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

The ACCC requested (email of 27 January 2008) that Optus provide a response to Telstra's submissions regarding Optus' profitability levels for the ULLS.

Specifically, the ACCC invited Optus to provide a submission on the questions below:

- **Do Optus consider that Telstra's analysis is an accurate reflection of Optus' current profitability levels, and likely profitability levels under the $30 undertaking price scenario? Have Telstra accurately calculated the financial indicators in their analysis? Please provide evidence to support your claim.**
- **Do the revenue figures correspond to the appropriate services and are the appropriate costs included?**
- **Is there a complete set of recent data available?**
- **Is the methodology used by Telstra the same as Optus use for financial reporting? If not, what are the key differences?**

In this supplementary submission Optus provides a response to these questions.

Telstra's submission quoted an out-dated Optus investor presentation and historic financial reports to support its view that access seekers generate high margins on ULLS. Telstra therefore inferred that moving to a price of $30 per month for access to the ULLS would have a limited impact on the margins of access seekers and would not negatively impact upon the state of competition. Optus submits that these statements are misleading and do not present a true picture of the returns available to access seekers using the ULLS. As a result they should be given no weight in the Commission's assessment on Telstra's ULLS Undertaking.

Telstra's data is almost 3 years old

Optus highlights that many of the figures submitted by Telstra are based upon old and out-of-date data. For example, to estimate Optus' ARPU, monthly costs and capex charges Telstra relied on an Optus presentation that occurred in June 2006. Whilst this presentation is 3 years old and clearly no longer relevant, it has nevertheless been taken out of context and is not at all representative of Optus' real margins in ULLS either as presented then or in the present day. As can be seen in the Attachment 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.

Regardless, Optus believes that the Commission is in a strong position to critique the validity of Telstra's estimates as such financial information has already been collected in the RAF accounts that Optus supplies on an annual basis.

Notwithstanding this, Telstra's analysis combined data from three different reporting periods – the aforementioned data from June 2006, as well as financial reports (MD&A reports) for reporting periods ending in June 2008 and March 2008. This piecemeal approach clearly undermines the validity of the end results as Telstra has simply strung together historic information without any justification of how it may relate to Optus' present situation.

Telstra's EBITDA estimate is highly inflated

Telstra incorrectly submitted that Optus' EBITDA (earnings before interest, taxes, depreciation and amortisation) for the ULLS will be 55.67 per cent if the ULLS price is set at $30. Optus believes that Telstra's EBITDA estimate is simply wrong since it does not include all costs associated selling and providing the ULLS service.

The reality is that whilst using the ULLS affords access seekers lower costs than resale (leading to higher returns), access seekers must pay more than the monthly access charge to utilise the ULLS. Optus submits that access seekers incur significant capital, once-off and recurring operating costs in addition to the access charge paid to Telstra. These costs include:

- the capital costs of installing DSLAM equipment in Telstra's exchanges and the backhaul required to connect that equipment to the core;
- the capital costs associated with new or upgraded back office systems to provide provisioning, customer billing and customer care capability;
- the ongoing operating costs of running, housing and maintaining that equipment. This includes significant fees levied by Telstra for renting space in its exchange buildings;
- Optus' customer acquisition costs and
- the once-off costs associated with connecting a customer. In addition to the ULLS monthly fee, Telstra charges a number of once-off fees for activating a ULLS such as a single connection fees (**CiC**), migration fees (**CiC**) and call diversion fees (**CiC**).

Telstra does not appear to have adequately accounted for all of these costs in its analysis. It follows that Telstra's analysis is unlikely to be an accurate reflection of Optus' current profitability levels, or its likely profitability levels under the $30 undertaking price. When these costs are properly taken into account the likely margins resulting from ULLS services will be significantly lower than that which has been calculated by Telstra.

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.[1] This highlights that although ULLS is not a loss making investment, ULLS margins are highly sensitive to access prices.

CiC

Tellingly, the Imputation Testing Reports that Telstra submits to the ACCC quarterly indicate that Telstra makes an imputed margin of -6.24 per cent on a bundle of ADSL and voice package (using historic costs). This analysis is based on a ULLS access price of $14.60. [2]

In summary, Optus submits that Telstra's analysis is not an accurate reflection of Optus' current profitability levels or of its likely profitability levels under the $30 undertaking price scenario. The ACCC should continue to reject Telstra's ULLS Undertaking for a $30 access price as it would almost certainly lead to the dilution of competition with the result that the long-term interests of end users would be severely compromised.

[1] Singapore Telecommunications Limited and Subsidiary Companies, *Management Discussion and Analysis of Financial Condition, result of Operations and Cash Flows for the Second Quarter ended 30 September 2008*, page 40.
[2] *ACCC Imputation Testing and Non-Price Terms and Conditions Report relating to the Accounting Separation of Telstra for the September Quarter 2008*.

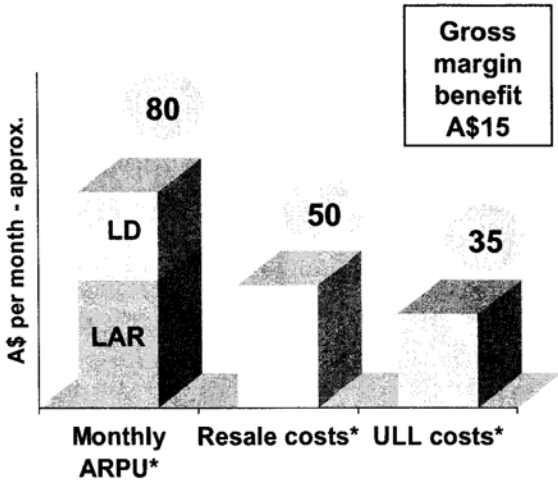
Attachment

- 2 slides from Optus Investor Briefing – 29 June 2006.

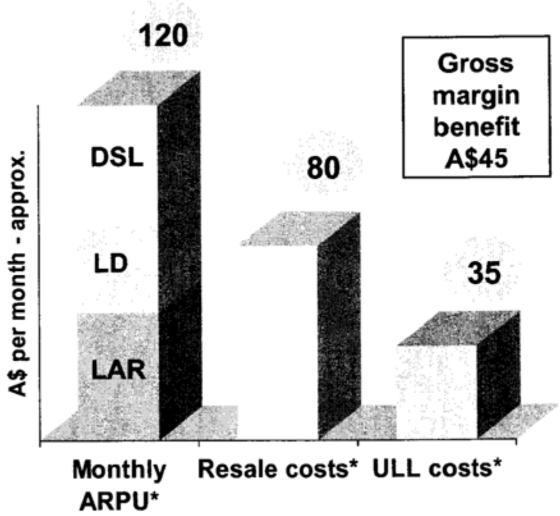
ULL offers potential for gross margin improvement

'yes' OPTUS

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

Optus – best scale in customers

'yes' OPTUS

Optus offnet base Dec04 — 709k
- 621,000 local voice
- 88,000 DSL

ULL improves offnet margins in medium term

Additional costs of ULL network spread over large customer base
- customer service and migration
- backhaul and other network opex

One-off costs and gradual migration mean that ULL will be EBITDA negative initially.

Substantial existing customer base in rollout areas reduces breakeven risk
- fit out costs ca. A$100,000 per exchange excl backhaul

As scale of network grows - ULL should improve margins for existing (and new) offnet customers.