



Telstra Corporation Ltd.

Report on Timing of Capital Expenditure and Demand in Telstra's ULLS Specific Costs Model

Michael Potter

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Table of Contents

1. INSTRUCTIONS AND SCOPE	1
Instructions	1
Relevant qualifications and experience	1
Prior report	1
2. DOCUMENTS RELIED UPON	2
3. THE ULLS MODEL	2
Assumption as to timing of expenditure	3
CAPEX and tilted annuity	3
Average subscribers assumption	4
4. OVERALL CONCLUSIONS	6

Index of Annexures

- Annexure 1 Resume of Mr T.M. Potter.
Annexure 2 Extracts from the Telstra ULLS Model.

1. INSTRUCTIONS AND SCOPE

Instructions

- 1.1 I have been engaged by Mallesons Stephen Jaques ("Mallesons"), solicitors for Telstra Corporation Limited ("Telstra"), to provide a report in respect of a model ("Model") used by Telstra to calculate a specific cost recovery for Telstra's Unbundled Local Loop Service ("ULLS").
- 1.2 Specifically, I have been asked to comment upon the timing of recovery of particular specific costs categorised as capital expenditure ("CAPEX"), and the attribution of CAPEX to the average number of subscribers in each of the financial years covered by the Model.

Relevant qualifications and experience

- 1.3 I qualified as a Chartered Accountant in 1990 and I am a director of Axiom Forensics Pty Ltd. Prior to my role at Axiom Forensics Pty Ltd, I was a partner of the forensic accounting division of Ferrier Hodgson. For the past 8 years, I have provided expert accounting reports in litigation matters, undertaken financial investigations and fraud investigations, and provided general consulting services. I have been instructed on behalf of Telstra in other certain matters. A copy of my resume is attached as annexure 1 to this report.
- 1.4 Clifford Wong, a manager at Axiom Forensics has worked on this report and accompanying schedules under my supervision. I have reviewed the results of his work and I am satisfied as to their accuracy. The opinions expressed in this report are mine.

Prior report

- 1.5 I have previously provided a report dated 15 April 2005 ("my first report") pursuant to instructions received from Mallesons on behalf of Telstra in respect of the use of average or year end Services in Operation ("SIOs") to calculate a specific cost recovery for Telstra's ULLS and Spectrum Sharing Service ("SSS").

2. DOCUMENTS RELIED UPON

- 2.1 The documents I have relied upon in preparing this report are as follows:
- 2.1.1 Electronic copy of the Model, a copy of which is attached as annexure 2.
 - 2.1.2 Draft document prepared by Telstra titled "The timing of capital expenditure and demand in Telstra's ULLS specific costs model".
- 2.2 The information in those documents have not been the subject of an audit or independent verification by me and as a consequence I have no opinion on the accuracy or reliability of those documents. In view of this limitation, I reserve the right to amend my opinions and conclusions should further information be made available to me subsequent to the date of this report which materially affects the expressions of opinion contained herein.

3. THE ULLS MODEL

- 3.1 The Model calculates a specific cost recovery in providing the ULLS for the period 1 July 1999 to 30 June 2008.
- 3.2 I have confined my review of the Model and opinions to the recovery of CAPEX specific cost elements within the Model.
- 3.3 As regards to the recovery of specific costs in relation to CAPEX, the Model undertakes the following steps:
- 3.3.1 Total CAPEX for each financial year ended 30 June 2001 to 30 June 2006 is identified.
 - 3.3.2 An assumption is made that the timing of the CAPEX is 1 January or midpoint of each financial year for the purposes of the Model, on the basis that the CAPEX is incurred during the financial year.
 - 3.3.3 A calculation is made to determine a tilted annuity factor¹ to allocate the CAPEX incurred by Telstra into a C-I-C period.
 - 3.3.4 The tilted annuity amount in respect of CAPEX in each financial year is allocated for the recovery calculation in the Model to the following C financial years. For example, C-I-C

¹ Described as the "Tax corrected capital charge factor" in the Model.

3.3.5 The timing of the tilted annuity allocated in each of the subsequent financial years is assumed to be 31 December. For example. C-1-C

3.3.6 The tilted annuity amount for CAPEX at 31 December of each financial year is recovered by allocating it to the average subscribers in that financial year.

Assumption as to timing of expenditure

3.4 As stated in paragraph 3.3.2 above, an assumption has been made in the Model as to the timing of the CAPEX whereby the CAPEX incurred within a particular financial year is, on average, assumed to have occurred on 1 January or midpoint of that financial year.

3.5 In the absence of particular information identifying the specific dates within a financial year as to the timing of CAPEX incurred by Telstra, I am of the opinion that it is reasonable to assume that the CAPEX would have been incurred at the midpoint of that financial year, or 1 January. In my experience such an assumption is usual practice.

CAPEX and tilted annuity

3.6 As I have stated above, the model provides for recovery of CAPEX in the C-1-C following the financial year in which the CAPEX was incurred. The proportion of the original CAPEX to be recovered and attributed to each of the following C-1-C C/C is calculated utilising the tilted annuity formula.

3.7 The tilted annuity formula is a proxy for economic depreciation and calculates a specific cost recovery for CAPEX over the assumed life of the asset acquired, which takes into account the following factors:

3.7.1 Financing costs associated with the CAPEX;

3.7.2 Changes in prices over time as measured by the rate of inflation; and

3.7.3 The cost trend of systems development or technology over time.

- 3.8 Utilising numbers from the Model as an example of the application of the tilted annuity formula, Telstra is said to have incurred \$C-I-C million in CAPEX during the 2001/2002 financial year, or 1 January 2002 utilising the assumption described in paragraph 3.3.2 above. The tilted annuity formula calculates a recovery percentage for each of the following C-I-C detailed in the following table:

Table 1: Application of the Tilted Annuity Formula

C - I - C

- 3.9 The particular tilted annuity formula used in the Model restates CAPEX when made in future dollars over C-I-C adjusted for various factors identified in paragraph 3.7 above. The consequence of the particular formula used is that the first annuity has been restated in dollars assuming payment of the annuity in the subsequent financial year. It is therefore, in my view consistent with the assumption as to the timing of CAPEX expenditure and the particular tilted annuity formula used to lag the recovery of the annuity in the Model by one year from 1 January to 31 December.

Average subscribers assumption

- 3.10 In my first report, I compare the appropriateness of utilising an average number of subscribers in a financial year to the method of utilising the concluding number of subscribers in a financial year, to determine the monthly charge for recovery of specific costs.
- 3.11 I conclude in my first report that it is more appropriate to utilise the average number of subscribers in a financial year as the approach results in full recovery of the specific costs, whereas using the concluding number of subscribers in a financial year would result in an over estimation of the total number of subscribers in any one financial period paying the calculated monthly charge. This has the affect that the calculated recovery using the concluding number of subscribers in the relevant financial year is materially less than the ULLS specific costs which are sought to be recovered.
- 3.12 The Model calculates an average number of subscribers as at 1 January for each relevant financial year. This is accomplished by taking the simple average of the number of subscribers as at the start and end of each respective financial year.

3.12.1 For example, the Model calculates the average number of subscribers for the 2001/2002 financial year to be $\frac{C-1-C}{2}$ an average of $\frac{C-1-C}{2}$ (number of subscribers at the start of the 2001/2002 financial year) and $\frac{C-1-C}{2}$ (number of subscribers at the conclusion of the 2001/2002 financial year).

3.13 For the above reasons, I am of the opinion that the Model appropriately uses average subscribers for each respective financial year.

4. OVERALL CONCLUSIONS

- 4.1 The following diagram provides a graphical representation of how the Model calculates the CAPEX specific cost recovery for ~~€-1-C~~ million of CAPEX incurred by Telstra in the financial year ended 30 June 2002:

Diagram 1: Illustration of CAPEX Recovery – Telstra ULLS Model

C-1-C

- 4.1.1 The CAPEX is assumed to have been incurred on 1 January 2002 (refer to paragraph 3.3.2 above), whereby the CAPEX is recovered over the following 5 financial years commencing on 31 December 2002.
- 4.1.2 The annuity cost to be recovered on 31 December of each financial year is allocated across the calculated average number of subscribers for the relevant financial year (average of the number of subscribers at the start of the financial year and at the conclusion of the financial year).
- 4.2 For the reasons detailed above, I am of the opinion that there is consistency in the methodology used in the Model, between allocation of the tilted annuity to be recovered on the 31 December of each financial year (after taking into account the lag in the first year and the assumption that the CAPEX is incurred on 1 January of the relevant financial year), and the use of an average number of subscribers for each relevant financial year to recover the CAPEX incurred by Telstra. That is, the timing for demand matches the appropriately lagged tilted annuity for CAPEX recovery.

Dated this 15th day of August 2006



Michael Potter
Director
Axiom Forensics Pty Ltd

Telstra Corporation Ltd.

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Model**

**Annexure 1:
Resume of Mr T. M. Potter**

Michael Potter – Curriculum Vitæ

Director

Qualifications / Memberships:

- **Bachelor of Commerce**
University of Western Australia.
- **Associate member of the Institute of Chartered Accountants in Australia.**
- **Associate member of the Insolvency Practitioners Association of Australia.**
- **Cert IV in Fraud Control (Investigations).**

Experience

I have been a Chartered Accountant since 1990 and have thirteen years insolvency and litigation experience. For the past eight years I have specialised in the provision of forensic accounting services to my clients. I have acted as an independent expert in numerous litigation matters.

Specialisation	Period Details	Description
Forensic Accounting	2004 to present Axiom Forensics, Sydney.	Principal of Axiom Forensics.
Forensic Accounting	1998 to 2004 Ferrier Hodgson, Sydney.	Six years specialist experience as director and partner in charge of the forensics division of Ferrier Hodgson.
Insolvency and litigation	1985 to 1998 Ferrier Hodgson, Sydney & Perth.	Thirteen years general insolvency experience at Ferrier Hodgson in Perth and Sydney, involving a large number of insolvency administrations concerning all areas of insolvency. This included a large number of litigation matters relating to creditors' claims and recovery of preferences.

Particular Expertise - Forensic Accounting

- Expert testimony.

- Litigation support, including valuations, economic loss and damages assessments, contract disputes including costs, cost accounting, ACCC pricing disputes, copyright claims.
- Fraud & corruption investigations and risk management.
- Financial investigations, including asset tracing, review of transactions, reconstruction of accounting records, franchisee revenue reporting, breaches of Corporations Act, insolvent trading.
- Insurance claims – fidelity, product liability.

Recent Engagements

My recent experience includes acting as an expert in the following matters:

Industry	Type of Assignment	Special Issues
Pay TV	Forensic-Litigation Support (expert accountant's report)	Valuation of Pay TV business including expert testimony
Retail	Forensic-Litigation Support (expert accountant's report)	Deficiency Analysis and source and application of funds for proof of loss in claims against auditors of significant retail group
Telecommunications	Forensic-Litigation Support (expert accountants report)	Telecommunications Industry & ACCC regulatory accounting regime. Pricing principles for long distance telephony. Costing methodologies.
Telecommunications	Forensic - Financial Investigations	Testing of assumptions and pricing for broadband services used in an economic model for ACCC pricing dispute.
Telecommunications and Pay TV	Forensic - Litigation Support (expert accountants report)	Assessment of damages claim. Valuation methodologies. Inter-relationships between various Telecommunications and Pay TV products.
Telecommunications	Forensic-Litigation Support (expert accountants report)	Assessment of loss of profits damages claim. Billing processes and related issues.
Telecommunications	Forensic - Litigation Support (expert accountants report)	Assessment of damages claim concerning local and overseas operating and capital costs.
Telecommunications	Forensic - Litigation Support (expert	Assessment of loss of profits and damages claim alleged to have occurred on termination of

Industry	Type of Assignment	Special Issues
	accountants report)	mobile dealers contract.
Telecommunications	Forensic - Financial Investigations	Consideration of pricing for isp carriage services between entities in a major international telecommunications group.
Telecommunications	Forensic - Financial Investigations	Report on prospects of loss being established for a retailer of broadband services against a wholesaler.
Insurance	Forensic - Financial Investigations	Leader of investigation team for the Australian Securities and Investments Commission. Examinations conducted. Issues of accounting, insolvency and breaches of director's duties.
Clothing and Textiles	Forensic - Financial Investigations	Investigation of insolvent trading and directors breach of duties for Australian Securities and Investments Commission. Included conduct of examinations.
Property	Forensic - Financial Investigations	Investigation of group transactions with related parties, insolvent trading and directors breach of duties for Australian Securities and Investments Commission. Included attendance at examinations.
Custodian and Funds Management.	Forensic - Financial Investigations	Investigation of internal controls and large number of derivatives transactions to identify whether any financial irregularities within a major international bank acting as superannuation fund custodian.
Funds Management	Forensic - Financial Investigations	Investigation of fund managers activities and breaches of directors duties.
Superannuation	Forensic - Financial Investigations	Investigation and expert report for Australian Securities and Investments Commission as to adequacy of disability payments.
Rail Transport	Forensic - Litigation Support (expert accountants report)	Investigation of manipulated costs claim in contract involving electronic systems for a number of projects for purposes of mediation.
Rail Transport	Forensic - Litigation Support (Report for mediator)	Independent investigation of costs claim pursuant to contract and report for parties in a mediation.
Gaming Technology	Forensic - Litigation Support (expert accountants report)	Independent investigation of costs claim pursuant to contract and report for parties in a mediation.
Resources / Mining	Forensic-Litigation Support (expert accountants report)	Assessment of damages claim for loss of royalties that led to settlement.

Industry	Type of Assignment	Special Issues
Maritime	Forensic-Litigation Support (expert accountants report)	Presentation of expert evidence in Court. Assessment of damages claim concerning seized ship and cargo. Commercial and legal issues specific to Maritime Industry.
Tobacco	Forensic - Litigation Support (expert accountants report)	Assessment of damages claims (three assignments) including expert testimony.
Resources & Retail	Litigation Support Assessment of damages claim	Presentation of expert evidence in Court. Accounting for contractual relationships. Breaches of licensing agreements.
Hotels	Litigation Support and fraud investigation	Investigation of claims of alleged fraudulent misrepresentation by large investment bank and management concerning accuracy of financial accounts relied upon by purchaser of a worldwide hotels marketing group.
Government	Fraud Investigation	Investigation for Australian Federal Police and Australian Taxation Office of alleged fraud by employee including overseas funds tracing and wealth analysis.
Retail - Jewellery	Fraud Investigation	Investigation and reporting for insurance recovery of stock misappropriation, false refunds and personal expenses obtained by state manager.
Wholesaling – Fruit and Vegetables	Litigation Support	Expert testimony and report on claimed loss of profits as a result of termination of supply agreement.
Computer Software	Litigation Support	Copyright issues - accounting for profits. Joint conference of experts and expert testimony. Issues included costing and accounting methodologies.
Free to Air TV	Litigation Support	Expert report on valuation issues. Selection of valuation methodologies. Assessment of economic conditions during late 80's early 90's. Industry overview. Investment issues.
Media Publishing	Litigation Support	Report for use in litigation. Quantification of loss.
Retail – Ski and Leisure wear	Litigation Support	Expert report on loss of profits due to closure of business arising from petrol site contamination

Industry	Type of Assignment	Special Issues
Property	Litigation Support	Expert testimony and reports on alleged frauds by shareholders and managers in real estate agency.
Fire Control Systems	Litigation Support	Assessment of damages claim. Selection of valuation methodologies and discount rate, including calculation of loss on perpetuity.
Printing	Litigation Support	Business valuation Review of financial accounts and accounting procedures
Printing	Litigation Support	Assessment of loss of profits arising from supply of equipment alleged to be defective.
Commercial property	Forensic- Fraud investigation	Overseas investigation of frauds and recovery of real property in a joint venture.
Education	Forensic- Fraud investigation	Tracing of transactions. Forensic IT techniques (discovery of duplicate accounting records). Asset recovery.
Insurance	Forensic- Fraud investigation	Assessment of claims in a number of employee fraud matters for an insurer including debtors frauds, payroll and petty cash, kickbacks etc.
Pharmaceutical	Litigation Support	Assessment of product liability claim and loss of profits for insurer.
Printing	Forensic- Fraud investigation	Surprise "audit" of several franchisees to identify under reported revenues, unauthorised websites etc.
Food Processing	Forensic- Fraud investigation	Expert testimony on employee fraud. Overseas transaction tracing.

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Annexure 2: Extracts from the Telstra ULLS Model

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