telstra, and a range of other public assets, for a total return of $20 billion. Even allowing for subsequent inflation and interest savings the implementation of such a proposals would have been a fiscal disaster for the Australian public, implying a loss of at least $20 billion. It will be shown in this submission that similarly large losses can be expected if Telstra is fully privatised as proposed in the *Telstra (Transition to Full Private Ownership) Bill 2003.*

Equally significantly, a review of the debate reveals that most of the arguments put forward in the 1990s have been discredited or substantially weakened by further analysis and by empirical experience of the operations of privatised enterprises in partially deregulated markets. A string of technical and financial failures have undermined the simplistic assumption of private sector superiority.

1. Fiscal impacts of privatisation

Although a number of arguments for privatisation have been put forward the central claim has usually been that privatisation improves the financial position of governments. To assess this claim it is necessary to compare the sale price (less any costs of sale) with value of the asset in continued public ownership. Equivalently, the value of the flow of earnings under continued public ownership may be compared with the interest savings obtained when privatisation proceeds are used to repay public debt.

The appropriate valuation procedure for a publicly-owned asset such as Telstra is based on the saving in public debt interest represented by the flow of profits of the enterprise. The asset value is equal to the present value of the flow of post-tax real profits discounted at the real rate of return on public debt. That is, the valuation is given by the amount of debt that could be sustainably serviced on the basis of the flow of profits of the enterprise.

A number of misconceptions need to be clarified here. The first is the idea, implied by the treatment of asset sales as negative outlays in the Budget papers, that the proceeds of the sale of assets such as Telstra are equivalent to revenue raised from taxation. In fact, asset sales involve the loss of a stream of future income, and the proceeds should not be treated as current income. The present Treasurer correctly criticised the previous government for using asset sales to conceal Budget deficits and has announced an intention to focus on the underlying Budget deficit, which excludes the proceeds of asset sales and repayments of State and government business enterprise debt. Thus, it is the inappropriateness of treating the proceeds of asset sales as revenue has been clearly recognised. Unfortunately, the issue has been muddied by the announcement of an environmental spending package of $1 billion, contingent on the partial sale of Telstra. Since the sale or retention of Telstra will have no effect on the underlying Budget deficit, the question of whether the proposed environmental package is desirable and affordable is independent of the sale of Telstra

Next, many analysts focus attention on the flow of dividends remitted to the Budget sector, rather than on the flow of profits. That is, these analysts disregard retained earnings reinvested in the enterprise. This is an error in the evaluation of either a private or a public enterprise. A basic result in the theory of finance is the Modigliani–Miller theorem which states that dividend policy is irrelevant to the value of an enterprise. This result is true for both private and public enterprises. (In considering a future stream of earnings, it is necessary to take account of the opportunity cost of profits that are reinvested in the enterprise. A useful measure that is more robust than dividends is that of free cash flow. To avoid problems associated with the evaluation of retained earnings, this submission will employ the conservative procedure of disregarding the potential for increased profits derived from reinvested earnings and instead assuming that earnings are stable over time.)

Finally, it is frequently assumed that the value of an enterprise in government ownership must be equal to its value in private ownership. This is not true for two main reasons. First, there is the issue of regulatory risk discussed above. This reduces the value of an asset such as Telstra to private owners, but not to the public. Second, there is the problem of the ‘equity premium’. There is a large divergence between the rate of return demanded by private equity holders and the real rate of return on public debt or good quality private debt. This divergence cannot be explained as a pure risk premium, at least on the basis of standard life-cycle consumption models, and hence has become known as the ‘equity premium puzzle’. The equity premium puzzle may be explained by the observation that capital markets do not work costlessly or perfectly efficiently. In particular, it is not possible to take out insurance against losses incurred as a result of recession. Hence the premium required for bearing systematic risk is substantial, whereas, under perfect capital markets, it would be negligible.

The analysis above has been developed in more detail in joint work with Professor Simon Grant and has been published in leading international peer-reviewed economics journals, including the *American Economic Review* and *Economica.*

Dividend imputation

The imposition of company tax on government business enterprises such as Telstra was justified on the basis of competitive neutrality. In fact, however, privately owned companies receive the benefits of dividend imputation. Under a fully neutral system, the Commonwealth would include notional imputation credits in the evaluation of the flow of dividends received from Telstra, and make a corresponding offset against company tax revenue.

As long as Telstra was wholly owned by the public adjustments of this kind were a matter of accounting convenience, with no direct economic impact. However, when privatisation is considered, it is necessary to take account of the tax benefits of dividend imputation flowing from the Commonwealth to the purchasers of Telstra shares. Since privatisation, Telstra has adopted a policy of paying out 60 per cent of earnings as fully franked dividends, a policy which is rational from the viewpoint of private shareholders.

Real and nominal interest rates

Over the last hundred years, real interest rates in developed countries have averaged around 1 per cent. However, it seems likely that this low real rate is due in part to unanticipated inflation and that the equilibrium value of the real interest rate is between 3 and 4 per cent. If it is assumed that the likely rate of inflation over the next ten years is around 2 per cent, the prevailing 10-year bond rate of 6 per cent implies a real interest rate of 4 per cent. The use of the nominal rate of interest to discount cash flows equal to Telstra's current profit is equivalent to an assumption that Telstra's earnings will remain stable in nominal terms. The use of the nominal rate of interest to discount cash flows equal to Telstra's current profit is equivalent to an assumption that Telstra's earnings will remain stable in nominal terms.

Fiscal costs and benefits of past and proposed privatisation of Telstra

Following the passage of the *Telstra (Dilution of Public Ownership) Act* 1996, one third of the public shareholding in Telstra, One third of the government's shareholding, consisting of approximately 4.3 million shares, was sold at an average price of $3.40 yielding sale proceeds of $14 billion, all but $1 billion of which was used to repay debt. This privatisation was claimed as a success because strong demand for shares ensured a sale price at the upper end of the range of expectations, because purchasers of shares enjoyed strong capital gains reflecting the oversubscription of the share issue, and because the retirement of debt permitted interest savings of around $900 million per year.

From the viewpoint of taxpayers, however, the existence of capital gains for buyers was not an indication of success, any more than the shareholders of a private firm would regarded as successful the sale of an asset at a price which allowed buyers to make immediate profits on resale. The partial privatisation of Telstra exemplified the tendency for public assets to be sold for less than their market value, which in turn is usually less than the value of the stream of profits accruing to the public sector.

The fundamental question in evaluating the partial sale of Telstra is the comparison between the earnings foregone as a result if privatisation and the interest saving from the repayment of debt. A series of previous analyses have shown that, assessed on this basis, the first-stage privatisation of Telstra produced a substantial loss to the public, which has grown over time. The estimates of Telstra’s earnings growth and value in public ownership presented in my submission to the 1996 Senate inquiry (Appendix) have, if anything, proved conservative. The medium scenario used in that analysis projected post-tax profits of $2 billion per year (1996 values) from 2000 onwards.

In fact, post-tax profits have been close to $4 billion dollars, with the exception of an extraordinary loss of nearly $1 billion on Telstra's investment in the Asian telecommunications venture Reach. Clearly, an investment of this kind would not have been undertaken

The second-stage privatisation, conducted at a time when share prices for telecommunications enterprises were inflated by the technology bubble was roughly neutral in terms of its impact on the public fiscal position. However, a greatly superior outcome could have been obtained if Telstra's Internet assets had been sold off and the proceeds used to restore full public ownership of the core network. I advocated precisely this course of action in the Financial Review on 30 March 2000 (about two weeks before the bursting of the NASDAQ bubble, which concluded:

> Fortunately, the 'new economy' bubble, while it lasts, provides a

> solution to the dilemma [of partial privatisation]. Telstra's local, long-distance and mobile assets currently account for around half its market value. The other half is the 'new economy', including pay-TV and Big Pond. The incoherence of Telstra's recent management is due as much to the internal conflict associated with the combined roles of content carrier and content provider as it is to the mixture of public and private ownership.
>
> Splitting Telstra would not only make good commercial sense, but would provide a simple route to renationalisation. Private shareholders could be offered the choice of shares in the 'new Telstra' or repurchase at a price equal to the average received by the government in its two sell-offs. After disposing of any residual holding in 'new Telstra', full public ownership of the core telecommunications network could be restored without any net public outlay.
>
> A simultaneous decision to lower local call rates to 20 cents across the board would provide a payoff to the real owners of Telstra, the Australian public, while making it clear that 'old Telstra' would serve the national interest rather than its current objective of 'maximising shareholder value'.

Had this course of action been followed, the Australian public would have gained billions of dollars and avoided losses such as those incurred in the Reach fiasco.

Privatisation at current prices

The analysis may be presented both in terms of earnings per share, and in terms of the aggregate market value of Telstra

For the last couple of years, the combined value of post-tax earnings and imputation credits has been around 40 cents per share, enough to service $6.70 of debt at an interest rate of 6 per cent. That is, on the conservative assumption that Telstra's profits will remain stable in nominal terms, the value of shares in public ownership is $6.70. On the more reasonable assumption of stable real profits, the value of shares in public ownership is around $10.

Expressing the same points in terms of total value, the sum of post-tax earnings and dividend imputation credits for Telstra may be estimated at $5 billion per year. This implies an aggregate valuation of about $80 billion, using a 6 per cent discount rate or about $125 billion using a 4 per cent discount rate. The loss associated with selling the remaining shareholding at a price of $5 per is therefore between $10 billion and $30 billion.

The government has already recognised that, at current share prices, the proceeds from the sale of the public shareholding in Telstra would not be sufficient to justify forgoing the associated stream of earnings. The converse is true. At the current share price, the repurchase of the private minority shareholding would improve the public fiscal position.

2. Economic arguments for and against infrastructure privatisation

Until the 1980s, infrastructure systems such as telecommunications networks were publicly-owned, vertically integrated monopolies in most countries. The main exception was the United States, but even there, the combination of regulated monopolies, pricing based guaranteed rates of return and heavy reliance on bonds for financing produced outcomes very similar to those under public ownership.

There were two main reasons for public ownership of infrastructure. First, it was generally accepted that infrastructure networks constituted natural monopolies, in which services were most efficiently supplied by a single integrated enterprise. In such cases, regulation of prices was necessary. Although it was possible, as in the United States, to award the relevant monopoly rights to private or quasi-private firms, long experience with regulated monopolies of this kind suggested to most observers that this was a less satisfactory solution than public ownership. For services that are consumed broadly by the community as a whole, public ownership internalises the conflict that would otherwise arise between the interests of the regulated firm's owners, who benefit from higher prices, and those of consumers and voters, who benefit from lower prices.

In an infrastructure network, natural monopoly arises from a combination of efficiencies of scope, scale and density. The precise demarcation of these terms is not standardised, but the substantive sources of natural monopoly are well-understood. Efficiencies of scope arise when multiple services are provided over the same network (for example voice and data communications). Efficiencies of scale arise when the service area of the network is expanded (for example, when a number of local networks are integrated to form a national network). Efficiencies of density arise when the numbers served in a given area increase, either because more customers connect to the service or because competing suppliers merge.

The second major grounds for public ownership was the belief that adequate investment in infrastructure would only be undertaken by the public sector. This belief was based in part on observation of the combination of wasteful duplication with inadequate services to outlying areas that had arisen when competitive firms engaged in infrastructure investment, as in the case of 19th century. A second crucial factor was the fact that private equity investors demanded higher rates of return than did purchasers of government bonds. This 'equity premium' could not be accounted for by standard economic models, but appeared to reflect inadequacies in capital markets.

This equity premium problem was the basis of the key finding of the Royal Commission set up in 1948 by the conservative Playford government in South Australia to examine the performance of the privately-owned Adelaide Electric Supply Company

Over the period of the last 24 years [to 1948], the Company has paid in dividends and interest nearly 2 million pounds more than if the Treasury rate had been paid. Future capital costs at Treasury rates would result in reduced capital costs and lower charges.

On the basis of this and other findings of inadequate performance, Playford nationalised the industry. For the following fifty years, the Electricity Trust of South

Australia (ETSA) supplied electricity efficiently, met a range of social objectives and yielded returns greater than or equal to the cost of capital to the Treasury.

From the 1980s onwards, public ownership was replaced by privatisation in many countries. Although the political imperative for privatisation was frequently driven by the spurious fiscal benefits apparently generated by asset sales, there was also a newly developed economic case for privatisation, which rested on two main arguments. In essence, these arguments turned traditional views about natural monopoly and the public role in long-term capital investment on their heads.

The first argument was that technological changes had rendered the concept of natural monopoly obsolete. In the future, it was claimed, large-scale integrated infrastructure enterprises would be replaced by competitive markets dominated by small, nimble players employing the Internet to avoid the need for ownership of large-scale capital assets. In the electricity industry, the most prominent representatives of this trend were 'asset-light' energy trading firms such as Enron and Dynegy. In telecommunications, most attention was given to 'competitive local exchange carriers (CLECs)' such as PSINet in the United States, and OneTel in Australia. The 1996 Telecommunications Act was supposed to facilitate the rise of CLECs.

The corollary of this view was the claim that old-style telecommunications enterprises, such as Telstra, based on the ownership of local telecommunications networks, were doomed at best to stagnation and more probably to extinction. In 1998, for example, Communications Minister Alston asserted that "Telstra's best years may lie behind it".

The second argument for privatisation was based on the 'efficient capital markets hypothesis'. Drawing on the exaggerated respect for the wisdom of capital markets that developed during the 1980s and 1990s, advocates of the efficient capital markets hypothesis claimed that the best guide to decisions about investment in infrastructure (or any other industry for that matter) were the asset prices generated in markets for financial assets such as shares and bonds.

Experience since 1998 has refuted both elements of the case for privatisation. It has become clear that natural monopoly is more important than ever before. Entrants to the telecommunications and energy trading industries have gone bankrupt in large numbers, Incumbent local exchange carriers have retained dominance and are seeking mergers to generate economies of scale. In the United States, the failure of the 1996 reforms is generally acknowledged. On current trends, mergers between local exchange carriers (Baby Bells) and the return of these carriers to the long-distance market looks set to reverse the breakup of the old AT&T monopoly, which took place in the 1970s.

The failure of the efficient markets hypothesis has been even more dramatic, particularly in the telecommunications sector. It has become clear that, in deregulated financial markets, asset prices and the investment signals they generate bear little or no relation to any underlying economic reality. During the 'bubble economy' of 1996-2000, the value attributed by stockmarkets to Internet-based and telecommunications businesses rose to around 5 trillion US dollars. In most cases, the associated enterprises are now bankrupt or else have shares trading at less than 10 per cent of their bubble era valuations.

The losses associated with the collapse in sharemarket values are 'paper losses', representing transfers of wealth rather than losses to society as a whole, though this is little consolation for retired workers who have lost their life savings while insiders have sold their shares for massive profits. However, absurd asset valuations necessarily lead to absurd investment decisions. During the bubble from 1996 to 1999, investments in Internet businesses and telecommunications infrastructure amounted to between 500 billion and 1 trillion US dollars. Virtually all of the money invested in Internet business has been dissipated, as has the majority of the money invested in the construction of multiple optical fibre networks, each with massive overcapacity. On current estimates, less then 5 per cent of optical fibre laid down during the bubble era is currently in use. It is likely that 80 to 90 per cent of excess capacity will be rendered useless by technical obsolescence and lack of maintenance before demand rises to meet capacity.

Australia shared in this experience, most notably in the 'cable race' between Optus and Telstra from 1994 to 1997. The networks rolled out by the two carriers have approximately 90 per cent overlap, but serve only about half the country. The combination of wasteful duplication in some areas with inadequate service in others is typical of the outcome when infrastructure investment decisions are driven by the short-term focus of capital markets. Fortunately, and in part because Telstra's activities were constrained by public ownership, the loss of wealth in Australia (around 1 per cent of GDP) was small in comparison to that incurred in the United States and elsewhere.

The demonstrable failure of capital markets to generate sensible asset prices or investment decisions was accompanied by a series of revelations about the actual operations of capital market participants including corporate executives, stockbrokers, sharemarket analysts, accounting firms and bond rating agencies. These revelations showed that none of the main participants in financial markets was performing their role adequately and that some sectors of the market, such as the research undertaken by stockbroking firms were systematically corrupt. Although these phenomena were exacerbated by the bubble, to which they contributed, many reflected tendencies that had been evident since the financial market deregulation of the 1970s, and had been exposed previously during the 1990-91 recession, but had been disregarded during the boom of the 1990s.

Experience of privatisation has also validated the views expressed by the 1948 Royal Commission in South Australia and many other advocates of public ownership of key infrastructure assets. As is shown in more detail below, privatisation has rarely yielded returns sufficient to offset the loss to the public sector of the dividends and retained earnings received under public ownership.

Regulation and public ownership

With the empirical arguments for privatisation looking shaky, advocates of privatisation have fallen back on an argument about process, one that seems immune to any possibility of being refuted by evidence.

This is the argument that privatisation of monopolies or near-monopolies like Telstra is desirable because, under public ownership, the government faces a conflict of interest in its roles as regulator and owner. This argument is remarkable because its conclusion is diametrically opposed both to common sense, and to the economic theory of principal-agent relationships.

In common sense terms, the idea that governments should not own businesses they need to regulate closely makes about as much sense as the idea that you should not own your own home, because of the conflict between your roles as landlord and as tenant. This idea is as nonsensical it appears. It is only in separating ownership and use that the conflict is created.

Sound economic analysis is consistent with common sense. Much work has been done on whether relationships between enterprises, or between government and business, should be dealt with through integrated ownership or through contractual and regulatory mechanisms. The closer and more complex the relationship, the stronger the case for ownership as a control mechanism.

In the case of monopolies (and near-monopolies like Telstra) the most important single regulatory decisions relate to prices charged to consumers or for third-party access. With privately owned monopolies, there is an inherent conflict here. If the price is set too high, consumers will suffer. If they are too low, investment will be inadequate. As regulator, the government has a conflict of interest. On the one hand, regulation is supposed to set efficient prices. On the other hand, as representatives of consumers, governments have an incentive to fix prices at inefficiently low levels.

Public ownership ‘internalises the externality’ and balances the incentives facing governments. If prices are set below the socially efficient level, the benefit to consumers is offset by a loss in revenue. The converse is true if prices are set too high.

There is an inevitable conflict between the interests of producers and those of consumers (there are also, of course, important common interests). Where the number of producers and consumers is large, this conflict is resolved through competition in the market. But the fundamental institution for resolving social conflicts is democratic government.

International trends

During the 1990s, there was a worldwide trend towards privatisation of telecommunications and other infrastructure services. The Communications Minister, Senator Alston commented, with some exaggeration, that the only country not going down the path of privatisation was North Korea. In Australia, both Labor and Liberal governments implemented privatisation policies, and there seemed little likelihood of a continued role for public ownership of infrastructure assets.

In the last five years, however, the trend towards privatisation has slowed, and in some cases, been reversed. Proposals for the privatisation of the electricity industry have been rejected in most Australian states. (This is partly due to the realisation, by both governments and potential buyers, that the higher-than-expected sale prices realised in Victoria were the result of miscalculation by buyers rather than an indication that the assets were worth more in public ownership. Most of the Victorian assets have been resold, frequently at a loss.) At the Commonwealth level, proposals for privatisation of Australia Post and Medibank Private, widely discussed in the 1990s, appear to have been abandoned.

Internationally, the trend towards privatisation has been slowed or halted in the United Kingdom and New Zealand, the two countries that led the trend towards privatisation in the 1980s and 1990s. In New Zealand, accident compensation has been renationalised, as has the main airline, Air New Zealand, and a new publicly-owned bank has been established. Negotiations are now under way for the repurchase of the privatised rail network. The rail network in the United Kingdom has also been effectively renationalised, and the Blair government has largely abandoned privatisation in favour of public-private partnerships.

Even in the United States, repeated failures in the privatised electricity industry have strengthened support for public ownership. In response to the failure of the privately-operated airport security system to prevent the September 11 attacks, the Bush Administration took over this activity, setting up a new Federal agency for the purpose.

In summary, in the 1990s, proposals for the privatisation of Telstra seemed to be riding an irresistible wave. Now the proposal for full privatisation appears as the last gasp of a movement that has run out of steam.

3. Alternatives to privatisation

Telstra’s current ownership structure is unsustainable. The persistence of a mixture of public and private ownership is undesirable in itself. In addition, it has led to a situation in which activities which ought to be undertaken by the public sector are being undertaken by an enterprise with fiduciary obligations to private shareholders while activities from which governments should be excluded are being undertaken by an enterprise with a majority public shareholding.

In general terms the appropriate solution is clear. Telstra should be split, with its ‘core’ activities being returned to full public ownership, while ‘peripheral’ activities are fully privatised. It is apparent that the core must include the local telecommunications network, and that the set of peripheral activities to be privatised must include Telstra’s Australian and domestic media ventures. The question of where the line is to be drawn is more complex, and will be addressed in the remainder of this submission.

Structural separation

The public policy case for structural separation

Telstra is unique among telecommunications enterprises worldwide in the range of services in which it holds a dominant or market-leading position. Telstra maintains dominance in all the areas where its predecessor enterprises, Telecom Australia and OTC were formerly statutory monopolies, including not only local, long-distance and international phone services but also related activities such as the telephone directory business. In addition, as would be expected given its history, Telstra is the dominant provider mobile telephony.

In relation to the Internet, Telstra not only provides the connection services (phone lines or cable connections) for the vast majority of subscribers, but is also the biggest single Internet Service Provider (ISP), providing such services as web hosting, email accounts and Domain Name Service (DNS). Through its Foxtel partnership, Telstra also dominates pay-TV services.

Taken together, Telstra's range of activities is unparalleled. To assemble a comparable span of market dominance in the United States, it would be necessary to merge not only the 'Baby Bell' local telephone companies and the dominant long-distance enterprise AT&T but the major cable companies and AOL Time Warner, which is the dominant ISP and a significant producer of media content. Of course, no such merger would be permitted in the United States on grounds both of competition policy and concern over the implications for public debate of the creation of such a media colossus.

Yet, as has been noted, it is inevitable under current regulatory structures that the pay-TV business will be integrated with free-to-air TV. Neither cross-media ownership laws nor, it appears, competition policy would prohibit the previously mooted purchase of Channel 9. And there is no reason to suppose that cross-media ownership laws will remain unchanged indefinitely. Relaxation of those laws would make Telstra the leading candidate to purchase any radio or newspaper networks that came on the market.

The anti-competitive implications of Telstra's unparalleled horizontal and vertical integration have been noted on many occasions, both by its competitors and by independent commentators. Given dominance in a wide range of connected markets, it is almost impossible to prevent abuses of market power.

The greater dangers associated with Telstra's dominance of so many communications markets have been obscured by the weak and ineffectual governance inevitably associated with an unstable mixture of public and private ownership, and the continuous scrutiny associated with the ongoing privatisation debate.

A resolution of the privatisation debate which preserved Telstra's current structure intact would quickly be revealed to have created a monster, whether the outcome was full privatisation or, less probably, renationalisation. Concern has long been expressed in Australia about the political power of media magnates such as Kerry Packer and Rupert Murdoch, especially when viewed in combination with the broad range of non-media business interests held by these magnates. Yet the power of Consolidated Press or News Limited would pale into insignificance when compared with that of a fully privatised Telstra. And of course, given the complex business relationships already in place, there is no reason why individual magnates such as Packer or Murdoch should not be able to obtain effective dominance of a privatised Telstra.

The implications of full renationalisation would be equally disturbing. As has already been noted, under its corporatised structure, Telstra is subject to none of the checks and balances imposed on the ABC. Under full renationalisation, Australia would have a higher degree of direct political control over the content of communications, and particularly the Internet, than any other democratic country.

The business case for structural separation

The uniqueness of Telstra's structure is not solely the result of constraints imposed in other countries as a result of public policy concerns. 'Conglomerate' enterprises like Telstra have generally performed poorly in the long term, although they have invariably been popular in periods of manic speculation such as the telecommunications and Internet ‘bubble’ of the late 1990s. In these periods, rising asset prices have produced automatic gains to those willing to buy assets of any kind. A range of spurious rationales has been manufactured in every such period.

The poor performance of investments driven by a supposed need for expansion is most evident in relation to Telstra’s Asian investments. These include a number of joint ventures focused on Hong Kong. It was grossly improper for a company majority-owned by the Australia public to engage in speculative foreign investments of this kind. Some consolation might have been yielded if the speculation had proved profitable but, as is usually the case, it did not. However, it is clear from the complaints of Telstra’s management at the time about the constraints imposed by public ownership, and from the greater disasters suffered by fully privatised firms, that public ownership served to limit the waste of Australian resources during the bubble period.

The case for preserving Telstra’s current structure

Having observed that there is a strong case for structural separation, it is of interest to examine the case for maintaining the current structure. In particular, it might be expected that successive governments, in adopting the policies that led to the current structure, would have assessed its advantages and disadvantages. In fact, however, the current outcome has arisen through a combination of accidents, inattention, short-term political imperatives and mistaken beliefs about the telecommunications market.

The original decision to merge Telecom Australia and the Australian Overseas Telecommunications Corporation into a single enterprise, Telstra, was the product of a complex compromise within the Labor Cabinet, rather than being the product of a reasoned analysis. Although, as will be argued below, it is not sensible to unwind this merger now, it is clear that the Cabinet overestimated the strength of the competition Telstra would face, and that this overestimation has been a persistent feature of telecommunications policy.

Telstra's dominance of the market for cable-based Internet and pay-TV services was similarly the accidental product of an ideologically-based unwillingness to intervene to produce sensible outcomes, even when the actions of the main players, Telstra and Optus, were clearly driven more by strategic and regulatory considerations than by any attention to market imperatives. Policymakers assumed that a laissez-faire approach would give rise to a situation where Telstra and Optus each had local cable monopolies, between them covering most of urban Australia, and with only modest overlap.

Instead, overlap was nearly 90 per cent, and the rollout ceased with the move to 'full competition' in 1997 leaving only about half the country with access to the network. Given Telstra's dominance in other areas of the market, it naturally emerged as the dominant provider, with Optus falling into its familiar position as follower.

Telstra's emergence as a dominant provider of Internet Services, and the disappearance of most of the independent firms that initially provided these services, was similarly the product of inattention. No consideration was given as to the desirability or otherwise of requiring a separation between content and carriage.

Throughout this process, governments and their advisers persistently underestimated Telstra's strength and overestimated the competition faced by Telstra. It is now apparent that most of Telstra's competitors based their business models either on the over-optimism of the late 1990s, or on 'regulatory arbitrage'. Examples of regulatory arbitrage include exploitation of advantages provided by the regulatory system to buy Telstra's services and resell them at a profit and 'Stackelberg follower' policies involving prices that are sufficiently below Telstra's to attract a modest market share, but not low enough to provoke a vigorous competitive response. Those in the former category, most notably, OneTel, have already failed. Those in the latter category are unlikely, by their nature, to pose a threat to Telstra's continued market dominance.

Although Telstra's managers, not surprisingly, favor preservation of an integrated structure, their delicate political position makes it difficult for them to engage in open public debate on the topic. As a result, the most coherent case for preservation of Telstra's structure is that put forward by the Communications, Electrical and Plumbing Union.

Telstra's optimal structure

The local telephone network

Despite claims to the contrary, the local telephone network is a natural monopoly and is likely to remain so for the foreseeable future, barring a drastic decline in the cost of mobile telephony, the main competing technology. It is increasingly evident that attempts to manage privatised natural monopolies through regulation are untenable in the long term. In the short run, evidence from the period prior to privatisation can be used as a basis for incentive-based regulation. In the long run, however, regulation of a monopoly business is inevitably based on cost plus rate of return.

Under private ownership, there is an inherent conflict between the interests of the regulated enterprise, which benefits from higher prices, and the interests of the public, which benefits from lower prices. If prices are set too low, the regulated firm can respond by cutting investment. However, in the context of a regulatory game, the firm has the incentive to threaten such cuts, even if the regulated price is in fact consistent with a market return to efficient investments. Hence, resources will be dissipated both in lobbying and in inefficient investment decisions designed to secure regulatory advantages. All of these processes are already evident in Victoria where privatised firms are seeking to renegotiate the rules under which they acquired assets in the electricity and public transport industries.

The same conflicts are potentially present under public ownership, but they are internalised by virtue of the fact that owners and consumers are, for practical purposes, the same people, namely the residents or citizens of the jurisdiction in question. Whereas under private ownership a decision to set prices to high results in a transfer of wealth from producers to consumers, under public ownership such transfers wash out. What households lose as consumers of the service in question they gain as taxpayers and consumers of government services.

In summary, the starting point for analysis is that the local telephone network should form the core of a fully publicly owned telecommunications enterprise, which I will refer to as Telstra Public

Retail services

It would be possible, in principle, to allow Telstra Public to own and operate the local telephone network, but not to allow it to deal directly with household and business customers. Under this model, Telstra would act purely as a wholesaler. Typically, it is assumed, a competitive market in retail services would rapidly emerge.

The thinking behind this argument reflects the technological assumptions that have been the basis of mistaken policies in the past. There is every reason to suppose that there are strong economies of scale between operation of the local telephone network and the provision of retail services such as connections, repairs and billing. The idea that these services can simply be separated is simply wishful thinking.

This proposition is not merely theoretical. Under the third-party access regime to which Telstra is subject, consumers are free to purchase their retail services from competing firms. The majority, however, have chosen to purchase directly from the actual service provider, Telstra. The imposition of structural separation between network ownership and retail services would deprive consumers of the option that most clearly prefer.

It is also doubtful that this model would produce a competitive outcome. It is far more likely that Telstra's privatised successor would dominate the market. However, in the absence of an obvious technical basis for market dominance, the private retailer would probably be subject to less stringent regulation than is currently applied to Telstra, making consumers worse off once again.

In summary, retail services should remain integrated with the provision of the local telephone network as part of Telstra, but the requirement to allow access to competing retailers should be retained.

Long-distance and international services

The imposition of compulsory separation between local and long-distance services was the centrepiece of the 1982 consent decree which resolved an antitrust action brought by the US Department of Justice against the dominant telecommunications enterprise AT&T. Under the degree AT&T retained its long-distance and other businesses, while a number of geographically separate local telephone companies (Regional Bell Operating Companies or ’Baby Bells’) were created.

Although this policy produced some favorable outcomes initially, it is increasingly regarded as untenable. The seven RBOCs have been merged into four (Verizon, SBC, BellSouth, and Qwest), with the elimination of at least one (probably Qwest) being viewed as virtually inevitable within the next couple of years.

More importantly, the RBOCs are very likely to be allowed to re-enter the long-distance telephony market in the near future. AT&T is likely to merge with one of them as part of this process. Thus, the net impact of the 1982 decree will have been to break the old AT&T monopoly up into three or four geographically separate pieces.

There are substantial economies of scope in allowing consumers to deal with a single provider for both local and long-distance services from a given network, especially when, as in Australia, it is not always possible for consumers to determine which numbers are local and which are long-distance. Once again, a compulsory separation would foreclose an option most consumers clearly prefer.

Similar points apply to international services. Although it is possible to argue that a more competitive outcome could have been achieved if Telecom and AOTC had never been merged, leaving the domestic and international markets completely separate, the question has been resolved. The market that has emerged is one in which consumers expect domestic and international services to be supplied as part of a single package.

ADSL connection services

Asynchronous Digital Subscriber Line (ADSL) technology is one of the two main methods used to provide broadband Internet access (the other being hybrid fibre-coax cable, discussed below). ADSL services are provided using the local (copper wire) telephone network, of which Telstra is the sole provider.

The provision of Internet connections using ADSL technology therefore involves three potentially distinct services

(i) the provision and maintenance of the local telephone network connection;

(ii) the provision of the ADSL connection over the local network;

(iii) the provision of ISP services;

The approach taken in the United States, following the 1996 Communications Act, was to provide all three components separately, with an RBOC providing (i), a DSL ‘‘wholesaler’ providing (ii) and an ISP providing (iii). The resulting division of responsibilities was a recipe for disaster. Technical problems produced an epidemic of buckpassing in which each component provider blamed the other two. In particular, the RBOCs had no interest in assisting third-party providers of a service that they could potentially deliver in the future.

By contrast, the older model in which a range of competing ISPs provided services to consumers using modems designed to operate over ‘plain old telephone service’ (POTS) lines never encountered severe difficulties. This model allows for a fairly clear distinction between ‘carriage’ and ‘content’, making it relatively straightforward for consumers to assign responsibility for different aspects of service quality.

This analysis suggests that the feasible policy options are either a fully integrated ADSL service, like that currently offered by Telstra, or a common carrier model in which

Telstra provides the ADSL connection for a range of competing ISPs. As has been argued already, the second model is to be preferred.

ISP services and Web content

The main arguments for separating Telstra's ISP and Web content businesses from its core telecommunications business have already been set out. To summarise, the main positive argument arises from the anti-democratic and anti-competitive effects of allowing a regulated monopoly provider of essential services to be a content provider and media enterprise. The negative argument is based on the absence of any obvious social benefits such as economies of scale and scope arising from allowing Telstra to undertake such a high degree of vertical integration. As has already been noted, Telstra is unique in its level of vertical and horizontal integration.

The HFC network and pay-TV

Applying the analysis presented for other components of Telstra's network, it is straightforward to conclude that the content services currently provided over Telstra's hybrid-fibre coax (HFC) cable system, including pay-TV and broadband ISP services, should be separated from the core business. A more difficult question relates to the allocation of the network itself. The general principle of separating carriage from content implies that the HFC network should be retained as part of the core business, as does the possibility of using the network for voice telephony. On the other hand, if a model of 'competition between technologies', discussed by Quiggin (...) is adopted, separation between copper-wire and HFC networks would be a natural consequence.

The problem is further complicated by the residual effects of the 'cable race' between Telstra and Optus. The problems arising from the existing of two half-built and largely duplicate networks must be resolved before any real progress can be made in this area. The nature of this resolution will impinge on the appropriate structure for Telstra.

Mobile telephony

The situation of mobile telephony is similar to that with HFC cable. The choice between retention and divestiture must be made in the light of a more general reorientation of policy regarding mobile telephony. Concerns about competition must be balanced against the clear desire of many consumers to deal with a single provider for telephone services of all kinds.

In addition, it is necessary to consider the general public preference for Telstra to be retained, as far as possible, intact and in full public ownership. A clearly articulated proposal to strengthen Telstra's core business by disposing of peripheral operations could gain public support. However, it seems likely that many Australians would regard the mobile telephony business as part of Telstra's core operations and their views should be respected.

WhitePages and Yellow Pages

A number of RBOCs in the United States have used the sale of White Pages and Yellow Pages operations to assist in capital restructuring. Although there is no compelling case for the divestment of Telstra's White Pages operation, there is equally no compelling case for its retention. The sale of assets of this kind could be used to finance various capital restructuring options, such as the repurchase of private shareholdings.

Other peripheral assets

Telstra's expansionist drive has resulted in the acquisition of a wide range of peripheral assets, most of which have performed poorly. The most notable is the joint venture with Hong Kong Telecom. While it is too late to retrieve the loss imposed on Australian taxpayers by this irresponsible venture, it is essentially that assets of this kind be separated from the publicly-owned core network.

Implementation

Since the current wave of privatisation began it has frequently been argued that, once an enterprise has been privatised it can never be returned to public ownership. This is a curious claim in view of the fact that a wide range of enterprises in many countries, including Australia, were nationalised in the first three-quarters of the 20th century. It has been conclusively refuted in the 21st century as a number of privatised enterprises have been renationalised (Railtrack in the United Kingdom, accident compensation in New Zealand), new public enterprises have been established (the Post Office bank in New Zealand) and some activities previously undertaken by private enterprises have been nationalised (airport security in the United States).

The proposal to fully privatise Telstra's peripheral activities while nationalising the core business greatly enhances the range of options available for the process of nationalisation.

First, there is a choice regarding which, if either, of the successor enterprise would retain Telstra's formal identity and which would be 'spun off'. If the core business were maintained as Telstra, the peripheral assets could be sold off or floated off and the proceeds used to repurchase privately owned shares. Alternatively, Telstra could sell its core telephony assets to a new publicly owned enterprises, with the government's Telstra shareholding being sold off at the same time. The new privately-owned firm would then be free to pursue the expansionist plans of the current management, if they retained the support of shareholders.

Two other issues, closely related concern the choice between immediate and gradual renationalisation and the willingness of government to take on some debt to finance renationalisation. Given a commitment to eventual renationalisation, there is no particular reason for governments to seek an immediate return to full public ownership. Rather the proceeds of the sale of peripheral assets could be used to finance the repurchase of shares from those willing to sell at the current market price. The remaining minority shareholders would continue to receive dividends, but would not exercise significant control over the board or have any prospect of receiving a takeover bonus. Their shares could be repurchased gradually over time, using Telstra's internally generated funds.

Alternatively, the government could take on some additional debt to make what would be, in effect a takeover offer. Assuming a sufficiently high acceptance rate, standard takeover rules could be used to compulsorily acquire the shares of the remaining locked-in minority.

A final option would be a formal renationalisation, with appropriate compensation under the takings clause of the constitution. Although feasible, this seems less attractive than the market solutions discussed above.

Concluding comments

Until recently, policy debate surrounding Telstra has been dominated by the presumption that full privatisation is inevitable and that renationalisation is unthinkable. Any debate in which crucial policy options are ruled out as unthinkable is unlikely to produce sensible outcomes and this has clearly been the case in relation to Telstra.

Fortunately, the option of renationalisation has become a practical reality in numerous recent instances around the world. It is clear that the only coherent response to Telstra's unsatisfactory structure and governance is a combination of renationalisation and divestiture.