Reforming Telstra

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Introduction

Over the past six years the public's shareholding in Telstra has been reduced by the Howard Government to 50.1 per cent, the scope of Telstra's activities has altered, and the entire telecommunications sector has changed.

As a result of sweeping technological change, Telstra's responsibilities now incorporate both traditional activities with obvious public sector characteristics and newer activities more appropriate to the private sector.

Labor remains committed to retaining majority government ownership of Telstra. Privatising Telstra would create a huge private monopoly which would totally dominate telecommunications and be almost too powerful to regulate.

Telstra's current choke hold on the market would no longer be inhibited by the constraints which go with government ownership. Privatisation would only worsen the problems experienced by people in rural and regional Australia. It would allow Telstra to abandon its obligations to invest in our national communications systems, and concentrate on squeezing maximum profits from our most lucrative telecommunications markets.

Merely accepting the status quo, however, is insufficient. Public ownership of Telstra is a means to an end, not an end in itself. The existence of a 49 per cent minority private shareholding has altered the ways in which that public ownership can be employed for public benefit.

Positive solutions to the telecommunications problems experienced by consumers and businesses require much more than just defeating the Howard Government's privatisation agenda.

More than ever before, telecommunications services are central to our lives. Most businesses depend on efficient, affordable communications for their economic viability. We all rely on our communications systems to sustain our everyday lives, from maintaining contact with loved ones through to tackling emergencies.

Telecommunications are essential services. All Australians have a right to access reliable, high quality and affordable telecommunications services.

The following principles are at the heart of Labor's approach to telecommunications policy:

1. Ensuring that consumers receive the highest quality services, widest choice and cheapest and fairest prices possible
2. Ensuring that consumers in regional and rural Australia have full access to communications services
3. Maximising employment in the communications and information technology sectors
4. Ensuring that businesses have access to globally competitive and innovative communications services.
5. Maximising competition, investment and innovation in Australia's communications networks

Australia needs a telecommunications sector characterised by universal access, vigorous competition, rapid innovation and high quality services delivered at the lowest possible prices. Telstra will continue to be the most important player in the sector, particularly as the national guarantor of universal access, but it should not be allowed to completely dominate the market to the extent that anti-competitive outcomes occur.

The sector should encompass a reasonable number of competitors who in aggregate compete with Telstra in as many market segments as possible and make sustainable profits.

When considered in the light of these general principles, there are clear deficiencies in our existing telecommunications sector. Competition is still seriously inadequate, with Telstra completely dominating the entire sector and earning almost all the profits.

Under John Howard, Telstra is being allowed to behave as if it were just another private company, like the banks, slugging consumers with higher prices and sneaky fees. The regulatory regime is extraordinarily complex and cumbersome. It enables Telstra to exploit its size and dominance to prevail over competitors.

Telstra is reducing investment in its network while investing billions in offshore ventures and preparing to buy a commercial television network. Australia's broadband takeup is lower than most industrialised nations, and the quality and extent of telecommunications services in rural and regional Australia is still very inadequate.

Privatisation of Telstra will worsen these problems and impede the pursuit of appropriate solutions.

Competition

After more than a decade of competition, Telstra is still totally dominant in the Australian telecommunications sector. At the end of 2001 Telstra controlled 83 per cent of the local call market, 86 per cent of the basic access market, 72 per cent of the long distance market, 50 per cent of the international market, 50 per cent of the mobile telephony market, 53 per cent of the pay TV market and 96 per cent of the directories market. (Telstra briefing to industry analysts, January 2002).

In overall terms, Telstra occupies approximately 75 per cent of the Australian telecommunications market, and earns over 90 per cent of the profits in that market. It is only because of the emergence of new sectors like mobile telephony, where Telstra's in-built advantage is much lower, that its share of the total telecommunications industry is not even higher.

Telstra's return on equity in recent years averages over 30 per cent, well above most equivalent Australian companies. These extremely healthy returns are delivered by Telstra's domestic operations, particularly in regulated markets. Its offshore ventures provide only thin returns. (Australian Competition and Consumer Commission Chairman's speech to Australian Telecommunications Users Group, October 2, 2001).

Telstra's EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) as a percentage of revenue for 2000-01 was 52.8 per cent, the highest since the introduction of competition in telecommunications a decade ago. In 1994-95 its EBITDA was 41 per cent. In the six full years since then, Telstra's EBIT (Earnings Before Interest and Tax) figure has more than doubled. The strength of Telstra's finances is not necessarily reflected in its share price.

Despite its strong market position and profits Telstra's price: earnings ratio is the lowest of the world's top fifteen telecommunications companies.

Whichever way these facts are viewed, they reveal an extraordinary level of market dominance. The Australian Telecommunications Users Group argues that "competition in telecommunications has stalled", and claims that Telstra's healthy profit performance is driven by staff cuts and price rises, not competition. Others assert that underinvestment in the network, and the recent strength of the Australian economy as a whole, explain Telstra's very strong financial position.

Since the demise of OneTel and the dot com crash, the initial spread of competition in the sector appears to be going into reverse. Many smaller players are in difficulties, and the prospects for further erosion of Telstra's dominance are limited. Although it is conceivable

that Telstra's dominance is attributable to extraordinary levels of efficiency and skill, it is much more likely that scale, incumbency and skill in exploiting opportunities offered by the regulatory regime provide the main explanations for this dominance. Telstra's control of the ubiquitous Customer Access Network is at the heart of this dominance.

Consumers Slugged

In November 2001, immediately after the Federal election, Telstra increased its flag-fall fee for mobile phone calls from 20 cents to 25 cents, a 25 per cent increase. It also increased its fees for text messaging from 22 cents to 25 cents, a 13 per cent increase. In February 2002 it introduced new mobile phone plans with $150 early exit fees and $50 insufficient use fees.

Telstra makes very healthy profits from its mobile telephony division, and occupies roughly half of the Australian market. No substantial justification for these price increases has been provided. If anything, the continued growth in mobile telephony and the explosive growth in text messaging should allow for price reductions, not increases.

Over the same period, Telstra introduced new Internet access plans with increased prices for medium level users, huge price increases for school Internet access, and a new split White Pages structure with a $126.50 fee for small business proprietors wanting to be listed in both the business and residential sections.

Although it is restrained by price caps in some areas, recent experience shows that Telstra will use its dominant market position to slug consumers wherever it can. Forthcoming relaxation of the price cap regime will only exacerbate these problems.

There are still substantial sections of the Australian telecommunications market where Telstra has little genuine competition. Local call services in many parts of Australia are still completely dominated by Telstra. The prospects for competition from other networks are inhibited by the fact that Telstra is the dominant player across the board.

The role of the Foxtel cable network as a competitor to Telstra in telephony and broadband services is compromised by the fact that it is owned by Telstra. Communications Minister Senator Richard Alston has recently drawn attention to this problem, but he has failed to address it (Speech to Australian Subscription Television and Radio Association annual conference, February 22, 2002).

Since the Federal election in November 2001, Telstra has undertaken a thorough restructuring of its pricing strategies in most parts of its business in order to increase revenues.

This restructuring has included:

- A 25 per cent increase in flag-fall fees for mobile phone calls, and introduction of mobile phone plans with $150 early exit fees and $50 insufficient use fees
- A 13 per cent increase in text messaging fees.
- New Internet fees with increased prices for medium-level users
- Substantially increased Internet access fees for schools
- A new split White Pages structure with a $126.50 fee for small businesses wishing to be listed in the business and residential sections
- Abandonment of the low-cost email product Easymail, which offered email services to customers without the additional cost of full Internet access.

The true impact of these changes is difficult to discern in some cases because of the complexity of the new regimes, but the overall effect is likely to be higher prices for consumers and more revenue for Telstra. Given that in most cases, such as mobile

telephony, text messaging and Internet charges, rapidly increasing usage should be generating price reductions, it is hard to avoid the conclusion that Telstra is using its enormous market power to milk more revenue from consumers.

No serious explanation of underlying cost surges justifying these changes has yet been provided. The Government's proposed new price cap regime is only likely to exacerbate these problems, particularly given that mobile telephony is to be removed from the price cap regime.

Inadequate competition in the telecommunications sector is bad for consumers and bad for the Australian economy. Telecommunications is now a fundamental part of most business activity, and the additional costs which flow from an insufficiently competitive telecommunications sector are built into the cost structures of businesses. Inadequate competition can also impact on particular businesses through insufficient diversity of products, poor quality service and low reliability.

A recent Australian Chamber of Commerce and Industry survey found that telecommunications costs rank third in the list of small business concerns, higher than the Howard Government's favorite, unfair dismissal laws.

A substantial proportion of Telstra's monopoly from its days as a publicly owned universal provider continues to exist, and is likely to do so for some time. The central question of telecommunications policy in Australia is: what is the best way of ensuring that the positive impact of competition, new investment and innovation is maximised, and the broader community obligation of Telstra to ensure that all Australians have genuine access to essential communications services is achieved?

Regulation

The structure of Australia's telecommunications market has given rise to an extraordinarily complex regulatory framework. This framework is intended to ensure a level of competition in spite of Telstra's inherent dominance, and to ensure that some of Telstra's longstanding community obligations continue to be delivered.

In broad terms, the telecommunications sector is subject to the following industry specific regulation:

1. The Universal Service Obligation, which obliges universal service providers (Telstra is the only one at present) to ensure that standard telephone services, payphones and prescribed carriage services are reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business.
   A temporary service must be provided when connections or fault repairs cannot be completed within specified time frames. Specific obligations cover the provision of equivalent services to people with disabilities. The Digital Data Service Obligation imposes a limited and outdated guarantee of access to data services, but with no restrictions on price. The USO is funded by a levy on all carriers.
2. The Customer Service Guarantee imposes time limits for the connection of telephone services, the repair of faults, and attendance at appointments by carriage service providers. These requirements vary according to the specific service being provided. Customers are able to claim compensation when carriage service providers do not meet the CSG standard. Fault rectification standards vary from one to three working days depending on the remoteness of the location.
3. Price caps on Telstra of CPI minus 0 per cent on local telephony and line rentals, and CPI minus 5.5 per cent on a basket of services including mobile telephony, long distance calls and international calls. Basic untimed local calls are capped at 22 cents per call, and payphone calls are capped at 40 cents. A further price-cap of CPI minus

1 per cent is imposed on a basket of services including connections, line rentals, local calls, long distance calls and international calls as used by the lower-spending half of Telstra's customers.
There are further caps on average prices charged to non-metropolitan customers relative to metropolitan customers. This price cap regime ends on June 30 2002, and the Government has recently announced some changes.
The new regime to commence on July 1 2002 will be built around three separate baskets, a cap on call services of CPI minus 4.5 per cent, a cap on line rentals of CPI plus 4 per cent, and a cap on connections at CPI.
Mobile phone services are to be removed from the price cap regime. In total, the new price cap regime is significantly less rigorous than its predecessor. Price cap regimes exist in Britain and Canada but not in the United States.

4. An industry-specific section of the Trade Practices Act, Part XIB, dealing with anti-competitive conduct. This section has only been used on a small number of occasions.
5. An industry-specific section of the Trade Practices Act, Part XIC, providing for access to facilities. The Australian Competition and Consumer Commission is empowered to declare certain facilities open for third party access, and ultimately to set a price for such access if it is not achieved by negotiation between the parties.
6. Conditions on carrier licenses, such as the requirement to submit Industry Development Plans, provide network information to other carriers, and consult with other carriers seeking access before making modifications to a network. The Government has announced that it intends to remove the Industry Development Plan requirement.
7. A variety of specific regulatory arrangements to deal with particular issues, such as carrier preselection and number portability. Such arrangements are generally provided for in sixteen industry codes developed under the auspices of the Australian Communications Industry Forum and ultimately the Australian Communications Authority.
8. The Telecommunications (Consumer Protection and Service Standards) Act 1999 includes provision for regulated access to the National Relay Service, access to untimed local calls, the Telecommunications Ombudsman scheme, protection of consumers when carriage service providers fail, access to emergency call numbers, and regulation of adult telephone services.

The regulatory arrangements in telecommunications involve numerous bodies:

- The Australian Communications Authority
- The Australian Competition and Consumer Commission
- The Australian Broadcasting Authority
- The Telecommunications Industry Ombudsman
- The Australian Communications Industry Forum
- Standards Australia
- The Department of Communications, Information Technology and the Arts.

The recent Productivity Commission report on Telecommunications Competition (*Telecommunications Competition Regulation* (Productivity Commission, Melbourne, 2001)) illustrates the complexity and opacity of telecommunications regulation. In particular, the extensive analysis of the access regime under Part XIC of the Trade Practices Act, and the different models of access pricing available, suggest that we have created an extremely complex regulatory regime which is failing to ensure optimal competition outcomes.

The regime is so complicated that it is virtually impossible to judge whether an appropriate balance between the interests of the incumbent former monopolist (Telstra) and the interests of competitors seeking access has been achieved. Telstra does not operate an internal transfer pricing regime between its wholesale and retail arms, so it is virtually impossible to make an accurate assessment of the effective price being charged.

Telstra's role as both network and service provider creates opportunities for it to unfairly cross-subsidise prices for its services, and discriminate against competitors in providing access to its network. Irrespective of whether this actually happens, this vertical integration of delivery of infrastructure and services is at the heart of the problems in Australian telecommunications, and is a broader issue for competition regulators in other sectors of the economy.

The regulatory maze has given rise to complex debates about the nature of the burdens imposed on Telstra, and how they should be accounted for in the competition regime. For example, the Government argues that the price cap on line rental fees has kept them at uneconomically low levels, and that this burden has been carried by Telstra through usage prices and shifted onto their competitors through access prices.

The argument is questionable because it includes an inevitably arbitrary allowance for the sunk cost of the existing network inherited from the fully publicly-owned monopoly Telecom Australia. It is very hard to determine conclusively whether such an "access deficit" exists, and if so, what is its magnitude, because any calculation of the true cost of line rental is necessarily based on disputable assumptions. Indeed, it is by no means certain that the prices which Telstra charges for access to its network are unreasonably high.

ACCC determinations are based on calculations of the cost of the most efficient use of available resources, not Telstra's actual costs. Some even contend that Telstra is cross-subsidising its competitors through unrealistically low access prices.

The Government has recently announced that it will allow Telstra to increase its line rental charges over several years to eliminate this notional deficit. It has put in place a package of initiatives to protect low-income earners from the impact of these increases, but these measures will only compensate some of those adversely affected. Telstra's obligation to deliver these services is to be inserted into its licence conditions, further adding to the complex web of regulation. It remains to be seen whether this licence condition will provide adequate protection for these services.

The regulatory regime is so complicated that any sense of transparency is clouded in complexity. The opportunities for Telstra to game the regulatory regime and use its massive size to overwhelm much smaller competitors, particularly through use of delaying tactics and resort to every legal avenue available, are extensive.

There is much debate about the extent to which Telstra uses such tactics, but the evidence suggests that it does so extensively, and very effectively. Under the existing regime for resolving access disputes, the process involves declaration of the infrastructure or service, negotiation between the parties, formal arbitration by the ACCC, an appeal to the AustralianCompetition Tribunal which is effectively a re-hearing of the case, and an appeal to the Federal Court on questions of law. It is quite common for cases to settle just before arbitration, in which case the details of the access arrangement remain private and no precedent is set. The regulatory regime does not provide for any equivalent to a class action, so each claim for access must be dealt with individually.

Telstra enjoys an inherent advantage in negotiations because its knowledge of commercial and operational issues with respect to its own network and negotiations and disputes with other access seekers, inevitably exceeds that of a particular access seeker.

The Government recently announced that it intends to make major modifications to the access regime:

1. Empowering the ACCC to set benchmark prices and terms for access to core telecommunications facilities
2. Abolishing the right to appeal ACCC access decisions to the Australian Competition Tribunal
3. Extending the regulatory regime relating to exemptions and undertakings to include services not yet declared or supplied
4. Strengthening the accounting separation requirements on Telstra's wholesale and retail arms

Full detail of these proposals has not yet been released.

Although the structure of the telecommunications market in Britain is similar to Australia's, the regulatory regime governing access is a good deal more rigorous. Industry regulator Oftel sets uniform terms and conditions for other operators to access the network, effectively in the form of a price cap, and it is open to those operators to seek to negotiate alternative arrangements with British Telecom if they wish to. BT is required to publish strictly separated accounts for its wholesale and retail divisions, and BT Wholesale is required to deal with BT's competitors on exactly the same terms that it deals with BT's retail arm.

Similar methods of setting access prices exist in Singapore and Canada, although the structure of the Canadian telecommunications market is quite different. The Unites States regime for resolving access disputes is similar to Australia's negotiate – arbitrate model, but with more restricted appeal rights.

Access delayed is access denied

In 1997-99 in the wake of the introduction of full competition in telecommunications, Telstra provided two voluntary access undertakings specifying a general price for access by competitors to its Public Switched Telephone Network. The Australian Competition and Consumer Commission rejected the price in the first undertaking as 50 per cent too high, and rejected the price in the second undertaking as 40 per cent too high.

AAPT sought access on negotiated commercial terms to Telstra's PSTN, and failed to reach agreement with Telstra. In December 1998 it sought arbitration from the ACCC.

In due course the ACCC handed down a decision, which Telstra then appealed to the Australian Competition Tribunal. After lengthy preliminary processes but prior to the commencement of the substantive part of the appeal, Telstra issued proceedings in the Federal Court on legal issues associated with the backdating of the ACCC's decision. Faced with the prospect of more expensive delays and court battles, AAPT recently settled the case.

In effect resolution of the issues associated with AAPT obtaining access to Telstra's network has taken almost five years. Even where conditional access is obtained subject to final resolution of issues in dispute, it is still a totally unsatisfactory basis for Telstra's competitors to invest capital and develop competitive services.

Although a substantial array of services and infrastructure are subject to the access regime, it is open to the ACCC to revoke an access declaration. It is currently considering doing so for local call services in capital city CBDs on the basis that there is sufficient competition from other networks in those markets. As a significant proportion of CBD businesses and residents do not have access to these competing networks, such a decision could lead to local call price increases for these customers, unless Telstra is subject to alternative

regulatory pressures. Whether or not such pressures already exist is the subject of vigorous debate.

Some access disputes have taken years to resolve. For example, AAPT's claim for access to Telstra's Public Switched Telephone Network commenced arbitration in December 1998, and before that time was the subject of formal negotiation. The case returned to the Federal Court in April, and was settled recently because of AAPT's unwillingness to countenance further costly delays.

AAPT encountered similar delays in its efforts to gain access to the Optus network. Ironically in New Zealand, where the roles are reversed, Telstra complains about delays in resolving access disputes regarding the network owned by AAPT's parent company, Telecom New Zealand. Such prolonged access disputes are not restricted to Telstra's fixed line network. The Seven Network's legal dispute with Foxtel over access to its network has taken a similar amount of time, and is still continuing.

Such delays impose considerable pressure on access seekers to agree to accept access on less favourable terms. In an industry in which technology is changing very quickly, this operates as a very substantial barrier to effective competition. ACCC Chairman Professor Alan Fels accuses Telstra of "gaming the process", and suggests that it spends over $50 million per annum on legal fees. (Speech to ATUG Conference, October 2, 2001).

Some attempt has been made to alleviate these problems by empowering the ACCC to issue interim determinations, but this has had limited effect. Delays in access to Telstra's network have even been raised by the United States Trade Representative in the annual report on foreign trade barriers released in early April. The Government has recently indicated an intention to address these issues by abolishing the right to appeal the merits of ACCC access decisions, and requiring more rigorous accounting separation of Telstra's retail and wholesale activities. Details of these proposals, which will require legislative amendments, have not yet been made public.

The impact of the access regime upon investment also requires scrutiny. In particular, it is important that the prospect of any access regime does not deter investment in the creation of new networks. Investors are entitled to know whether such networks will be subject to an access regime and if so, what the rules of that regime will consist of. This is the central question surrounding current debate about digitisation of the Foxtel network.

An objective examination of the existing regulatory regime suggests that we should do better. Further privatisation would exacerbate problems in the access arrangements. In the hands of an aggressive private owner, Telstra could strengthen and exploit its market dominance at the expense of consumers and ultimately the entire Australian economy. If Australia is to achieve genuine competition in telecommunications, we must clearly look for other alternatives. Overseas experience suggests that this will not be easy. Although a variety of different regulatory regimes exist, experience since the introduction of competition has been reasonably similar. British Telecom, for example, is also subject to claims that it abuses the regulatory system to maintain its dominance over new competitors.

Telstra's Structure

Regardless of its ownership Telstra will continue to be a hybrid incorporating conflicting imperatives. At one level, it is a universal service provider with extensive community obligations and exposure to public accountability mechanisms. At another level it is a fully commercial operation, making major offshore investments, gaming regulations and squeezing customers. These roles are inevitably in conflict.

Telstra has invested over $5 billion in its alliance venture with Pacific Century Cyber Works (PCCW). In effect, $2.5 billion of Australian taxpayers' money has been invested in a Hong

Kong mobile phone network and an Asian wholesale voice, data and Internet carrier. Given the lack of investment in Australian communications infrastructure and demonstrated superior returns, many would question whether this is an appropriate use of Australian taxpayers' money. This is especially true at a time when there is no shortage of investment opportunities in public infrastructure in Australia. Telstra has already written down the value of part of its PCCW investment by $1 billion.

Telstra has a large number of subsidiaries operating in many other countries, the most substantial of which is in New Zealand. Such investments may be appropriate in some circumstances, particularly where they help to generate efficiencies or greater expertise in the Australian market, but while Telstra remains publicly-owned its primary focus should be on delivering telecommunications services for its majority shareholders, the Australian public. During the dot.com boom, it was widely argued that incumbent telecommunications companies needed to expand both into content and overseas to survive. Like most business fads, this theme has since receded. Under the burden of heavy debt, for instance, British Telecom is scaling back its foreign ventures and intensifying its focus as a domestic telecommunications services provider.

Two years ago Telstra tried to buy the Nine Network. There is no legislative barrier to Telstra buying a major media organisation, and it is clear that this aim has not been abandoned, as Telstra Chief Executive Ziggy Switkowski made clear in recent comments. (*Sydney Morning Herald*, March 7, 2002). An investment of this kind would be inappropriate particularly given its implications for competition in these increasingly convergent markets. It would increase Telstra's already enormous market power through even greater vertical and horizontal integration. It would deliver effective government ownership of the number one commercial television network, and an inappropriate investment of public capital.

It is also doubtful whether Telstra has the necessary expertise to manage this investment. The recent experience of AOL-Time Warner and Bell Canada suggests that building large conglomerates around the theories of technological convergence in media and telecommunications may destroy a lot of shareholder value.

Telstra's investment in Foxtel is another example of the contradictions inherent in Telstra's structure. Rather than seeking to develop pay television, telephony and broadband services, this investment appears to have been largely a defensive strategy designed to protect Telstra's telephony interests and neutralise the incipient competitive threat from Optus.

The recent deal between Foxtel and Optus to merge content acquisition by their pay television networks changes this dynamic, but creates different problems through Telstra's expansion into the content market. Allowing Telstra to become a dominant player in content is likely to further undermine competition in telecommunications. The success of 3G mobile telephony networks, for example, will depend heavily on their operators' access to content. If Telstra effectively controls Foxtel and the Nine Network it will be in an extremely powerful position in the future battle for supremacy in 3G.

Telstra's involvement in Foxtel complicates its relationship with some customers. Television Oceania, a pay television supplier to major hotels and businesses, is currently negotiating with Telstra about the forthcoming closure of Telstra's Lasercast network, which Oceania uses as its delivery system. Telstra states that the system is outdated technology and that it can provide an alternative, but admits that it may sell the Lasercast network to Foxtel, which competes with Oceania in the content market. Oceania is understandably suspicious of Telstra's motives.

Telstra's position in Foxtel, and the de facto monopoly emerging from the Foxtel-Optus deal, also threaten to entrench Telstra as the gatekeeper in the new world of converged television and telephony applications. Digitisation of the Foxtel network may involve set-top boxes which double as digital television receivers.

Unless there is a dramatic change in consumer behaviour or the Government's regulatory regime, the vast majority of digital receivers in Australian households would be Foxtel set-top boxes, connected to Foxtel/Telstra billing systems. Telstra would therefore be in a position to control the delivery of new interactive services through digital television, and to further exploit its market power by bundling its various products into packages which place its competitors at a serious disadvantage. If the Government's proposed cross media ownership laws are passed, Telstra could also acquire the Fairfax newspaper group and extend its dominance into the classified advertising market.

At recent market valuation of Telstra shares, the Australian Government has between $30 and $35 billion invested in Telstra. Since 1991, Telstra has been required to act commercially. Telstra's minority private shareholding requires Telstra to act in a way which is not oppressive to the interests of those shareholders. Clearly community benefit does derive from the Government's investment through very substantial dividends, preservation of some essential services and some restraint on potential abuse of monopoly power by Telstra. The current Government's approach deliberately delivers little leverage from that investment other than the dividend.

Investment, Innovation and Employment

Monopolistic arrangements are usually not conducive to optimal investment and high levels of innovation. Telstra has been accused of neglecting its core network since the introduction of competition. Investment levels have fluctuated over this period, and have declined substantially over the past two years. Telstra's recently announced capital expenditure for the first half of 2000-01 was $1.66 billion, well down on the equivalent figure for the previous financial year of $1.98 billion, and decidedly thin in comparison with the figure for the first half of 1998-99 of $2.14 billion. While some argue that Telstra's continuing monopoly inhibits investment, others contend that inadequate investment is the result of the introduction of competition and the imposition of short-term market imperatives upon Telstra.

The incentive to invest is complicated by the existence of access regimes, and the incentive to innovate is dulled by the need to protect existing products and neutralise threats from competitors. Some industry analysts argue that Telstra delayed the introduction of ADSL to protect its existing services.

A mounting chorus of voices is now raising concerns about the limited take up of high-speed Internet access, generally known as broadband, in Australia. At present less than 2 per cent of Australian households are connected to broadband. With Telstra planning to have ADSL or cable available to 90 per cent of premises by 2003, the primary barrier is price. As the dominant provider, Telstra's pricing regime is clearly deterring potential consumers from participating in broadband. Inadequate competition means that there is insufficient pressure on Telstra to improve its product. Recent intervention by the ACCC forced Telstra to reduce its wholesale ADSL prices by between 30 and 50 per cent, after it had claimed that this was not feasible. A recent Macquarie Bank study found that Telstra broadband prices are 30 per cent higher than those in Britain and the United States. Consumer access to broadband is also being inhibited by Telstra's use of "pair gains" to deliver two telephone lines to individual households. Instead of providing two separate lines, Telstra splits a single line in two, thereby precluding the use of ADSL and diminishing dial-up Internet speed.

Although Australia has a history of quick takeup of new technology, we are starting to fall behind in access to broadband. In June 2001 Australia ranked sixteenth in the OECD, with a broadband penetration of 0.39 per 100 inhabitants, compared to Korea at 13.91, Canada 6.22, Sweden 4.54, and the United States 3.24. (*OECD Broadband Report* (Paris, 2001)). We have a big future as a major player in the global information economy, but only if the

enabling technologies are accessible to the overwhelming majority of Australians. Although it is important to be cautious in such matters, and avoid lavish investment on projects of dubious economic value, there is still a problem to be dealt with. Limited demand for broadband may in part explain the rate of takeup, but if that is the main problem it is difficult to see why a similar country such as Canada is so much further ahead of Australia. The current structure of the Australian telecommunications market is hardly ideal for the longer term process of ensuring broadband access throughout Australia. With Telstra totally dominant in all markets the prospects for rapid expansion in broadband may be inhibited by inadequate competition.

The Howard Government has done very little to foster the growth of broadband access. It has frittered away money on politically driven projects and denigrated broadband as useful only for children playing computer games. It has recently responded to widespread criticism of its approach by establishing two broadband committees and leaning on Telstra to spend $50 million promoting broadband services. Such initiatives are likely to have only marginal impact on the challenge to ensure that broadband access and takeup accelerate rapidly.

In recent years Telstra has cut its workforce drastically. Since 1996 the number of people working for Telstra has fallen from over 76,500, to a little over 40,000, with a very substantial proportion of this reduction occurring in regional Australia. Some of this reduction has arisen through contracting out certain activities, and this is reflected in the fact that non-Telstra employment in the telecommunications sector increased by approximately 30,000 over the same period. The overall reduction in telecommunications employment over this period contradicts earlier Howard Government projections.

This deluge of outsourcing has created significant problems, particularly in regional Australia. Major job cuts and continuing uncertainty about possible future sale have cast a pall over Telstra's Network Design and Construction arm. As a result of declining Telstra investment, declining work from other telecommunications companies, and changing technology, large numbers of highly-skilled workers are losing their jobs. Many are in parts of regional Australia where alternative employment options are limited, and Telstra is doing little to find alternative employment within Telstra for them.

Over the past three months Telstra has been engaging in a much more extensive outsourcing experiment entitled Total Area Service Management. This experiment involves outsourcing Telstra's core activities of network installation, operation and maintenance. Telstra has recently scaled back the scope of the project, but it is still actively pursuing the concept of outsourcing its core workforce. Recently leaked internal documents reveal that the driving factor in this experiment is cutting the wages and conditions of these highly skilled workers.

Outsourcing of non-core activities is a legitimate component of any major business. Outsourcing a function in order to improve efficiency is unexceptional. Outsourcing in order to cut wages does not increase efficiency, it merely redistributes the rewards of economic activity.

Maintaining and running the fixed line network is at the very heart of Telstra's existence. Contracting out these activities raises questions about what kind of company Telstra will eventually become. It may intend to become a "virtual telco" which employs few people engaged directly in running a telecommunications network but has extensive investments in other sectors such as media and entertainment. This scenario raises very serious questions about the future of Australian telecommunications, in particular, the role of Government in ensuring that all Australians enjoy reasonable access to essential telecommunications services.

Regional and Rural Australia

Recent debate on telecommunications issues in Australia has been dominated by concerns about Telstra's performance in rural and regional Australia. As new technology has multiplied the variety of communications services available, the level of choice and service in regional Australia relative to that available in the major cities has deteriorated. In some cases these problems are also apparent on the outer fringes of Australia's major cities.

Inadequate mobile phone coverage, limited Internet data speeds, excessive time taken to install lines and fix faults, and general deterioration in the core network are examples of the everyday problems experienced by large numbers of Australians living outside the capital cities. Any approach to dealing with reform of Telstra must clearly address these problems. The deteriorating state of Telsta's entire fixed line network in particular is an issue which must be addressed.

The Besley Inquiry (*Report of the Telecommunications Service Inquiry* (Canberra, 2000)) found that customers in regional, rural and remote areas were much more likely to experience high fault rates than metropolitan customers, and that Telstra's performance in remote area fault rectification was significantly below performance levels elsewhere. The inquiry found that approximately 6 per cent of all Telstra lines are not capable of data speeds sufficient to enable reasonable use of email and the Internet.

Services in Regional Australia

On February 6, 2002, 10 year old Sam Boulding suffered a fatal asthma attack at his home in north-eastern Victoria and later died. His mother's efforts to call an ambulance were severely impeded by the fact that her telephone was not working. Over the period between January 26 and February 8, Ms Boulding's phone was out of service for approximately seven full days and six partial days. It was affected by three separate faults during that period.

Subsequent inquiries revealed that Telstra declared a Mass Service Disruption due to adverse weather conditions, which therefore removed its obligation under the Customer Service Guarantee to fix faults within two working days. Inquiries also revealed that Ms Boulding was unaware of her right to apply for priority service because of her son's medical condition, and that Telstra's systems for dealing with priority customers are virtually dysfunctional. This issue was canvassed in the Besley Report in September 2000, but very little was done to address the problem prior to Sam Boulding's death.

There are still very serious problems with the standard of telecommunications services in rural and regional Australia. The Howard Government has failed to address these problems, but remains committed to the privatisation of Telstra.

To tackle these problems, the Government has spent $325 million (as at March 2002) under its Networking the Nation program, and has committed a further $141 million for a variety of telecommunications improvements including better dial-up Internet services and enhanced mobile phone coverage. Much of this money has been frittered away on isolated and fragmented projects which have limited impact on the generic telecommunications problems in regional Australia.

The most recent Australian Communications Authority report on telecommunications performance indicates that problems are still widespread. It reported a 13.2 per cent increase in Telstra's CSG-related faults, with particular problems in South Australia and Tasmania. Fault rectification in remote areas continued to lag behind the rest of the nation, and Telstra's payphone repair performance was described as "ordinary". The number of payphones operated by Telstra declined significantly. (*Telecommunications Performance Report* (Australian Communications Authority, Canberra, 2001)).

The current Customer Service Guarantee regime also has design weaknesses and contains no effective penalty arrangement for breaches which are allowed to continue for some time. This encourages Telstra to fix the less complex problems quickly, and allow a small number of difficult problems to languish.

Reports by Price Waterhouse Coopers and the Australian Communications Authority into the circumstances surrounding the death of Sam Boulding in February 2002 have highlighted the ongoing problems with Telstra's performance in regional Australia. Over the 12 days leading up to Sam's death, the Boulding phone was not in proper working order for most of the time. Telstra's performance in fixing three separate faults was clearly inadequate, and it failed to advise Ms Boulding that she was entitled to apply for priority service because of her son's medical condition. Telstra used a Mass Service Disruption exemption to relieve it of its obligations under the Customer Service Guarantee.

The Government has responded to these reports by imposing a new licence condition on Telstra requiring it to deliver an effective priority service regime and limiting the use of Mass Service Disruptions to avoid CSG obligations. These changes are positive, but they add further to the ever-expanding maze of complex regulatory arrangements in telecommunications which flow directly from the structure of Telstra and the sector.

It is unlikely that these problems can be resolved by ever more complex and onerous licence conditions. Licence conditions do not guarantee government access to the necessary information to make these determinations. Majority public ownership remains the most effective mechanism for ensuring that Telstra is accountable.

he Howard Government's approach to Telstra has shifted the burden of achieving good telecommunications outcomes in regional Australia onto the regulatory regime. If the rest of Telstra is sold, the regulatory regime will be expected to carry the entire burden. It is already failing to deliver decent outcomes now. If we are to improve the quality and reliability of telecommunications services in regional Australia, we have to examine alternative strategies. Further privatisation will only make things worse, and ever-expanding inefficient regulation is not the answer.

The intersection between community service obligations and competition in Australian telecommunications is extremely messy and complex under the existing regime. In order to be able to better deliver on the essential service components of Telstra's activities it is necessary to streamline competition arrangements. Even reducing the enormous sums which are spent on extensive legal battles (estimated by the ACCC to be $50 million per year) would liberate resources which could be used to deliver better community service outcomes. The current regime does not ensure genuine competition, and does not provide a sound foundation for an adequate and equitable delivery of community service obligations.

Opening up Telstra

The primary reform challenge in telecommunications is to achieve a clearer definition of Telstra's role, and to ensure that the regulatory regime enables it to fulfil its obligations. To achieve better and cheaper services for consumers, full access to communications services in regional Australia, and greater innovation and investment in our communications networks, we need to re-examine the entire structure of the telecommunications sector.

The most commonly proposed alternatives to the existing framework of regulation revolve around the principles of transparency and open access. These principles require that all service-providers gain access to the network on equal terms, and that those running the network have no interest in favouring one service-provider over others while still achieving a reasonable return on investment. This would require some kind of separation of Telstra,

whether internal accounting separation or full separation into two companies, in order to clearly distinguish its wholesale and retail activities.

A tentative step along the path to openness and transparency has recently been taken by the introduction of the Regulatory Accounting Framework. The RAF requires Telstra to provide confidential accounting information to the ACCC in a form which separates the costs of running the network from the costs of delivering services.

In the most extreme form of separation which is sometimes proposed a truly open and transparent arrangement would involve two separate companies running the Telstra network and delivering services to customers. This approach is usually called structural separation. Such an approach has been taken as part of the privatisation of some other public enterprises, such as in the rail and electricity sectors. It is broadly analogous to the road transport system, where the roads are owned and maintained by one organisation, and a variety of other organisations compete to provide transport services on those roads. At present Telstra not only owns and controls most of the information highways, it dominates all the markets for provision of services on those highways.

A separate company running Telstra's network would deal with all service-providers equally, and seek to maximise competitive use of the network. The company would be legally required to act in its own commercial interest. The incentives for anti-competitive behaviour would be substantially reduced. Cross-subsidies could be borne by the various service-providers in a more transparent and equitable fashion. In theory, more genuine competition would lead to more investment and innovation, better services and lower prices.

In a recent paper the OECD recommended such corporate separation (internal or full structural separation) as a means to generate increased competition in utilities such as electricity and telecommunications. (*Structural Separation in Regulated Industries* (OECD, Paris, 2001)). The OECD found that access regimes and similar regulatory arrangements are seldom fully effective, and that although accounting separation strategies have some merit, they are not likely to be as effective in delivering openness and transparency as full separation measures. However, it did point out that there are costs as well as benefits in corporate separation, and that these costs may outweigh the benefits to competition. In 2001 British Telecom decided to undergo the most robust form of corporate separation (full structural separation) essentially for commercial rather than regulatory reasons, by selling its network. It later changed its position when a new chief executive took over, but it is still under pressure from competitors and market analysts on the issue.

Recently the House of Commons Culture, Media and Sport Committee suggested that the proposal to separate British Telecom's network from the rest of the company be re-examined. Similar pressures have appeared in the United States, with the Public Utilities Commission of Pennsylvania requiring Verizon to split its network and retail activities, a decision subsequently overturned in the courts.

Any sensible discussion of Testra's future must consider the possibility of full structural separation, although this idea may not be viable as its time may have passed. Some argue that it is too late to head down the path of full structural separation because of the minority private shareholding in Telstra. Although this certainly makes full structural separation more complicated, it may not render it impossible. For example in the United States, the privately owned A T & T was separated – long distance call provision being separated from local telephony – in the interests of competition.

Less robust corporate separation strategies, such as internal separation, are still feasible for Telstra. This kind of approach could involve network and services companies fully owned by Telstra, but with separate boards and management.

The current options for achieving greater transparency and openness in Australian telecommunications include:

1. Strengthening the Regulatory Accounting Framework obligations, for example, requiring that the information is publicly available.
2. Much more strict internal separation, requiring Telstra Wholesale to deal with Telstra Retail on an arm's length basis equivalent to its dealings with external providers, and enforcing much higher standards of transparency with respect to costs, pricing and cross-subsidies. Telstra would be required to disclose full details of its pricing and costs to the ACCC. The British Government has imposed a regime of this kind upon British Telecom. It appears that the Howard Government is planning to head at least some way down this path. This approach would be designed to minimise the extent to which Telstra obtains an unfair advantage from its control of the network, without eliminating genuine synergies such as Telstra's entitlement to price discounts based on the volume of usage.
3. Splitting Telstra into two companies, each of which remains in majority government ownership (either directly or through a Telstra holding company) and imposing more stringent obligations of competitive neutrality on the services provided by the retail company. This approach would provide a stronger guarantee of competitive neutrality than a purely internal separation, and it would avoid the difficulties associated with any reconfiguration of ownership between the two companies. Both companies would continue to have an obligation to act in a manner which is not oppressive to Telstra's minority shareholders.
4. Splitting Telstra into two companies, and buying back the network into full government ownership. This would require a major restructuring process in which the respective ownership profiles of Government and private shareholders in Telstra are reconfigured. It does not involve further privatisation of Telstra, but rather concentrating the Government's ownership in the area which is arguably of greatest significance to the community, the network.

There are other possible reform strategies which involve splitting up Telstra along different lines than the proposed separation of wholesale and retail activities.

It has been suggested in the past that Telstra should be broken up into a number of regional companies. While this proposal may theoretically make it easier to deal with telecommunications problems in rural and regional Australia, it would do little to resolve the problems of inadequate competition. Many regional markets are less suitable for competition, as the Government's failed USO contestability trials have demonstrated.

Another possibility is to separate Telstra into a number of specialised businesses, such as fixed-line telephony, directories, pay television, mobile telephony and Internet services. Such a focus on Telstra's horizontal integration across numerous business activities would reflect overseas experience to some extent, and could lead to more genuinely competitive markets with more competition between different networks such as fixed-line and mobile telephony. However, it does not address the central issue of access to the network, and could involve a significant destruction of value in areas such as billing and marketing. As previously outlined, Telstra's current structure does require reconsideration from this angle, particularly its role in pay television and media. Whether it is appropriate to go further and separate closely-related telephony businesses is a different question.

Breaking up dominant incumbent telecommunications companies horizontally into separate businesses, in some cases in different ownership, has become widespread in Europe. In Spain Telefonica has separated out its Internet, directories, mobile telephony, media content, data, call centres and submarine cable businesses. Other major European companies such as France Telecom and British Telecom have taken similar initiatives. Prominent academic economist John Quiggin recently argued that Telstra should be separated along these lines, with its core business of fixed line telephony returning to fully public ownership. Separating Telstra in this way would restrict the company to its traditional

fixed line telephony role, resembling the former Telecom of twenty or thirty years ago. It would affect Telstra's capacity to bundle products into packages, and may unfairly advantage its competitors.

Aside from the options involving some kind of separation, the only remaining alternatives appear to reside in strengthening the existing framework. The Regulatory Accounting Framework requires Telstra to provide separated accounts to the ACCC on a confidential basis. The ACCC believes that it does not provide sufficient accounting transparency to enable it to determine the effective price Telstra charges itself for access to its network, because it is based on Telstra's existing internal structure.

The broader regulatory regime could be strengthened in various ways, for example removing the right to appeal against ACCC access decisions, as Labor proposed at the last election and the Howard Government now proposes to do. Currently the merits of these decisions can be appealed to the Australian Competition Tribunal, thereby permitting a virtual re-hearing of the original case. Sanctions could be built into the access regime to discourage regulatory gaming, such as penalties for a party failing to accept an offer which is more advantageous than the final arbitrated outcome. The various regulators in telecommunications could be consolidated into a single regulatory body.

Problems with the network, particularly in regional Australia, could be tackled by widening the Universal Service Obligation and Customer Service Guarantee, and extending the USO levy to help finance additional investment in the network. Telstra could be asked to increase its investment in the network in return for rebalancing of access requirements, allowing it to charge competitors more for access. The Government could make specific contributions to network investment from the Budget. Such approaches would be difficult to undertake on anything other than a quite modest level, and may undermine the viability of the competition regime.

Strategies could be developed for strengthening the market position of Telstra's competitors, for example by subsidising the building of alternative networks. One common criticism of the Government's Networking the Nation program is that much of the funding has flowed indirectly to Telstra, when it could have been used to assist alternative providers and foster greater competition. Redirection of Government assistance could help to restructure the sector, allowing the large number of small, mostly struggling companies to consolidate into much more viable competitors to Telstra and Optus. Recent Government attempts to achieve this through two trials of competitive tendering for the Universal Service Obligation have been essentially misconceived.

While Labor provided in principle support for the USO contestability trials, the outcome of these trials suggests that it may be better to foster competition where circumstances are conducive to it, and ensure that Telstra can continue to deliver its essential services obligations without being disadvantaged in its efforts to compete in other market segments.

All these approaches need to be further evaluated, but they may not be sufficient to solve the problems in Australia's telecommunications sector. Regulatory reform would undoubtedly assist, but it could also add to increasing complexity. Funding Telstra's competitors would raise questions about the role of government in making investment decisions, and would be likely to be very limited in scope because of budgetary constraints.

Reform proposals involving some degree of separation of Telstra raise a number of major issues, particularly those involving some greater level of separation between Telstra's wholesale and retail activities. Balancing the requirements of transparency and accountability against the needs of commercial confidentiality, defining the separate components of the organisation, reforming the regulatory arrangements and protecting the interests of minority shareholders would present major challenges. The remaining sections address these issues

under the scenarios of internal and full structural separation along wholesale and retail lines, Telstra as one company strictly separated internally, and Telstra split into two companies.

Where would the line be drawn?

Telstra is a very large and complex organisation. Allocating most of its constituent parts to a "network" or a "services" pile would not be hard, but some areas would be more difficult. Certain ancillary activities, such as corporate services and marketing, would probably have to be split up between the two new entities. At present, Telstra is divided into the following divisions:

Corporate Centre

Telstra Country Wide

Telstra Mobile

Telstra Wholesale

Infrastructure Services

Telstra International

Telstra Retail

Infrastructure Services responsibilities include planning, design, construction and operation of fixed communication networks and associated systems, and customer service, installation and repairs. Telstra Wholesale sells wholesale products and services to other carriers and carriage service providers. Telstra Retail provides sales and billing for residential, business and government customers, and manages other customer services such as directories and payphones. In 2000-01, 23 per cent of Telstra's revenue came from fixed line sales, 14 per cent from mobile telephony, and 14 per cent from Internet and data services.

Drawing a line between services and infrastructure may also be complicated by the increasing technological sophistication in telecommunications. It may be difficult to excise particular services which are effectively embedded in the infrastructure and which could readily be characterised either as retail or wholesale activities. It is possible that certain existing services, such as call centres, may need to be separated into infrastructure and services categories. Administration of Telstra's existing data centres and international agreements with carriage service providers would probably need to be attached to the network company. The position of certain operational components of the network would need to be examined. For example, the origination and termination of calls between the fixed line network and mobile networks would need to be clarified.

Some argue that Telstra's directories should be included in any separated network company, as they carry powerful natural monopoly characteristics. If this arrangement did not eventuate, it may be necessary to develop a new regulatory regime for directories.

Difficulties with drawing lines would be relatively limited when using internal separation to achieve greater openness and transparency. There should be no major reason why either or both Telstra's network or its retail arm could not be separated into wholly-owned subsidiaries which then enter into contracts with the parent body or each other. This is exactly what occurs with Telstra's Network Design and Construction arm.

More serious difficulties would arise in the construction of regulatory definitions, which could possibly open up new opportunities for regulatory gaming. It would also be important to ensure that new obligations of transparency and accountability did not unduly impinge on the legitimate need for Telstra Retail to maintain commercial confidentiality equivalent to that enjoyed by its competitors.

Splitting Telstra could raise specific anomalies. It would be essential to ensure that any such anomalies are very minor, and have minimal impact on the efficiency, accessibility and competitiveness of the telecommunications sector. Recent experience with British Telecom's attempt to separate itself into two companies suggests that difficult arguments would arise, but should be capable of resolution.

What would happen to existing regulatory arrangements?

Existing legislation governing Telstra would require extensive review if any separation strategy is pursued. It is likely that a variety of prevailing regulatory arrangements governing Telstra's structure and activities would need to be updated.

Clearly if Telstra were fully structurally separated, parts of the existing regulatory regime may become redundant. Some kind of access regime would still be required to govern commercial access to the network, but without the inherent conflicts in the existing regime it would focus more on technical issues. Pricing would be more transparent, and non-discriminatory as between service providers. Administration of the network would necessarily require some kind of participation from carriers selling services on it, for example through a formal advisory board. Before making any decision to internally or fully structurally separate Telstra it would be necessary to develop a new regulatory model for access to the network which addresses these issues. This model would be much less cumbersome and intrusive than the existing arrangements, producing efficiencies and savings which could be passed on to consumers. Such models should deliver clearer pricing and investment signals, leading to more efficient allocation of capital within the company, including the network. This would also allow more efficient and effective price controls to be maintained, ensuring better and fairer protections for consumers based on actual rather than assumed costs. Key price controls including the 22 cents cap on local calls and regional price parity would be maintained, and price controls for low and middle income earners could be better targeted. At present untimed local calls are guaranteed by the Telecommunications Act 1997 and the Telecommunications (Consumer Protection and Services Standards) Act 1999, on the basis of Telstra's call zones as at July 1 1991. Telstra has recently offered effective extensions to existing zones through its Wide Call Option and Regional Call Option.

The mechanism for ensuring the Universal Service Obligation and the Customer Service Guarantee may need to be varied depending on which parts of Telstra ended up in the network company. If, for example, the provision of pay phones and rectification of phone faults were to stay as part of the network the USO and CSG obligations covering those services could be transferred to the network manager. The substance of the USO and CSG must not be diminished, indeed both need to be upgraded to reflect the new range of data services upon which Australians increasingly rely. Any new arrangements must ensure that consumers are not disadvantaged.

Internal separation of Telstra would open the way to significant regulatory reform. The access regime would be streamlined, and price controls would be more efficient and better targeted. Maintaining the USO and CSG would be relatively straightforward, but they may require some revisions to reflect the impact of the new regulatory arrangements. These efficiencies need to be assessed against any increase in other regulatory compliance costs incurred by Telstra, given that internal separation would impose much stricter accounting and reporting obligations.

How could separation be done?

Internal separation of Telstra into two separate companies without changing the ownership configuration would require either regulatory intervention or management involvement, which would be much more difficult to obtain if Telstra is fully privatised. In various forms

this kind of change occurs occasionally in the private sector. There are several options for dealing with such a separation which would require careful consideration. The real difficulties arise in any proposal to split Telstra into two companies, particularly if ownership is restructured to create a publicly owned network and a privately-owned services provider. Shifting the minority shareholding into ownership of one part of what currently constitutes Telstra is conceptually simple but likely to be very complex and difficult in practice.

There are several ways in which this objective could be achieved. The most obvious is for Telstra to sell all of its businesses other than the network, and then to return the sale proceeds to its shareholders. The proceeds accruing to the Government could then be used to buy the shares still held in the remainder of Telstra by private shareholders. Alternatively, the Government could acquire the network from Telstra, compensate minority shareholders, and pay for this compensation by selling its shares in the non-network remainder of Telstra. This could also be achieved through a trade sale, with the Government buying the network from Telstra and using its Telstra shares as consideration for the purchase.

Many issues would arise in this process. Valuation of private shareholdings, the extent to which sale and purchase processes are market-based, rights to the Telstra name, and the impact on the Telstra share price prior to separation are examples of major issues which would need to be addressed. If the network is acquired first, some form of bridging finance strategy would be required.

Splitting up Telstra could only be undertaken in a way that fully protects the interests of minority shareholders, and which does not infringe the Corporations Law and s.51 (xxxi) of the Australian Constitution, which protect their rights. Incidental stamp duty and Capital Gains Tax liabilities would need to be eliminated, to ensure that shareholders are not disadvantaged by an effective realisation of an asset which they have not initiated. If Telstra were to sell its network to the Government at a price above its tax depreciated value it would incur an effective tax penalty. If the number of Telstra shares is reduced, Telstra could lose some franking credits. With the network operating as a separate entity, new GST arrangements would prevail. A variety of such taxation related issues could emerge depending on the method of separation employed, and would need to be addressed. It would also be necessary to restructure Telstra's existing debt of approximately $13 billion.

The substantial transaction costs involved in full structural separation could make such a change undesirable. Such costs would extend well beyond the usual costs associated with such major business transactions to include a variety of consequential costs, such as business reorganisation costs in each of the new companies. A number of transmission of business issues would need to be dealt with, such as guaranteeing the employment and terms and conditions of existing workers.

Valuation would be a critical issue in any proposal to return the network into full Government ownership. The ACCC uses a valuation method for determining an appropriate pricing regime for former public utility infrastructure networks. Market sources suggest that if this methodology were employed, the value of Telstra's fixed line network would be somewhere between $20 billion and $25 billion, depending on whether or not those parts of the network which are already exposed to competition from other networks are included. Other methods of valuing Telstra's network could produce different results. The ultimate value of the network would depend largely on the new regulatory regime which would govern its operations and in particular, the prices it could charge.

Would separation destroy value?

The traditional argument in favour of maintaining a variety of economic activities within one very large corporation is that this generates economies of scope and scale through incorporating a wide range of related economic activities within the one organisation. A

horizontally and vertically integrated Telstra generates internal synergies which enhance efficiency.

At present it is impossible to estimate the extent of such synergies, and to what extent they derive from inefficiencies in the access regime. We must avoid destroying economic value which arises from genuine synergies, but ensure that monopolistic behaviour is not rewarded. Although the importance of economies of scope and scale is less prominent in economic theory than it once was, it should be treated seriously. A process which is done internally within one company that is changed into a formal transaction between two separate companies is likely to involve additional transaction costs. Even under an internal separation model this may be the outcome.

The existence of third party access arrangements, which in effect impose some of those additional costs anyway, reduces this concern. Technological change in the information technology and telecommunications spheres is tending to undermine returns to scale. The value of economies of scope is likewise being undermined by benefits accruing to specialisation.

Horizontal and vertical integration often conceal true costs, leading to inefficient investment decisions that destroy value. Some market analysts support the full structural separation of British Telecom because they believe that the value such a transaction would release would outweigh the value of lost synergies within the company. Corporate separation could help to expose inefficiencies in Telstra's current structure, releasing value to the benefit of shareholders and consumers. Whether this would exceed the benefits obtained by Telstra through the synergies generated by its current structure would need to be examined, but there are significant market pressures for splitting up large conglomerates which need to be considered. Recent experience in Europe indicates that investors believe the costs of conglomeration of telecommunications activities into a single giant business outweigh the synergies. Horizontal separation of particular businesses by major European telecommunications companies has tended to have a positive impact on share prices. Whether this would occur in any vertical separation of Telstra would need to be considered.

The future of the government's dividend from Telstra is also a major consideration. In 2000-01, Telstra returned a dividend to the Government of $1.159 billion. If full structural separation of Telstra is pursued, the Government would need to continue to obtain reasonable dividends from the operations of its telecommunications company, or find equivalent revenue or savings from elsewhere.

These concerns would require careful consideration before any decision to fully structurally separate Telstra is taken. The benefits to openness, transparency and economic efficiency from splitting Telstra into two companies may be very substantial, but it should not proceed if those benefits are outweighed by the impact of transaction costs and loss of economic value. Internal separation would also carry some costs, but of a much more limited nature.

Where would this leave the future of the network?

One argument against returning the network to full public ownership is that this part of Telstra's business is likely to decline in value as technological change opens up competing opportunities. Some argue that mobile telephony and wireless networks will ultimately prevail, gradually rendering Telstra's core network, the Customer Access Network, redundant. The prospect of delivering telecommunications services into the home through existing electricity wiring is also beginning to emerge.

Some argue that by fully structurally separating Telstra and buying back the existing network the Government would expose itself to a heightened risk of "technology stranding". As

alternative delivery mechanisms take over, the Customer Access Network could become virtually obsolete.

However any risk is already factored in to the market value of Telstra and would be a significant component of any market response to the Government's plan to fully privatise Telstra. The Howard Government can hardly argue against separating Telstra on the basis that this would leave the Government owning an enormously overvalued asset, given that it is trying to sell that same asset to private investors.

The advent of ADSL has also softened some of the claims that the network is destined for obsolescence, and it is important to avoid the intoxication which often accompanies the emergence of new technologies, which sometimes have a fraction of the impact initially predicted. The Telstra network has two enormous advantages which should not be ignored: it already exists, and it is virtually ubiquitous. We must take account of the risks associated with the emergence of new technologies, but also keep in mind that technological change offers the possibility of enhancing the strength of the network just as much as it entails threats to it. These risks could also be ameliorated by ensuring that the network company continues to have access to alternative service delivery technologies. The Productivity Commission recently noted that Telstra's network is likely to remain the primary telecommunications network for the forseeable future (*Telecommunications Competition Regulation* p.111*).*

If the network is fully structurally separated, it would be important to ensure that incentives to innovate and invest in new technology are maximised. Regulatory oversight would be required to ensure that investment decisions are not unduly influenced by external factors. The interests of carriers would need to be reflected in administration of the network, but not to the extent that they prevailed over the longer-term interests of consumers, for example by reducing investment to lower costs and thereby access prices. Balancing this imperative with the need for continuing price-caps would require a new set of regulatory arrangements.

Under any corporate separation model (internal or full structural separation) it would be extremely important to ensure that investment incentives are not reduced and that an appropriate return on investment is ensured. Under any form of separation it would be vital to ensure that continuing investment is not jeopardised by factors such as Government budgetary problems. Maximising use of the network, through both network and services competition, is the best way to ensure continuing investment and good returns.

Conclusion

The opening up of Australian telecommunications to competition has been only a partial success at best. The future level of competition in the sector remains problematic, and major public policy issues must now be confronted. Telstra still constitutes three-quarters of the industry, earns over 90 per cent of its profits, and dominates all markets in the sector. Telecommunications services in regional Australia are seriously inadequate, and Telstra's network is deteriorating.

There is clearly a need to rethink our approach to telecommunications policy. We must introduce greater transparency and openness into the operation of our communications networks and develop a clearer definition of Telstra's role. Minor fiddling with the existing regulatory regime is unlikely to solve the mounting problems in Australian telecommunications.

Further privatisation of Telstra will simply worsen these problems. It is time for a wide-ranging public debate around the options for major reform of Telstra and telecommunications regulation.