Telstra: should it be privatised?

Rod Maddock

Head of Equities Research

Commonwealth Bank of Australia

Contents:

1. Introduction

The issue of how best to organise the provision of essential services in Australia has had a long and complex history. Many services for the provision of gas, electricity, water, fire services etc have oscillated between models of public and private provision over our history. There was a time in our history when even butchers' shops were publicly owned.

In some areas, such as water provision, Australia's large climatic swings and highly variable rainfall, make very large dams necessary. This requires large capital investments. Clearly there was a broad temptation, faced with the need for such large capital investment in infrastructure, and while capital markets were poorly developed, for the public sector to take the lead role in such major infrastructure projects. In a country of recent settlement, and with a large need for infrastructure, extensive public provision was thus easily understood. Even there however, it is not essential, since (for example) railways in the USA were largely developed in the private sector whereas they were public in Australia.

Historically then, public ownership was justified by:

- poorly developed private capital markets;
- the need for large investments;
- the high levels of risk in an underdeveloped country;
- the willingness of governments to bear such risk; given
- the perceived need for such services.

Times have changed. Most importantly capital markets have matured significantly:

- the raising of large amounts of capital to invest in projects is now routine;
- devices for private investors to assume risk, or for the better allocation of risk between public and private investors, are well developed; and
- the appetite of governments to assume investment risk has diminished as the demands for increased social expenditure have increased.

The current round of reforms in Australia has proceeded unevenly. Some public enterprises like the government banks and the airlines were privatised routinely. Other such as Australia Post seem destined never to be privatised. In between we have sectors such as electricity where there is an mix of privatised and state owned enterprises competing uncomfortably in an evolving market. The case of Telstra sits oddly in this mix. It is partly privatised and enmeshed in an extensive public discussion about the appropriate way forward.

The issue has been particularly complicated by the recent history of attempts in other countries to reform telecommunications. Where telecommunications seemed to move to different beat to the rest of the economy, recent experience around the world has emphasised the importance of understanding clearly that it is an industry like many others, and, most importantly, subject to the same market constraints. Exponential growth, even in telecommunications, does not last forever.

2. What are the issues?

2.1 The case for the provision of services by private firms rather than their delivery by state–owned enterprises hinges around a number of straightforward propositions.

The issues relevant to the privatisation of Telstra apply to most other privatisations around the world. These focus on:

- the effectiveness of private versus state-owned provision of services;
- the equity effects of moving from one to the other;
- the issue of how to ensure that the services provided via facilities which are difficult to duplicate, are delivered efficiently (in terms of cost and price);
- industry policy in the sense of how the services relate to those delivered in other markets (which will depend on the ability of other firms to enter these markets and compete); and
- the investment/divestment decision itself.

This is a very standard list.

2.2 The first is that, in general, the structure of incentives is superior under private enterprise. This is not to deny that the incentives are sometimes wrong, or less than ideal, but there is a clear presumption that the sequence of incentives (as we move from shareholders to board to managers to employees) is better-focussed in the case of private firms. Policies such as corporatisation have been used to find a suitable half-way-house but in general their effectiveness wears off over time. Corporatisation thus has little long term effectiveness in fixing the incentive problem. This suggests that private corporations are likely to be more *effective* in achieving their goals because they have greater freedom as to how they implement them.

2.3 The *equity* effects of the move from public private ownership are more difficult to address. The great advantage of a market system is that it is anonymous, that it does not generally discriminate amongst customers according to their personal characteristics, although it may on the basis of their demand for the good concerned. Public policy however is often concerned to deliver advantages to one or other group of consumers, often on the basis of their capacity to influence election outcomes. The move from public to private is thus usually accompanied by

- some regulatory overlay,
- some licensing conditions, or
- an income transfer,

designed to offset the equity effects of the change of ownership.

Privatisation forces parties to specify quite specifically what element of the services produced by a company like Telstra are designed to serve social goals. In public enterprises these are often hidden, obscure and opaque. The improved transparency is good for the quality of decision making but causes political difficulties are people's sense of entitlement are scaled back.

2.4 The difficulty of duplicating the facilities which produce telecommunications services results in some additional complexities. The approach we have adopted in Australia has involved the development of an access regime, an institutional mechanism which allows third parties to use the facilities of others to produce service in competition with them.

> It is important to remember however that this regulatory fix is a solution to a technological issue, and not one related to ownership. If Telstra were still 100% government owned, the access regulations would still apply. It may even be easier to apply access regulations to a private firm than it has been to government enterprises (such as the railways).
>
> If there is a complication it relates to the great technological uncertainty which surrounds telecommunications. The multiplicity of platforms and standards makes it hard to understand what to regulate and how to do it. On top of this, the range of products which can be delivered via these various platforms is also evolving rapidly which makes it hard to know where the greatest needs will emerge. Finally, it appears that the broadcasting and telecommunications markets are increasingly subject to overlap, but subject to quite different regulatory approaches (content with broadcasting, and technology with telecommunications).

2.5 Infrastructure facilities, such as those involved in the customer access network (CAN), in telecommunications, can be used to produce services in many markets. Clearly an increasing number of services directed towards your home telephone number must be directed through the final stages of the copper wire into your home. Whoever owns that copper has the capacity to interfere in many downstream markets.

> The usual solution here is again regulatory, and again does not really depend on who owns the facility company. If Telstra were publicly owned or privately owned, the same issue of preventing their potential

abuse of any market power which arises from their control of the wire into your home would arise. Again this is a regulatory problem not an ownership problem.

2.6 The decision of any government to sell an asset, such as part ownership of a telephone company, is at some level a commercial decision. The owner must be of the view that selling is advantageous. This can arise because

- either investors believe they can generate superior returns from ownership (through better management or greater operational flexibility),
- or, because the seller perceives that private owners will be able to generate greater value even if it is not immediately clear to the new owners.

The main issue here is that public firms are often subject to restrictions on the lines of business they can pursue. Australia Post for example appears very reluctant to invest offshore, or even to pursue the domestic logistics business as hard as private firms like Toll and Patricks have. Again the behaviour of the publicly-owned electricity companies in NSW has appeared quite different from that of their private counterparts in Victoria. In general we would not expect government-owned corporations to manage risk as well as private corporations.

More broadly, public enterprises can operate as effectively as private enterprises but only if they are free from direct political interference. However, if they are free of all political interference there is little reason to operate them in the public sector.

The consequence of this is that Telstra is almost certainly worth more to private owners than it is to public owners, in the sense that private owners will be able to use the resources of the company to create more value.

2.7 In summary then we have a simple checklist in answer to the questions of whether Telstra should be privatised. Privatisation

- will increase effectiveness and profitability
- will have ambiguous effect on equity

- has no impact on regulation of essential facilities
- has no impact on other markets
- will generate greater product and value.

3. How might they be addressed?

3.1 Public policy approaches

Seen this way, concerns about the privatisation of Telstra break down into three parts.

First, the resources tied up in the company would be used better if the business were privatised. The presumption then should be in favour of privatisation.

Second, the regulatory problems should not be allowed to colour the issue of privatisation. The difficulties of regulating a piece of shared infrastructure such as the local loop in telecommunications are not related to the ownership of the facility. They have to do with the structure of costs arising from the technologies employed. These are hard problems, but separate ones from those involved in privatisation.

The third concern then has to do with equity. And this is really the only problem.

The picture becomes murkier however when we consider the mechanisms we might use to address equity concerns.

In general it seems strange to use telecommunications policy as a mechanism of addressing concerns over equity. We have a welfare system to do that and generally have moved away from using public sector prices to redistribute purchasing power within the community.

Nevertheless, one of the legacies of past political interference, from the period when telecommunications was run by the Post-Master General's Department, is that many prices and expectations of service delivery were established politically. That is, we need to address the legacies of past political interference in how telecommunications was provided.

3.2 The politics of privatisation

Reform is always likely to involve difficult political issues because there are inevitably groups of people who have a vested interest in the status quo. People have made investments in businesses, skills or locations, the value of which changes when policy or prices change.

In the case of telecommunications, where prices or services have generally been falling, price to consumers is probably less of a concern than in many other privatisations. The focus is rather on the quality of services, and particularly of telephony services.

3.2.1 Quality of service

The main focus of equity concerns is thus on aspects of the quality of service, and especially the quality of service in areas of low population density. The Besley Report set out a matrix of concerns of those in remote and regional Australia.

The key recommendations fell into three broad categories:

- improved service connection, reliability and repair times;
- enhanced mobile coverage;
- better information and involvement of rural communities; and
- special issues covering remote indigenous issues.

Very significant progress has been made towards meeting most of these objectives. See the paper "Telecommunications Service Inquiry" at www.dcita.gov.au/cgi-bin/trap.pl?path=5967 which details progress against the Besley issues, and the latest Telecommunications Performance Monitor from the Australian Communications Authority, which reports on Telstra having maintained connection and fault clearance performance across Australia at well above benchmarks for the past year.

3.2.2 Influencing the regulatory decision making

The Government is in the process of reconsidering some crucial areas of the regulatory framework which sit around telecommunications. One key area of debate concerns the price caps which limit Telstra's pricing flexibility. Such price caps are a standard feature of many privatisation processes for two reasons.

First they give politicians greater certainty. This is because the politician concerned is able to give voters certainty about the prices which will apply after privatisation.

The second function of the price caps is as a device to limit Telstra's market power. This is most important at the wholesale level: if Telstra sets the price to other companies which want to use the network too high, it will reduce their capacity to compete with Telstra in markets for value added services. Here most attention should focus on the price of direct access to the wire.

The whole approach to price capping which sits around Telstra is currently under review. With the benefit of recent experience it is clear that many of these caps are now unnecessary. Some of the markets being covered are now sufficiently competitive for the caps to be redundant, and in other cases it is clear that the caps are not necessary to meet the policy objectives. Significant reform of the caps is called for. The main focus of these politically sensitive caps should now be on the very basic services with the basic connection fee being a major issue since the current charges are so far out of kilter with costs.

3.2.3 Who is likely to be influential

The decision making is now clearly in the political arena. There are two stages: first getting the governing Parties to a concrete proposal, and second getting the Parliament to agree. As with any democratic political decision, it is the median votes who are most important.

Within the Government this makes the position of the National Party crucial. The argument within that party appears mainly pragmatic. As such it should not prove an insuperable problem since the discussion will be over how the interests of their supporters are protected, and advanced, by the sale process. This is a fairly standard matter of compensation, but being the median voters they should be able to extract rather more than their 'share'. They are thus likely to be overcompensated.

In the House of Representatives there are likely to be few real issues. In the Senate however the Government will need to put together a winning coalition in support of the sale.

The composition of the Senate from July 2002 is

Liberal/National	35
ALP	28
Democrats	8
Greens	2
Independents	2
One Nation	1

In a house of 76 Senators, the Government needs 39 votes to form a majority. The ALP has stated an unequivocal opposition to the sale, and hence will not be part of any winning coalition. There are however a lot of alternative ways in which the required 4 votes could be accumulated. Of these potential median voters, 3 are from Tasmania, 3 from Queensland, 2 from SA, 2 WA, 2 NSW and one Victoria.

Since the Government only requires 4 of 13 votes, it should be able to develop policy positions which are congenial to 4 Senators with Tasmanian issues, those with strong environmental concerns, or those focussed on small state issues, in the process of developing effective majorities.

The difficulty that will emerge is that these voting blocks are likely to prefer to impose regulatory solutions and conditions on any move towards a sale. Such an approach is thus likely to bring the whole panoply of regulatory considerations back into play.

3.3 Issues related to price

Governments face significant political risks in a major privatisation. If they set the price too high, then it is difficult to sell the asset. If they set the price too low, then they stand accused of selling off public assets cheaply.
The price of Telstra shares is now 29% below the price at which the last tranche was sold. A sale at the current prices is thus likely to be difficult to move. This is especially true when many other telecommunications assets in the Asian region will also be available to investors.

There are two basic approaches which they might adopt to this:

- reform the regulatory regime so that the shares are more valuable; or
- wait, and hope the market situation improves.

Shares in telecommunications stocks tend to be cyclical. Within the stock market the emphasis at the moment is on value stocks rather than growth stocks. This will clearly change and has in recent decades on a fairly regular basis. Nevertheless, the Government has to consider the political window of opportunity and this need not coincide with the stock market cycle.

The more immediate strategy then for the Government is to address the weakness of the share price through a judicious reform of the regulatory environment. Currently some 70 percent of Telstra's revenue is captured within a price cap.

These price caps serve a dual purpose

(i) They are routinely imposed to help to insulate politicians from risk. Caps allow politicians to say that the price of the service will not rise by more than a certain amount, or even to mandate that prices will fall, after a privatisation;

(ii) They are also used by regulators as surrogates when there is a monopoly provider for the price pressure competitors might impose in a normal market.

The current review of the price caps provides a clear opportunity for the Government to rethink the price caps. Ideally they should be restructured to allow Telstra to compete more freely on a wider range of products. If investors were confident that the scope of regulation would be narrowed significantly, then this is likely to lead to higher share valuations.

The other main areas of potential to increase the share price through regulatory changes concern

(i) the treatment of the universal service obligation;

Most modelling, and recent experiments by the Government with tendering out the USO obligations, suggests that the obligation to provide universal service cause a significant revenue deficit. If the Government were to recognise the full value of the obligation, and compensate Telstra accordingly, the company's share valuation would rise.

(ii) the treatment of the CAN deficit.

Again, the revenues gained from charging customers for access to the CAN are significantly less than most estimates of the cost of providing this service. Allowing Telstra to fully recover reasonable costs in this are would raise the share price.

Table 1: International price capping arrangements

Country	Broad-based Cap	Country	Broad-based Cap
Austria	No	Greece	CPI + 3
Canada	No	Canada	Approval for >CPI
Finland	No	Netherlands	Approval for >CPI
Korea	No	Portugal	CPI –2
Malaysia	No	Denmark	CPI –3
NZ	No	Germany	CPI – 4
Sweden	No	France	CPI– 4.5
US	No	UK	CPI–4.5
Japan	Approval	Australia	CPI– 5.5

Sources: Communications Outlook and Productivity Commission "International benchmarking" December 1999.

4. How can we move forward?

The basic reading from the analysis above is that the full privatisation of Testra is likely to go ahead. There are three practical concerns:

(i) *meeting the concerns of the National Party*:

Recent changes to the operations of Telstra seem to be meeting most objections so that the problems becomes one of finding a mechanism which ensures this into the future. This seems quite manageable.

(ii) *getting minority party support in the Senate*:

The fragmentation of the minority parties in the Senate makes this a standard problem of building a coalition in support of change. The process is likely to involve some trade-offs, and a willingness to compromise on other issues, but seems achievable.

(iii) fixing the regulatory scheme

While the regulatory problems really have nothing to do with ownership, and hence nothing to do with privatisation, they will turn out to be crucial. There are two reasons for this: first, because the National Party and the minor groups in the Senate are likely to seek regulatory assurances as part of the package needed to get them to agree to privatisation; and second, because reform of the regulatory structure is the main tool available to the

Government to raise the valuations analysts place on the firm and hence on its sale price.

At first glance the interests of the Government in ensuring that Telstra's share price (and hence revenue) is higher than it currently is, and of other interests in ensuring that neither do product prices rise nor service quality fall, are diametrically opposed. This is not a true reflection of the position. Telstra is a multi-product firm so its prices have many dimensions, political groups have multiple interests, and the Government has a range of tools available, so that with intelligent bargaining both sides should be able to be satisfied.

5. Conclusions

The full sale of Telstra does seem likely within this term of government. Most of the barriers to a sale can be addressed by pragmatic trade-offs.

The key issue is not likely to rest with politics but rather with regulation.

The fundamental regulatory issue relates to the customer access network (CAN). The piece of copper wire into your home constitutes a bottleneck through which most telecommunications needs to pass. While wireless technology is increasingly an option, the market power arising from control of this bottleneck is still considerable. The only sensible long term solutions are those which allow parties access to the CAN at a price which allows them to compete with Telstra in product markets which use the CAN, and generates sufficient revenue to pay the fixed costs of maintaining and developing the CAN.

In virtually all other areas, the price caps should fall away. This is because there is competition and entry in most other markets for telecommunications services. Normal rules relating to unconscionable conduct, to price fixing and so on should then be applied in these markets to deal with any inappropriate market conduct in other areas.

Reference

Besley et al 2000 "Connecting Australia" being the Telecommunications Service Inquiry for the Australian Department of Communications, Information Technology and the Arts.