Maximising Telstra's Value

Malcolm Moore
16-Jul-2005

Introduction

1. Abstract

This proposed lateral solution will give steady and strong growth to Telstra/BigPond and other associated telecommunication stocks on the ASX over several years, together with an intuitive infrastructure approach to provide essential footing for Australia's developing IT and financial industries. This proposal is in line with the Treasurer's (Peter Costello) very recent announcements foreshadowing an overhaul of Australia's decade-old national competition policy, which has proven to become extremely expensive and unworkable. ***("Mr Costello said creating productive and efficient national infrastructure -- electricity, water and gas -- was the economic main game."[1])***

In comprehending this proposal, it is necessary to empathise with the mindsets in both competitive business and infrastructure business, and through realising these

[1] The Australian 29 June 2005

diametric differences, lateral strategic solutions then emerge that will satisfy the Federal Government, Merchant Bankers, stock exchange - financial industry - superannuation requirements, competitive telecommunications businesses, Australia’s telecommunications infrastructure, IT business development, all businesses in Australia and a wide range of community services.

For some decades Merchant Bankers have been coercing the Federal Governments for the full sale of Telstra for reasons of ‘efficiency’ and ‘competition’. The Federal Government can see the money that can be ‘generated from the full privatisation sale’ but relatively short-term past history has shown that the earlier partial sale of Telstra did not bring the benefits that the Merchant Bankers stated in their business cases, making the full sale highly questionable. Optus (which now has exactly the same internal business conflicts as Telstra) was grafted off Telecom Australia, privatised then lost to an overseas interest, SingTel.

The earlier partial sale of Telstra put the Federal Government in a dilemma where the benefits of selling cannot be realised (as demonstrated by the languishing TLS share price of about $4.90 for some years). Merchant bankers and associates are still pressing for the sale, so that the financial fraternity can give them 10 to 20% of Telstra’s revenue. This proposal has a list of recommendations leading through a strategy that will provide a win-win solution for the Federal Government, all Australian businesses and Australia’s citizens.

2. Historical Background

Historically, telecommunications started in Australia in 1865 and it has continued to support government, businesses, communities and create new businesses off it ever since. Since the early 1970s there has been heavy international pressure from USA based Utility companies via the World Trade Organisation (WTO) for the Federal Government to privatise its infrastructures. The reasons for ‘privatising’ were based on competitive accounting practices and this accounting clearly showed that in privatising Australia’s telecommunications, tremendous efficiencies could be realised and this would drive down user costs. (To date no 'efficiencies' have been realised due to competition - actually the reverse - and all 'efficiencies' to date have been credited to technology advances!)

Without inside working knowledge of telecommunications at the time, phone call costs were comparatively high and all service was carried via the Post Office, as the Post Master General’s (PMG) Department nationally managed Postage and Telegraphs (and about 70% of families had telephones). Most major cities had automated switching, and all long distance calls were operator connected. All equipment was hand-manufactured and manual labour costs were a major budget component.

The WTO had a far more sinister strategy and that was and still is to float the Australian telecommunications infrastructure on the stock market, and manage it in the same manner as electricity companies in the USA. The 1930’s depression was a direct result of greed in the USA stock market – directly related to electrical companies – issuing future on futures. This catastrophe almost repeated itself with the collapse of Enron in 2001 (another floated ‘electricity’ company) – again issuing futures on futures (greed on greed).

The first step was to split the PMG Department into several bodies, one being the Postal service and another being Telecom Australia. With these now split in about 1975, Telecom Australia had no customer interface – apart from district offices. This put the WTO in a prize position as the next step was to show that this now faceless body was also inefficient. With creative accounting a measure of efficiency was based on the number of people employed per 10,000 lines! Naturally this showed that Telecom Australia was very inefficient, as maintenance was not contracted out to hide the facts, as it was in some other parts in the world - even though prices were consistent with other countries.

The fact was that Telecom Australia was highly efficient, but the measuring tools used in competitive accounting showed exactly the opposite. This was caused by the USA based electricity Utility companies that had proactively (over several decades) removed literature and teachings about the negative effects of competition. This will not be in any Economics course – refer to: *Prof Sharon Beder, Power Play: the fight for control of the World's Electricity, ISBN 0 908011 97 0, Scribe Publications, Melbourne.*

In line with this mantra of efficiency and competition, the Davidson enquiry 1982 followed this line and proclaimed that Telecom Australia was inefficient and that certain measures were to be adopted to make efficiencies. One of the measures that came into being was no surprise, was to introduce 'competition' to force Telecom Australia to become more efficient in the (false) belief that competition will drive down prices!

The early 1980s brought with it a wide range of technological advances, including printed circuit boards for mass production, the wide use of integrated circuits, and the introduction of digital switching. These technologies combined to implode the costs of telecommunications switching equipment, provide a wide range of services previously unavailable, and increase the reliability of this equipment by a factor of at least 20 times. None of these had anything to do with competition in Telecom Australia!

The late 1980s brought with it another wave of technological advances, including very stable digital transmission techniques, the introduction of optical fibre for inexpensive long distance communications, personal computers, common channel signalling, and fast mass production techniques. These technologies combined with previous technology advances to further implode the costs of telecommunications transmission and signalling equipment, provide another wide range of services previously unavailable, and increase the reliability of this equipment by a factor of at least another 20 times. None of these had anything to do with competition in Telecom Australia – but competitive policies wrongly claimed the credit!

User prices came down marginally over several years, then as competition increased the prices plateaued out and now are rising – so it is clear that competition does not drive down user prices – technology advances did that! Competition drives prices up and service down.

The rise and rise of Internet from the early 1990s till now has made little change to the network structure, and little change in overall telecommunications costs – because the increasing costs of competition have swallowed up the savings made through technology advances like Voice over IP (VoIP), ADSL and SDH/ATM on WDM in optical fibre (OF).

So we now have an Australian telecommunications structure that I believe is too thin outside major capital cities and this lack of infrastructure is the prime reason that people cannot support businesses outside these major capitals. Consequently our younger generations are leaving the rural cities and country areas in search of work, and that is putting an inordinate amount of stress on our major capital cities – which is reflected in very high city residential costs, very high rentals, both partners in families having to work, and that has lead to family social problems on massive scales, which in turn seriously drains our Federal financial resources for all the wrong reasons.

3. The Wish List

In setting out to resolve this dilemma, it is important to gather the desired wishes and recognise these. At least then these desired wishes can then be identified and addressed. The following headings address several concerns that I am aware of, and this is not exhaustive.

3.1. Strong ASX Value

Companies that have strong ASX values have a range of structural similarities in them. Some of these similarities are:

3.1.1. Focussed Business Line

Competitive businesses that have a clearly focussed business product line are the ones that excel and the reason is simple in that by having a common goal or purpose, then all energies are directed towards that goal and not elsewhere.

Currently Telstra/BigPond is in a dilemma with retail sales and marketing arm selling retail telecommunications products, a wholesale arm selling wholesale to both themselves and to other competitive resellers and other carriers, and a physical network/equipment arm. There is no argument that this very broadly focussed approach has a range of self-conflict issues that seriously blunt the Telstra/BigPond business focus – even to the point that various parts of the same organisation are in direct conflict with each other and this cannot be good for internal business and external competition. (Optus and Orange have exactly the same problem.)

With the retail sales and marketing arm of Telstra spun off as a private company being BigPond (taking with it all the competitive retail business interests of Telstra), this leaves Telstra as an infrastructure business clearly focussed on providing the best service standards possible into a wholesale market and more importantly, it positions BigPond as a very clearly focussed competitive business to retail/resell telecommunications products from Telstra (as a wholesale provider) and any other telecommunications infrastructure (wholesale) provider.

If there is any doubt that this would not be a very strongly priced ASX company then look at other companies on the ASX that are focussed on retailing whole supplied products. Consider Coles/Myer (CML), Woolworth's (WOW), Foodland (FOA), Harvey Norman (HVN), etc and a plethora of other competitive reselling businesses already on the ASX and doing very well - so there is no argument here. Telstra/BigPond has a long list of contractual agreements with a huge range of businesses and telecommunications expertise that is very difficult for competitive start-up businesses to mimic.

If there is still any further doubt then look at BHP and its' spinning off of Bluescope (BSL) and both companies benefited, not only on the ASX but on business streams too.

3.1.2. Household Name

Companies having enough exposure through the media, product labelling, or simply being around for decades; that their company names are known by most people in most households.

Telstra has been around for about 140 years in its various forms and it is without doubt it is one of the most commonly known business names in Australia. In more recent years Telstra has marketed its Internet products under the banner of BigPond, and now Telstra and BigPond are synonymous, so BigPond is now also a very well known household name.

If Telstra was to 'spin off' BigPond as a competitive business there would be no problem in using the name BigPond as this name is already extremely well known. This in itself will give the spun off company a head start in remaining strong on the ASX.

3.1.3. High Entry Point

Competitive businesses have been around for some decades and over that time they have built their structure, and any other company that wishes to compete in that part of the competitive market is going to have to grow to an equivalent size before they really are a threat.

As it stands the Australian telecommunications has an almost prohibitive entry point because of the few major incumbents Telstra/BigPond, Optus (SingTel), and Orange (Hutchison) and any competitive business that wishes to make an entry into this market will need to have a massive capital backing.

Telstra/BigPond has its name from OTC (Overseas Telecommunications Corporation) and Telecom Australia, all of which originally came from the Post Master General's (PMG) Department in 1966; and quaintly enough the DCITA (Department of Communications Information Technology and the Arts) – a Federal Government Department (as an infrastructure business) is in effect the morphed remainder of the PMG!

Telstra's retail sales and marketing arm is a highly competitive business in its own right and physically it is big, with a high entry point because of enduring contractual agreements, and a large stable revenue making it rather difficult for any other competitive business to move into this area and seriously devalue this business. This intrinsically gives Telstra/BigPond (retail / reselling) a strong ASX value. (Note: This does not include network equipment!)

3.2. Ongoing Superannuation Support

Funding superannuation via investment in the ASX is commendable as it effectively injects funds into Australian companies. The first issue is that the baby-boomers will be going into retirement in the next 10 to 15 years and most of these will need substantial superannuation support – hopefully through investments in Australian companies – facilitated via the ASX.

The second issue is that the ASX basically consists of about 20 to 30 big companies and the rest are much smaller companies, and if Telstra (TLS) was removed from the ASX then as this company is one of the heaviest traded and invested ASX based companies, then this would leave a serious hole in the ASX investment portfolio. BigPond (BPD) will fill that!

Telstra (TLS) is locked in as a virtual permanent and major investment vehicle in the ASX, but there is an incredible sticking point – the TLS share price has languished around the $4.90 mark for several years and frankly it is a poor investment choice because the share price falls when Telstra has to invest in infrastructure, and rises when the Board of Directors is shored up by people with a wealth of competitive business acumen, and lacking infrastructure business acumen. These people are on the Board of the wrong business.

This share price should be rising by about 7% to 15% per year, and it can't because Telstra is encumbered by a very large infrastructure that needs constant investment, and it has a Board of Directors that have a strong competitive business focus – which is virtually diametric to what is really required to lead and direct this (largely) infrastructure business!

Simply by spinning off the retail/reselling portion of Telstra/BigPond (as BigPond BPD) and converting all private shareholding to BigPond from Telstra, and taking the existing Board of Directors to run BigPond, then this spun off competitive business will have a very clear focus, strong continual revenue, little overhead, household name, excellent existing product range and a stable and reliable wholesale source.

With these attributes the new BigPond (BPD) will an ideal investment vehicle that will be able to continually grow in intrinsic value and stock on the ASX will provide further strength for supporting the baby-boomers without dragging on the Government financial purse.

As Telstra is then removed from the competitive business arena, and firmly positioned in the infrastructure business arena, it can get on with the job of anticipating network growth and providing that network for competitive businesses and communities to grow on. If Telstra then decides to perform a major network upgrade, this will not negatively impact on the BPD share price – in fact it will act positively on the share price as this means that there will be more revenue stream for BPD to purchase and on-sells to competitive business and the public.

Telstra's optimal position will be a sub-Government commission with its own funding, operating as an efficient infrastructure business where the initiatives to develop the infrastructure and manage the finances come up from within and not down from the Minister.

3.3. Publicly Known Wholesale Rates

In telecommunications there are two effective user rates. First are the retail product rates and these are individual depending on the service, its intended usage and a sign-up period. The second is the wholesale product rates and these are bulk prices based on location (or area) intended bulk usage, grouped service standards, and bulk quantity of services.

A competitive business is naturally very secretive about wholesale prices as these provides an open door for a competitor to work out the sales margins and then the competitors' approximate revenue, and that leaves the competitive (retail) business vulnerable for possible takeover. If a large competitive business also provides retail products then competing retailers that buy their wholesale products from that competitive (wholesale) business can find themselves in a price war that they cannot win, as the larger competitive business will be able to internally undercut to keep and grow market share.

An infrastructure business is naturally very up front and open about wholesale product costs as it has a long-term view of its products, because it has equipment installed and in use over several decades. With this mindset, an infrastructure business is looking to recover the equipment costs in about 50% of the life cycle, which may amount to say 15 years. This is in stark contrast to retail products (in competitive businesses) that have a life cycle of about 6 to 24 months.

It therefore makes sense that infrastructure businesses should manage the wholesale pricing, and as there is no real competition and that life cycles are typically several years, there is no rush to recuperate the funds in the first few years, so the pricing for wholesale products can be stable and openly promulgated.

3.4. Low End-User Costs

Competitive businesses have a very simple philosophy in asking the highest price possible for products, and the higher the demand for the product, the higher the asking price. Conversely if the supply is high then the price comes down – and that is simple Economics!

Large privately owned competitive businesses with a monopolistic control of the market are able to control the supply of products and therefore can to a large degree control the price to maximise their profits. This is also simple Economics! Monopolies only exist in competitive business environments – because of the mindset of competitive management.

By having an infrastructure business provide the products/services, the profit margin is naturally minimised because of economies of scale, and the need for a moderate but not maximised ROI. This provides the footing for a few competitive retail/reseller businesses to buy the wholesale products at known low commercial rates and on sell these products/services as value-added retail products.

User costs are a function of the wholesale costs (which will be common and standard) and the retail mark-up. Sponsoring, advertising and marketing costs will impact on competitive business operating profits and this will determine the level of publicity that competitive businesses will use to promote their retail products.

3.5. Excellent Service Standards

Service standards in telecommunications relate to phones and Internet being usable, being able to connect, communicate clearly/quickly, and meter/billing accuracy.

In a Competitive Business service standards are an overhead cost that is uncomfortably tolerated as a means to make a profit. If at all possible these overhead costs would be eliminated and that means that service standards would be minimised – and this is why regulation is required in competitive markets. Clearly, service standards are not part of competitive business, so lip service is provided and that is why competitive businesses push for de-regulated markets – to minimise their service standards, and maximise profits.

In an Infrastructure Business service standards are the basis for business and a lot of work goes into specifying the standards base line and improving the processes so that these service standards are continually improved. It is common practice to regularly review the service standards and then tighten the specification because improved service standards in one area positively impact in other areas. Clearly, excellent service standards are an imperative for an infrastructure business base line, and the need for Government regulation is minimised.

Service standards are therefore part of infrastructure business, and not part of competitive business. Infrastructure business will naturally take on the role and responsibility for excellent service standards, and this takes a lot of the weight off government departments to legislate service standards onto unwilling competitive telecommunications businesses.

3.6. Equitable Services Possible

In 1982, the Davidson report brought in competition as the panacea to a problem that did not exist, and in that same move, it also introduced what was called the Universal Service Obligation (USO) to ensure that customers in regional and remote areas in Australia had basic telephony services (equivalent to the minimum standards in metropolitan areas at that time).

The underlying problem was that (at that time) almost all the Telecom Australia network was based on analogue electronics, mechanical switching, and manually assisted switching. Because equipment was then hand manufactured, it was prohibitively expensive and consequently telephone access beyond major cities was difficult to engineer, install, commission and maintain. (This was the unsighted reason why Telstra appeared inefficient!)

The Davidson report recognised that regional and remote telephony services were generally a poor standard, and the USO initiative was introduced to make sure that funding was provided to regional and remote Australian based customers to lift their telephony service standards.

With digital transmission, digital switching, printed circuits, surface mount, optical fibre and a range of signalling technologies all came together in the early 1990s; equipment costs plummeted and reliability rocketed. This culminated in a range of new customer access technologies that greatly improved telephony access in regional and remote areas, but in a competitive business approach, these areas are very expensive to maintain and certainly do not return a profit – so minimum infrastructure is installed.

By repositioning Telstra from its current position to an infrastructure business, it is then in Telstra’s interest to provide equitable telephone and Broadband Internet services in rural and remote areas, so that communities can thrive, and businesses can benefit and become highly profitable from this infrastructure. This is in stark contrast to the USO approach where competitive telecommunications businesses are fighting each other not to provide the necessary funding. This also will remove government pressure in resolving the ongoing USO funding.

3.7. Ability to Support the Information Age

In the past decade compared to the developed world. Telstra has fallen from about 4th to about 14th in regards to network developments, and this is because the Board has restricted infrastructure development as this activity causes the share price to drop. The funds go to infrastructure instead of the shareholders.

Although optical fibre technology came of age in about 1986 and virtually all Telstra is connected internally with optical fibre, the customer access network (CAN) still remains ageing copper pair technology and this was engineered for voice: not data, and especially not Broadband Internet. ADSL has been pressed into service but this is a stopgap technology that is already seriously outdated and it will become a white elephant structure – because it was a short-term technology solution.

There has been considerable pressure from Merchant Bankers and other financiers to fund the replacement of the ageing copper CAN with optical fibre – but the current associated inter-exchange network is far too thin in any but the major cities to carry this capability. If this is externally funded then there will be further deficits against Telstra.

The replacement of the ageing CAN with optical fibre is a large national project that needs to be done in synchronism with considerable bolstering of the inter-exchange network, and this is an infrastructure business imperative. The current Board management structure of Telstra / BigPond with a competitive business focus is prohibiting technological advances in the telecommunications sector and these delays are impacting on the future sustainability of Australia's GDP. With structural then physical separation, Telstra (wholesale/infrastructure) will not be prohibited from introducing these necessary technologies for Australia.

4. Conclusion

In the last few decades, telecommunications in Australia has moved from an elite product into an essential service, and it is now one of the main focal points for the future competitive business development – and we have moved from the Industrial Age into the Information Age and our new Information Economy will depend on an ongoing efficient and effective telecommunications infrastructure as a prime essential service in Australia.

The prime agenda for any competitive business is to make money (by whatever means - ethical or not) for its shareholders. (That is why competitive businesses should never be Government owned.) The prime agenda for an infrastructure business is to provide essential services at high standards so that competitive businesses and communities can thrive from their use. (That is why responsible Governments must own and manage essential services.)

With the understanding that Telstra was pushed into being a partial competitive business, it is now far clearer to comprehend that Telstra has an immense capital-intensive infrastructure business that it is protecting in any form that it can – including self-conflicts in pricing.

Competitive businesses see an immense capital revenue stream in Telstra and this is the prime reason that financial institutions have and are continuing to coerce politicians to 'privatise' Telstra. From a financial aspect taking 10 to 20% of the revenue and putting this into the financial market was a godsend for the ASX – but this was very short sighted.

It therefore stands to reason that the infrastructure side of Telstra must be a sub-Government Commission, and the reselling side of Telstra/BigPond will be become the privatised side, first structurally then physically spun off. That completely fixes the self-conflict of pricing, conflict of ownership, and conflict of regulation issues, conflicts of infrastructure, and puts a very marketable competitive business on the ASX register.

Telstra is set up in Business Units and it is a no-brainer to sort these out like sheep in a sheep run into Infrastructure and Reselling (some may need a little tweak) - I know, I worked in and with almost every area within Telstra and in a Multinational for more than 35 years!

Although Telstra has been on the Australian Stock Market (as TLS) for several years the share price has never reached its full potential and after reaching a peak of about $7.40 the price has languished around the $4.90 mark for the last three or four years.

There is a considerable upside that can be obtained by first structurally separating Telstra into a competitive retail reselling business (as BigPond), and an essential service wholesale provider (as Telstra), then physically separating the two structures with the shareholders in the ASX moving to BigPond, and the essential service provider becoming a sub-Government Commission staying as Telstra.

This restructuring also follows the same path to correct the problems looming in the electricity supply infrastructure as recently highlighted by the Treasurer, Peter Costello.

5. Recommendations

As the long-standing push to privatise Telstra has not revealed the benefits that were claimed, this has severely discredited the integrity of Merchant Bankers and the financial fraternity. From this perspective the issue is now to drive through with the full sale of Telstra irrespective of the consequences, take the commissions for the sale and blame the changed conditions for the problems caused. ***Clearly the outright selling of Telstra has major obvious flaws that will negatively impact on the Government, business, and the community in general, so alternate solutions need to be identified and implemented.***

In Australia (and probably worldwide) because of overwhelming competitive business accounting processes, virtually all accounting is done in terms of the immediate bottom line and in terms of that business being assayed. This process of accounting in no way fits with infrastructure businesses as here the bottom line is measured in terms of support that is provided to competitive businesses and communities. ***The process of using competitive accounting practices to measure infrastructure business has to cease immediately as this is clearly an unethical competitive practice. Infrastructure accounting practices need to be developed and instituted to account for all infrastructure businesses – and this includes all Government Departments.***

Telstra is now both an Infrastructure Business and a Competitive Business. Clearly it has two diametrically opposing mindsets within itself and this is the prime cause for inefficiencies. ***Telstra needs to be structurally then physically separated and the competitive business (retail product development and sales/services reselling) spun off as the privatised part.***

As this already fully privatised part of Telstra will have a narrow competitive business focus, a large and continuing revenue stream and well recognised business name (BigPond – BPD) the privatisation process is very simple. ***All holders of Telstra (TLS) are to be given a 1 for 1 equal value share in BigPond (BPD) and concurrently all TLS shares will become void.***

BigPond will have a clear competitive business focus based on providing retail services purchased in wholesale from Telstra (infrastructure) Corporation and other infrastructure providers as BigPond sees fit. The process of placing BigPond as the reseller, positions it as unencumbered by infrastructure and other limiting issues, making it a highly competitive business. ***With Telstra having spun off BigPond as the privatised company and having BigPond as clearly focussed on retailing wholesale telecommunications products, this keeps a strong and continuous revenue through BigPond and this keeps a very high value in this company, so really there is little to stop the share price from appreciating greatly.***

There is nothing stopping other competitive business resellers from entering this telecommunications reselling market. ***The ACCC based legislation, and cases relating telecommunications non-competitive actions should be minimised, as this competition base is from a common source with common and openly known wholesale pricing.***

Current legislation encompasses customer service standards in wholesale form. Because retail products offer a choice of various services and service standards, the number and range of retail products far exceeds that of wholesale products. With the move to Telstra (infrastructure), these service standards effectively move from legislation into part of the wholesale product specifications, greatly lightening the legislation burden carried by the Government. ***In specifying the range of available wholesale products, Telstra (infrastructure) will include service standards and other network engineering criteria and this will be the basis for wholesale pricing and industry standards.***