

PRICE EQUIVALENCE FRAMEWORK REPORT RELATING
TO THE OPERATIONAL SEPARATION OF TELSTRA FOR
THE SEPTEMBER 2007 QUARTER

PUBLISHED ON 5 OCTOBER 2007



Table of contents

| | |
|--|----|
| Glossary and acronyms | 3 |
| Summary | 4 |
| 1. Introduction | 5 |
| 1.1 Background to Operational Separation | 5 |
| 1.2 Testing for Price Equivalence | 6 |
| 2. Telstra's Imputation Test | 7 |
| 2.1 Economic basis for imputation testing | 7 |
| 2.2 Principles Guiding Telstra's Imputation Test | 9 |
| 3. Telstra's Imputation Test for PSTN Voice | 12 |
| 3.1 Test Methodology | 12 |
| 3.2 Results | 13 |
| 4. Telstra's Imputation Test for ADSL and PSTN Voice | 17 |
| 4.1 Test Methodology | 17 |
| 4.1 Results | 18 |
| 5. Material Price Proposals under Operational Separation | 21 |

Glossary and acronyms

| | |
|-------|--|
| ACCC | Australian Competition and Consumer Commission |
| ADSL | Asynchronous Digital Subscriber Line |
| DSLAM | Digital Subscriber Line Access Multiplexer |
| IWP | Internal Wholesale Price |
| LCS | Local Carriage Service |
| LSS | Line Sharing Service |
| OSP | Operational Separation Plan |
| PEF | Pricing Equivalence Framework |
| PSTN | Public Switched Telephone Network |
| RAF | Regulatory Accounting Framework |
| SSS | Spectrum Sharing Service |
| ULLS | Unbundled Local Loop Service |

Summary

This report provides the quarterly report of Telstra's performance in accordance with the requirements of the Operational Separation Plan (OSP) and the Pricing Equivalence Framework (PEF). Under the PEF, Telstra is required to report to the public any material price changes that occurred over the period covered by this report, from 1 July 2007 to 30 September 2007 (the September 2007 quarter). The threshold for determining whether a price change is material was agreed between the ACCC and Telstra.

Accordingly, Telstra reports that it made no material price changes to ADSL and PSTN voice services over the September 2007 quarter.

Telstra has agreed to publish imputation test results in relation to the price change that was below but closest to the materiality threshold and that was imputation tested by Telstra during the September 2007 quarter. All information in this report is provided in order to fulfil Telstra's reporting requirements under the PEF. To avoid any doubt, by providing the information in this report, Telstra does not waive any legal professional privilege that may exist in the imputation test results or Telstra's imputation test.

The price change closest to the threshold during the September 2007 quarter involved introducing three new bundles of PSTN and ADSL or cable broadband plans for residential customers in areas where ADSL2+ or cable is available. The results of two runs of Telstra's imputation test are reported:

- The first run on a bundle of PSTN voice services; and,
- The second run on a bundle of ADSL and PSTN voice services.

Telstra passed both runs of Telstra's imputation test prior to the implementation of the price change – with margins of 21.3% on the bundle of PSTN voice services (see section 3) and 33.2% on the bundle of ADSL and PSTN voice services (see section 4). The margins on the bundle of ADSL and PSTN voice services are forecast to decrease after the implementation of the price change (see section 5).

1. Introduction

This report provides the quarterly report of Telstra's performance in accordance with the requirements of the OSP and the PEF.

The report includes information relating to the methodology used in Telstra's imputation test, also referred to as the Retail Pricing Tool in the OSP and the PEF, the results of Telstra's performance on price equivalence, and details regarding any material price changes during the quarter or, in cases where there are no material price changes, details will be provided regarding the price change closest to the material threshold imputation tested during the quarter.

This report is produced quarterly and is released within 5 business days of the end of the relevant quarters, which are January to March, April to June, July to September and October to December.

1.1 Background to Operational Separation

Operational Separation is implemented as a statutory condition of Telstra's carrier licence, specified in Part 8 of Schedule 1 to the *Telecommunications Act 1997*. Operational Separation is designed to address concerns that arise from Telstra's ownership of infrastructure which other telecommunications companies use to provide services to consumers. The objective of Operational Separation is to promote transparency and equivalence in the supply by Telstra of key services to other telecommunications companies.

Under the legislative framework Telstra was required to prepare a draft plan for Operational Separation, undertake public consultation and submit the draft plan to the Minister for approval. The draft plan was required to meet the legislative requirements set out in Schedule 1 to the *Telecommunications Act* and in two Determinations made by the Minister under the Act: the *Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005*, and the *Telecommunications (Operational Separation – Designated Services) Determination (No. 1) 2005*.

After consultation with Telstra and the ACCC, and taking into consideration the views of industry stakeholders and members of the public, the Minister approved Telstra's OSP on 23 June 2006.

Telstra's OSP supports the provision of high quality wholesale services through the establishment of four strategies (Customer Responsiveness Strategy, Service Quality Strategy, Information Equivalence Strategy and Information Security Strategy), a Price Equivalence Framework and internal contracts.

A copy of Telstra's OSP, the four strategies, the PEF and the internal contracts can be found on Telstra Wholesale's website:

http://telstrawholesale.com/custsupp/performance_separation.cfm.

1.2 Testing for Price Equivalence

Price equivalence is tested using Telstra's imputation test, which is subject to confidentiality and legal professional privilege. The aim of Telstra's imputation test is to determine whether an efficient competitor can replicate Telstra's retail price offers and is used for the specific purpose of obtaining legal advice as to Telstra's conduct in relevant markets including advice as to whether Telstra's conduct is lawful in accordance with Part XIB of the Trade Practices Act. Telstra's imputation test assesses whether there is sufficient margin for an efficient competitor to compete with Telstra in the relevant retail market(s) given:

- The wholesale costs or costs of self supply that are, or would be, faced by an efficient competitor; and
- The cost of transforming wholesale products or self-supplied inputs into retail products.

The general principles that guide Telstra's construction of its Imputation test are set out in Telstra's PEF Strategy. The scope of Telstra's Imputation test includes BigPond ADSL services and PSTN voice telephony services offered on a mass market basis to residential and business customers. Telstra's imputation test does not extend to arrangements that are customised or tailored specifically for individual customers.

The list of Designated Services (that is, wholesale services), as at 30 June 2006, which are applicable to the PEF is as described in the Designated Services Determination. Each of the Designated Services as at 30 June 2006 has been matched to those retail services that are subject to the PEF. Where retail services could be provided by alternative Designated Services, Telstra's imputation test uses the most efficient (that is, lowest cost) Designated Services.

Importantly, nothing in the PEF replaces, limits, extends or affects the Trade Practices Act. Telstra's imputation test results are not determinative of whether Telstra has or has not acted consistently with the Trade Practices Act.

2. Telstra's Imputation Test

This section briefly outlines the economic basis for imputation testing and the principles guiding Telstra's imputation test.

2.1 Economic basis for imputation testing

The economic basis for imputation testing is to assess whether the difference between a vertically integrated firm's retail and wholesale prices impose a 'vertical price squeeze'. A vertical price squeeze can arise if a vertically integrated firm is the monopoly supplier of an input essential to downstream (usually retail) production undertaken by both itself and its downstream rivals. In that case, a price squeeze occurs if the vertically integrated firm sets a margin between its essential upstream (input) prices and its downstream (retail) prices that is too small for efficient firms to be able to compete to profitably supply the downstream market.

If no vertical price squeeze exists then sufficient margin exists for efficient competitors to replicate the vertically integrated firm's retail price offering. An imputation test that demonstrates no vertical price squeeze also demonstrates equivalence. That is, for an imputation test to pass (ie for the resulting margin to be zero or above), the vertically integrated firm must be recovering from its own

retail prices at least the same as it charges its competitors for essential wholesale inputs.

For this reason, Telstra's imputation test assists in demonstrating price equivalence between Telstra and its wholesale customers and is essential in order to obtain legal advice as to the lawfulness of Telstra's conduct in relevant markets.

The general construction of the imputation test is represented by the following simplified formula:

$$Pr - Pi - Cav \geq 0$$

Where:

- Pr is the downstream price of the vertically integrated firm (or more generally, the revenues it would earn if it supplied the contested services and/or customers);
- Pi is the price of, or more generally revenues from, the essential inputs sold by the vertically integrated firm; and
- Cav is the cost an efficient firm would necessarily incur in transformation the essential input into the downstream service. These costs are called avoidable transformation costs.

In practice, the imputation test uses the avoidable transformation costs of the vertically integrated firm because:

- The identity of the vertically integrated firm is not in doubt (while the identity of the most efficient firm might be); and
- The information on costs of the vertically integrated firm required for imputation testing will be known by it.

The test thus uses the vertically integrated firm as a proxy for the most efficient supplier of the retailing services. If the vertically integrated firm is not the most efficient firm, then the imputation test will understate the true imputation margin earned by an efficient firm.

If the formula holds, then the imputation test is passed and one can conclude that there has been no price squeeze and that equivalence exists between the prices that the vertically integrated firm is charging its own downstream operations and its wholesale customers.

2.2 Principles Guiding Telstra's Imputation Test

The PEF Strategy outlines the general principles with which Telstra's imputation test is consistent. Most importantly, the PEF Strategy identifies the principle of bundling and the appropriate mix of wholesale inputs. On bundling, the PEF Strategy states that where the retail prices being tested are conditional on customers taking a bundle of services, or where bundling is a common method of supplying the market, the imputation test should be conducted over the relevant bundle of services. On the mix of wholesale inputs, the PEF Strategy states that they should reflect the most efficient mix of network technologies available for delivering the relevant volume of the product. In this way, the test will reflect an efficient competitor's network delivery.

The PEF Strategy also discusses the scope of services and customer groups that should be covered by Telstra's imputation test. The scope of Telstra's imputation test in terms of retail services includes BigPond ADSL and PSTN voice telephony services. The matching between these retail services and the Designated Services is set out in the table below. As noted above, where retail services could be provided by alternative Designated Services, Telstra's imputation test uses the most efficient (ie lowest cost) Designated Services. The scope of Telstra's imputation test in terms of customer groups is mass market residential and business customers.

| Designated Services | Relevant retail service(s) |
|--|--|
| 1. Domestic PSTN Originating Access Service | National long distance calls, International long distance calls, Fixed-to-mobile calls |
| 2. Domestic PSTN Terminating Access Service | National long distance calls |
| 3. Local Carriage Service (LCS) | Basic Access and Local Calls |
| 4. Wholesale ADSL Layer 2 Service | BigPond ADSL |
| 5. Line Sharing Service (LSS) aka Spectrum Sharing Service (SSS) | BigPond ADSL |
| 6. Unconditioned Local Loop Service (ULLS) | Basic access, Local calls, National long distance calls, International long distance calls, Fixed-to-mobile calls and BigPond ADSL |
| 7. Domestic Transmission Capacity Service | BigPond ADSL |

The PEF Strategy identifies the major inputs that are used in Telstra’s Imputation test. These are as follows:

Internal Wholesale Price: The internal wholesale price for Designated Services used in Telstra’s imputation test will initially be based on the average wholesale yield calculated across all wholesale customers taking the relevant Designated Service. Telstra may also run its imputation test using the internal wholesale price set at the wholesale yield associated with the lowest available or actual wholesale price.

Avoidable Transformation Cost: Telstra’s imputation test will incorporate the avoidable cost of transforming the Designated Service to a retail service to the extent practicable. If sufficient estimates of avoidable costs are not available, Telstra may use the average costs of transforming the Designated Service to a retail service.

Revenues: In general, Telstra's imputation test will incorporate all revenues derived from the relevant retail services associated with the full relevant customer base, regardless of whether customers were on superseded plans.

3. Telstra's Imputation Test for PSTN Voice

This section sets out the methodology used to construct the PSTN voice run of Telstra's imputation test and presents the results of the run for the relevant quarter.

3.1 Test Methodology

The first run of Telstra's imputation test is for PSTN voice telephony services. As identified in the previous section, these services are Basic Access, Local calls, Domestic long-distance calls, International long-distance calls and Fixed-to-mobile calls. Given that BigPond ADSL is not included in this run, the relevant Designated Services are PSTN originating and terminating access, LCS and wholesale line rental.

The run is constructed for each retail service individually and also tests the full bundle of PSTN voice telephony services. While Telstra presents some of the test results for individual services, it believes that the relevant result is the margin calculated across the full bundle of PSTN voice telephony services. With the exception of the HomeLine Part service, Telstra's PSTN pricing is based on customers taking the full bundle of PSTN voice telephony services from Telstra. In addition, bundled supply of PSTN voice telephony services is a common method of supply in the market. Therefore, based on the principles outlined in Telstra's PEF Strategy, the margin available to competitors should be assessed across the full bundle of PSTN voice telephony services.

The retail revenues used in the run are sourced from Telstra's general ledger for the relevant quarter. The Internal Wholesale Prices (IWPs) for the Designated Services are calculated on the basis of average yields and are sourced from the actual wholesale revenues for the relevant quarter divided by the relevant volumes. The transformation costs are sourced from the most recently available historic Regulatory Accounts. The level of costs taken from the Regulatory Accounts are based on a detailed study of avoidability.

3.2 Results

The results of Telstra’s imputation test run for the bundle of PSTN voice telephony services prior to the implementation of the price change below but closest to the material threshold in the September 2007 quarter are presented in Figure 1 below.

Figure 1a: PSTN Voice Imputation Test Margin – Business Customers

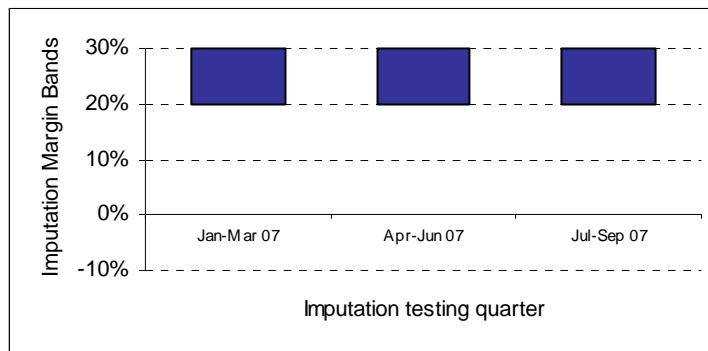


Figure 1b: PSTN Voice Imputation Test Margin – Residential Customers

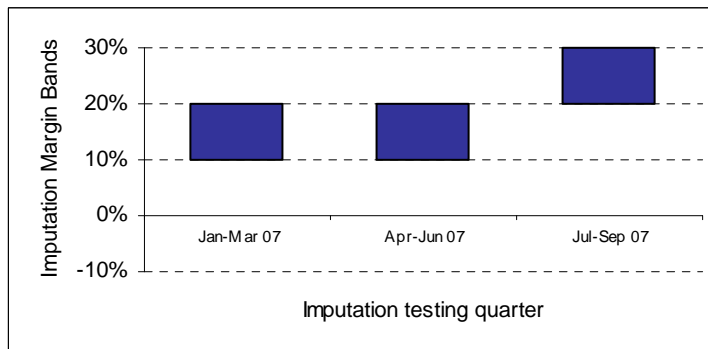
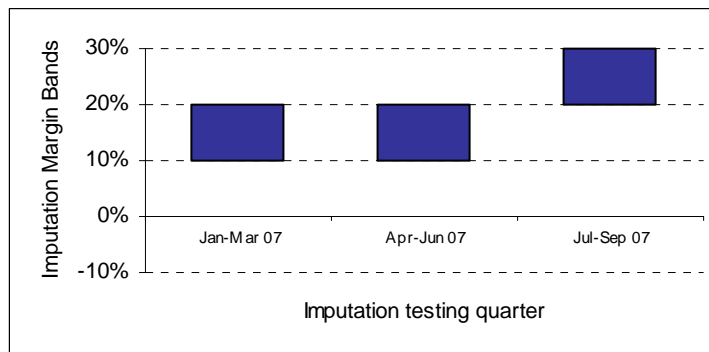


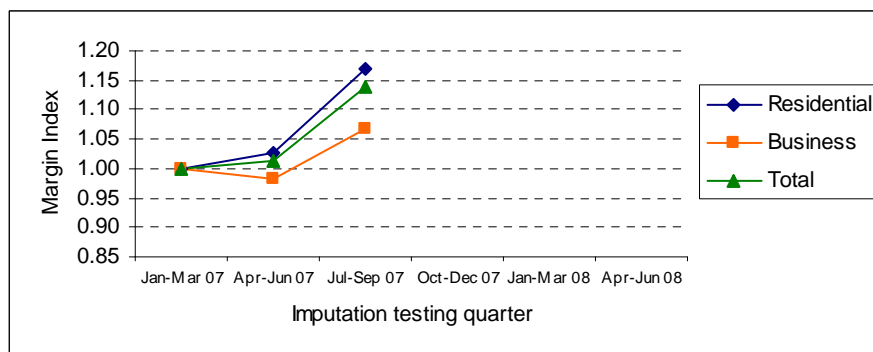
Figure 1c: PSTN Voice Imputation Test Margin – All Customers



Note: The data that is used in Telstra’s imputation tests are one quarter old at the beginning of the imputation testing period, being the most current quarterly data available. For example, the imputation test which begins to be used in April 2007 is based on data from the quarter ending December 2006.

A more concise comparison of the margins from quarter to quarter is presented in Figure 2 below. The margin from the test run, in dollar terms, has been converted to an index, which is set equal to 1 for the January-March 2007 imputation testing quarter.

Figure 2: PSTN Voice Imputation Test Margin – Index of Margins



The contributions to the change in margin (from revenue, IWP, and transformation costs) between the last two quarters are presented in Figure 3 below. The total change in the margin for each customer group has been normalised to 1 for an increase in margin or -1 for a decrease.

Figure 3: Contribution to Change in Margin Between the Quarters Ending June 2007 and September 2007

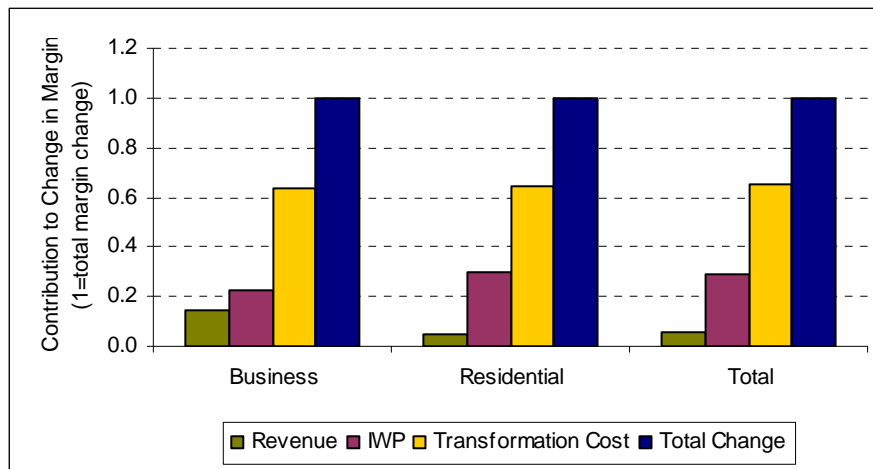


Figure 4 below presents the change in Telstra’s imputation test margins between the current quarter and the preceding quarter by product.

Figure 4: Change in % Margin by Product Between the Quarters Ending June 2007 and September 2007

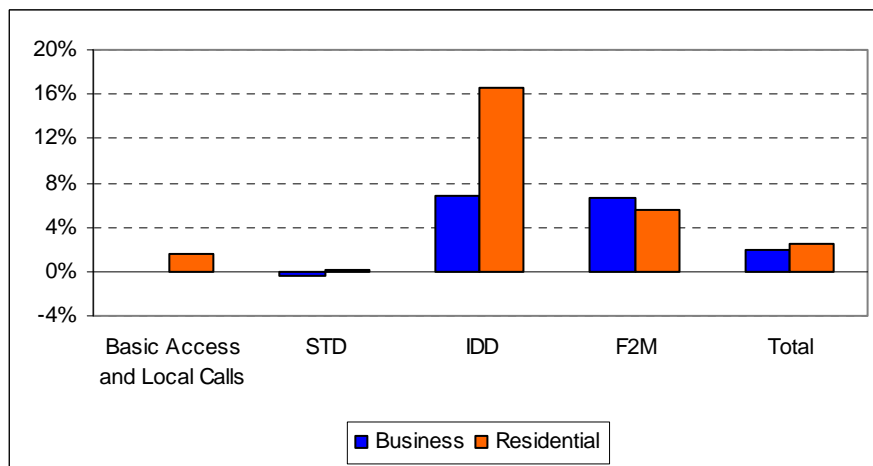


Figure 5 presents the results of Telstra’s Imputation Test in tabular format.

Figure 5: PSTN Voice Imputation Test Margin

| | Residential | Business | Total |
|------------------------------------|---------------|---------------|-----------------|
| Quarterly Aggregates | | | |
| Total Revenues | \$941,166,005 | \$301,041,273 | \$1,242,207,278 |
| Wholesale Charges | \$560,900,801 | \$168,018,111 | \$728,918,912 |
| Transformation Costs | \$189,836,064 | \$58,522,982 | \$248,359,046 |
| Imputation Margin | \$190,429,139 | \$74,500,180 | \$264,929,319 |
| Imputation Margin (%) | 20.23% | 24.75% | 21.33% |
| Per average SIO per quarter | | | |
| Average SIOs | 5,592,534 | 1,465,963 | 7,058,497 |
| Total Revenues | \$168 | \$205 | \$176 |
| Wholesale Charges | \$100 | \$115 | \$103 |
| Transformation Costs | \$34 | \$40 | \$35 |
| Imputation Margin | \$34 | \$51 | \$38 |

4. Telstra's Imputation Test for ADSL and PSTN Voice

This section sets out the methodology used to construct the ADSL and PSTN voice run of Telstra's imputation test and presents the results of the run for the relevant quarter.

4.1 Test Methodology

The second run of Telstra's imputation test is for the bundle of ADSL and PSTN voice services. BigPond's ADSL pricing is dependent on whether customers preselect their PSTN voice services to Telstra. Therefore, in cases where BigPond's ADSL revenues are dependent on Telstra also providing PSTN voice services, PSTN voice services are included in the run. In cases where BigPond's ADSL revenues are not dependent on Telstra providing PSTN voice services, only ADSL services are included in the run. The bundling of ADSL services with PSTN voice services is a common method of supply observed in the retail market and therefore the test run is constructed on a bundled basis.

As with the PSTN voice test, ADSL revenues are sourced from Telstra's general ledger for the relevant quarter. The costs used in the ADSL run are dependent on the most efficient means of supplying the retail service. There are two options available to efficient competitors for supplying the bundle of services equivalent to Telstra's BigPond ADSL and PSTN voice services:

- the combination of ULLS, LSS and Domestic Transmission Capacity; or
- the combination of Wholesale ADSL, PSTN originating and terminating access and the local carriage service.

Both sets of costs are calculated for each exchange and the lowest cost option (ie the most efficient option) is used in the run.

As with the voice run of Telstra's imputation test, the IWP for the Designated Services are calculated on the basis of average yields and are sourced from the actual wholesale revenues for the relevant quarter divided by the relevant volumes. Transformation costs are sourced from the RAF where appropriate and

in other cases, such as the costs associated with DSLAMs, are estimated on a bottom-up basis.

4.1 Results

The results of Telstra’s imputation test run for the bundle of ADSL and PSTN voice telephony services prior to the implementation of the price change below but closest to the material threshold in the September 2007 quarter are presented in Figure 6 below.

Figure 6a: ADSL and PSTN Voice Imputation Test Margin – Business Customers

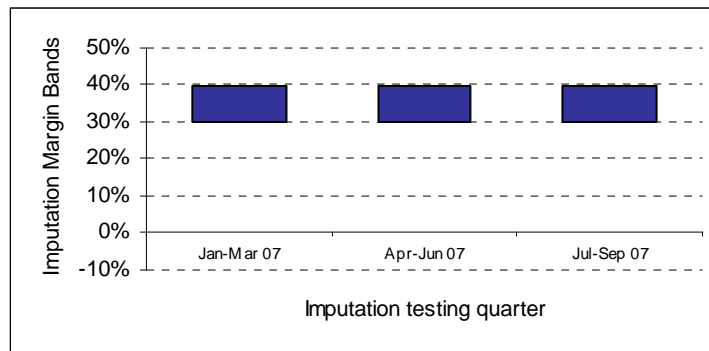


Figure 6b: ADSL and PSTN Voice Imputation Test Margin – Residential Customers

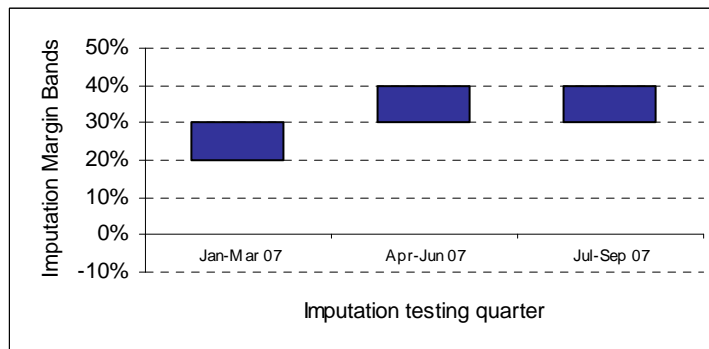
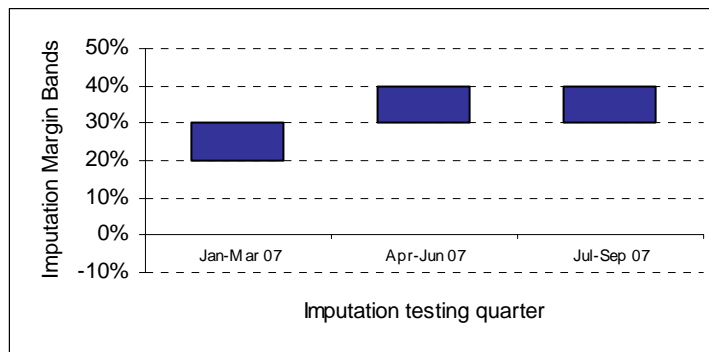


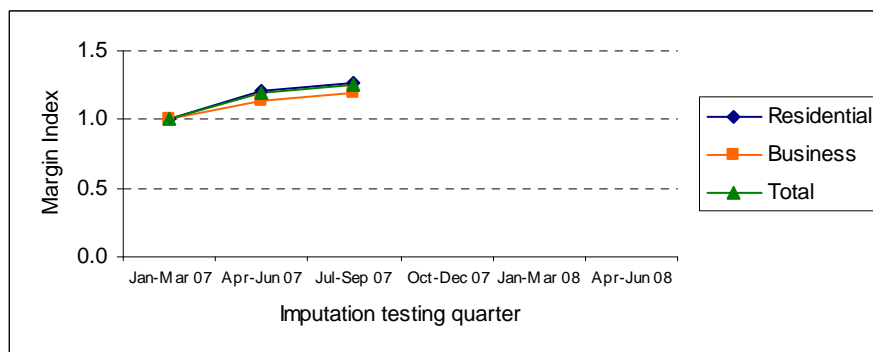
Figure 6c: ADSL and PSTN Voice Imputation Test Margin – All Customers



Note: The data that is used in Telstra’s imputation tests are one quarter old at the beginning of the imputation testing period, being the most current quarterly data available. For example, the imputation test which begins to be used in April 2007 is based on data from the quarter ending December 2006.

A more concise comparison of the margins from quarter to quarter is presented in Figure 7 below. The margin from the test, in dollar terms, has been converted to an index, which is set equal to 1 for the January-March 2007 imputation testing quarter.

Figure 7: ADSL and PSTN Voice Imputation Test Margin – Index of Margins



The contributions to the change in the ADSL and PSTN voice imputation test margin (from revenue, IWP, and transformation costs) between the last two quarters are presented in Figure 8 below. The total change in the margin for each customer group has been normalised to 1 for an increase in margin or -1 for a decrease.

Figure 8: Contribution to Change in Margin Between the Quarters Ending June 2007 and September 2007

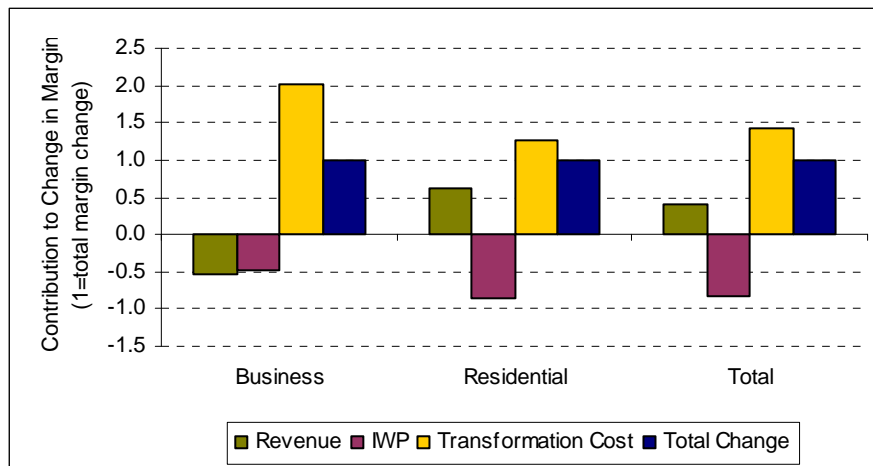


Figure 9 presents the results of Telstra's Imputation Test in tabular format.

Figure 9: ADSL and PSTN Voice Imputation Test Margin

| | Residential | Business | Total |
|------------------------------------|---------------|--------------|---------------|
| Quarterly Aggregates | | | |
| Total Revenues | \$356,723,003 | \$64,861,552 | \$421,584,555 |
| Wholesale Charges | \$123,324,647 | \$20,492,836 | \$143,817,484 |
| Transformation Costs | \$117,996,057 | \$19,637,661 | \$137,633,718 |
| Imputation Margin | \$115,402,298 | \$24,731,055 | \$140,133,353 |
| Imputation Margin (%) | 32.35% | 38.13% | 33.24% |
| Per average SIO per quarter | | | |
| Average SIOs | 1,181,812 | 196,417 | 1,378,228 |
| Total Revenues | \$302 | \$330 | \$306 |
| Wholesale Charges | \$104 | \$104 | \$104 |
| Transformation Costs | \$100 | \$100 | \$100 |
| Imputation Margin | \$98 | \$126 | \$102 |

5. Material Price Proposals under Operational Separation

Only material retail price decreases and material wholesale price increases are subject to the PEF. The threshold for materiality of a proposed price change, as agreed between the ACCC and Telstra is a change in the incremental revenue for the relevant retail voice, retail ADSL service, wholesale voice and/or wholesale ADSL service of more than 3%. The threshold is determined by comparing the incremental revenue from a service (calculated by averaging the annual forecast incremental revenue) to the annual revenue from that service.

Telstra's imputation test results for each material price change proposal will be provided to the ACCC no later than four business days after customers have been generally advised of the price change by Telstra or, where the price change takes effect within four business days after customers are generally advised of the price change, on the day the price change takes effect. Telstra's imputation test and its results are the confidential information of Telstra and are subject to legal professional privilege. They, therefore, cannot be disclosed to the public or to wholesale customers.

This section provides a summary of the material price changes notified to the ACCC during the quarter covered by this report or, if there were no material price changes, then a summary of the price change that was below but closest to the material threshold and imputation tested by Telstra. The materiality of the price change is assessed by the change in incremental revenues, calculated using the methodology set out in section 7.2 of the PEF Strategy.

There were no material price changes during the September 2007 quarter. The price change that was closest to the materiality threshold and imputation tested during the September 2007 quarter involved introducing three new bundles of PSTN and ADSL or cable broadband plans, each with discounted installation charges. The offer is below the line and only for residential customers in areas where ADSL2+ or cable is available.

This price change will not have an impact on the imputation test margin on the bundle of PSTN voice services. The Imputation test margin on the bundle of ADSL and PSTN voice services is forecast to decrease for residential customers, to have no impact on the margin for business customers, and to reduce the average margin. The changes are not sufficient to reduce the margins into a lower band than as reported in Figure 6.