TELSTRA CORPORATION LIMITED

Telstra's Ordinary Access Undertaking for the Unconditioned Local Loop Service (Band 2):

Response to Optus and iiNet Submissions on Profitability Analysis

(Attachment 1 to Telstra's Response to the ACCC's Discussion Paper dated 23 December 2008)

11 March 2009

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A Executive Summary

1. Optus and iiNet have provided separate submissions[1] criticising Telstra's detailed analysis of the profit margins that would be available to them from the use of ULLS assuming the $30 per month access charge proposed in Telstra's Band 2 ULLS Undertaking. This analysis was contained in Attachment 1 of Telstra's response submission to the ACCC's Draft Decision, which is dated 23 December 2008. Telstra challenges the criticisms made by Optus and iiNet in a number of respects, including:

   - they are not supported by reliable evidence or by any clear identification of the alternative way in which Optus and iiNet suggest their margins should be calculated – the submissions seek to confuse and avoid the issue rather than address it;

   - in criticising Telstra's analysis the companies contradict their own investor guidance which they have released to the ASX;

   - as detailed in the body of this submission, iiNet and Optus' criticisms of Telstra's analysis are based on spurious assertions about the way in which customers purchase telecommunications services in the current market (iiNet denies the prevalence of bundling); an illogical approach to the allocation of DSLAM costs; speculation about their own business cases, rather than any clear analysis of their business case; and

   - Optus' position in relation to their limited margins is contrary to its observed market behaviour.

2. Moreover, neither Optus nor iiNet has provided more up to date relevant information in relation to its performance than that used by Telstra, as requested by the ACCC in its email of 27 January 2009. To the extent that such information may have been provided, it has been provided on a confidential basis to the ACCC only. Telstra has not had a chance to analyse the information and has not been provided with a description of the general nature of the information. Telstra considers that it at least should be provided with a description of the information over which confidentiality is claimed sufficient to assess whether that claim is properly made.

B iiNet Submission

3. iiNet claims that Telstra's profit calculations for iiNet (and Optus) are incorrect because:

   - they assume that the bundling rate for telephony and broadband services is 100% across the iiNet customer base; and

   - they include LSS services in the calculation, which need to be excluded.

4. iiNet claims that correcting for these errors delivers a "weighted EBITDA" of 22.7% rather than the 50% to 51% implied by Telstra's calculations. iiNet's calculation assumes an access charge of $16. Further, iiNet calculates that a $30 price would reduce the "weighted EBITDA" to 1.2%. iiNet submits that "Excluding LSS customers and correcting for a 100% bundling rate does not require disclosure of confidential material".

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[1] "*Optus Supplementary Submission to the Telstra ULLS Undertaking (2008-2010): A response to the ACCC's request for further information on Optus' ULLS margins - February 2009*" and "*Further submission from iiNet - 2 February 2009*"

[CONFIDENTIAL VERSION - DRAFT]

5. However, iiNet does not provide the information or calculations that underpin these assertions and hence it is not possible to verify such assertions. As a result, no weight can be placed on iiNet's claims. Telstra, on the other hand has provided its calculations in a transparent manner and with clear reference to the sources of the data relied upon.

6. Further, iiNet's claims are inconsistent with the very high returns it has announced publicly. iiNet's Investor Strategy Briefing for 2008 states that it has made a total DSLAM investment of $53.3 million and secured a return of $85.6 million[2]. At a hurdle rate of 18% iiNet reports Internal Rate of Return (IRR) to date of 69%. As iiNet's roll-out of DSALMs includes a large share of regional exchanges with lower demand, the returns for metropolitan exchanges alone would presumably be higher than the overall figure. If iiNet's expected return on its DSLAM investments has been significantly revised downward, it has an obligation to provide the revised information to the market and to the ACCC for the purposes of the undertaking.

7. Further, iiNet's criticisms of Telstra's calculations are unwarranted.

8. iiNet suggests that Telstra's assumption that 100% of customers bundle broadband and voice services is invalid. The purpose of the modelling exercise is to determine iiNet and Optus' profitability as a result of the efficient use of ULLS, which involves supplying the full bundle of broadband and voice services to end consumers. Telstra notes that there is a very high rate of bundling with more than 95% of ADSL customers also purchasing a fixed line service. Further, if access seekers wish to supply customers with ADSL only, they can purchase Telstra's LSS service at significantly lower cost than ULLS. Therefore, the price of ULLS will have little impact on the margins to be derived from supply of unbundled ADSL services.

9. In fact, the model's assumption that the customer purchases a bundle comprising of a single residential ADSL service and a single residential voice service understates the revenue available to iiNet as it could in fact offer higher value services over a single ULLS, including multiple voice services and/or business grade data services.

10. In terms of naked DSL, Telstra notes that for the most part this has not developed as a broadband only service. In most cases naked DSL is packaged with VOIP that is fully interconnected with the PSTN. Telstra understands that in the case of iiNet's naked DSL services, all of their packages come with a VOIP service that includes free local and national calls.

11. iiNet's criticism regarding the inclusion of LSS based services is also incorrect. The only instance where LSS volumes enter the calculation is in the allocation of shared capital costs. Telstra determines the capital costs for ULLS by taking annual total depreciation and amortisation (D&A) charges (for all iiNet's activities) and converting these into a per monthly SIO amount based on the total number of "On-Net" services. The approach in Telstra's calculations is to assume that "On-Net" services include ADSL SIOs supplied both using ULLS and LSS. As a matter of simple logic, DSLAM costs should be distributed over all of the services that are supplied using the DSLAMs and a DSLAM is as necessary to access the LSS as it is to access the ULLS. It is unclear how this approach (which distributes capital costs over the full range of services) understate costs and hence overstate available margins.

12. The implication of this approach is that a proportionate share of capital costs is allocated to ULLS and LSS, which is entirely appropriate . Telstra's analysis then takes only those capital costs allocated to ULLS, that is, it excludes capital costs allocated to LSS. If iiNet

[2] See Investor Strategy Briefing, Infrastructure, 2008, Greg Bader, 8 December 2008, available at http://www.aone.net.au/investors/081208-investor-strategy-infrastructure.pdf

disagrees with this approach then it should explain why a less than proportionate share of capital-related DSLAM costs should be attributed to LSS-based services than ULLS-based services.

13. So far as the inclusion of LSS services in the SIO figures is concerned, with the exception of capital costs, the profitability analysis is not sensitive to the level of SIOs included. In particular, overall annual revenue, cost and margin amounts are derived by multiplying monthly per unit amounts by the number of so-called "On-Net" ADSL SIOs (and then by 12, in order to derive annual amounts). In other words, the On-Net ADSL SIO figure is used in the calculations to gross up per unit amounts into annual total amounts. In other words, the revenue figure in the calculation is a "hard figure" and is not unduly inflated by the inclusion of LSS services.

14. As can be seen from the table below, it is possible to undertake the same profitability analysis, expressing values on a (monthly) per unit basis. Other than the calculation of capital costs (depreciation), this approach does not rely upon SIO data. As Table 1 shows, this approach to estimating iiNet's profitability yields the same results (in terms of estimated margins) as Telstra's original analysis. There should be no concern that the inclusion of LSS SIOs in the calculation has either unduly inflated revenues or diluted costs in Telstra's calculations.

Table 1: Summary P&L - iiNet Bundled ADSL and Voice (expressed on a monthly per unit basis)

Financial Year	2007	2008
Revenues	$107	$108
ULLS Monthly Rental Charges	$14	$14
Other COGS	$9	$8
Total COGS	$23	$22
Gross Margin	$83	$86
Gross Margin (%)	78.18%	79.66%
Marketing expenses	$3	$4
Office costs	$5	$5
Administrative expenses	$5	$7
Total Opex	$13	$15
EBITDA	$71	$71
EBITDA (%)	66%	65%
Depreciation	$12	$11
EBIT	$59	$59
EBIT (%)	55.42%	55.20%

C Optus Submission

15. Optus criticises Telstra's analysis on the following grounds:

- Telstra's reliance upon a June 2006 Optus investor presentation is invalid, as the date of the presentation renders the data contained in the presentation no longer relevant;
- Telstra's use of data contained in this presentation has otherwise been taken out of context, such as to understate or not fully represent the extent of ULLS costs;

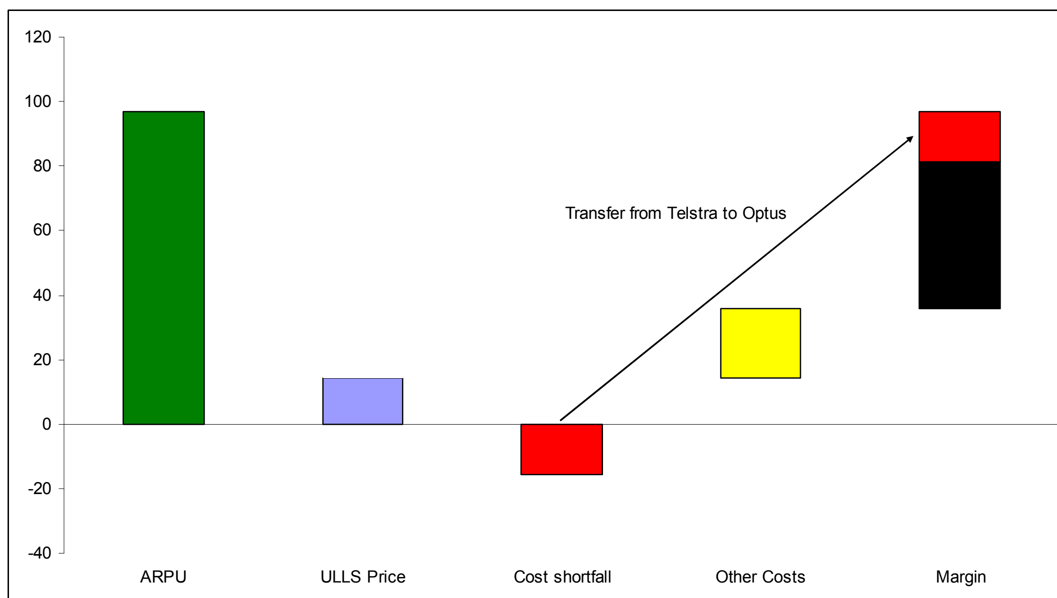
- Telstra's use of multiple source documents, for multiple periods, in and of itself, invalidates its results; and

- Telstra "does not appear to have adequately accounted for" all relevant capital costs, ongoing operating costs and once-off connection costs and fees.

16. Despite these criticisms, to Telstra's knowledge Optus presents no data or calculations to demonstrate its contrary assertions. Rather, it merely speculates that when all relevant costs are taken into account, "the likely margins resulting from ULLS services will be significantly lower than that which has been calculated by Telstra" and "Telstra's analysis is unlikely to be an accurate reflection of Optus' current profitability levels". In the circumstances, the onus is upon Optus to demonstrate why it says that the data relied upon by Telstra is invalid, inconsistent or irrelevant by reference to what it says are the correct figures, This is particularly the case given that the data is originally published by Optus to advise its investors and is notified to the ASX. If Optus is of the view that the information is no longer correct, it has an obligation (including under the ASX Listing Rules) to provide updated information to the market. To the extent that Optus may have provided relevant information to the ACCC on a confidential basis, Telstra and its advisers have been denied access to that information, or even a description of the nature of the information, and therefore Telstra has had no chance to consider or comment upon the adequacy of that information.

17. In Telstra's view, the current situation involves a value transfer from Telstra to Optus and simply increases the already large margins available to Optus while undermining Telstra's ability to recover costs. As illustrated in Figure 1 below, Optus' average revenue per user (ARPU) for the bundle of fixed voice and ADSL is close to $100, which covers a ULLS price of just $14.30, other costs related to the supply of ULLS of approximately $22 and provides a very substantial margin of over $60 per customer, of which at least $16 represents a transfer from Telstra's cost recovery.

Figure 1: Composition of bundled ARPU, 2008



18. Optus does note that "The EBITDA for all fixed line services for Optus' consumer and small-medium business (SMB) division for the September quarter was only 13 per cent, as has been reported publicly", presumably, to imply that Optus' ULLS margins are lower than those calculated by Telstra. However, presenting a margin for such a broad category of services – when data more specific to the services of interest in this

proceeding is (publicly) available – is clearly inappropriate. The EBITDA cited by Optus includes resale based services (that is, where Optus buys wholesale line rental and wholesale ADSL from Telstra, which it has admitted in its own submission have lower margins than services provided using ULLS) and services Optus sells to consumers using its own HFC network. Telstra requests that Optus provide its EBITDA for ULLS only to compare to Telstra's calculations, on a confidential basis if need be.

19. Moreover, Optus seems to imply that Telstra's results overstate Optus' true margin, by referring to the margin on a bundle of ADSL and voice services supplied over ULLS using historic costs, as presented in Telstra's Imputation Testing Reports. However, Telstra has previously written to the ACCC in relation to its concerns over the methodology used to derive the imputed margins presented in these reports, including:

    - the use of total costs rather than avoided costs;
    - the double-counting of CAN costs; and
    - the calculation of figures on a national basis, rather than Band 2 specifically.
    - the failure to use the most efficient means of wholesale supply (it assumes every one of Telstra's customers are supplied using ULLS, even those in less densely populated areas not supplied by Optus or iiNet).

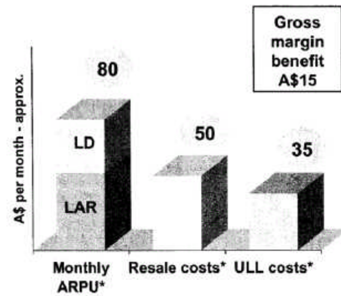
20. Contrary to Optus' suggestion that it would not be able to compete on the basis of a $30 ULLS price, Optus in fact appears to have considerable 'head room' within its current broadband offerings. Telstra is aware of Optus introducing a "Fusion Lite" Plan, which will have an ongoing monthly charge of $49, which is some $30 cheaper than its current $79 Optus Fusion offer. Even allowing for the higher usage allowance under the current Optus Fusion offer, and the joining fee under the Fusion Lite plan, the introduction of this discount plan casts significant doubt on Optus' claim that an increase in the ULLS price will impact on its ability to compete in the market.

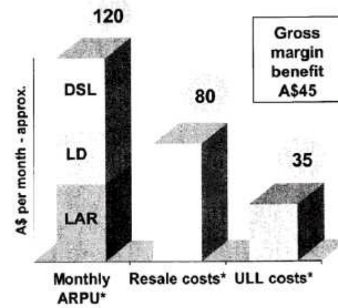
21. Finally, Telstra notes that the presentation referred to in the Optus submission is different to the presentation cited as part of Telstra's analysis. The relevant slide from the presentation referred to in the Optus submission is as follows:

ULL offers potential for gross margin improvement

Today's opportunity >500k
• offnet LD/local voice only

Growing opportunity >80k
• combined – voice/DSL





To realise potential benefits requires scale and good execution

* Approximate amounts based on Q3 FY05 and 'Band 2' ULL undertaking of A$22/mth – includes LD interconnect

The relevant slide cited in Telstra's submission is as follows:

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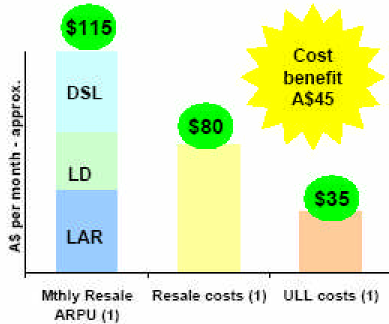
ULL – net EBITDA benefit from FY08

Cost benefit highest for combined voice/DSL resale customer
• over 250K combined resale subs at Mar 06



ULL cost benefit for pure voice customers A$15
• approx 400k voice resale customers at Mar 06

To realise ULL benefits requires scale & good execution

Capex A$150m

Existing offnet base [2] >900k
• reduces breakeven risk

ULL will be EBITDA -ve in FY07
• migration costs >A$10m per 100K subs

[1] Approximate amounts based on Q4 FY06 and 'Band 2' ULL undertaking of A$22/mth – includes LD interconnect
[2] Offnet voice plus DSL customers at Mar 06

22. The main difference between the graphs is the reference to "Gross Margin Benefit". It appears that on this basis Optus claims that "this presentation merely highlighted the gross margin improvement through the reduction in interconnect costs as between

services offered over ULLS rather than resale. It did not present a true EBITDA margin analysis taking account of the additional costs Optus would incur to utilise ULLS." However, it is clear from the slide cited in Telstra's submission that references are to "costs" and "cost benefit". There are no references to "costs of goods sold" or "COGS".