

## STRATEGY FOR NEGOTIATING WITH POTENTIAL INVESTORS IN NBN CO

1. This paper builds upon three papers previously prepared by the Broadband Working Group: "The Negotiating Strategy" and the "NBN Co Privatisation Strategy" prepared for the meeting of 17 March 2009 and "Telstra – Engagement Strategy", prepared for the meeting of 6 March 2009.
2. The context for the paper is to further explore issues associated with attracting private sector investment in NBN Co while retaining majority Government ownership and control until the point of full privatisation. The paper addresses three separate but related issues.
  - The strategy for negotiating with Telstra and other potential investors in NBN Co.
  - How the Government should respond to early approaches from potential investors.
  - The position the Government should adopt on ownership caps – ensuring that they are compatible with the Government's strategy to build the network as well as the longer term privatisation of the Company.
3. These three issues all relate to the interaction between the Government and potential investors as well as how the Government will attract and manage private sector investment as a way of reducing the overall cost to the Commonwealth.

### Summary of key points:

4. The advice of the Working Group is for the Government to adopt a measured approach and:
  - that there are likely to be many early approaches by a range of possible investors, including Telstra;
  - no company is likely to invest in NBN Co until the details of the company and the regulatory framework (and, in all likelihood, the legislation) are settled - post implementation study - and the company has a credible business plan with its prospects for success able to be ascertained:
    - as such early offers to invest are unlikely to be credible or on acceptable terms;
  - there may be some credible and acceptable early offers (for example offers to lease or buy existing infrastructure) but the Government will not be in a position to accept them immediately and should indicate its interest in ongoing discussion;
  - the Government does not need to rush into negotiations with investors making early offers. The Government should keep interested parties engaged through consultation rather than negotiation;
  - the Government must remain the majority shareholder in the company until the point of full privatisation;
  - with respect to Telstra, the Government must maintain a firm position consistent with its announcement; and
  - the Government should wait for early advice from the implementation study interim report before settling the details of NBN Co and setting ownership caps. Setting caps early on may inadvertently affect the privatisation strategy.

## **1. Negotiating Strategy**

### **Goal for negotiation**

5. The overarching goal is to build the NBN Co network in the most efficient way with a secondary aim to attract private sector investment into NBN Co to reduce the overall cost to the Commonwealth while preserving the structural reform and competition benefits of the Government's package. A key element of the reform is that NBN Co will be a wholesale only firm and it will treat all retail customers equally.

6. In the longer term, the approach to privatisation is also dependent on the extent of private sector investment in NBN Co in the immediate lead up to divestment. If the company is successful in attracting private equity investment to any significant extent, the scale of the Government stake to be divested would be reduced. However, this gives rise to risks that the private investors may seek to constrain the manner and timing of the Government's eventual divestment, unless conditions for participation are established from the outset that protect the Government's flexibility appropriately.

### **Negotiation strategy**

7. With respect to Telstra, the strategy is to adopt and maintain a strong and credible position from the announcement with the goal of getting Telstra to reconsider its position and ultimately approach Government to invest in or use NBN Co's network on the Government's terms. In the near term the strategy is to maintain a strong, credible and consistent position to Telstra without tying the Government's hands. The ideal outcome, over time, is the structural separation of Telstra by action of the Board. It is possible that the Telstra Board may choose not to engage meaningfully in negotiations for a considerable time. Telstra may choose to compete against NBN Co, using platforms such as the HFC network or other means with a focus on price - at least during the initial build phase before NBN Co becomes a credible threat.

8. For all investors the strategy is to set clear, transparent rules for the operation of NBN Co that give potential investors the necessary certainty about the company they would be investing in and confidence that the company has a viable, sustainable business.

### **Mechanisms to support private investment and structural change**

9. Facilitating structural change and greater competition is one of the Government's core policy objectives. NBN Co is being established as a wholesale only company so as to minimise the problems associated with vertical integration whereby one retail provider is granted more favourable treatment than other providers.

10. To preserve the benefits of NBN Co being a wholesale company, mechanisms will be required to prevent customers of NBN Co, for example retail telecommunications companies, also obtaining a controlling interest in the company.

In addition to an ownership cap applying to any customer of the network, there will be other mechanisms such as a requirement that directors of NBN Co have to be independent, and a prohibition on investors who are also NBN Co customers having the right to appoint board members or senior executives, or to veto decisions – refer Annex A.

11. With respect to telecommunications companies looking to invest in NBN Co, the ownership caps would only apply to companies who offered retail telecommunications services. This means that while Telstra remains vertically integrated its investment in NBN Co would be limited by the caps since it would be offering retail telecommunications services.

12. If Telstra separated into two (or more) companies – a retail service provider (Telstra Retail) and a network and wholesale company (Telstra Wholesale) – Telstra Retail's investment in NBN Co would always be limited by the caps, while Telstra Wholesale's investment would not. Telstra Wholesale's investment would always be limited by the Government's need to remain majority shareholder until privatisation.

#### **Who might negotiations be held with?**

13. Potential investors and their likely goals include the following.
- Telstra – will be looking for influence and control over NBN Co.
  - Other retail telecommunications companies (Optus, Macquarie, Internode) – will be looking for influence over NBN Co.
  - Wholesale fibre optic transmission network operators such as Next Gen – will want NBN Co to use their assets either through vending in assets in return for shares; a long term lease arrangement; or by selling assets to NBN Co.
  - Non telecommunications infrastructure companies such as electricity retailers – may be looking to get NBN Co to use their assets such as ducts and poles through an equity arrangement with NBN Co or under a leasing agreement.
  - Infrastructure funds - looking for safe passive investments with long term sustainable returns so will want evidence of viability of NBN Co's business case. This group is unlikely to approach the Government until NBN Co has proven itself to be viable – this might be at the same point as the Government considers full privatisation.

#### **Position in negotiations**

14. The Government's minimum conditions for negotiation are the terms of the announcement. The Government should not enter into any negotiations that would compromise its policy objectives or force it to alter its position. It is expected that it will be some time before conditions exist that are conducive to private equity participation. This will be well after the implementation study is completed, and will occur once NBN Co has a credible business plan, is operating effectively and its prospects for success can be adequately ascertained by prospective equity investors.

15. Longer term objectives also need to be taken into account, with the perspective of eventual divestment by the Government. The participation of private equity investors has the potential to complicate the eventual divestment of NBN Co, as minority investors will seek to influence the Government's sale outcomes, in order

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to protect their positions. To ensure appropriate financial returns for the Government from the privatisation, it will be very important to retain absolute discretion about the timing, and means of disposal for the Australian Government stake in any agreements entered into to provide for private equity participation.

16. Based upon the proposed announcement and the Government's longer term objectives, private sector investment should only be allowed if it meets, or is consistent with, the following conditions:

- that the network is based around fibre optic to the home and workplace;
- NBN Co will build and operate the network on a wholesale only basis;
- no customer of NBN Co can gain effective control (veto or powers of influence) of the company;
- services on the network will be regulated by the ACCC; and
- the terms of participation are consistent with the long term objective to privatise the Government's stake in NBN Co.

17. Within the terms of the announcement there is some scope for consultation. Annex A indicates those areas in the total package where negotiations might be held with Telstra (for example on future telecommunications regulation).

18. The Board of NBN Co will be able to provide advice on prospective equity investors, although ultimately the decision to accept new investors will be a decision for shareholders.

19. The Board will have an interest in the introduction of private sector equity investors as they have fiduciary duties (and potential liabilities) with respect to all shareholders. The Board will also be interested in any obligations contained in shareholder agreements with new investors which may affect the governance and operational arrangements for the company. The Board will also have a keen interest in the level of debt in the company.

20. It is important that the process for engaging and negotiating with potential investors is fair and open to all potential investors. It is also critical that any negotiated outcome with a potential investor, including with Telstra, is publicly defensible.

### **Telstra specific strategy**

21. The crucial element of the strategy with respect to Telstra is the position adopted by Government prior to negotiations commencing. The Government's focus should be on creating an environment in which Telstra decides that it is in its long term interests to negotiate with the Government on the Government's terms. This strategy requires the Government to adopt a firm position with Telstra when it makes offers to the Government that are inconsistent with the conditions set out in the announcement.

22. The Working Group considers it likely that Telstra will initially approach the Government with a number of proposals which the Government will need to politely but firmly resist.

*Telstra's approaches*

23. Telstra will approach the Government in relation to regulatory reforms and attempts to negotiate the terms of its investment in NBN Co.

24. Areas where Telstra is expected to try to negotiate the terms of its investment in the NBN Co and the Government's response include:

- the level of any ownership cap restrictions – the Government should not compromise on the level of the caps required to deliver the competition outcomes;
- right to appoint board members or senior executives – the Government should not agree to this as it begins to provide Telstra with levers to control or influence the company;
- timing and location of the network rollout – the Government could negotiate with Telstra on these to some extent if Telstra decides to invest; and
- wholesale access prices – these will be governed by the ACCC and there is no scope to negotiate.

25. The position with respect to Telstra assumes negotiations with a vertically integrated company, or the retail arm of a structurally separated Telstra. The situation would be different if the Government was negotiating with the wholesale arm of a structurally separated company – that is, the former Telstra wholesale business since:

- a wholesaler's interests are to maximise the use of the network and NBN Co is a wholesale only company;
- the interests of the wholesale arm of Telstra investing in NBN Co are for NBN Co to maximise the number of people using its network; and
- a wholesaler has no incentive to discriminate in favour of any particular retail company.

26. In other words a wholesale company's (spun off from Telstra) interests in NBN Co would be more aligned but not identical to the Government's.

27. There is a risk associated with allowing wholesale telecommunications companies to invest, without being limited to the caps if they are direct wholesale competitors with NBN Co. This risk is mitigated by the constraints on how NBN Co operates as set out in Annex A.

*Governance arrangements underpinning any negotiations*

28. The Working Group recommends that the Government adopts a consistent set of principles in any early discussions with Telstra (or any other retail telco), and throughout any subsequent negotiations.

29. In the longer term, the Working Group considers that there needs to be a single commercial negotiator (for example an investment banker) backed by a team of advisers. The Working Group also sees merit in the shareholder ministers (the Minister for Broadband, Communications and the Digital Economy and the Minister for Finance and Deregulation) agreeing with other Ministers:

- who will be the negotiator;
- the details of the negotiating mandate; and

- the guidelines for Ministers to follow to ensure that all approaches by Telstra are directed to the negotiator.

### **Strategy for other investors**

30. The strategy for negotiation with other retail telecommunications companies trying to invest in NBN Co is similar to that for Telstra.

31. The strategy with other potential investors who are not customers of NBN Co is less complex. We anticipate that any company looking to make a significant investment (10 per cent or more) in NBN Co will want some say in the company's operations.

32. The Government could negotiate terms with these investors that gave them some say in the way the network is deployed and operated or with respect to investment decisions by the company. The only constraints on this are:

- that these negotiations should not occur until the Government has settled, in legislation, the details of NBN Co; and
- at no point should the Government negotiate any terms that compromise the Government's ability to:
  - fully privatise NBN Co at a time of its choosing;
  - control the regulatory and governance arrangements for the company; and
  - achieve its competition policy outcomes.

### **Timing of negotiations**

33. It will be some time before the Government is in a position to accept private sector investment into NBN Co, however it is possible that some potential investors will approach the Government before all the details of NBN Co are settled and it is a fully functional company.

34. To avoid the risk of the Government being accused later of oppressing minority shareholders, or of the Government being constrained by minority interests in how it establishes, and eventually privatises, NBN Co, the preference is for minority shareholders to be accepted when:

- the company has been properly established with a Board of Directors selected by the Government;
- the governance arrangements have been settled and confirmed in legislation; and
- any restrictions on the operation of the company are settled in legislation.

35. In practice we think that investors are most likely to join NBN Co when the rules are clearly settled. However companies may seek to negotiate on the details of the NBN Co governance arrangements in order to make the company a more attractive investment.

## **2. Responding to early approaches**

### **Response if Government is approached early – before it is ready to negotiate**

36. While the Working Groups thinks it unlikely that Telstra will seriously look to negotiate to invest in NBN Co, on the Government's terms, before legislation is passed, there is a strong chance that Telstra could approach the Government early to:

- try to influence the nature of any legislative measures; or
- offer the Government options that are inconsistent with the policy and are thus unacceptable, but that may be made to look superficially attractive.

37. The Working Group's view is that investors will not make serious attempts to join NBN Co until it is fully established and operational. Investors will want a legal relationship with a fully operational company.

38. Any early approaches, from Telstra or any other potential investor, should be welcomed on the basis of consulting, rather than negotiating, with the Government. The Government should encourage any potential investor, including Telstra to contribute its views to the implementation study, and to provide a submission in response to the Regulatory Reform Discussion Paper.

39. There is a small possibility that potential investors will ask to be represented on the Reference Group that is overseeing the Implementation Study in order to be able to influence the outcomes. The Government should not accede to this as it would fundamentally undermine the purpose of the Reference Group and the Implementation Study, as well as be unfair to the rest of the industry that were not represented.

40. The Working Group expects the different types of potential investors to approach the Government at different times with different offers. Annex B sets out who might approach the Government when and what the Government's position should be.

## **3. Ownership caps**

41. SPBC asked whether or not the Government should set the level of ownership caps immediately. The Working Group's advice is that the caps should not be set immediately and should be informed by the implementation study

42. The Working Group considers that before private sector investors are willing to make a financial commitment they will need full information on the nature of NBN Co and any restrictions on its operations, and what will be in the legislation, including on ownership caps. Given this, the Working Group does not see a pressing need to set the caps immediately in terms of attracting investment, however the Working Group believes the Government needs a clear position on how the caps will be set.

43. The caps are critical to preserving the Government's intention of having genuine separation of wholesale and retail providers in the telecommunications market. While the caps are important during the period in which the Government is the majority owner of NBN Co, they become essential when NBN Co is fully

privatised. The level of the caps should be set with full privatisation in mind.

44. The key public message is that the Government is looking to attract private equity, but there will be ownership restrictions to ensure that NBN Co is truly a wholesale only company and that it is not controlled by any retail customers. It is important that the competition policy objective is met even when the Government has fully privatised the company. Possible talking points are at Annex C.

45. The ownership caps will have a direct impact on investment in NBN Co by Telstra. It is likely that Telstra will attempt to influence the Government into setting a high cap and may focus its efforts on lobbying key Senators to amend any legislation introduced by the Government to set the ownership caps. Telstra may do this without expressing or offering any commitment to invest in NBN Co, but simply to keep its options open in the future.

46. At the time of the announcement the Government should indicate that ownership caps will be introduced, but that the level of the caps (individual and aggregate) will be determined by the Government based upon advice from the Implementation Study. Ownership caps will be finalised as part of a package of legislative measures to be introduced in late 2009.

47. It is also possible that the question of foreign ownership caps may be raised. Annex C also contains talking points on this issue.

*Consequences of getting the caps wrong*

48. The consequences of getting the level of the cap wrong are substantial:

- a cap that is too low may reduce the chances of private sector investment; and
- a cap that is too high will undermine the competition benefits of the Government's policy.

49. If the Government wanted to consider caps before expert advice is available a lower cap would best protect the Government's competition policy objectives. With this in mind, the most directly relevant precedent is the restriction on airlines owning airport operating companies since it is designed to prevent airlines getting the benefits of vertical integration (the 5 per cent limit on airline shareholding in Airport Operator company under the Airports Act 1996).

DBCDE  
3 April 2009



**Principles for negotiation**

<b>Possible points of negotiation</b>	<b>Is the position negotiable</b>
Establishment of NBN Co and that NBN is wholesale only	Not negotiable
Telstra can invest cash or fold in assets (eg ducts)	Yes, subject to negotiations and a strict cap on ownership.
Level of the Ownership cap	Can be discussed, but level of cap will be determined following implementation study or based on relevant precedents
Could Telstra participate in decision making in relation to operations of NBN Co including: - Access - Price - timing of rollout - where rollout occurs and phasing of rollout	No No No Yes – if other Government conditions are met and Telstra is willing to participate through equity or assets
Could Telstra discuss immediate regulatory reforms	Yes, on the same basis as other stakeholders
Could Telstra re-focus discussions on technology away from FTTP and back to FTTN	No
Could Telstra be involved in the rollout of the NBN	Possibly, but need to ensure that NBN Co has ultimate control
Could Telstra have a say in the design of the network and use of existing infrastructure.	Yes, but need to ensure NBN Co has ultimate control.
Could Telstra veto the regulatory regime that will apply to NBN Co	No

**Sequencing of negotiation:**

Timing	Potential Investor's position	Government's position
After the announcement but before NBN Co properly established	<b>Telstra</b> – may offer alternative approaches, including that Telstra build the network in metropolitan areas.	Welcome Telstra's interest in engaging, but make clear that engagement must be consistent with the Government's announcement – this isn't.
	<b>Wholesale fibre transmission operators like Next Gen</b> – will offer to engage with NBN Co about use of their assets	Welcome the engagement and indicate that they should contribute to the Implementation Study and that NBN Co will be interested in talking to them when it is more established.
After the Implementation Study interim report but before legislation is introduced	<b>Telstra</b> – seek to influence legislative changes to water down any changes that strengthen separation arrangements and that restrict scope for Telstra to invest in NBN Co	Government indicates that it is prepared to discuss these issues but only when Telstra puts forward an alternative proposition that would deliver structural reform.
After legislation is passed settling NBN Co governance and the immediate regulatory reforms.	<b>Telstra</b> – if it has reconsidered its position, it could offer to put its assets into NBN Co in return for an equity stake.	Government could agree to an offer of this kind if the equity stake was within the ownership cap.
	<b>Other retail telecommunications companies</b> – may offer NBN Co their assets in return for an equity stake if they are concerned about being overbuilt	Government could agree to an offer of this kind if the equity stake was within the ownership cap
	<b>Wholesale fibre transmission operators</b> – seek to negotiate with NBN Co over the use of their assets	NBN Co could negotiate with them to the extent it was consistent with NBN Co's network design.
<b>non telecommunications infrastructure companies</b> such as electricity retailers – seek to negotiate with NBN Co over use of their assets.	NBN Co could negotiate with them to the extent it was consistent with NBN Co's network design.	

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After rollout is commenced and services are being offered	<b>Telstra</b> – if it has reconsidered its position, could offer to become a customer of NBN Co but only if it can also have some control over NBN Co	Government should indicate to Telstra that this is acceptable but only if Telstra’s retail arm does not have any degree of control over NBN Co. (ie. requires Telstra to structurally separate)
	<b>Other retail telecommunications companies</b> – will look to negotiate terms of access to NBN Co	NBN Co could negotiate to the extent it was consistent with the regulated access terms and conditions.
	<b>Infrastructure investment funds</b> – may look to invest in NBN Co but may want to have some say in appointing directors and senior management	Government could negotiate terms with these investors, as long as it did not affect the Government’s long term plan for full privatisation.

## **Possible talking points on ownership caps**

### ***What will the ownership caps be?***

Up until the full privatisation, the Government will be the majority shareholder in the company, holding at least 51 per cent.

We want the telecommunications industry to invest in the company, just as we want other investors. But we want to make sure that at no stage can a customer of the company have effective control of the company. This is about preserving an outcome in the interest of competition.

The consequences of setting the cap at the wrong level are serious, so we will not be pushed into a hasty decision. We will set the cap based upon expert commercial and legal advice, and we plan to obtain this advice through the Implementation Study.

*If pressed:* There are examples of similar caps in operation already, in particular the cap on airports owning airport operating companies (5%), or, for the purposes of broadcasting, the point at which a company is deemed to have control (15%).

### ***Won't ownership caps restrict co-operation with Telstra***

We want Telstra to be involved, but we also want to deliver sustainable structural reform to Australia's telecommunications market.

If Telstra or any other integrated telecommunications company, believes it is in their shareholders interests to own the network, then we would expect them to re-structure themselves to allow this to happen.

Telstra, and any other interested parties, are welcome to provide their views on the appropriate level of cap to the Implementation Study.

### ***Will there be foreign ownership caps?***

Clearly any sizeable foreign interest in the company would be considered by the Foreign Investment Review Board, just as it would for any other company.

The Government is going to be the majority owner of the company until full privatisation. Until then it will clearly be Australian owned.

This is, therefore a question that doesn't need to be considered until the Government is looking to fully privatise.