

BE CAREFUL WHAT YOU WISH FOR

Transcript from the Comms Day Congress – Broadband Futures

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Thank you Graham and good morning everybody. It's great to be here on a beautiful Melbourne morning. As Graham said, I'm the Group Managing Director of Telstra Wholesale, so I represent the part of the business which sells access to Telstra's network and wholesale products.

It seems like every time I come to one of these conferences I start with something like here we are again at an interesting crossroads in terms of the future of the industry. But I have to say it again in September 2008. Here we are again at an interesting crossroads in terms of the future of our industry.

What will the future investment picture look like? What will the next wave of technology evolution deliver? What will customers be prepared to pay for? Can our industry deliver the economy for the next wave of productivity improvement? These are all questions, which I know the people in those room are, and need to be, thinking about.

As I was preparing to speak today, I came across a recent speech given by Verizon chairman and CEO, Ivan Seidenberg, which he gave at the US Consumer Electronic Association dinner in April this year.

Mr Seidenberg, whose country has spent about \$23 billion on its fibre network delivering twenty and fifty megabit download speeds to more than ten million homes in seventeen states in the US, described what his company's networks could do.

He said this: "The uses of these ultra high bandwidth networks will take us far beyond what we can imagine today. They will transform entertainment, education, commerce, medicine and the arts. They will have virtually unlimited capacity. They will create whole new industries and involve the entire technology sector in a virtual cycle of investment, innovation and growth."

Let's hope he's right about that. If we think big enough they will help us to address some of the most important social challenges of our time: Reforming health care with virtual medicine and electronic records, Saving energy and the environment, improving education with distance learning and online tutors, empowering people with disabilities and bringing more people into the workforce and spreading prosperity by connecting the world's populations to the global economy.

Everyone in this room knows what he's talking about and I think technology, in this country just as in the US, does have the potential to unleash innovation, creativity and ingenuity across the economy.

Just maybe it could help to grow the economy in Australia when the resources boom finally ends and let's hope that's no time too soon with what's happening in the financial markets at the moment. But it also requires big risky investments to achieve the step change that Seidenberg is talking about.

In the case of Verizon, when they reported their results in June this year, they had signed up only two million customers. The market will ultimately decide whether the investments that his company is making are wise or not. At least, however, he's operating in a commercial environment where his company doesn't have to contend with any regulatory constraints determining how, where and to whom he chooses to roll out the network.

At this point in time, about four weeks into the Federal government's twelve week request for proposal process to build Australia's high speed national broadband network, we're faced with some very hard calls and some hard decisions as a company, and as a nation regarding what happens next in our industry.

With volatile financial markets that Graham (Lynch) has already referred to and the threat of recession in the US, our build will be a risky and difficult proposition; and without the right regulatory setting Australia will not be able to attract the high levels of capital required to build our infrastructure. Whether it be communications infrastructure or water, energy, roads or rail.

From our point of view, we think it's time to accept some fundamental facts. The reality is Telstra probably is the only company capable of building a National Broadband Network.

Telstra is absolutely committed to an open access network but for this to happen we need regulatory certainty and an assurance that arbitrary and capricious intervention from the regulator doesn't kill the investment, including an assurance that the structural separation of Telstra is ruled out.

So plenty of these initiatives are happening overseas and I thought I'd do a little bit of a trawl through to see what we can learn from those other jurisdictions.

Many people in this room would no doubt have seen the announcement in Singapore over the weekend of SingTel and others as the successful bidders for Singapore's NBN - a new line to homes built in that country.

Hopefully we'll hear more from Art Price from Axia NetMedia who is speaking after me about what is happening in Singapore. It does seem though that the comparisons to the Australian situation are chalk and cheese.

Despite a rather complex structure my understanding is that under their arrangement the passive network will be seventy per cent owned by the Singapore government and controlled by SingTel. SingTel will build and maintain the fibre and SingTel will also be a bidder for the active part of the network as well.

SingTel is not being separated but is actually acquiring a controlling stake in the new network to join with its controlling stake in a PSTN network and in the cable network in Singapore. Not that there's anything wrong with any of that but it does need to be seen for what it is.

The other point to emphasise is that what is being built in Singapore is a totally new fibre to the home network, not an upgrade to the existing PSTN network as is being proposed here in Australia. So how is it that they can afford a full fibre to the home network and we can't?

Well I guess if you just have a look at the relative size of Singapore and Australia and compare their relative population densities, you have your answer and a partial explanation as to why it's so difficult to do these things in a country the size of Australia. Singapore has a population of about 4.5 million people in a country which is a mere 707 square kilometres.

So for those of you who have visited Singapore you'd know that most of the population live in high density apartments which makes it a lot easier to roll out the fibre network. This tiny country's population density is 6,489 persons per square kilometres.

Queensland, by comparison, has a similar population that covers 1.7 million square kilometres with only 2.42 persons per square kilometre. Our most populous state in Australia, New South Wales, has about 6.8 million people in an area of 800,642 square kilometres and a population density of 8.6.

Australia, as a whole, with a population of 21.3 million covering an area of 7.7 square kilometres and a population density of 2.6 people per square kilometre presents a completely different set of terrestrial challenges when it comes to rolling out a next generation network to 98 per cent of the population. Like I said, it's chalk and cheese and an extra challenge for us.

That applies not just in the telecommunications industry, but more broadly to infrastructure built in a country the size of Australia. In the US, which has a population of about 301 million and covers 9.6 million square kilometres and has 31 people per square kilometres, Verizon and AT&T have started to roll out next generation networks on an extensive scale.

After the FCC withdrew unbundling regulation which applied to the new build, Verizon is deploying fibre to the premise and AT&T has opted for FTTN. I guess we're yet to see who's made the right choice there. Fibre networks now pass millions of consumers and business who have embraced an array of value-added services.

These deployments have clearly increased competition. Cable operator, Comcast, has responded to Verizon's deployment by matching the service speeds offered by Verizon. The United States General Accounting Office found that cable rates were sixteen per cent lower in areas where mobile service operators faced competition from a wire line.

In San Antonio, a Time Warner cable product director said that the launch of new products including the triple play service was a direct response to AT&T's entry.

In Santa Rosa, California, it is suggested that Comcast's decision to ramp up a myriad of new features like video on demand and more channels was a response to AT&T.

And in Houston it's suggested that a Comcast decision to offer high definition channels, video on demand titles and digital phone features was a response to competing IPTV offerings.

So what we are seeing is that FTTN investment is a catalyst for competition.

In contrast, across the Atlantic in the UK, BT, mired in the costly and involved process of introducing operational separation have not entirely committed to an FTTN rollout. It's heralded 21st century network is little more than a core network upgrade at this point.

However, Virgin Media's announcement that it was upgrading its HFC network to DOCSIS3 finally motivated BT to announce a partial FTTN rollout provided that it can get the right regulatory settings, a not unreasonable request.

A recent empirical study of investment by 180 telecommunications operators in Europe over a ten year period has found that access regulation has a strong disincentive effect on investment by new entrants. Introduction of access regulation on the incumbent's network translates into a loss of twenty five percent of new entrant investment stock in the first year.

Over a five year period, entrants would invest in double the amount of infrastructure in the absence of access regulation than if there was access regulation. We have a live example of this problem in Australia. SingTel Optus is a heavy user of regulated access particularly ULLS within its HFC footprint and treats over a third of homes passed as unserviceable by its HFC network, compared to less than five to six per cent treated as unserviceable by overseas cable companies.

As a result we do not see in Australia the speed war between cable and copper based networks as is currently occurring in the UK and the US.

Learning from the US and the UK, as the UK regulator, Ofcom, puts it, competition at the deepest level of the network should remain the main game in an NGN world and poorly designed regulation can kill off competition.

In Europe a number of carriers are seeking to deploy next generation networks including KPN in the Netherlands.

Just to keep going with the population density theme, the Netherlands has a population of 16.4 million, a land mass of 41,528 square kilometres and 395 persons per square kilometre. These figures are worth bearing in mind when you look at what these different countries are choosing to do.

KPN is planning to fully convert its network so that it is entirely based on IP by 2010.

Once completed, it would operate a single broadband fibre optic cable infrastructure to enable KPN and other providers to offer voice, internet and television services. KPN is seeking to enter into wholesale arrangements with DSL operators, which would allow a smooth transition to the NGN world.

And we've been in close contact with our colleagues in that company to figure out how it's going. The arrangement would allow access to wholesale broadband, amongst a set of commitments aimed at ensuring commercial competitiveness for access seekers.

Whilst the regulator OPTA is generally supportive of KPN's plans and agrees that a rollout would encourage further competition, progress has been slowed significantly by the regulator's role in, and supervision of, the wholesale agreements.

After many months, KPN's plans are now behind and no wholesale customers have yet signed up for the new arrangements.

As most people in this room are probably aware, in the United Kingdom, BT was required to separate in 2005.

From our perspective, separation has been a disaster in the UK, with BT's own statutory reports showing the cost of implementation has now blown out to \$206 million and still rising. As a result, Britain has slumped to number 22 in the OECD top 30 countries for maximum broadband speed.

This is in a country which has a population of about 60.7 million, a land mass of 242,900 square kilometres and 246 people per square kilometre, in case you were wondering.

A report from Oxford University released this month showed that although the UK has a high broadband penetration rate, the quality of connection ranks it behind many other countries in Europe, including Latvia and Lithuania, as well as France, Germany and Scandinavian countries.

The new Chief Executive, Ian Livingston, has made it clear that any commitment to deploying a Next Generation Network depends on Ofcom, the regulator, allowing the company to make a fair rate of return and capital.

In a clear case of be careful what you wish for, wholesale customers are now complaining about the adverse impacts which the chaos within BT, unleashed by separation, is having on them.

Although separation was introduced to improve BT's pretty bad record of wholesale customer service, Ofcom has found that service quality has not improved and may even have gone backwards in the three years since separation was introduced.

Let me quote from a recent Ofcom survey of the attitude of wholesale customers to separation:

- "Openreach has been totally focused on delivery of the undertakings, the enforced adherence to strict timelines and required focus on particular products and market sectors is considered to have been a detriment - to the detriment of innovation and service quality."¹
- "The asymmetric split between BT Wholesale and Openreach is acknowledged by almost all to be an awkward one. Some of the product boundaries are unnatural. For example, should wholesale line rental be an Openreach, or in BT Wholesale? And, consequently, the relationship between Openreach and BT Wholesale can be hard work. There is a perception among some CPs that wholesale has lost its identity and sense of purpose"²

¹ December Evaluation Report, page 66

² December Evaluation Report, page 69

- “Communication across the group can be stilted - there is certainly nervousness, and no-one wants to be ‘fired’ because they’ve breached an undertaking.”³
- “The undertakings have been overly prescriptive, and in some areas unnecessary. For example, separation of systems, or IPstream Connect taking up a huge amount of BT’s bandwidth and creating a slow and awkward innovation cycle.”⁴
- “An overly cautious, ‘one size fits all’ approach is resulting in an equivalently average or poor service rather than equivalently excellent services. I can honestly say that I don’t hear these kinds of complaints from my wholesale customers.”⁵

From an operational standpoint, many will agree that with increasing levels of automation of services, Telstra Wholesale have saved them quite a lot of money in recent years. In fact, currently in excess of 99 per cent of all orders are processed in the same day by Telstra Wholesale, with 82.5 per cent of orders not touching human hands but flowing through our systems automatically.

The facts speak for themselves: a vertically integrated Telstra is delivering significantly better wholesale service than a functionally separated BT.

So far this year BT’s shares have underperformed Telstra’s by more than 25 per cent, just reinforcing that such separation adds cost and complexity to the detriment of both customers and shareholders.

Let’s turn to New Zealand. New Zealand, and I’m sure you were desperate to know, has a population of about four million and a landmass of 270,534 square kilometres, resulting in 14.9 people per square kilometre.

Telecom New Zealand was given notice by the New Zealand Government that it must split its business into separate retail, wholesale and network divisions in May 2006. It is the only country to follow the UK functional separation model.

And whilst it’s not exactly the same, it is experiencing much of the cost and disruption faced by BT. Telecom New Zealand has estimated the cost of compliance with operational separation will be \$164 million over four years, plus operational costs of up to \$25 million in 2008 and \$33 million in opex after 2008.

Shares in the company fell 21 cents, or 7.24 per cent, after the announcement. And unless something changes, New Zealand is likely to continue to lag behind the rest of the world on broadband.

Of course, we should bear in mind that Telstra is already subject to operational separation guidelines introduced in 2005. Those guidelines, and the reports that have been issued under them, show that access seekers are already getting equivalent treatment now.

Just to remind people, the Telstra Wholesale business unit is physically located away from retail business units, and we have security measures to control access. Decision making is quarantined through my role, reporting directly to the CEO.

³ December Evaluation Report, page 69

⁴ December Evaluation Report, page 71

⁵ December Evaluation Report, page 70

The retail business units do not have access to wholesale customer confidential information, and Telstra Services and Telstra Operations only have the information that they need to perform their roles and fulfil our wholesale contracts.

There is equivalence in the provisioning, billing and fault handling of designated services, including local calls, transmission, PSTN, Interconnect, ADSL, ULLS and LSS.

Wholesale customers are notified annually about forthcoming material adverse changes to their services via the long-term notification report, and more regularly and as required about other operational issues; for example, outages and ADSL availability; along with quarterly reports against KPIs. Last year we sent more than 200 separate communications to our customers.

We have been closely studying the Next Generation access products being developed overseas in developing our own proposed wholesale products for the NBN world. We believe that our wholesale products will be world class.

They will be better and more flexible for wholesale customers than the new IP wholesale products Telecom New Zealand has committed to in its operational separation plan, and that BT has announced for its NGA trial.

Come April or May 2009, when a decision will be made on the outcome of the NBN, I will be here selling access to Telstra's high quality networks and providing my customers with the best possible customer service.

We will have every incentive to drive take-up through the wholesale channel as well as retail channels. If we don't win the NBN tender, I will still be selling access, but with much more limited opportunities for new products and future differentiation for my customers.

One thing I won't be doing is buying access from any proposed competitive network.

Our internal research tells us across the board our wholesale customers value the breadth and depth of our service, which helps them to take costs out of their own business and gives them the confidence that they can service the needs of their end users.

Our mission is to sell a broad range of flexible product offerings that our customers value and can use to develop their own differentiated retail products and services, from their own investments and building their own networks over the top of the inputs that they buy from me.

Recognising the critical role that Ethernet plays in delivering these new generation of services, Telstra Wholesale is continuing to develop and expand our Ethernet offerings. In the near future, we will be announcing some exciting developments with our carrier grade Ethernet product.

We have also expanded our DSL product suite, with a recent launch of ADSL 2+ based services. These are just a couple of examples of how we are looking ahead and delivering high quality, reliable and ultimately valued services.

All of these offerings are being developed on commercial terms with no interference from the regulator. That is what is possible when markets are

allowed to work. If you get it wrong, others can and will invest and take market share from us. That is as it should be.

The NBN has the potential to herald an exciting new era of competition, choice and innovation.

Telstra has guaranteed that its upgraded network will be open access. We will seek to have the open access rules agreed upfront for the life of the project.

Unlike the Telstra monopoly, Telstra would welcome infrastructure competition if we build the NBN. We expect that, just as they do now, others will invest as and when it makes sense for them.

The core wholesale services will be made available to access seekers on a basis equivalent to Telstra's own business unit.

Wholesale customers will have an ability to shape the performance characteristics of their downstream services, independently of Telstra, giving all providers a platform to innovate and differentiate the services they choose to offer, competing on service, products and value as well as price.

This is our commitment to the industry, and we have said this from the very start.

We need to have rules that encourage investment and let markets make the choice about investing capital. The markets where Next Generation Networks are going ahead are those in which regulators have recognised the need to have rules that encourage investment.

So just in closing, there are plenty of lessons to be learnt from overseas experience; not all of that experience translates to our unique environment in Australia. Clearly, we have challenges associated with the size of the country and the relatively small population.

I think the lesson out of all of this is you do have to be careful what you wish for, because ultimately it might not be what you really want.

Thank you for your time today.