1 December 2005

The Manager

Company Announcements Office
Australian Stock Exchange
4th Floor, 20 Bridge Street
SYDNEY NSW 2000

**Office of the Company Secretary**

Level 41
242 Exhibition Street
MELBOURNE VIC 3000
AUSTRALIA

Telephone 03 9634 6400
Facsimile 03 9632 3215

**ELECTRONIC LODGEMENT**

Dear Sir or Madam

**Telstra Regulatory Briefing**

In accordance with the listing rules, I attach a copy of a media announcement – "Telstra seeks investment certainty for IP network", and presentation to be made today, for release to the market.

Yours sincerely

**Douglas Gration**
Company Secretary

# Media Release

1 December 2005 337 / 2005

## Telstra seeks investment certainty for IP network

Telstra will begin building its new IP broadband network as soon as next year if its shareholders' investment is protected from regulations that would otherwise allow competitors to piggyback on the multi- billion dollar project.

The new network will offer Telstra's customers super-fast broadband at speeds of over 12 Mbps.

Telstra Group Managing Director, Public Policy and Communications, Phil Burgess said today; "If Telstra's 1.6 million Australian shareholders are being asked to build the new network, then they shouldn't be forced to hand it over to our competitors.

"You can't ask Telstra shareholders to invest in a new broadband network, and then allow competitors to pay none of the cost but still enjoy the same benefits," Burgess said.

At an investor briefing in Sydney, Mr Burgess said Telstra would be seeking legislative reforms before proceeding with the network upgrade. He said existing laws designed to give companies certainty before going ahead with major new investments were inadequate because the processes were slow and cumbersome, with decisions subject to challenges that would delay Telstra's plans by at least two years.

The key immediate regulatory reforms Telstra believes are essential to promote competition, investment and equal services to all Australians are:

1. An average ULL price of $30
2. Limiting operational separation requirements to existing wholesale core services and
3. Exempting new services from mandated 3rd party access.

Telstra Chief Financial Officer, Mr John Stanhope, said Telstra was not seeking to escape regulation altogether; "Telecommunications should be regulated in the same way as other industries, rather than singled out for additional regulation that discouraged new investment.

"Regulation should be fair, consistent and equitable. Special telecommunications regulations applying only to Telstra, introduced to give competitors a leg up and a head-start in the 1990s should be restricted to the legacy technology they have used successfully to establish and grow their Australian businesses," he said.

"New arrangements are necessary so Telstra, or any company prepared to invest, can now go ahead with the next generation of advanced telecommunications services that will provide major benefits to all Australians."

# Media Release

"If this does not happen, Australia risks seeing a devastating drain of capital overseas and away from telecommunications. We also risk seeing a massive transfer in wealth from Telstra's Australian shareholders to the largely foreign shareholders of our major competitors.

"Australians will not get the next-generation of technologies and services they need to ensure our economic competitiveness in the global market.

"It's now more than a decade since Australia's telecommunications market was opened to competition. Telstra's competitors are now big and profitable - in many cases backed by multinational corporations many times bigger than Telstra," Mr Stanhope said.

**Telstra Media Contact:** Rod Bruem, Tel: (02) 9206 0092 / 0438 288010

# Regulatory Briefing

1 December 2005

## Disclaimer

These presentations include certain forward-looking statements that are subject to various risks and uncertainties. Actual results, performance or achievements could be significantly different from those expressed in, or implied by, these forward- looking statements. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors, many of which are beyond the control of Telstra, which may cause actual results to differ materially from those expressed in the statements contained in these presentations. For example, the factors that are likely to affect the results of Telstra include general economic conditions in Australia; exchange rates; competition in the markets in which Telstra will operate; the inherent regulatory risks in the businesses of Telstra; the substantial technological changes taking place in the telecommunications industry; and the continuing growth in the data, internet, mobile and other telecommunications markets where Telstra will operate. A number of these factors are described in Telstra's Annual Report and Form 20-F.

All forward-looking figures in this presentation are unaudited and based on AGAAP. Certain figures may be subject to rounding differences. All market share information in this presentation is based on management estimates based on internally available information unless otherwise indicated.

# Phil Burgess

Group Managing Director

Public Policy & Communications

## Three Purposes

- First
  - How regulations have reduced investment in Australia's telecom future
  - The negative impact of regulation on Telstra's business
  - How over-regulation destroys shareholder value
- Second
  - Provide a clear map for fixing the regulation in Australia
- Third
  - To clearly outline the regulatory reforms required to execute the 15 November 2005 plans for the future

# This session is not about politics

## Taking Care of Business

Factors Shaping Performance

⇨Management

⇨Work force

⇨Business climate/regulations

## The Burden of Over-Regulation

Over-regulation:

- ⇨reduces investment
- ⇨reduces consumer choices
- ⇨stifles innovation
- ⇨creates competitive imbalances

## Introductions

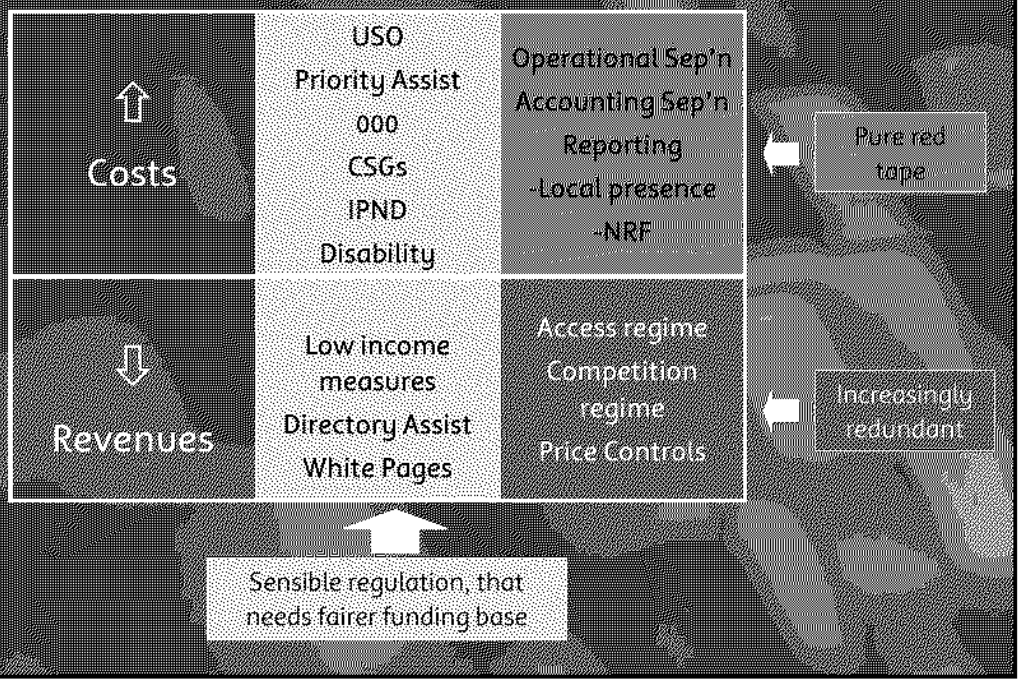
| | |
|---|---|
| ⇨Kate McKenzie | Deputy Group Managing Director, Public Policy & Communications |
| ⇨John Stanhope | Chief Financial Officer |
| ⇨Jeff Eisenach | Chairman CapAnalysis LLC |
| ⇨Tarek Robbiati | Deputy Chief Financial Officer |

# Kate McKenzie

Deputy Group Managing Director

Public Policy & Communications

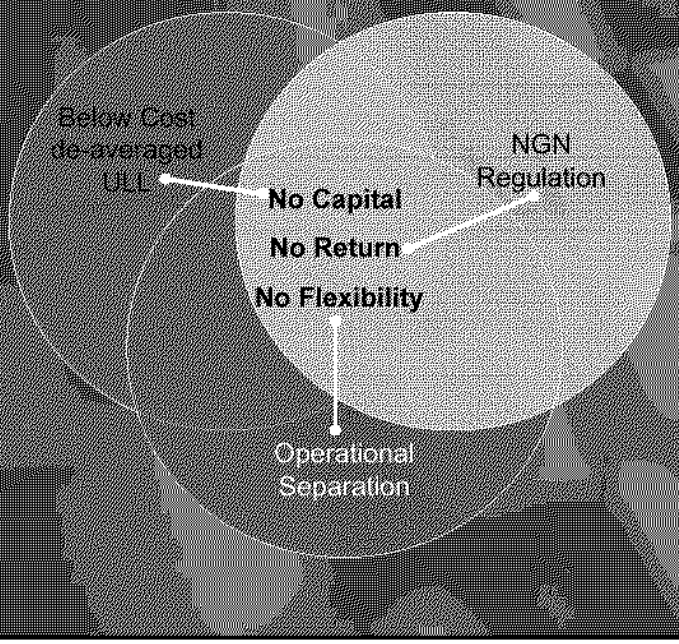
## Telstra Operates In A Complex Regulatory Environment



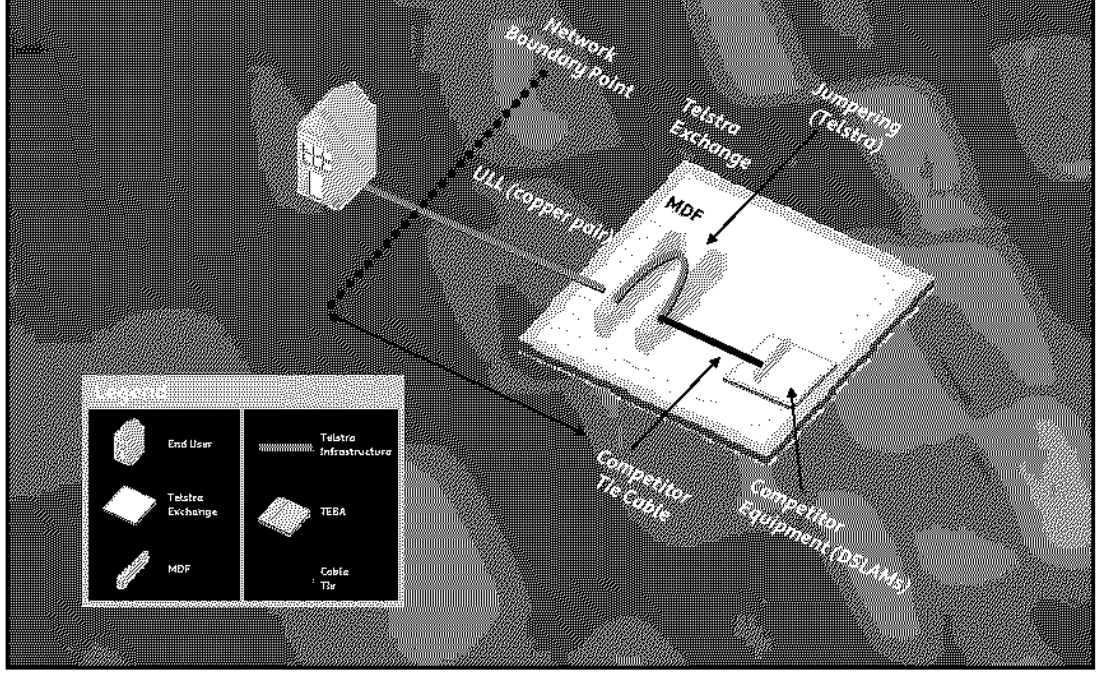
## Today's Focus

- Telstra has identified 3 key investment targets
  - Upgrading the core network
  - Upgrading the fixed access network
  - Rolling out a single national 3G wireless network
- The fixed access network investment decision pivots around 3 key regulatory issues
  - Unconditioned local loop pricing
  - NGN regulation
  - Operational separation

## Recipe For Stalled Fixed Access Investment



# Unconditioned Local Loop



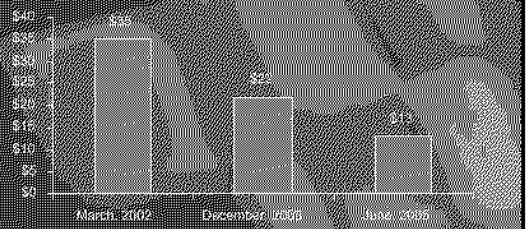

# Unconditioned Local Loop Pricing Levels

## The History of ULL pricing

- **October 1998** - ACCC first proposes de averaged prices
- **March 2002** - ACCC pricing principles specify a band 2 price of $35
- **January 2003** - Telstra lodges undertakings on an averaged basis ($20 in Band 1, $40 in Bands 2, 3 and 4)
- **October 2003** - ACCC releases model terms and conditions, proposes base prices of $12, $22, $40 and $100 for Bands 1 to 4 with adjustment mechanism for under recovery of costs
- **November 2003** - Telstra lodges revised undertakings for core services matching the ACCC's model terms and conditions
- **October 2004** - ACCC releases draft decision rejecting Telstra's undertaking – in turn, rejecting its own adjustment mechanism
- **December 2004** - In response Telstra removes the adjustment mechanism
- **August 2005** - ACCC issues draft decision specifying price of $7, $13, $27 and $244 for bands 1 to 4

**Does anyone, apart from the regulator, believe that costs (largely copper and trenches) have declined by 63% since 2002?**

ACCC Estimates of ULL costs in metro areas



# Unconditioned Local Loop Pricing Structure


"Australia is one of the few countries with geographically-averaged tariffs for end-users, but geographically de-averaged prices for ULL"

"if the regulator wishes to preserve the geographically averaged structure of end-user prices, it is essential to geographically average ULL prices."

*OECD, Access Pricing in Telecommunications, 2004*

# Impact On Investment

Wholesale revenue Drops with below-cost access prices

+

Retail revenue Drops from matching cherry-pickers

→ Lower revenues →

Less fixed line investment/ de-averaging at retail

## Regulating Next Generation Networks

- What is the regulatory test?
  - In telecommunications – promotion of competition
  - In all other industries – natural monopoly test
- Hence ACCC has compelled the resale of contestable services like ADSL (and threatened it on other services)
- Telstra faces unacceptable risk of 3rd party access at regulated prices that don't allow a commercial return

## Existing Declared Services

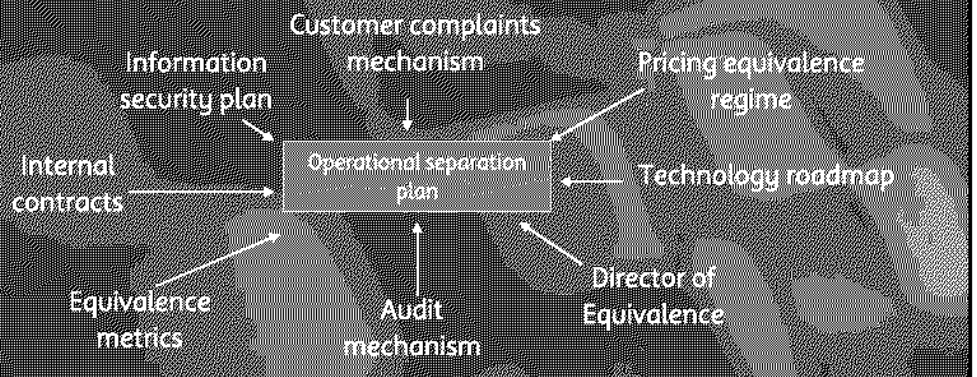
- Domestic PSTN Originating access
- Domestic PSTN Terminating access
- Digital Data Access Service
- Conditioned Local Loop Service
- Integrated Service Digital Network Terminating Service
- Integrated Service Digital Network Originating Service
- Local Carriage Service
- Local PSTN Originating Service
- Local PSTN Terminating Service
- Unconditioned Local Loop Service
- Analogue Subscription Television Broadcast Carriage Service
- Line Sharing Service
- Mobile Terminating Access Service
- GSM Service Declaration Technology - Neutral
- Domestic Transmission Capacity Service

## What Is Required?

- Telstra doesn't oppose access rights altogether
  - 3rd parties will continue to have access to declared services
  - This includes ULL, which can be used to build alternative broadband networks
- All potential investors in higher speed fixed access networks require certainty that the regulator will not confiscate the returns on any investment by mandated 3rd party access
- This requires
  - Moratorium on declarations under Part XIC
  - Reform of Part XIB such that only applies to declared services
  - Clear exclusion of new services from operational separation

## Operational Separation

- Adds substantial complexity to Telstra operating systems, increasing costs and reducing flexibility
- Risk of even greater imposts given lack of clarity around scope of regime and the pricing elements



## Conclusion

Telstra

- Telstra proposes ground-breaking investments that shift Australia into the digital future
- The fixed access network upgrade can only proceed with
  - averaged ULL pricing at a fair price
  - new infrastructure subject to general regulation, not industry-specific rules designed to guarantee access to the legacy network
  - operational separation is constrained to legacy services
- Telstra shareholders can't fund the fixed access network upgrade without these things

CAP ANALYSIS

# Mandatory Unbundling in the US: Lessons Learned the Hard Way

**Jeffrey A. Eisenach, Ph.D.**
**Chairman, CapAnalysis LLC**

# Background

- Deregulation began with the Telecom Act of 1996
- Mandated ULL for telecom services
- Narrowband and DSL were covered; cable modem services were exempt
- Federal Communications Commission issued overall regulations in August 1996
- State PUCs issued pricing rules in 1997-1998
- Ligitation continued through 2004

CAP ANALYSIS

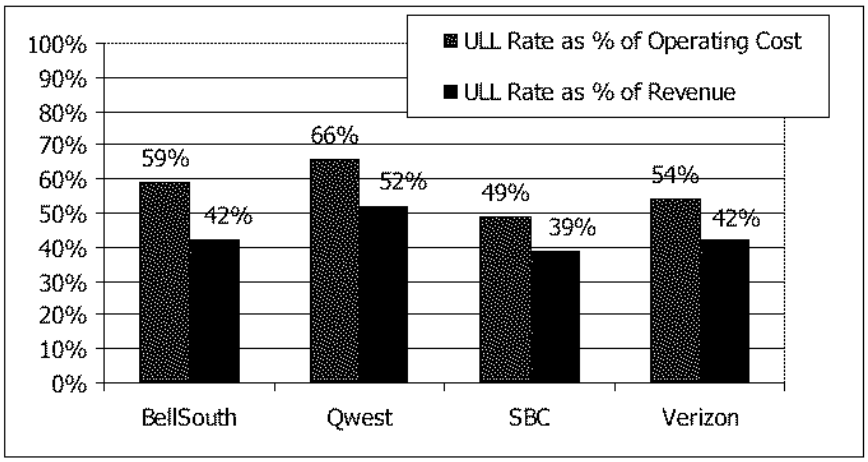
# Implementation Was Aggressive

- Mandated resale covered loops, switches and transport (creating the "UNE-Platform")
- Prices were initially set at 50% of operating costs – then reduced further by 25-50% between 1999 and 2003
- FCC Chairman Reed Hundt: FCC gave CLECs...

*"...a fairer chance to compete than they might find in any explicit provision of the law."*

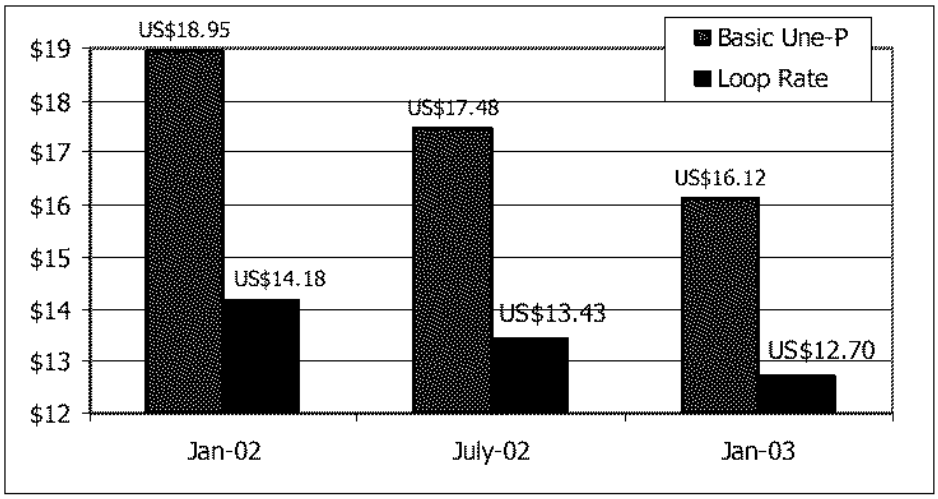
CAP ANALYSIS

# ULL Rates Were Set Below Cost




CAP ANALYSIS

# ...And then lowered further



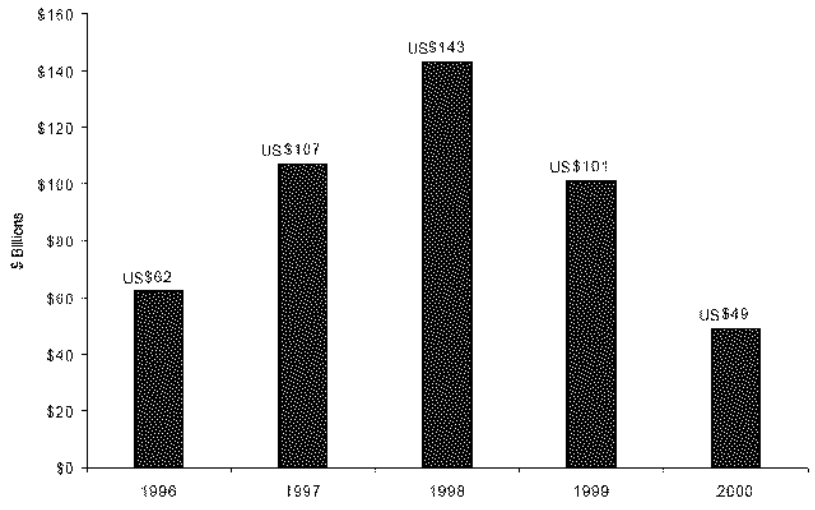

CAP ANALYSIS

# Results

- Entry by ~300 CLECs, which raised ~US$450B in capital, largely in high-yield debt
- Business plans focused on "cream skimming" in business markets and cities where rates were above cost
- Most of the capital was "invested" in aggressive marketing, not telecom infrastructure
- Virtually all CLECs went bankrupt
- The Exception: Cable – exempt from regulation – invested US$75 billion in an HFC broadband infrastructure

CAP ANALYSIS

# CLEC Hi-Yield Debt Issuance

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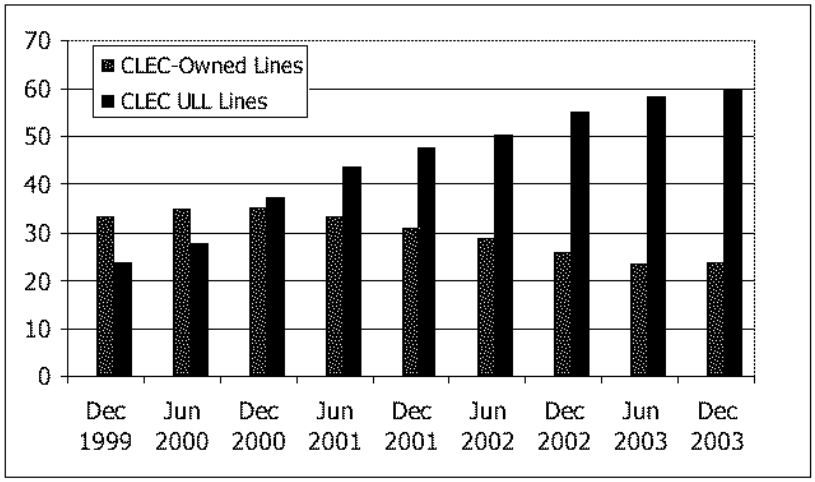
# Increasing Reliance on ULL

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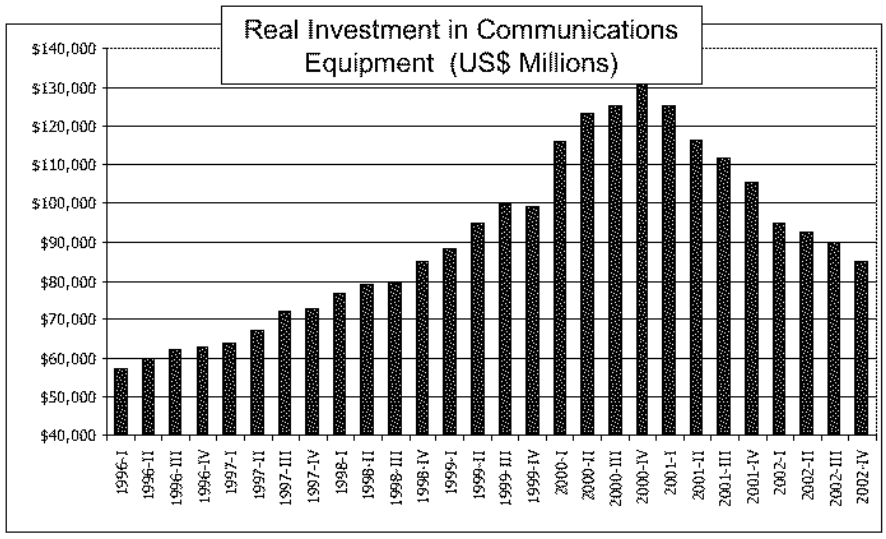
# 2001: Investment "Bubble" Ends




Source: U.S. Department of Commerce Bureau of Economic Analysis

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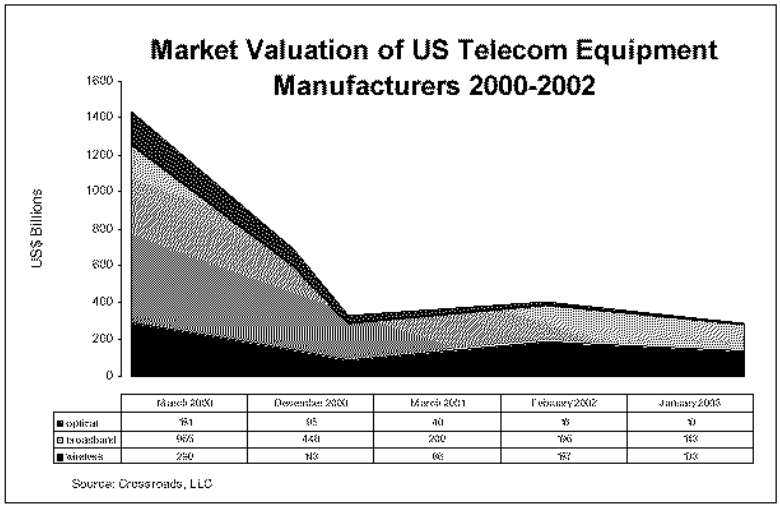
# Equipment Stocks Collapsed

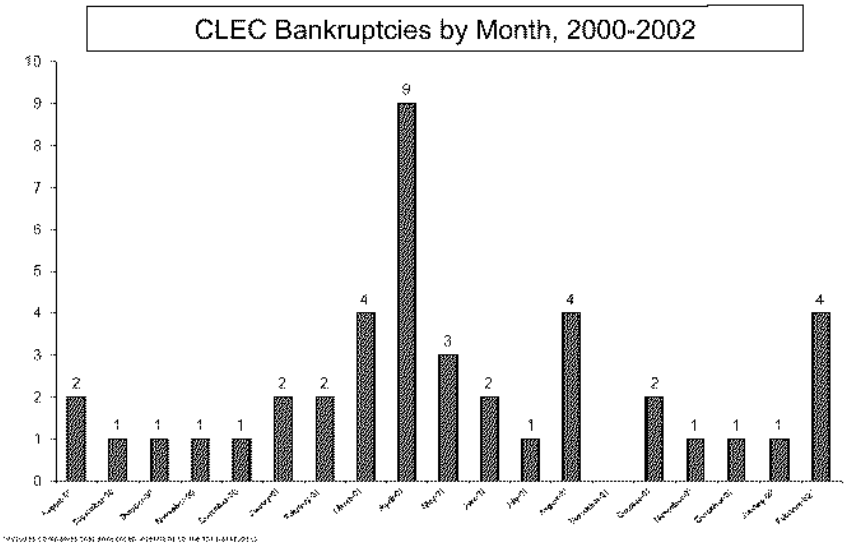



| | March 2000 | December 2000 | March 2001 | February 2002 | January 2003 |
|---|---|---|---|---|---|
| optical | 181 | 95 | 40 | 18 | 10 |
| broadband | 965 | 440 | 200 | 105 | 103 |
| wireless | 250 | 110 | 65 | 67 | 103 |

Source: Crossroads, LLC

CAP ANALYSIS

# CLECs Went Bankrupt

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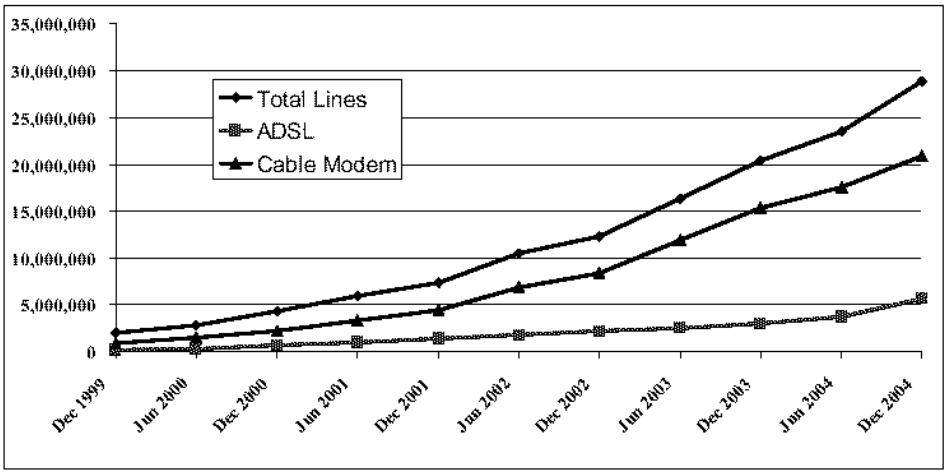
# Cable Dominated Broadband

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# Verdict: ULL Experiment Failed

- Virtually every CLEC went bankrupt, costing investors hundreds of billions of dollars; equipment sold at 5-10 cents on the dollar
- The biggest ULL players – AT&T and MCI – no longer exist as independent companies
- Major contributor to 2001 recession: The U.S. economy lost more than 600,000 telecom jobs in 2001 and 2002
- The only lasting facilities-based investment occurred in the one sector – cable – that was not regulated…and did not rely on ULL

CAP ANALYSIS

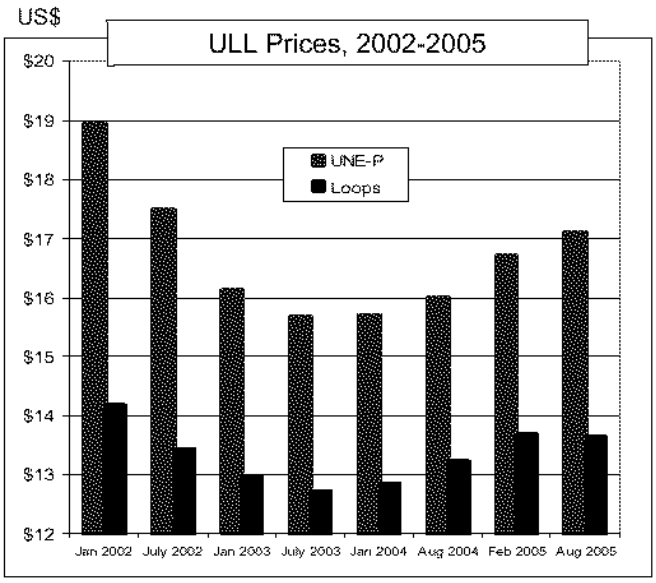
# New Policy Direction

- ULL scaled back (e.g. no longer covers switching) and PUCs are raising prices for remaining elements (i.e., loops)
- Cable modem exemption from resale confirmed by FCC in 2002
- FTTC/FTTH exempted from resale in August 2003
- DSL exempted from resale in September 2005

**All broadband facilities are now exempt from mandated resale requirements**

CAP ANALYSIS

# PUCs Are Raising ULL Prices




CAP ANALYSIS

# FCC: ULL Reduces Investment

"The record shows that the additional costs of an access mandate **diminish a carrier's incentive and ability to invest** in and deploy broadband infrastructure investment."

*Federal Communications Commission*

*September 23, 2005*

CAP ANALYSIS

# FCC: Safe Harbour for DSL Will Encourage Risk-Taking

"Eliminating [mandated access to DSL] will make it more likely that wireline operators will **take more risks** in investing in and deploying new technologies than they are willing to take under the current regime."

*Federal Communications Commission*

*September 23, 2005*

CAP ANALYSIS

# FCC: Mandated Sharing Impedes Innovation

"Requirements that would guarantee ISPs access to [wireline broadband transmission] would **impede the development and deployment of innovative wireline broadband Internet access technologies** and services."

*Federal Communications Commission*

*September 23, 2005*

CAP ANALYSIS

# FCC: Mandated Sharing Is Not Necessary for Competition

"Facilities-based wireline carriers **have incentives to make, and indeed already make, broadband transmission capacity available to ISPs**, absent regulation."

*Federal Communications Commission*

*September 23, 2005*

CAP ANALYSIS

# FCC: It's Not Just Cable

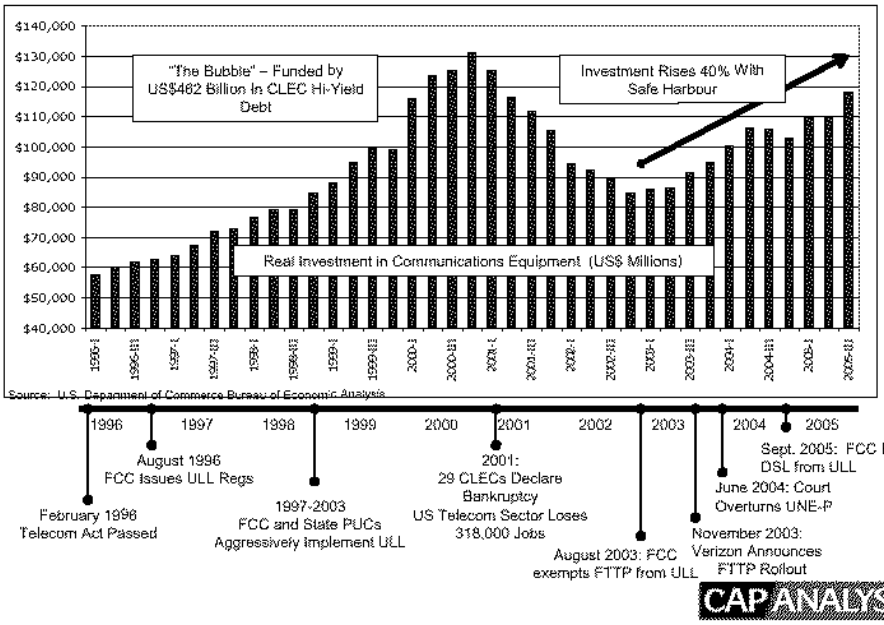
"The threat of competition from other forms of broadband Internet access, whether satellite, fixed or mobile wireless, or a yet-to-be-realized alternative, will further stimulate deployment of broadband infrastructure….These **emerging broadband platforms exert competitive pressure** even though they currently have relatively few subscribers."

*Federal Communications Commission*

*September 23, 2005*

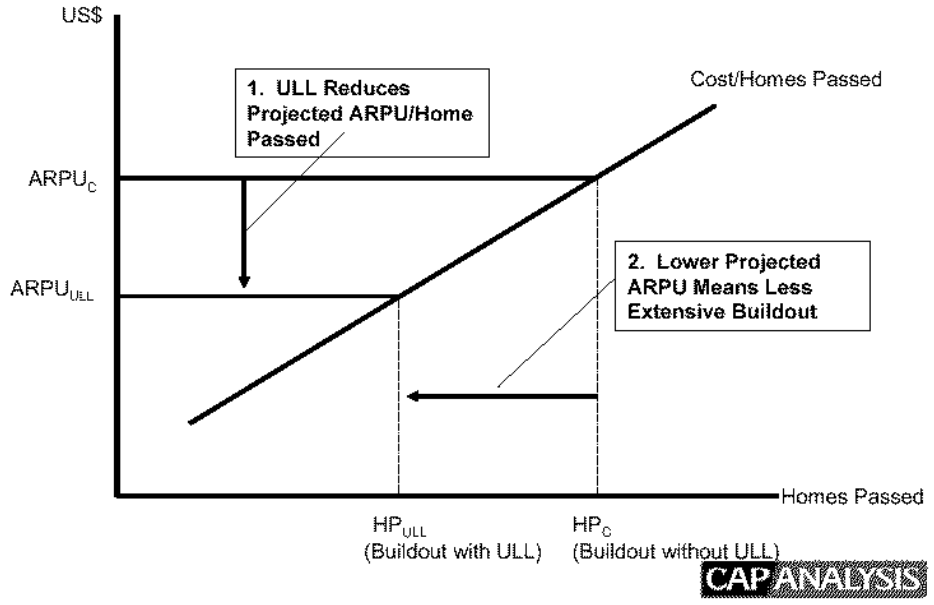
CAP ANALYSIS

# Investment Has Responded




CAP ANALYSIS

# The Simple Economics of ULL and NGN Buildout




# ULL Economics of European New Entrants

Telstra

## Typical Shared ULL Economics in the UK

| Components | Type | Description and Typical Accounting Treatment |
|---|---|---|
| ULL Line Rental (*) | ⇨ Annual Fee per line | • Opex | ⇨ £27 per line, Expensed |
| | ⇨ One-Off Connection Charge | • Capex | ⇨ £83 per line, Depreciated over 5 years. Depends on churn |
| Exchange Preparation | ⇨ Site Survey | • Capex | ⇨ £2788 per Site, Depreciated over 5 years. |
| | ⇨ Setup costs (6 sq m per Exch.) | • Capex | ⇨ £1380 per Site, Depreciated over 5 years. |
| Exchange Equipment | ⇨ Power systems, Air.Con. Systems, etc. | • Capex | ⇨ For 200 Line Capacity: £6,649 Depreciated over 5 years<br>⇨ For 400 Line Capacity: £9,974 Depreciated over 5 years<br>⇨ For 600 Line Capacity: £13,299 Depreciated over 5 years |
| New Entrant Equipment | ⇨ DSLAMs, etc. | • Capex | ⇨ For 200 Line Capacity: £16,000 Depreciated over 5 years<br>⇨ For 400 Line Capacity: £28,000 Depreciated over 5 years<br>⇨ For 600 Line Capacity: £36,000 Depreciated over 5 years |
| Annual Running Costs | ⇨ Power Costs<br>⇨ Air. Con. Costs | • Opex | ⇨ For 200 Line Capacity: £2,628 Expensed<br>⇨ For 400 Line Capacity: £2,897 Expensed<br>⇨ For 600 Line Capacity: £3,166 Expensed |
| Annual Traffic costs (**) | ⇨ Backhaul, Virtual Paths, etc. | • Opex | ⇨ For 200 Line Capacity: £4,500 Expensed<br>⇨ For 400 Line Capacity: £7,500 Expensed<br>⇨ For 600 Line Capacity: £11,000 Expensed |

*(*) Values Regulated by Ofcom as of June 2nd 2005.*
*(**) Assumes 512Kbit/s per line @ 2to1 contention Ratio*
*Source: BT OFCOM Equipment Memorandum, Evolet Analysis*

# ULL Economics of European New Entrants

Telstra

## UK New Entrant ULL Economics and Implications

| Cost Component for Shared ULL (£) | Annual Cost per line 200 Line Capacity | 400 Line Capacity | 600 Line Capacity |
|---|---|---|---|
| a. ULL Line Rental | £27.0 | £27.0 | £27.0 |
| b. Amortisation of Connection Fee @20.0% churn | £16.6 | £16.6 | £16.6 |
| c. Amortisation of Capex Installed by BT | £13.5 | £8.8 | £7.3 |
| d. Amortisation of AltNet/ISPs Capex (DSLAMs, etc..) @80.0% Capacity | £20.0 | £17.5 | £16.0 |
| e. Cost of Operating the Exchange @80.0% Capacity | £16.4 | £9.1 | £6.6 |
| f. Backhaul @80.0% Capacity and @ Contention Ratio of 20/1 | £28.1 | £23.4 | £22.9 |
| **Total DIRECT COSTS** | **£121.7** | **£102.4** | **£95.4** |
| .. Return on Capital (10%) | £13.4 | £10.5 | £8.9 |
| .. Impact of 25% Churn | £4.2 | £4.2 | £4.2 |
| **Total COSTS** | **£139.2** | **£117.1** | **£108.5** |
| Cost Curve Advantage relative to 200 Line Capacity | | -15.9% | -22.1% |

⇨ ULL Cost Economics reflect the population density. They structurally favour Urban centres relative to Rural centres: the bigger the exchange, the lower the cost per line.

⇨ De-averaging ULL line rentals with lower urban relative to rural line rental costs exacerbates the issue and lowers the incentive for New Entrants to invest in rural areas

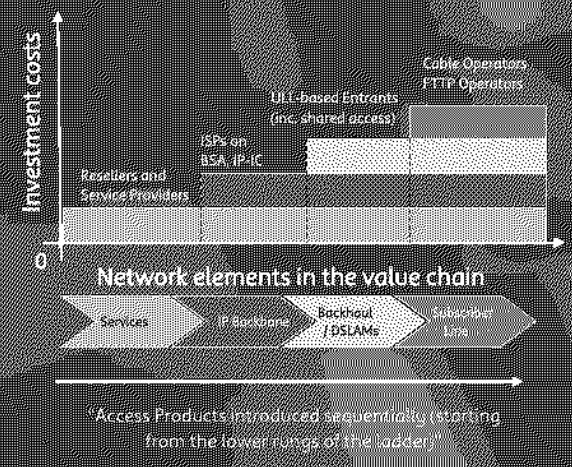
*Note: Assumes 80% Capacity Utilisation and Churn of 20%*
*Excludes all other operating costs (eg Billing, Testing, marketing)*

# EU Regulators Position on De-averaging

- ⇨ OFCOM (UK): "There are consumer affordability and significant practicality issues associated with de-averaging charges. Therefore, on balance, Ofcom considers currently that charges for LLU services should continue to be geographically averaged"
- ⇨ ARCEP (France) « Several studies have shown that the average cost of a line is a function of the density of the corresponding geographical area. The cost tends to increase when the density decreases. Several observations conducted in the early 2000s have shown that alternative operators tend to roll-out their infrastructure in the most densely populated areas first, and highlighted the lack of roll-out plans beyond those areas. Therefore, it appeared necessary for the Authority to limit the calculation of the ULL costs to an average cost »

# Impact on NGN of EU Broadband Access Regulation

## The Ladder of Investment Model (*)




*Source: (*) Martin Cave and Ingo Vogelsang, November/December 2003, "How access pricing and entry interact"*
*Note: BSA = Bit Stream Access (A version of Wholesale ADSL), IP-IC = IP Interconnect (Wholesale ADSL with IP Interconnection)*

## Comments

- ⇨ Based on the policy making belief that allowing access to different levels of existing access network infrastructure will eventually lead to entrants investing in their own access network.
- ⇨ Developed in late 2003, and applied retrospectively to justify regulatory intervention
- ⇨ The real issues are the relative price points for each service, migration and switching costs

# Impact on NGN of EU Broadband Access Regulation

Telstra

## The European Reality

- In **Denmark:** The introduction of Bit-Stream Access combined with Cost-based pricing of the local loop has lead to a standstill in the take-up of LLU: players are now moving down the ladder
- In **France,** most independent ISPs disappeared following the introduction of cheap ULL
- In **Sweden**, **Germany and the Netherlands**, large scale market entry was possible without use of bitstream products.
- Now in **Germany**, ULL-based operators are objecting to the introduction of wholesale line rental

## Lessons Learned

- **Migration is NOT happening**: Where new entrants invest in assets following the Regulator's commitment to a strategy, the Regulators feel obliged to protect the investment made by the new entrants
- **The ladder is a recipe for regulatory arbitrage and undermines new investments**: Overly interventionist concept which requires the Regulator to actively intervene to structure the market and thereby determine the business strategy of the various players .
- As a consequence, New Entrants adopt a « wait and see » attitude towards new investments.

# Impact on NGN of EU Broadband Access Regulation

Telstra

## EU Commission Intent

- i2010 Initiative to accelerate broadband penetration across the EU
- Focus on promoting *platform-based* competition to secure *innovation* and *sustainable competition*

Disconnect

## EU Regulation Reality

- With the Exception of a few countries (Sweden, Germany), competition is *service-based* (resellers).
- Broadband Access Innovation in fixed line has not occurred (No new standards for fixed line Broadband)

**Emerging View**

- Broadband assets are becoming replicable thanks to technology innovation, and therefore, promoting platform-based competition involves withdrawing (or not imposing) mandatory access.
- For example: Deutsche Telecom recently presented a plan to invest EUR3bn to develop FTTP in Germany. RegTP, the German Regulator and the German Government are arguing with the EU for the need to stimulate innovation by encouraging and protecting investments in NGN platforms.

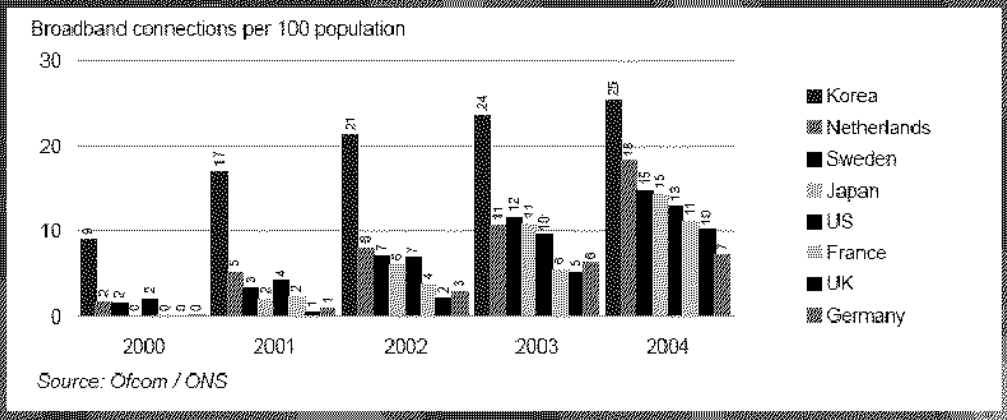
# Supporting Material

## Measuring European Regulatory Efficiency in Developing Broadband Markets

**Key Criteria**

- ⇨Penetration of Services
- ⇨Lower Prices for Consumer and Businesses
- ⇨Sustainable competition through platform competition

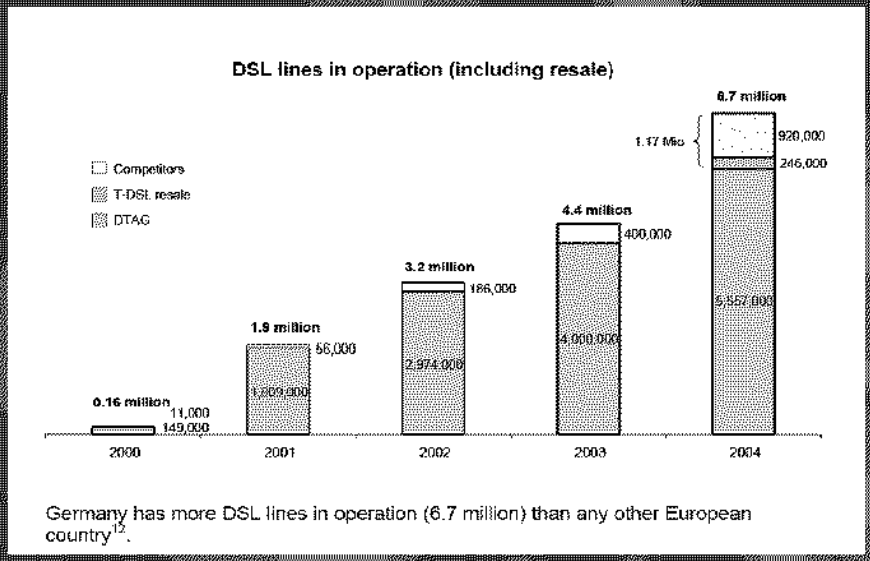
# Broadband Penetration in Major Economies




Source: OFCOM -The Communications Market 2005, August 2005

# Broadband Penetration in Major Economies

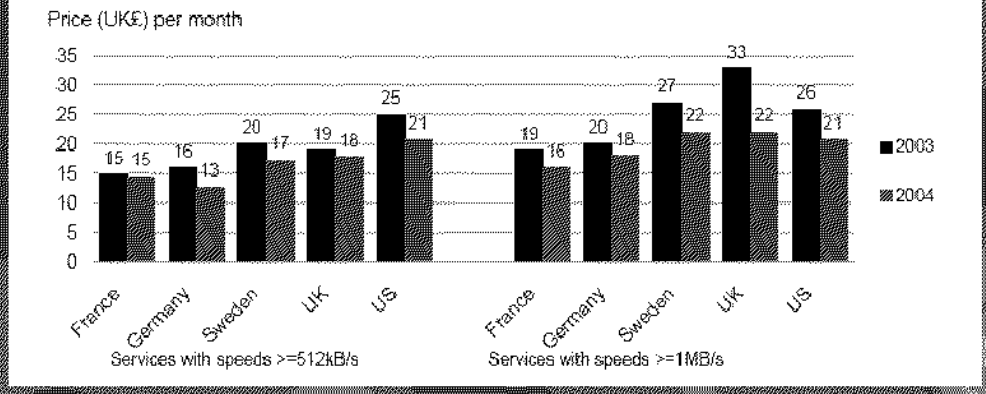
## Germany




Germany has more DSL lines in operation (6.7 million) than any other European country[12].

Source: RegTP. Data as of January 2005

# ADSL Prices in Major Economies

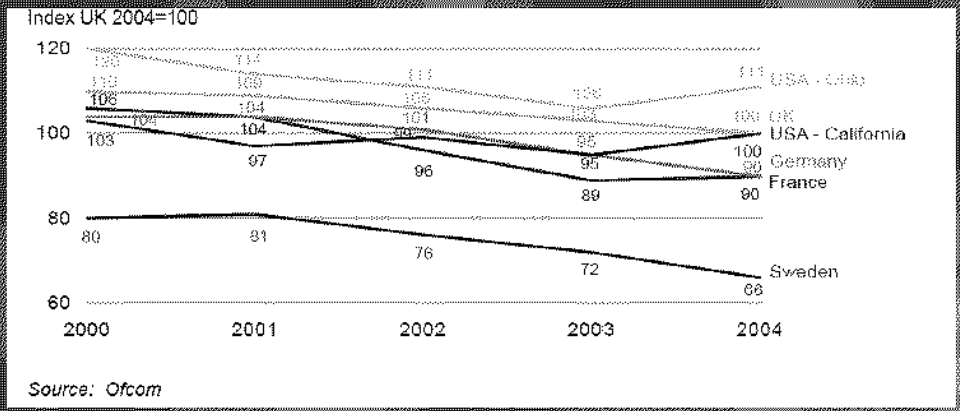



*Source: Ofcom*

Source: OFCOM -The Communications Market 2005, August 2005

# Business Prices in Major Economies

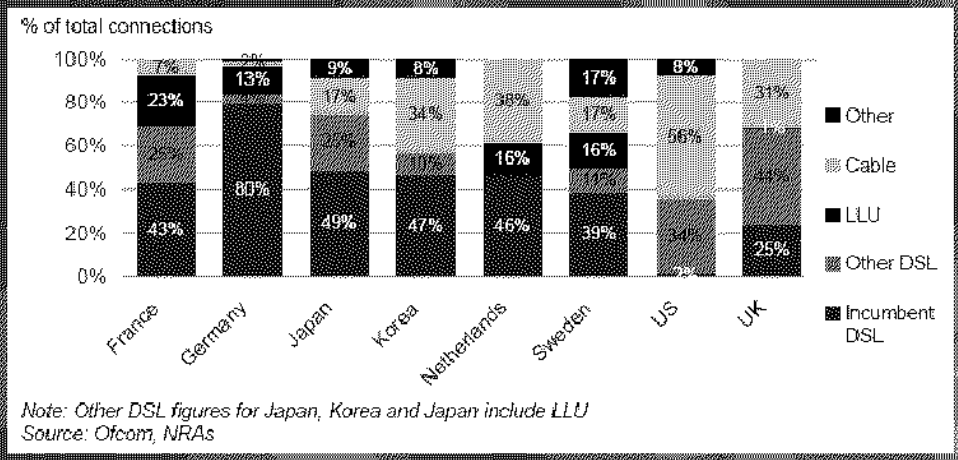
## Prices for small business Fixed lines




*Source: Ofcom*

Source: OFCOM -The Communications Market 2005, August 2005

# Broadband Platform Competition




*Note: Other DSL figures for Japan, Korea and Japan include LLU*
*Source: Ofcom, NRAs*

Source: OFCOM - The Communications Market 2005, August 2005

# References


- Ofcom: "Local loop unbundling: setting the fully unbundled rental charge ceiling and minor amendment to SMP conditions FA6 and FB6 Consultation document", 7 September 2005
- ARCEP: "Notification à la Commission européenne du projet de décision définissant la méthode de valorisation des actifs de la boucle locale cuivre ainsi que la méthode de comptabilisation des coûts applicable au dégroupage total", November 2005
- Commission Communication "i2010 – A European Information Society for growth and employment", COM (2005) 229 final, p. 4 f
- Extended impact assessment to the i2010 Communication, SEC(2005) 717/2, p. 30
- ERG (European Regulators' Group) remedies CP, ERG (03) 30rev1, p. 69, which talks of the ", generally held view that to promote innovation,
- Growth and efficiency all the way through the value chain; infrastructure based competition delivers more sustainable consumer benefits in the long run.", OECD Working Party on Telecommunications and Information services policies, The development of broadband access in OECD Countries , October 2001, p. 4
- Martin Cave and Ingo Vogelsang, November/December 2003, "How access pricing and entry interact", Telecommunications Policy, Volume 27(10-11), pp. 717-727
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- ETNO - Reassessing the ladder of investment, November 2005

# John Stanhope

## Chief Financial Officer

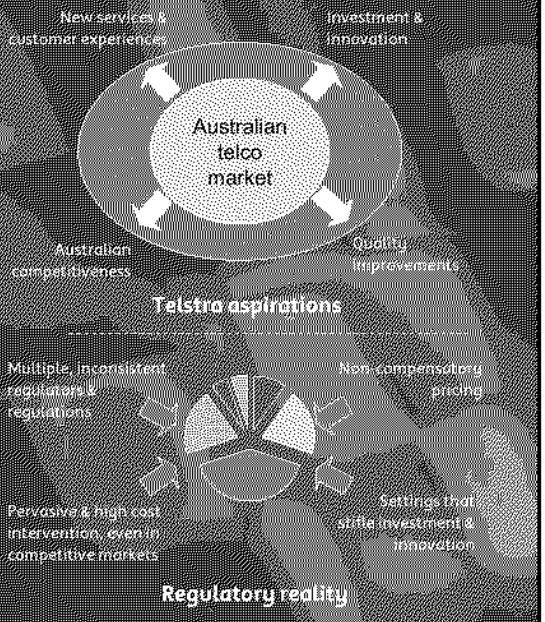
# Financial Impacts of Regulation

While Telstra seeks to invest, innovate and improve . . .,

. . . the ACCC decisions stifle investment & innovation, and focus on re-distributing industry value.

Key regulatory issues & impacts outlined here include:

- Current and pending regulatory decisions have material, negative impacts on Telstra's value.
- The ACCC ULL pricing decisions are the latest in a series of non-compensatory pricing decisions.
- Operational separation has potential to further erode Telstra value.
- Overall, despite many years of regulation, the long list of ACCC pricing inconsistencies denies investors any certainty over pricing and returns.



# Facts and Myths

| Myths | Facts |
|---|---|
| Optus claims that Telstra has previously quantified the impact of ULL at $68m as opposed to $800m p.a. | $68m was an estimated 05/06 impact as opposed to any estimate of future impact, which has been consistently stated to be approx $800m in 2009/10 based on a $13 (ACCC) versus $30 (Telstra) Band 2 access price. The 05/06 figure is small as ULL is only now approaching a mass market roll out. |
| ACCC claim that the main point of difference between ACCC and Telstra 's ULL pricing is in relation to a relatively small amount of IT and systems costs ($20-$25m). | Telstra believes the cost of providing ULL is some $491m more than the ACCC's upper limit calculation. |
| Telstra's potential loss in revenue in Band 2 is significantly overstated as Telstra will not lose all Band 2 customers | The major impact on Band 2 revenues is the flow through of lower retail access prices across all Band 2 customers. So it is not so much lost customers but price reductions to match competition which leaves less cash investment for future innovation. |

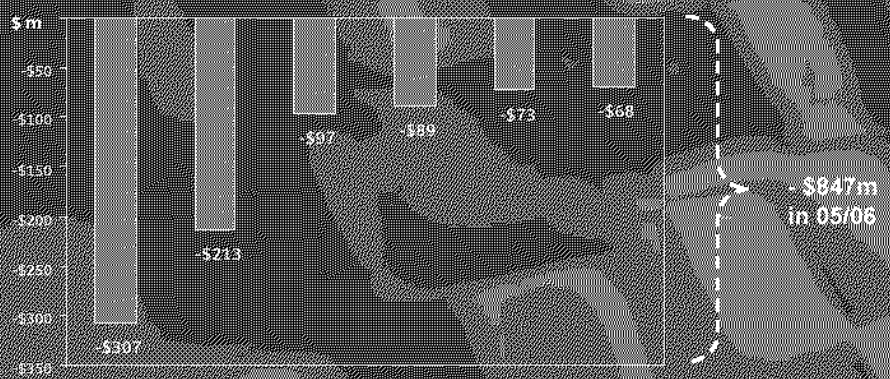
# Facts and Myths

| Myths | Facts |
|---|---|
| Telstra can increase Retail prices to fully recover costs in Band 4 (rural areas) | Under current market conditions Telstra cannot increase all its retail prices to fully recover costs ($144) when competitors are paying effectively capped costs of $45 (avge) reselling off Telstra's network through wholesale Basic Access, OTA, LCS & Broadband. |
| In calculating metro/rural access subsidy within Band 4 there is a fundamental mismatch between Telstra's **costs** of $144 per month in providing ULL and $45 per month **Retail** customer revenue. | Based on the ACCC's costing, Telstra incurs costs in Band 4 of $144 per SIO. However, **wholesale** customers can use this copper access network by paying Telstra approx $45/SIO average (this is for resale services). Based on the copper network costs alone, the subsidy to wholesalers for these services is therefore $99 per SIO.<br><br>While it is true that Telstra has Retail services in Band 4, resale access pricing effectively prevents Telstra from fully recovering its costs from retail customers. As noted above, Telstra cannot increase its retail prices to fully recover costs when competitors are allowed to offer services and pay costs of only $45. Band 4 customers are subsidised by Band 1, 2 & 3 customers.<br><br># $45 - This is a blended wholesale rate that includes telephony and a percentage of DSL. |

# Regulatory Pricing – Estimate Of 05/06 Wholesale and Retail Revenue Impact

Telstra

Telstra estimate of revenue impact of regulatory decisions that have already been made, or are pending




**PSTN OTA** priced below efficient cost

**Local Call Resale** priced below efficient cost

**Local Call Override** – OTA/LCS arbitrage

**Retail Price Controls** – impact of new CPI – 2.5%

**Mobile Terminating Access** – rate decline price flow through

**Pricing of ULL** – below average costs is $22 Band2

Key assumptions are stated in supporting material

# Band 2 Revenue Loss & Band 4 Cross Subsidy

Telstra

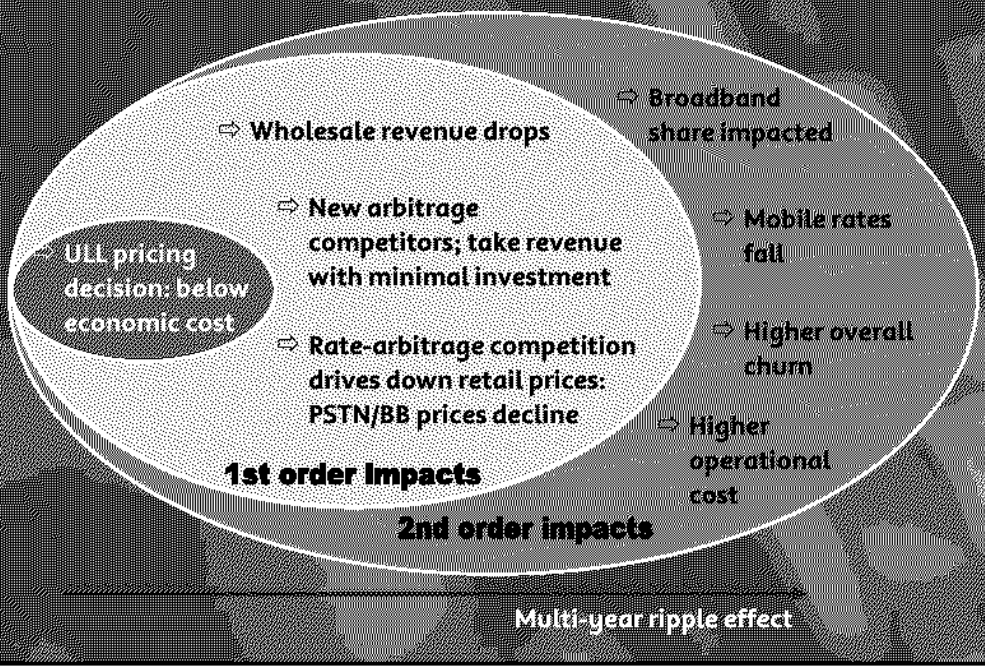
## Band 2 Revenue Loss

- There are approximately 7.5m services within Band 2
- If ULL access prices fall from $22 to $13 in Band 2 competitors are likely to flow this through to Retail prices in an attempt to win share.
- Telstra will be forced to reduce Retail prices accordingly to maintain its market position.
- Therefore Telstra's stands to lose $9 per month revenue across both it's Wholesale and Retail base.
- This equates to approximately $800m ($9 per month x 12 months x 7.5M = $800m+)

## Band 4 Cross Subsidy

- There are approximately 715k services within Band 4
- The ACCC has estimated the cost of providing ULL to these customers is $144 per month.
- Wholesale competitors can resell Telstra's PSTN & Broadband access for around $45 per month (average).
- This equates to an effective Band 4 cross subsidy of $99 per month or over $800m (715k x $99 x 12 months = $800m+).

# ULL Pricing Creates a Ripple Effect Across Markets




# Economic Impacts of Regulation: ULL Example

**Revenue (cash) Impacts:**

⇨ The table below quantifies the 1st and 2nd order impacts of ULL

| Band 2 ULL Average Price Assumptions | FY 07/08 $30 $m | FY 07/08 $13 $m | FY 07/08 Delta $m | FY 09/10 $30 $m | FY 09/10 $13 $m | FY 09/10 Delta $m | 10yr DCF |
|---|---|---|---|---|---|---|---|
| **1st Order** | | | | | | | |
| Decline in Wholesale PSTN/BB Resale Revenue | -707 | -707 | - | -1,068 | -1,068 | - | |
| Increase from ULL Revenue Stream | 405 | 190 | -215 | 604 | 292 | -312 | |
| Reduction in Retail Pricing - PSTN & Broadband | -505 | -864 | -359 | -698 | -1,167 | -469 | |
| | | | | | | | $6.1b |
| **Total 1st Order Impact** | **-807** | **-1,381** | **-574** | **-1,162** | **-1,943** | **-781** | |
| **2nd Order** | | | | | | | |
| Reduction in Mobile pricing | - | -171 | -171 | - | -240 | -240 | $1.7b |

**Assumptions:**

⇨ Competitor build within Band 2 only and ULL penetration rate @ 20% over 10 years

⇨ 50% of the lower competitor access price are assumed to flow through to retail pricing and is assumed to impact over a 5yr period

⇨ Mobile ARPU reduces to retain fixed/mobile price parity (assumed @ approx 2.0 times)

⇨ DCF calculations are post tax and based on terminal growth rate of 1.5%

⇨ ULL penetration the same at both $30 and $13 given size of margin opportunity (conservative assumption)

# Impact of ULL Price Levels of $30, $22 and $13

Telstra

## The financial impact of Lower ULL prices is significant.

The incremental **first order** impact alone on revenue for the company compared to the average price of $30 is in the order of:

| Band 2 | 07/08 | 09/10 |
|---|---|---|
| For $22 ULL - | -$250m | -$350m |
| For $13 ULL - | -$570m | -$780m |

This impact would be spread across wholesale and retail products. In terms of impact to key Telstra metrics this would mean :

| | 09/10 | 09/10 | 09/10 |
|---|---|---|---|
| ULL Price | @$30 | @$22 | @$13 |
| Revenue CAGR over 5 years | 2.5% | 2.2% | 1.9% |
| EBITDA Margin | 50.9% | 50.2% | 49.4% |
| NPAT CAGR over 5 years | 3.2% | 2.0% | 0.6% |
| Gearing % | 44.0% | 47.1% | 50.6% |
| ROI % | 29.0% | 27.8% | 26.4% |

# Competitor Margin Opportunity

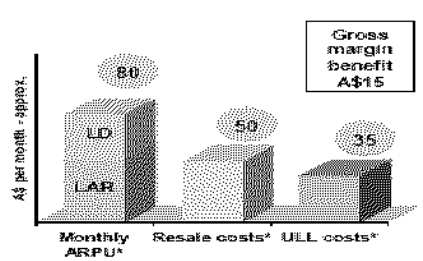
Telstra

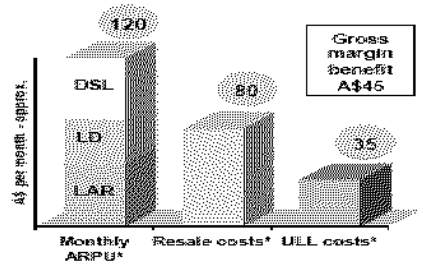
## ULL offers potential for gross margin improvement

'yes' OPTUS

**Today's opportunity** – offnet LD/local voice only — >500k

**Growing opportunity** – combined – voice/DSL — >80k




**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.

*Source: Optus Consumer and Multimedia Investor Briefing 5th April 2005*

# Free Rider Windfall For Telstra's Competitors By Cherry Picking The Traditional Telecom Cross Subsidy

Telstra

## Effect on Telstra Economics

- De-Averaging assumes Telstra can recoup some of its losses in metropolitan areas by increasing network access charges in regional / rural areas
  - But this would require **substantial increases in network wholesale prices**, with flow-on implications for rural/regional retail prices
  - **Or a substantial value loss to Telstra** if rural/regional retail prices not allowed to rise substantially to compensate
  - Or a third alternative which is a **new large Government subsidy to the telecoms industry – Optus & ACCC suggestion** (i.e. $800m p.a. cash)

- Network price economics:

| ACCC assumption | Reality |
|---|---|
| Band 4 ULL Price: $144 / month (cost of copper only) | Band 4 access rate set at wholesale rates<br>➢ PSTN only: approx. $40/month<br>➢ PSTN / DSL: approx. $70/month |

**So economic impact on Telstra based on ACCC estimate of ULL costs if rural/regional retail prices not allowed to rise:** 715K customers x ($144 - $43(1))/month = in excess of **$800m p.a. unrecoverable revenue.**

(1) Blended average PSTN and PSTN / DSL customers assuming average 25% DSL penetration

# High Speed Data Access Declaration Ripple Effect

Telstra

- ⇨ High speed **data services** are **forced** to be made available
- ⇨ **New competitors enter**
- ⇨ **Telstra no longer differentiated**
- ⇨ **Price based competition**
- ⇨ Data **ARPU declines**
- ⇨ BigPond **share impacted**

**1st order impacts**

- ⇨ **Mobile data rates fall**
- ⇨ Customer **acquisition** and **retention costs** increase
- ⇨ **Operational cost increases**
- ⇨ Retail **PSTN revenue declines faster**

**2nd order impacts**

**Multi-year ripple effect**

# The History of ACCC Pricing Decisions

Telstra

After 8 years of price regulation in the telecommunications industry the record of the ACCC shows:

| | | | |
|---|---|---|---|
| A long series of internally inconsistent pricing decisions | A history of **"changing course"** when a pricing method doesn't deliver the right results | A record of **varying pricing approaches by industry**, thereby increasing uncertainty & compliance costs | An economic disregard for how its decisions align with government policy (ie **wholesale pricing out of kilter with retail policy**) |



# ACCC Telecommunications Pricing Decisions Reflect Years of Inconsistency

Telstra

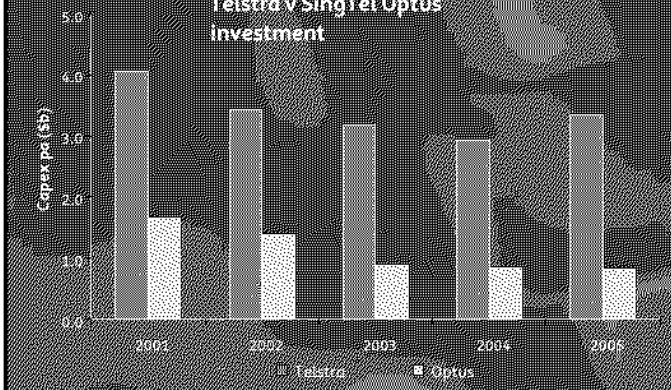
The table below shows:

- **Multiple pricing methodologies** in use within telecommunications;
- **Inconsistent methodologies** being used for substitutable services;
  - this creates "**rate arbitrage**" opportunities for firms using Telstra's network to compete
- **Wholesale pricing** decisions that are **inconsistent** with the government's retail pricing requirements as expressed in Price Controls and licence conditions.

After 8 years of price regulating the telecommunications industry, the ACCC is further than ever from providing the industry with **reasonable surety** as to the **pricing methodologies** it will employ.

| | Pricing Methodology | Averaged or de-averaged pricing? | Substitutable Services | Is the retail equivalent service subject to Price Control? |
|---|---|---|---|---|
| Local Call Resale | Retail Minus | Averaged | PSTN OTA | Yes |
| ULL | TSLRIC | De-averaged | PSTN OTA, SSS, LCS, BA Resale | Yes |
| MTA | Retail Benchmarking, TSLRIC | Averaged | Nil | No |
| PSTN OTA | TSLRIC | De-averaged | PSTN OTA, SSS, LCS | Yes |
| Basic Access Resale | Retail Minus | Averaged | ULL | Yes |
| Wholesale DSL | Not declared, but PART XIB impact | Averaged | SSS, ULL | No |

# Telstra's Investment Commitment

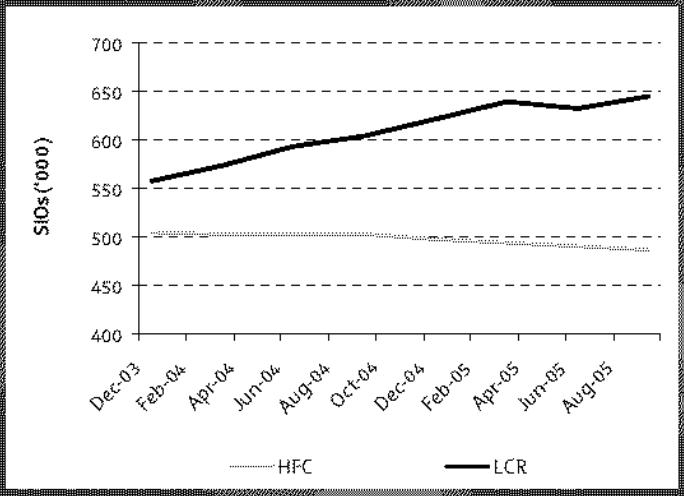



Telstra - domestic core capex for fiscal year ending June. Optus - capex for fiscal year ending March. Source SingTel Quarterly Management Discussion and Analysis.

- Telstra's ongoing investment dwarfs that of SingTel Optus.
- Of the investment that SingTel Optus does make:
  - A significant proportion is mobile related.
  - Any fixed line investment is:
    - geographically limited
    - in low cost areas (ie metro and CBD),
    - in high population density regions.
- This investment supports its cherry-picking strategies, but does little to benefit many consumers or the industry.

# Optus' Preference for Resale Over Direct Connect SIOs

Optus continues to add resale customers, while scaling down its HFC direct connects




Source: SingTel Quarterly Management Discussion and Analysis.

Since December 2003, SingTel Optus has increased its resale customer base by 86,000, while reducing its HFC direct connect customers by 19,000.

This pattern of behaviour suggests either:

- SingTel Optus is partially free-riding (in that it is cheaper to buy access from Telstra than to operate its own network); and/or,
- Telstra is a more efficient operator than SingTel Optus, and resale terms and conditions enable SingTel Optus to share Telstra's economies of scope & scale.

# Access to Next Generation Networks

## The claim ...

- Telstra's copper network is a legacy of its monopoly history.
- The copper network generates large cash-flows, which enable Telstra to fund a Next Generation Network.
- Competitive access should therefore be assured on Telstra's NGN.

## ... and the reasons it is opportunistic and wrong

- When Telstra was part-privatised in 1997, the ownership of the copper network (& other assets) was legally transferred to the company, and shareholders bought shares on this basis. Short of nationalisation, non-shareholders have no right, nor legitimate claim, to the ownership of or proceeds from the network.
- Telstra supplies access to its copper network in accordance with regulatory requirements, including specified terms and conditions.
- The competitive carriers seeking access to Telstra's NGN did not operate in Australia pre 1997, and therefore did not contribute to the building of the copper network. Now, again without contributing (this time to the NGN), they opportunistically seek the right to benefit from Telstra's investment.
- Telstra's competitors consist of large multi-national telcos, many of which could fund their own Next Generation Network. Instead, they invest elsewhere (eg s SingTel has systematically invested in Asian mobile businesses while limiting its Australian fixed network investment to high density, metropolitan and CBD areas - ie cherry-picking).

# Supporting Material

# Basis of Regulatory Financial Impact Estimates

| Regulatory Impost | What is being measured | Impact $m |
|---|---|---|
| **Price Controls** | | |
| Retail Price Controls | 05/06 impact of CPI-2.5% versus roll-over of existing regime (6 month impact) | 89 |
| Pricing of PSTN OTA | Difference between ACCC rate and Cost Based TSRLIC | 307 |
| Pricing of Local Call Resale (LCS) | Difference between Retail Minus v Cost Based TSRLIC | 213 |
| | | |
| Pricing of Mobile Terminating Access (MTA) | Reduction in MTA rates with flow through to F2M and Mobile rates | 73 |
| Local Call Override | Ability of carriers to selectively use PSTN OTA ("Local Call Override") or LCS for local calls | 97 |
| Pricing of ULL | Difference between Undertaking (band 2) price of $22 v price of $30 (based on average cost); | 68 |
| | **Estimated 05/06 Impact** | **847** |

# The ACCC Pricing Methods Change Over Time, Even For The Same Services

The ACCC regularly changes its position on pricing, as the examples below show.

**ULL pricing**

| Date | Estimated demand by 2005 | ACCC's preferred Band 2 ULL price/month | ACCC estimate of network costs | Implied ULL specific costs | Implied costs of supplying ULL | % cost reduction from Mar 2002 |
|---|---|---|---|---|---|---|
| Mar-02 | 400,000 | $35.00 | $12.00 | $23.00 | $110,400,000 | |
| Dec-03 | 140,000 | $22.00 | $12.00 | $10.00 | $16,800,000 | 84.78% |
| Jun-03 | 43,811 | $13.00 | $12.00 | $1.00 | $525,732 | 99.52% |

- To counter any risk of over- or under-recovery of ULL costs, Telstra suggested a reconciliation fund and process. The ACCC rejected this, thereby exposing Telstra to under-recovery of its costs of supply. Notably, access seekers face no such risk.
- While the ACCC recognises an access deficit on PSTN services, it does not for ULL pricing, even though ULL is also a PSTN-based service.
- From the date ULL was declared, the Commission has calculated ULL prices on the basis that Telstra's competitors using ULL should bear these costs as they are responsible for the costs being incurred. However, in its Draft Decision in August 2005, the Commission completely departed from this approach and opted for an approach whereby the majority of these costs are allocated to Telstra, reducing the level of costs included in the ULL price substantially.

**MTA pricing**

- GSM terminating rates, based on "retail benchmarking" were established in the ACCC's July 2001 pricing principles paper.
- In June 2004, on the basis of prices not declining as much as anticipated under the pricing method, the ACCC moved to TSLRIC as its preferred pricing methodology.

# Phil Burgess

Group Managing Director

Public Policy & Communications

# Question & Answer


Telstra
THANK YOU