

When the *Telecommunications Review* asked outgoing Telecom Chairman Dr Roderick Deane to share his views on the pressing issues facing the leading industry player he obliged. Here are his answers to probing questions from *Telecommunications Review* journalist David Dickens.

DD In what shape is Telecom now?

RD If you look at the international comparatives of Telecom as we do on a number of fronts we can get a measure of each particular part of our operation and compare it to best practice internationally. Although there is always scope for improvement, we are in quite good order. Against most of the international comparisons we rank well for efficiency, processes and productivity levels. So we are in quite pleasing order compared with best international practice.

At board level we look at this material routinely. In terms of our purchasing policies, and our supply arrangements we are in a sound position. We do a lot of work with one or two major suppliers and recently the board saw a detailed comparison of what prices we might be paying compared for example with the leading Chinese suppliers. These prices are very competitive partly because our suppliers while being American or European based, have plants in China as well. We are in good shape.

On the financial front, we are a strong company with an excellent credit rating, a sound balance sheet, and good returns from our operational businesses. The major challenges we face are competition and technological change, which it is of course our job to cope with, and regulatory change, which is government driven and is proving very damaging for the company.

How do you as Chairman of the board keep in touch with politicians?

For the last few months we have not been as closely in touch as we would have liked to have been. Typically the chief executive and senior staff of the company meet with politicians on telecommunications issues. This happened more often than with board members who are non executive.

I would visit ministers reasonably regularly. In the last several months I would have visited half a dozen government ministers and talked to them not just about Telecom issues, I chair also the ANZ National Bank and Fletcher Building, but about issues that concern us across a broader front. I did a round with ministers recently expressing concern about (a) the extent of regulation and (b) the enthusiasm and aggressiveness with which it is being administered and (c) about the changes occurring in the regulatory environment and the uncertainty that is creating for our investment programmes. If one has a regulatory environment, one makes an investment and then changes occur, the return typically goes down and one has a serious dilemma. I got a respectful hearing from the various Ministers I called on. Did I get a reaction ? Not really. This is a government

heavily driven by regulatory interventionism. I have not seen a government in New Zealand since Sir Robert Muldoon's days that has been as regulatory inclined as this one.

What is driving this government's telecommunications agenda?

It seems to be government and politically driven more so than government official driven. But the culture in the public service has changed over the last few years and become more conducive to all this regulation than was the case a few years ago.

Now what has happened over the last few years is that it has become much more inclined to centralized controls, including particularly over large elements of the private sector. Why anybody should assume government officials know better than people in the corporate world about how to run companies I have no idea. Most of them have no experience of working in the private sector or running a company, big or small.

Is it possible for regulators to do a good job, free from political interference?

The answer is very rarely. Look at unbundling. The Cabinet paper made it clear that they had not done any cost benefit analysis. Up front they said this analysis has not been done in the paper. Well that is astonishing because a year or two previously the Telecommunications Commissioner did a huge amount of analysis and concluded unbundling was not going to do the job the government wanted it to do. He recommended against unbundling and the government accepted that recommendation and then of course a year or so later changed their mind. And if you ask Bronwyn Howell at Victoria University, who has more knowledge around this issue by far than anyone else in New Zealand and is independent of us at the Institute for the Study of Regulation and Competition, her work shows that comparing analysis of other people's work shows there is no particular correlation between unbundling and broadband penetration. Broadband penetration gets driven by matters other than unbundling. So can government officials do a good job? I think it is extremely difficult for them in these sorts of industries to regulate in a successful way.

What about the British Telecom structural separation model?

If you talk to the BT people they will tell you their model is very complicated and doesn't necessarily reproduce easily into another environment for a whole stack of reasons. This is an issue for the management and the board of the company to ask, what do we do about this issue, now that the government has raised it. Typically in the past when the government has raised issues with us we have tried to cooperate. We have tried to find and work our way towards solutions. I would hope that is what would happen again but that won't be for me of course. My personal view is that any physical separation would not be a good idea, as illustrated by the huge problems we have accumulated in the electricity sector and which are simply not getting resolved. Solving regulatory induced problems by further regulation invariably is a recipe for bad outcomes and the electricity sector is a sad reminder to us of this dilemma.

Does Telecom pay high dividends and neglect investment?

Well that is nonsense. If you look at our accounts we are the largest single investor in New Zealand. We invest between \$700 and \$800 million per year. Our earnings are \$800 million a year if you look at normalized bottom line earnings. We do pay out good dividends because earnings growth rates are constrained, in recent years of course partly by government regulation itself. As we cannot grow earnings strongly, we are regarded as a utility yield stock. Yield stocks have to pay good dividends to keep their shareholders content because they are not getting growth opportunities to the same extent in the share price, as they would be in a company growing its earnings very strongly. All telcos are in this position and are obliged to provide their shareholders with a good yield and we do that. That is what is known as the cost of capital and you can't treat capital as though it is cost free. Unfortunately some politicians and government officials almost seem to view matters this way.

So then how do we spend so much on investment expenditure? We do that because we are a network infrastructure company and have very large depreciation allowances and that helps generate funding for investment. We are the second largest investor in New Zealand after the government and we are able to do that because of the particular structure we have got. High depreciation allowances arising from large past capital outlays help fund capital expenditure programmes and at the same time our dividend yield encourages shareholders to invest in the stock.

How does the board know shareholders are content?

We do a lot of work with shareholders. Now I certainly talk with some of them particularly the major ones. But the chief executive and the chief financial officer visit our major shareholders regularly. They do road shows in America and the United Kingdom for the offshore ones and they do these meetings extensively in New Zealand and Australia. They do some one on one, some in groups and also we have a small investor relations unit of two to three people and their full time job is keeping shareholders informed. They put out a lot of written material and they put up a lot on the web.

Does Telecom model regulatory impacts and effect and talk to shareholders?

At our March 2006 analyst briefings we set out in full the range of regulatory scenarios we thought the government might adopt. We set out the range of impact on our earnings from minus five per cent to minus 25 percent over the next two to three years on our operating earnings. These are very severe impacts. That set of scenarios included the very ones that were in fact introduced. They were at the severe end of the spectrum from a Telecom shareholders' point of view. We did not know which ones the government was going to choose but we had set out the likely range so people could take that into account when they were preparing estimates of likely regulatory impacts. People who said we had not warned them of the possible consequences of regulation seemed to simply ignore this comprehensive material.

Did the government keep you in the loop when they were thinking through their regulatory options over the last few months?

No not of recent times. Although we had occasional meetings, we were not kept as fully in the loop as previously so we were not aware of the details of the package that was announced. Like others, we were aware that there was a range of possibilities. It was those which we set out for shareholders and analysts.

Do you know why you were not informed ?

I think it was partly because they had decided to run it into the budget and so budgetary matters typically do not get consulted with the private sector for traditional and other reasons. Partly it was driven by other than straight economic issues. Let's face it, there are large elements of politics in all of this.

What would Telecom and telecommunications look like without regulation?

That is an interesting issue isn't it. The conventional wisdom seems to be that Telecom, because we own the network, has this very strong dominant position which some people conclude may inhibit the growth of broadband. However, there is another way of looking at this and that is that it is very much in our interests to look after our customer needs, it is very much in our interests to invest, and we need a good rate of return on that investment, so we are of course as anxious as anyone to grow broadband rapidly. That is my view.

I personally think there are two disincentives to the take up of broadband. The first is our ranking at around 22 is of course the same ranking as national income per head. So it's a question of what is affordable. We are not a wealthy country despite our pretensions and so not surprisingly those are equivalent rankings. Second, a very important driver is good free dial up internet access once you have paid your monthly rental. So having a free service is a huge disincentive to paying for another service that costs additional money.

Does the kiwi share impact on development?

Under the Kiwi Share we cannot increase our residential rentals in real terms to cope with the fact most of our traffic is now internet calling and most of the minutes on our lines are internet minutes rather than voice minutes. We have had no compensation for this huge growth in the internet because under the Kiwi Share we cannot charge for local residential calls. This has been a major dilemma for us since privatization. We are obliged to maintain the network in good shape under the Kiwi Share and we want to do that. But, it does mean there is this disincentive for people taking up broadband. I think the Kiwi Share itself has been an inhibitor.

Other inhibitors?

There have been several major inhibitors to the development of telecommunications in New Zealand. One has been that we were not permitted originally to purchase GSM

spectrum even though that was what we wanted to do. I think the mobile market would have been much more competitive and that would have helped the consumer. But we have two different network technologies and that is uneconomic for the country as a whole. That was purely a government decision for which officials who advised on the matter in the early nineties hold no accountability and most people have forgotten. The Kiwi Share is an inhibitor as it is putting a distortion in there that is actually inhibiting the take-up of broadband. Now I know some people will argue that is not the case but it defies logic to say that is not the case. The other major inhibition is of course regulation generally in the sense that first it creates great uncertainty for Telecom and the return (or lack of it) on our large investment programme and secondly because actual and prospective regulation creates continuous incentives for our competitors not to invest but rather to free load off Telecom's networks. This creates delays and distortions in the sense that government officials end up making decisions about markets which they know little about in operational terms and have no accountability for the outcomes. Name me an official who has ever run a major company. Project Probe is a good example of these problems.

Would we be better off without regulation?

In my view we would unquestionably be better off without regulation. Regulation creates distortions and delays and uncertainties. It fails to achieve the outcomes set for it so then people argue for ever more regulation without seeming to comprehend that while markets are imperfect they are immeasurably better than having the world run centrally and remotely by government. But it is not in our competitors' interests to argue that. Our competitors argue for regulation. They effectively want to be subsidized by Telecom's shareholders. Remember that we met the government decreed broadband overall target of 250,000 but did not meet the wholesale target. Why ? Well we certainly tried hard to meet it. But our competitors were really betting on more regulation coming to pass and for the medium term it is a better option for them because they could get more cross subsidies out of us effectively. So having us fail to meet the wholesale broadband target was in our competitors short run interests as they knew the government would provide them with more help at Telecom's expense. They want more and they want it for lower cost and regulation provides that. But it does not promote more and better investment.

Is Telecom a monopoly, if not, what is it?

Well clearly we are not a monopoly with respect to mobile. Vodafone have a bigger market share than us although we have recouped that position substantially in terms of our share of growth. We have been taking more than half the growth over the last couple of years. Our growth slowed essentially because we were having difficulty sourcing handsets. The fast growing part of the market is mobile. The other fast growing part is broadband and there are other competitors which are free to compete with us in that market and particularly in the most profitable parts of the market. TelstraClear has a substantial network and they are free to roll out that network further. They have cable in the major centers as well as a regular network so they can roll out broadband. There is Whoosh which has invested heavily and has some of New Zealand's best entrepreneurs

backing it. Beyond this, one has to bear in mind that our major competitors, Vodaphone and Telstra, are huge overseas companies, immeasurably bigger than Telecom, and the idea that they need us to cross subsidize them is nonsense. They are big and powerful and can stand on their own feet. New Zealand shareholders of Telecom should not have to prop them up.

So I would argue that we have got extensive competition. Everybody can interconnect with our network and we have no problem with them interconnecting with our network.

Our difficulty really is when we are expected to cross subsidise our competitors into what would otherwise be uneconomic propositions. We see no gain for the country long term in this. I have seen figures bandied around that our competitors will invest two billion dollars. Yet some of our most vocal critics are small companies. We have no problem with them interconnecting with us at economic rates and operating and competing vigorously with us. That is fine, but I do have a problem with them expecting us to prop them up and subsidize them. What they are all looking for is to minimize their own investments, work off back of telecom's investments, and be charged minimal rates for the privilege. Ultimately that will be uneconomic for the country too.

Is the real cost of capital recognised by regulators?

The Commerce Commission estimate of the cost of capital is miles below any commercial estimate of the cost of capital so that means it is likely to be unprofitable for us. So we have this terrible dilemma that the government expects us to roll out more broadband and to provide it to competitors at what we would regard as uneconomic rates. At the same time it will be unprofitable for us to do so because the cost of capital is substantial. As has been demonstrated the Telecommunications Commissioners estimates of the cost of capital are well below any market analysts' estimate.

Unbundling is a bit like a situation where you have own a house and you have built a new kitchen and all your neighbors can come and use your kitchen whenever they like to do so. They can do whatever they wish in your kitchen. Moreover they are not going to pay you anything like what is needed to cover your costs.

Why did you battle to look after your shareholders?

Well that is our job to look after shareholders interests and to grow value for them. Why would we want to cross subsidize our competitors? We are happy for our competitors to have a fair deal. We are also happy for them to interconnect with us but we think that should be done on terms that are reasonably profitable for us and thus for the nation. We don't see any point in having a whole stack of cross subsidies. New Zealand has had cross subsidies in a many industries in the past and they just turn out to be very damaging over a few years. They don't actually achieve what you want to achieve.

Where are we today?

We have got the decision. The board and management of Telecom say we have to accept it, that is the reality and we have to get on and grow the business. Two of us, Paul Baines (incidentally, he is one of NZ's most outstanding non-executive directors) and I have said well so be it, good luck, and we will go and do something else that is more rewarding. We have a fundamental disagreement with the new regulatory interventionism and so we have decided that it would not be appropriate for us to continue to be directors of Telecom NZ.

Is that the right approach, should Telecom just give up or should it keep on fighting?

RD laughs. I don't think I should answer that. You don't win fights with the government. The government is the government. They represent the people and if they legislate so be it and everybody has to comply with the law.

Could I pick up again on the cost of capital?

We battled with that but did not get there. A whole lot of independent analysts disagreed with the Commerce Commission. But they did not listen. If you look at the reports produced by ABN Amro and CSFB, independent of us, they were stunned. The only person who thinks the Commission cost of capital is sensible is the Commission itself. Everybody else thinks this is crazy.

We have kept on arguing. But these are not issues that attract much attention in the media.