Telstra Corporation Limited
ABN 33 051 775 556

EXPLANATORY MEMORANDUM

FOR THE RESOLUTION UNDER ITEM 2 AT THE ANNUAL GENERAL MEETING ON 18 OCTOBER 2011:

TELSTRA'S PARTICIPATION IN THE ROLLOUT OF THE NATIONAL BROADBAND NETWORK

VOTE IN FAVOUR

YOUR DIRECTORS UNANIMOUSLY RECOMMEND THAT YOU VOTE IN FAVOUR OF THE RESOLUTION

This is an important document and requires your immediate attention. You should read this document in full before deciding whether or not to vote in favour of the Resolution to approve the Proposed Transaction. If you are in any doubt as to what you should do, you should discuss this document with your professional adviser.

IMPORTANT NOTICES

General
This document is important. You should read it in full before making any decision as to how to vote on the Resolution set out in the accompanying Notice of Meeting and to be considered at the Meeting. A voting form for the Meeting is enclosed.

Purpose of this Explanatory Memorandum
This Explanatory Memorandum provides Telstra Shareholders with information which is material to your decision whether or not to vote in favour of the Resolution to approve the Proposed Transaction.

This Explanatory Memorandum forms part of the Notice of Meeting and must be read together with that notice.

A copy of this Explanatory Memorandum will be distributed to all Telstra Shareholders and is also available in electronic form at www.telstra.com

Preparation and responsibility
This Explanatory Memorandum has been prepared by Telstra and its Directors and is the responsibility of Telstra.

Grant Samuel has prepared the Independent Expert's Report in relation to the Proposed Transaction, which is set out in Annexure 1, and is responsible for that report.

Except to the extent they are responsible under the Corporations Act or any other applicable law, Telstra, its Directors, officers and advisers do not assume any responsibility for the accuracy or completeness of the Independent Expert's Report.

NBN Co involvement
None of the Commonwealth, any Government Agency, NBN Co, any Related Entity of NBN Co, or any of their respective representatives (being any directors, employees, officers, representatives, delegates, professional or financial advisers, agents, contractors or sub-contractors) assume any responsibility or liability in connection with the preparation of, or contents of, the Explanatory Memorandum, the Independent Expert's Report or the Notice of Meeting.

ASX involvement
A copy of this Explanatory Memorandum, the Independent Expert's Report and the Notice of Meeting have been given to ASX and ASX has confirmed that it does not object to their dispatch. Neither ASX nor any of its officers take any responsibility for the contents of this Explanatory Memorandum, the Independent Expert's Report or the Notice of Meeting.

Investment decisions
This Explanatory Memorandum does not constitute financial product or investment advice and has been prepared without reference to the investment objectives, financial situation or needs of any particular Telstra Shareholder or any other person. This Explanatory Memorandum does not in any way constitute an offer to sell, or a solicitation of an offer to buy, any Telstra Shares and should not be relied on as the sole basis for any investment decision relating to Telstra Shares or any other securities. If you are in any doubt as to what you should do, you should discuss this document with your professional adviser.

Forward looking statements
Certain statements in this Explanatory Memorandum relate to the future, including forward looking statements relating to Telstra's financial position and strategy. All statements other than statements of historical fact are, or may deemed to be, forward looking statements.

Sometimes, but not always, forward looking statements may be identified by the use of words such as "aim", "anticipate", "assume", "believe", "continue", "could", "estimate", "expect", "forecast", "foresee", "guidance", "intend", "may", "objectives", "plan", "potential", "predict", "project", "risk", "should", "will" or "would" or the negative of such terms or other similar expressions. Similarly, statements that describe Telstra's objectives, plans, strategy or expectations are, or may be, forward looking statements.

The statements contained in this Explanatory Memorandum relating to the impact that the implementation or non-implementation of the Proposed Transaction may have on Telstra's operations, earnings and future direction, and the advantages and disadvantages anticipated to result from the Proposed Transaction, are also forward looking statements.

These forward looking statements involve risks, uncertainties, assumptions and other important factors that could cause the actual results, performance or achievements of Telstra to be materially different from future results, performance or achievements expressed or implied by such statements. Such risks, uncertainties, assumptions and other important factors include, among others, the risks described in section 3.4. Actual events or results may differ materially from the events or results expressed or implied in any forward looking statement, and deviations are both normal and to be expected.

Other than as required by law, none of Telstra, its officers nor any other person gives any representation, assurance or guarantee that the occurrence of the events expressed or implied in any forward looking statement in this Explanatory Memorandum will actually occur. You are cautioned not to place undue reliance on those statements.

The forward looking statements in this Explanatory Memorandum reflect views held immediately before the date of this Explanatory Memorandum, unless otherwise stated. Subject to the Corporations Act and any other applicable laws, Telstra and its officers disclaim any duty to update these statements other than with respect to information that Telstra becomes aware of before the Meeting, and which is reasonably considered to be material to the making of a decision by you regarding whether or not to vote in favour of the Resolution.

To the maximum extent permitted by law, Telstra, its Directors, officers and advisers are not liable for any direct, indirect or consequential loss or damage suffered by any person as a result of relying on any forward looking statement in this Explanatory Memorandum.

Interpretation
Capitalised terms and certain abbreviations used in this Explanatory Memorandum are defined in the Defined Terms in section 9.

Unless otherwise indicated, all references to sections are references to sections of this Explanatory Memorandum.

All references to currency are to Australian dollars unless otherwise indicated.

Time and date
All times and dates referred to in this Explanatory Memorandum are times and dates in Sydney, Australia unless otherwise indicated. These dates and times are indicative only and are subject to change in accordance with the Corporations Act and all other applicable laws.

Privacy and personal information
Telstra and the Telstra Share Registry may collect, disclose, access or use your personal information in the process of conducting the Meeting.

No internet site is part of this document
No internet site is part of this Explanatory Memorandum. Telstra maintains an internet site www.telstra.com. Any reference in this Explanatory Memorandum to this internet site is a textual reference only and the internet site does not form part of this Explanatory Memorandum by virtue of any such reference.

Date
This Explanatory Memorandum is dated 1 September 2011.

CONTENTS

CHAIRMAN'S LETTER

Catherine Livingstone AO
Chairman

WHAT IS THE NBN?

The National Broadband Network (NBN) is a Government legislated initiative to provide all Australians with access to high speed broadband. The network is planned to be built over approximately 10 years, starting in 2011. The aim of the NBN is to connect 93% of premises in Australia with fibre to deliver broadband services with speeds of up to 100 megabits per second, with the remaining premises to be serviced by other technologies. The NBN will be built, operated and maintained by NBN Co, a Government Business Enterprise wholly owned by the Commonwealth.

Dear Shareholders,

I am pleased to present to you this Explanatory Memorandum explaining why your Directors unanimously recommend that you vote in favour of Telstra's participation in the rollout of the National Broadband Network (NBN).

THE GOVERNMENT'S NBN POLICY

The Directors' consideration of Telstra's participation in the rollout of the NBN was triggered by two major policy initiatives announced by the Commonwealth Government:

- the April 2009 decision to build and operate the NBN to provide fibre connections for high speed broadband services to 90% of Australian homes and businesses (subsequently increased to 93% of homes and businesses); and
- the November 2010 passage of legislation requiring Telstra to choose between voluntary structural separation or mandatory functional separation in relation to our fixed line business.

The Government's policy initiatives will result in a net loss of value of Telstra overall, irrespective of whether Telstra participates in the rollout of the NBN. Given this overall adverse effect, the Directors responded with an extensive process to ensure the best outcome for Telstra and Telstra Shareholders in these circumstances.

TELSTRA'S RESPONSE TO THE GOVERNMENT'S LEGISLATED INITIATIVES

Telstra undertook a rigorous analysis of the options realistically available to it, including options that did not involve Telstra participating in the rollout of the NBN.

Telstra also engaged in discussions with the Government and NBN Co to help determine which of the available options provided the most value for Telstra and its shareholders. A year of discussions with NBN Co and the Government culminated in the signing of the non-binding Financial Heads of Agreement in June 2010.

Having considered the other available options, the Directors determined that participating in the NBN rollout on the terms reflected in the non-binding Financial Heads of Agreement would be the best course of action for Telstra.

As a result, and following another year of complex negotiations, on 23 June 2011 Telstra signed Definitive Agreements with NBN Co and the Commonwealth which, together with the associated Government policy commitments and regulatory undertakings given to the ACCC, create the framework for Telstra's participation in the rollout of the NBN. The "Proposed Transaction" which is referred to in the Resolution to be put before shareholders at the AGM involves the implementation of these agreements. The approval of Telstra's shareholders is one of the key conditions which must be satisfied before the Definitive Agreements may be implemented.

THE BENEFITS OF THE PROPOSED TRANSACTION

We expect the Proposed Transaction and associated Government policy commitments will provide approximately $11 billion in post-tax net present value over its life. Compared with other alternatives, it should provide Telstra with:

- a better overall financial outcome, contributing to sustainable free cashflow generation in the medium term;
- a more stable regulatory environment in which to operate, allowing Telstra to focus on its customers; and
- greater strategic flexibility, enabling Telstra to maintain a strong focus on identified key areas of growth.

The Proposed Transaction also provides certain protections for Telstra in the event of a change in Government policy.

Without the Definitive Agreements, Telstra would continue to operate its Copper Network and HFC Cable Network but would largely forgo the approximately $11 billion value of the Proposed Transaction, would experience infrastructure competition from the NBN, would incur the significant costs and disruption of mandatory functional separation and would face potential exclusion from future wireless spectrum auctions.

YOUR DIRECTORS' RECOMMENDATION

Your Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution to approve the Proposed Transaction. The Directors consider that the Proposed Transaction is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and separate parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra, given current Government policy.

The Independent Expert has concluded that the Proposed Transaction is in the best interests of Telstra and its shareholders. The Independent Expert has also drawn two other key conclusions:

- if the rollout of the NBN is not completed as planned, Telstra Shareholders would still be better off if they approved the Proposed Transaction; and
- even if the likelihood of the NBN being terminated early were materially increased by Telstra Shareholders not approving the Proposed Transaction, the expected value of Telstra if the Proposed Transaction is implemented is greater than under the next best alternative.

The rollout of the NBN, and the way Telstra responds, is a defining moment for our company and your vote is important. You should read this Explanatory Memorandum carefully. If you are in any doubt as to what you should do, please consult your professional adviser.

C B Livingstone

Catherine B Livingstone AO
Chairman

WHAT IS THE PROPOSED TRANSACTION?

The Proposed Transaction involves the implementation of the Definitive Agreements by Telstra (subject to the Conditions Precedent being satisfied or waived).

The Proposed Transaction and associated Government policy commitments are expected to deliver approximately $11 billion in post-tax net present value (NPV) as at June 2010, subject to a range of dependencies and assumptions. This will not be in the form of an upfront payment, but is the present value of consideration and benefits to be received over many years. This value does not include broader benefits which Telstra may gain from the Definitive Agreements and which are hard to quantify.

INDEPENDENT EXPERT'S RECOMMENDATION

"In Grant Samuel's opinion, the Proposal is in the best interests of Telstra and its shareholders."

EXECUTIVE SUMMARY

Telstra Shareholders are being asked to vote on whether Telstra participates in the rollout of the National Broadband Network (NBN) through implementing the Proposed Transaction. The Resolution relating to this is set out under item 2 of the accompanying Notice of Meeting.

This Executive Summary provides an overview of the Proposed Transaction and outlines the key reasons why the Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution.

This Executive Summary and Explanatory Memorandum contain a number of capitalised terms. These terms are explained in section 9.

INTRODUCTION

In April 2009, the Government announced its intention to roll out the NBN. The Government has since taken significant steps to achieve this objective, including the establishment and funding of NBN Co and the introduction of legislation to support the rollout of the NBN.

NBN Co is now operating. It has commenced its rollout of the NBN and started to provide services in a small number of trial regions.

In addition to the Government's initiatives to roll out the NBN, Parliament passed legislation to require Telstra to undertake either:

- voluntary structural separation (for example, by ceasing to supply fixed line services to customers using a network it controls); or
- mandatory functional separation of its wholesale and retail operations (for example, by establishing separate business divisions and constraining dealings between them).

If Telstra does not elect to undergo voluntary structural separation, it is likely that Telstra would be prohibited from bidding for the next major release of wireless spectrum, which is considered necessary for Telstra to best continue the growth of its mobiles business.

The Government's policy initiatives will result in a net loss of value of Telstra overall, irrespective of whether Telstra participates in the rollout of the NBN. Given this overall adverse effect, the Directors undertook an extensive assessment process to ensure the best outcome for Telstra and Telstra Shareholders in these circumstances.

The Directors have determined that the best course of action is for Telstra to participate in the rollout of the NBN through the Proposed Transaction. This decision was made following consideration of the options realistically available to Telstra in light of the Government's commitment to introduce the NBN, including options that did not involve participating in the rollout of the NBN. This process involved an assessment of the regulatory and commercial implications of each option, as well as extensive negotiations with NBN Co and the Government, to establish an acceptable basis for Telstra's possible participation in the rollout of the NBN. The Directors have assumed that the Government will proceed with the rollout of the NBN irrespective of whether Telstra Shareholders approve the Proposed Transaction. This assumption is consistent with public statements made by the Government.

On 23 June 2011, Telstra entered into agreements with NBN Co and the Commonwealth (referred to as the Definitive Agreements). The Proposed Transaction involves the implementation of the Definitive Agreements by Telstra (subject to the Conditions Precedent being satisfied or waived). The Definitive Agreements, together with regulatory undertakings given to the ACCC and associated Government policy commitments, create the framework for Telstra's participation in the rollout of the NBN. The Definitive Agreements are subject to a number of Conditions Precedent, including Telstra Shareholder approval.

THE DIRECTORS' RECOMMENDATION

The Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution to approve the Proposed Transaction.

The Directors consider that the Proposed Transaction is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and separate parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra given current Government policy.

In particular, the Directors consider that, compared with other realistically available options, the Proposed Transaction should provide Telstra with:

- a better overall financial outcome, contributing to sustainable free cashflow generation in the medium term;
- a more stable regulatory environment in which to operate, allowing Telstra to focus on its customers; and
- greater strategic flexibility, enabling Telstra to maintain a strong focus on identified key areas of growth, simplify its business and concentrate on the needs of its customers.

The Proposed Transaction also provides certain protections for Telstra in the event of a change in Government policy.

Having determined that the best course of action for Telstra was to participate in the rollout of the NBN by implementing the Proposed Transaction, the Directors appointed the Independent Expert to review the Proposed Transaction. The Directors' recommendation is supported by the conclusions of the Independent Expert, whose report is set out in Annexure 1. Further detail on the Independent Expert's opinion on the Proposed Transaction is set out below.

INDEPENDENT EXPERT'S OPINION

The Independent Expert has concluded that the Proposed Transaction is in the best interests of Telstra and Telstra Shareholders. The Independent Expert's analysis shows that:

- the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion (post-tax net present value as at June 2011) greater than under the best available alternative; and
- the value differential remains substantial even under a wide range of alternative assumptions (for example, as to the timing of the rollout of the NBN Fibre Network).

The approach adopted by the Independent Expert in its assessment is similar to that taken by the Directors in their assessment of the Proposed Transaction compared with the best available alternative given current Government policy. In both cases, the assessment takes into account the value delivered to Telstra by the Proposed Transaction and associated Government policy commitments. The Directors, however, used some different assumptions compared with those used by the Independent Expert.

The material differences in the assumptions used, and the difference in the overall approach adopted, relate to:

- the loss of value attributable to Telstra no longer retaining the option to operate the Copper Network and broadband services on its HFC Cable Network;
- the impact of the likely prohibition on Telstra from bidding for the next major release of wireless spectrum and other potential regulatory imposts Telstra may face, if it did not elect to undergo voluntary structural separation;
- the timing of the rollout of the NBN Fibre Network; and
- the cost of capital used to determine the appropriate discount rate for valuing consideration received.

While the Independent Expert's assessment is based on a different valuation date from the date adopted by Telstra in its analysis, this difference does not have a material impact on the assessment of the Proposed Transaction relative to the best available alternative.

OVERVIEW OF THE PROPOSED TRANSACTION

KEY FEATURES

Under the Proposed Transaction (including the regulatory undertakings given by Telstra to the ACCC), Telstra will significantly change the way it operates certain parts of its fixed line business by disconnecting progressively Copper Services and HFC Broadband Services, commencing to acquire wholesale services from NBN Co and providing NBN Co with access to large volumes of certain types of Telstra's infrastructure. This will mean that Telstra will substantially rely on the NBN Fibre Network to offer fixed line services to premises in the NBN Fibre Footprint.

Telstra will continue to retain and operate its Next G® wireless network, Next IP™ core fibre network, backhaul fibre network and HFC Cable Network (for delivery of Pay TV Services). Telstra will also retain and operate its Copper Network and will continue to provide broadband services over its HFC Cable Network as relevant outside areas where the NBN Fibre Network has been deployed. Telstra will also retain ownership of the infrastructure accessed by NBN Co (except for Lead-in Conduits).

In return for its participation in the rollout of the NBN, Telstra will receive payments from NBN Co and the Commonwealth, and will benefit from certain Government policy commitments.

The key commitments under the Definitive Agreements include:

- Telstra disconnecting progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out;
- NBN Co committing to key product features and prices in supplying Telstra with NBN Co's Basic Service Offering on the NBN Fibre Network;
- Telstra providing NBN Co with long-term access to large volumes of parts of its infrastructure (including Dark Fibre Links, Exchange Rack Spaces and Ducts),

FIGURE A: INDEPENDENT EXPERT'S ASSESSMENT OF VALUE DIFFERENTIAL

DESCRIPTION	VALUE ESTIMATE	EXPLANATION
The Independent Expert's assessment of the value differential between Telstra under the Proposed Transaction and Telstra under the best available alternative	Approximately **$4.7 billion** (post-tax net present value as at June 2011)	Taking into account its own assessment of the value delivered to Telstra under the Proposed Transaction (the details of which are included in section 5 of the Independent Expert's Report) as well as the consequential impacts on Telstra's business operations, the Independent Expert has concluded that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion (post-tax net present value as at June 2011) greater than under the best available alternative. The Independent Expert has also undertaken sensitivity analysis and considered the impacts if the rollout of the NBN Fibre Network is not completed as planned.

as well as initial access to Lead-in Conduits (which will then be transferred by Telstra to NBN Co as lead-in fibre is installed in the Lead-in Conduit); and

- the Commonwealth implementing a package of measures including:
  - increased funding for Telstra's provision of the USO (Universal Service Obligation) services;
  - funding for the retraining of certain Telstra staff and for certain customer migration costs; and
  - arranging for NBN Co to conduct a public education campaign that informs end users about the nature and timing of the rollout of the NBN Fibre Network in their area.

In addition, the Government has made policy commitments to:

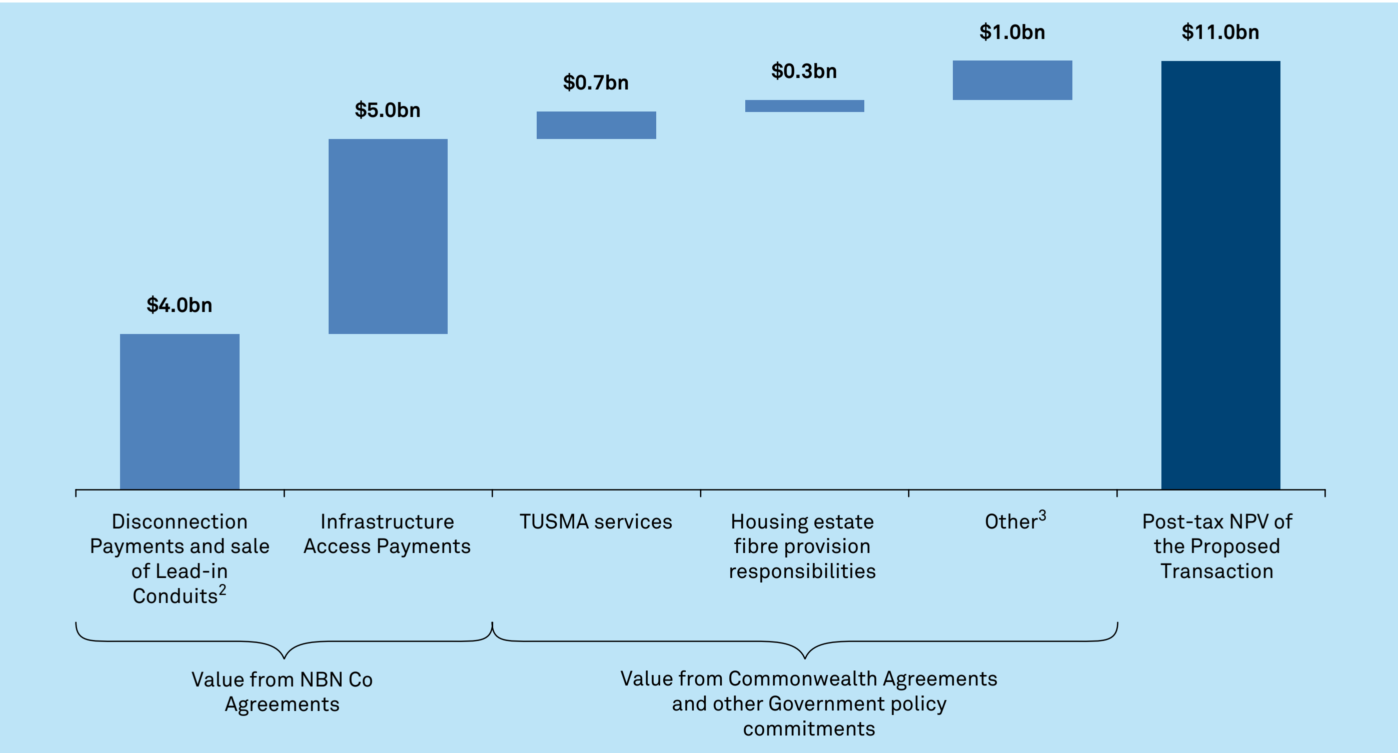
- implement reforms to the USO, including the establishment of the Telecommunications Universal Service Management Agency (TUSMA), which is to assume regulatory responsibility for the USO as the NBN Fibre Network is rolled out and to pay Telstra to provide the USO services; and
- make NBN Co responsible for installing fibre in new developments of 100 or more premises approved after 1 January 2011 as well as in smaller developments in areas that the NBN Fibre Network will reach within 12 months as it is being rolled out. This transfer of responsibility from Telstra to NBN Co is expected to allow Telstra to realise significant future cost savings.

VALUE OF THE PROPOSED TRANSACTION

Telstra expects the Proposed Transaction and associated Government policy commitments to deliver to it approximately $11 billion in post-tax net present value (NPV) as at June 2010, subject to a range of dependencies and assumptions. This value does not include broader benefits which Telstra may gain from the Definitive Agreements and which are hard to quantify. Further, it is not an assessment of the overall impact of the Proposed Transaction on the underlying value of Telstra, which has been separately considered by the Independent Expert in its assessment of the Proposed Transaction. This value will not be received in the form of an upfront payment, but is the present value of consideration and benefits to be received over many years. The composition of this value is summarised in Figure B below.

Telstra's assessment of the value of the Proposed Transaction differs in nature from the Independent Expert's assessment. Telstra's assessment of the value of the Proposed Transaction represents consideration and benefits Telstra expects to receive from NBN Co and the Government, whereas the Independent Expert's assessment (as shown in Figure A above) is of the differential between the value of Telstra under the Proposed Transaction and of Telstra under the best available alternative given current Government policy.

FIGURE B: THE APPROXIMATE POST-TAX NPV OF THE PROPOSED TRANSACTION[1]



Note 1: The values are discounted to the time of signing of the Financial Heads of Agreement in June 2010 to facilitate direct comparison with terms agreed at that time.

Note 2: While the sale of Lead-in Conduits is covered in the Infrastructure Services Agreement, it is included in the Disconnection Payments component of Figure B since it relates to assets or services Telstra will not control once the NBN Fibre Network is built.

Note 3: "Other" includes contractual commitments by the Commonwealth towards funding for retraining of Telstra staff, and migration of certain customers and services onto the NBN Fibre Network, as well as costs Telstra will avoid due to the public education campaign undertaken by NBN Co.

Telstra also expects to incur some costs to meet its infrastructure commitments to NBN Co and migrate services onto the NBN Fibre Network. This includes an estimated incremental $0.5 billion of costs over 10 years relating to operational expenses brought forward. These are accelerated customer migration costs borne as a consequence of the rollout of the NBN Fibre Network and costs in relation to necessary work on infrastructure required by NBN Co. Given this represents less than 1% of Telstra's likely total operating expenditure over the same 10 year period, Telstra expects to be able to account for these incremental costs within existing expenditure profiles by achieving savings in other areas of its business.

Telstra will incur approximately $0.9 billion of capital expenditure for necessary work on infrastructure and customer migration costs, as well as approximately $0.6 billion of operational expense for necessary work on infrastructure and maintenance activities. These costs are within Telstra's existing capital expenditure programs and operating expense targets and substitute for costs Telstra would otherwise incur. As such, they are not considered incremental to Telstra's current operations.

All of the above cost estimates are on a post-tax net present value basis as at June 2010.

KEY ADVANTAGES OF THE PROPOSED TRANSACTION

A BETTER FINANCIAL OUTCOME

The Proposed Transaction is expected to contribute to sustainable free cashflow generation in the medium term, providing Telstra with greater financial flexibility and a stronger balance sheet than under the best available alternative given current Government policy.

Under the Proposed Transaction and associated Government policy commitments, Telstra will receive:

- Disconnection Payments from NBN Co in relation to the disconnection of Copper Services and HFC Broadband Services, and payments for the transfer of Lead-in Conduits to NBN Co;
- increased revenue as NBN Co makes Infrastructure Access Payments for access to large volumes of parts of Telstra's infrastructure; and
- the benefit of payments received and costs avoided through the Commonwealth Agreements and other Government policy commitments.

These arrangements are expected to help offset the decline in free cashflow that is expected to result from a loss of Telstra's fixed line market share and margins as services are migrated onto the NBN Fibre Network.

Telstra also expects that it will save on future operating costs in relation to its Copper Network and HFC Cable Network as it reduces its use of these networks over time.

It is expected that the Proposed Transaction will not have a material impact on Telstra's financial results in the financial year ending 30 June 2012.

A MORE STABLE REGULATORY ENVIRONMENT

As part of the Proposed Transaction, Telstra has submitted an undertaking to the ACCC in which it commits to undergo structural separation to the extent of its contractual commitments to NBN Co to disconnect Copper Services and HFC Broadband Services provided to premises in the NBN Fibre Footprint. Telstra has also committed to various interim equivalence and transparency measures which relate to the supply by Telstra of certain legacy wholesale services.

If the ACCC accepts Telstra's Structural Separation Undertaking and the Draft Migration Plan, and these documents come into force, Telstra will:

- have certainty in relation to the form of separation that will apply to its fixed line businesses;
- avoid the significant costs and complexity associated with mandatory functional separation;
- avoid the legislative prohibition under the CCS Act that would otherwise prevent Telstra from bidding for the next major release of wireless spectrum, which is considered necessary for Telstra to best continue the growth of its mobiles business; and
- retain its HFC Cable Network and its 50% equity interest in FOXTEL.

Unless there is significant legislative change, the Proposed Transaction is also expected to provide Telstra with greater medium and long-term regulatory certainty than under the best available alternative. This is because:

- competition concerns over Telstra's vertical integration have consistently been identified as the main justification for the current level of access regulation of Telstra, so once Telstra voluntarily structurally separates, Telstra should face a lower risk of access regulation than under the best available alternative where it remains vertically integrated; and
- Telstra's USO responsibilities would be clearly defined in the TUSMA Agreement and Telstra would be compensated for any increase in the scope of those obligations beyond those defined by the scope of the current legislative arrangements.

GREATER STRATEGIC FLEXIBILITY

Telstra believes the Proposed Transaction will allow it to focus on implementing its corporate strategy and capture the opportunities that flow from so doing.

Telstra has been preparing to operate in an NBN environment since the introduction of the NBN was announced in April 2009. To succeed in this environment, Telstra will strive to improve customer satisfaction, continue to simplify its business and pursue existing and new growth opportunities in media, NAS and its Asian Business Operations. Some of these opportunities will be enhanced by the introduction of the NBN and Telstra's role in it as provided for by the Proposed Transaction.

Telstra believes its competitive strengths provide a strong foundation from which it can pursue its strategic priorities. In particular:

- Telstra's extensive customer base and the depth of its existing customer relationships are expected to assist it to achieve a high level of customer retention during the transition from Telstra's Copper Network to the NBN Fibre Network;
- Telstra's ability to leverage its economic scale and the reach of its operations, through initiatives aimed at improving service delivery, improving productivity and reducing costs, should enable it to achieve a competitive cost position as a Retail Service Provider on the NBN;
- Telstra is well positioned in the Australian telecommunications market and its broad product and service portfolio, and extensive experience in delivering voice and data services, should position it strongly to compete in an NBN environment; and
- Telstra's deep engineering and design capability will be critical in delivering superior performance from its Next IP™ core fibre network, delivering high quality solutions for its mobiles and corporate customers, and supporting the expansion of its media business.

PROTECTIONS IN THE EVENT OF A CHANGE OF POLICY

If NBN Co's rollout of the NBN Fibre Network ceases before it is completed, Telstra may not receive some of the earnings and cashflow or the benefit of some of the cost savings it would otherwise expect to receive under the Proposed Transaction and the interim equivalence and transparency commitments in the Structural Separation Undertaking would continue. If this occurs, however, there are four key protections on which Telstra can rely.

- **Long-term contractual commitments from NBN Co for certain infrastructure:** NBN Co will still be required to pay Telstra access payments under the long-term contract for infrastructure in use or subject to a confirmed order at the time the rollout ceases, except in certain circumstances.
- **A rollout termination payment of up to $500 million:** NBN Co has agreed, subject to limited exceptions, to compensate Telstra up to $500 million if, having reached a minimum of 20% of NBN Co's fibre coverage target (93% of premises), the rollout ceases. The amount payable scales down as NBN Co rolls out the NBN Fibre Network beyond 20% of the coverage target.
- **Protection against automatic termination of certain elements of the Government package:** The TUSMA Agreement as a whole cannot be automatically terminated if the rollout of the NBN Fibre Network has passed 20% of NBN Co's 93% coverage target. Instead, it requires the parties to renegotiate the TUSMA Agreement based on certain principles.
- **The right to continue to operate Telstra's existing fixed line businesses in areas where the NBN Fibre Network has not been rolled out:** Telstra will be able to continue to generate earnings and cashflow from the ongoing operation of the Copper Network and HFC Cable Network in areas where the rollout of the NBN Fibre Network has not occurred.

MATERIAL RISKS OF THE PROPOSED TRANSACTION

While the Proposed Transaction is expected to provide benefits and opportunities for Telstra, it also involves a number of material risks and operational challenges. These risks include the possibility that:

- the underlying assumptions made by Telstra in assessing the Proposed Transaction prove incorrect, including in relation to the advantages and disadvantages of the Proposed Transaction and the alternative options considered, and the speed and density of the rollout of the NBN Fibre Network;
- Telstra may not meet its obligations under the Proposed Transaction, such as meeting the agreed fitness standards for the infrastructure to be made available to NBN Co in the required timeframes;
- Telstra's transition from a vertically integrated provider of services on its own Copper Network and HFC Cable Network to becoming a reseller and user of services on the NBN Fibre Network is more costly or challenging than anticipated; and
- NBN Co may not be able to provide the services Telstra will rely on NBN Co for.

These and other risks are further outlined in section 3.4 of this Explanatory Memorandum.

WHAT WILL HAPPEN IF TELSTRA SHAREHOLDERS APPROVE THE PROPOSED TRANSACTION?

If Telstra Shareholders approve the Proposed Transaction, it will proceed once all outstanding Conditions Precedent are satisfied or waived.

As at the date of this Explanatory Memorandum, the key outstanding Conditions Precedent, in addition to Telstra Shareholder approval, are:

- acceptance by the ACCC of the Structural Separation Undertaking and approval of the Draft Migration Plan, in a form acceptable to Telstra and NBN Co; and
- separate ATO private rulings relevant to Telstra and NBN Co confirming the intended tax treatment of elements of the Proposed Transaction.

WHAT WILL HAPPEN IF TELSTRA SHAREHOLDERS DO NOT APPROVE THE PROPOSED TRANSACTION?

If Telstra Shareholders do not approve the Proposed Transaction, it will not proceed and Telstra will not participate in the rollout of the NBN (other than by providing NBN Co with access to certain infrastructure on an agreed, and/or potentially regulated, basis).

Importantly, the Government has stated that the rollout of the NBN will still proceed even if Telstra Shareholders do not approve the Proposed Transaction.

In addition, if the Proposed Transaction does not proceed, Telstra:

- will not receive payments from NBN Co on the scale anticipated under the Proposed Transaction or realise the value it has attributed to the Commonwealth Agreements and associated Government policy commitments;
- would expect to undergo mandatory functional separation and incur significant separation costs; and
- would likely be prohibited from bidding for the next major release of wireless spectrum, which would be expected to have adverse consequences for Telstra's mobiles business.

In light of the above, the Directors currently believe that Telstra's best course of action if the Proposed Transaction does not proceed would be to continue to operate its Copper Network and HFC Cable Network and upgrade these networks (where feasible) applying a least cost blended technology approach, in order to compete with the NBN.

FREQUENTLY ASKED QUESTIONS

	TOPIC	SUMMARY	WHERE TO FIND MORE INFORMATION
	THE NBN		
1	What is the National Broadband Network (NBN)?	The NBN is a Government initiative to provide all Australians with access to high speed broadband using either fibre, wireless or satellite services. The NBN will be built and operated by NBN Co, a company owned by the Commonwealth. The Government intends, with very limited exceptions, that the NBN will be an open access, wholesale only network. Telstra and other service providers will use this network to provide fixed voice, broadband and other data services to their customers.	Section 1.2
	DETAILS OF THE PROPOSED TRANSACTION		
2	What is the Proposed Transaction?	The Proposed Transaction involves the implementation of the Definitive Agreements by Telstra (subject to the Conditions Precedent being satisfied or waived). The Definitive Agreements, together with regulatory undertakings given to the ACCC and associated Government policy commitments, create the framework for Telstra's participation in the rollout of the NBN. In summary, Telstra has agreed to: • disconnect progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint; • acquire wholesale products from NBN Co, to enable the supply of fixed line voice, data and broadband services to customer premises in the NBN Fibre Footprint; and • provide NBN Co with access to large volumes of Telstra's infrastructure (which would largely continue to be owned by Telstra). In addition, the Government has announced that its policy intent is to relieve Telstra of certain regulatory obligations and Telstra will also avoid certain costs and be more fully compensated for other costs through various funding measures agreed with the Commonwealth.	Section 4
3	Why is Telstra entering into the Proposed Transaction?	The decision to participate in the rollout of the NBN was made following a review of Telstra's available options in light of the Government's commitment to introduce the NBN and separate parts of Telstra's business.	Section 1.4
4	What do the Directors recommend?	The Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution to approve the Proposed Transaction. The Directors consider that the Proposed Transaction is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and separate parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra given current Government policy.	Section 2.1

	TOPIC	SUMMARY	WHERE TO FIND MORE INFORMATION
5	What is Telstra receiving under the Proposed Transaction?	Telstra expects the Proposed Transaction and associated Government policy commitments to deliver to it approximately $11 billion in post-tax net present value as at June 2010 (subject to a range of dependencies and assumptions) over the life of the Definitive Agreements. This value does not include broader benefits which Telstra may gain from the Definitive Agreements, and which are hard to quantify, and nor is it an assessment of the overall impact of the Proposed Transaction on the underlying value of Telstra. It includes the value of payments from NBN Co for: • disconnecting progressively Copper Services and HFC Broadband Services that are provided to premises within the NBN Fibre Footprint; • selling Lead-in Conduits; and • providing NBN Co access to large volumes of certain types of Telstra's infrastructure. In addition, it includes value that has been attributed to Government commitments to relieve Telstra of certain regulatory obligations and certain costs that Telstra will avoid through various funding measures agreed with the Commonwealth.	Section 2.2.1
6	What is the Independent Expert's opinion on the Proposed Transaction?	The Independent Expert's view is that the Proposed Transaction is in the best interests of Telstra and Telstra Shareholders. The Independent Expert has concluded that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion greater than under the best available alternative. This is on a post-tax net present value basis as at June 2011.	Section 2.4 The Independent Expert's Report is set out in Annexure 1.
7	How does the value expected to be delivered by the Proposed Transaction differ from the Independent Expert's assessment of the value differential?	The value of the Proposed Transaction represents consideration and benefits Telstra expects to receive from NBN Co and the Government whereas the Independent Expert's assessment is of the differential between the value of Telstra under the Proposed Transaction and of Telstra under the best available alternative given current Government policy.	Sections 2.2.1 and 2.4 The Independent Expert's Report is set out in Annexure 1.
8	What will happen if the Proposed Transaction is not approved?	If Telstra Shareholders do not approve the Proposed Transaction, the Proposed Transaction will not proceed. Importantly, the Government has stated that the rollout of the NBN will still proceed even if Telstra Shareholders do not approve the Proposed Transaction. If the Proposed Transaction does not proceed, Telstra will continue to operate its Copper Network and HFC Cable Network, but: • will not receive payments from NBN Co on the scale anticipated under the Proposed Transaction; • will not realise the value it has attributed to the Commonwealth Agreements and associated Government policy commitments; • would expect to undergo mandatory functional separation and incur significant separation costs; and • would likely be prohibited from bidding for the next major release of wireless spectrum, which would be expected to have adverse consequences for Telstra's mobiles business.	Section 2.5

	TOPIC	SUMMARY	WHERE TO FIND MORE INFORMATION
9	What are the risks associated with the Proposed Transaction?	The Proposed Transaction involves a number of material risks that Telstra Shareholders should consider. The material risks to Telstra associated with the Proposed Transaction broadly fall into the following categories: • risks to underlying assumptions supporting Telstra's assessment of the Proposed Transaction, including in relation to the advantages and disadvantages of the Proposed Transaction and the alternative options considered, and the speed and density of the rollout of the NBN Fibre Network; • risks to completion of the Proposed Transaction; • regulatory risks; • risks relating to Telstra's performance of its obligations under the Definitive Agreements and regulatory undertakings; • risks to expected payments and possibility of increased costs; and • NBN Co performance risks.	Section 3.4
10	What are the Conditions Precedent to the Proposed Transaction?	There are a number of Conditions Precedent, including Telstra Shareholder approval, that must be satisfied or waived in order for the Proposed Transaction to proceed. As at the date of this Explanatory Memorandum, the key outstanding Conditions Precedent are: • acceptance by the ACCC of the Structural Separation Undertaking and approval of the Draft Migration Plan, in a form acceptable to Telstra and NBN Co; and • separate ATO private rulings relevant to Telstra and NBN Co confirming the intended tax treatment of elements of the Proposed Transaction. If the Conditions Precedent are not satisfied or waived by 5.00pm on 20 December 2011 (or any other date agreed to by Telstra and NBN Co), then the Proposed Transaction will not proceed.	Section 6.2
11	What are Telstra's restrictions with regard to its mobile services?	Telstra has agreed not to promote wireless services as a substitute for fibre-based services for a 20 year period from the commencement of the NBN Co Agreements. Telstra considers that, notwithstanding the potential risk of this restriction, it will continue to be able to promote and grow its mobiles business effectively, as Telstra can promote wireless services as a complement to fibre-based services, as a bundle with fibre-based services or as a stand-alone service. It can also promote its wireless services as competitive with those of other wireless carriers.	Section 4.2.2.3
12	Is Optus co-operating with NBN Co?	NBN Co and Optus have announced that they have entered into an agreement to progressively migrate customers on Optus' hybrid fibre coaxial (HFC) network to the NBN as it is rolled out and that, once migration is completed, Optus will decommission its HFC network (except for those parts used to provide ongoing support for mobile infrastructure and business customers). The announcement noted that the agreement was conditional on ACCC approval and satisfactory rulings from the ATO and included certain termination rights. If, however, for some reason, the agreement between NBN Co and Optus does not come into effect or it is not implemented as described, the Proposed Transaction will still proceed (subject to the Conditions Precedent being satisfied or waived). The implementation of the agreement between NBN Co and Optus is not a Condition Precedent to the Proposed Transaction.	Sections 3.4.4(f) and 6.2.4

	TOPIC	SUMMARY	WHERE TO FIND MORE INFORMATION
	PROTECTION FOR TELSTRA		
13	What happens to Telstra if the rollout of the NBN Fibre Network was to slow down or stop?	If the rollout of the NBN Fibre Network is very slow or ceases before it is completed, NBN Co would compensate Telstra for it being left with a geographically dispersed network (subject to limited exceptions). Telstra will not receive this compensation if the event occurs before the rollout of the NBN Fibre Network has reached 20% of NBN Co's current fibre coverage target (93% of premises). Assuming NBN Co completes at least 20% of its proposed rollout, this compensation is on a sliding scale from a maximum of $500 million, reducing to zero, depending on the progress of NBN Co's fibre rollout at the relevant time. If this should occur, Telstra will continue to receive cashflow (and bear the associated costs) from customers continuing to use Copper Services and HFC Broadband Services in areas where the rollout of the NBN Fibre Network has not occurred, and from any ongoing payments it will receive from NBN Co for certain infrastructure access provided. Telstra will also continue to be subject to the commitments in the Structural Separation Undertaking, including the interim equivalence and transparency commitments during the period up to the Designated Day, and the requirement to structurally separate at the Designated Day but only within the reduced deployment area of the NBN Fibre Network.	Sections 4.2.2.7 and 4.3.2.8

	TOPIC	SUMMARY	WHERE TO FIND MORE INFORMATION
	THE MEETING		
14	When and where will the Meeting be held?	The Meeting is scheduled to be held at 10.00am (Sydney time) on Tuesday, 18 October 2011 at the Sydney Convention and Exhibition Centre, Hall No. 1, Darling Drive, Darling Harbour, Sydney, with Telstra Shareholder registration commencing at 9.00am (Sydney time). The Meeting will also be broadcast live to the following venues: **Melbourne** – Sofitel Melbourne on Collins, Grand Ballroom, 25 Collins Street, Melbourne. **Brisbane** – Brisbane Convention and Exhibition Centre, the Great Hall, corner Merivale and Glenelg Streets, South Bank, Brisbane (due to time differences, the broadcast is scheduled to start at 9.00am Brisbane time). Please note that Telstra Shareholders will be able to view the proceedings and submit questions to the Chairman from the Melbourne and Brisbane broadcasts, but will not be able to lodge their votes. Telstra Shareholders attending these venues are encouraged to lodge their votes prior to the Meeting by following the instructions on the back of the Voting Form or in the Notice of Meeting.	Page XV ("What you should do") Please refer to the Notice of Meeting that accompanies this Explanatory Memorandum for full details on the Meeting.
15	How do I vote?	Telstra Shareholders and Employee Share Plan Participants can vote in person on the Resolution by attending the Meeting. Alternatively, you can: • appoint a proxy or nominee to vote on your behalf by completing section B of the enclosed blue Voting Form or green Nominee Form or appointing your proxy or nominee online; or • vote directly by completing section A of the enclosed blue Voting Form, or lodging your vote online.	Page XV ("What you should do") Voting and proxy instructions for the Meeting are set out on the back of the blue Voting Form (for Telstra Shareholders) or green Nominee Form (for Employee Share Plan Participants). This information is also set out in the Notice of Meeting that accompanies this Explanatory Memorandum.

WHAT YOU SHOULD DO

STEP 1	READ THIS EXPLANATORY MEMORANDUM IN FULL
	You should read this Explanatory Memorandum in full before deciding how to vote on the Resolution. If you have any questions, you can call the Telstra information line on 1300 88 66 77 (within Australia) or +61 2 8280 7756 (outside Australia) on weekdays between 8.30am and 7.30pm (Sydney time). If you are in any doubt as to what you should do, you should discuss this document with your professional adviser.
STEP 2	**VOTE ON THE RESOLUTION AT THE MEETING**
	Telstra Shareholders and Employee Share Plan Participants can vote for or against the Resolution by doing one of the following: • **attending the Meeting** on 18 October 2011 at 10.00am (Sydney time) at the Sydney Convention and Exhibition Centre, Hall No. 1, Darling Drive, Darling Harbour, Sydney; • **voting directly** by completing section A of the blue Voting Form and returning it to the Telstra Share Registry in accordance with the voting instructions; • appointing a **proxy** (or proxies) in the case of a Telstra Shareholder, or a **nominee** in the case of an Employee Share Plan Participant, in accordance with the voting instructions; • lodging your voting intentions **online** at the Telstra Share Registry website: www.linkmarketservices.com. au/Telstra The **voting instructions** are set out on the back of the blue Voting Form (for Telstra Shareholders) or green Nominee Form (for Employee Share Plan Participants). These details are also set out in the Notice of Meeting that accompanies this Explanatory Memorandum. Telstra Shareholders should note they are being asked to vote on more than one item at the Meeting. Please be sure to lodge your vote for each item.

DEFINED TERMS

This Explanatory Memorandum contains a number of capitalised terms. These terms are explained in section 9.

This page has been left blank intentionally.

1. BACKGROUND AND OVERVIEW OF THE PROPOSED TRANSACTION

This section of the Explanatory Memorandum:

- provides an overview of Telstra's businesses today and the Government's broadband and competition policy initiatives;
- explains the choices faced by Telstra as a result of the anticipated consequences of these policy initiatives on certain parts of Telstra's business; and
- sets out a summary of the Proposed Transaction.

Further detailed information regarding the elements of the Proposed Transaction, and Telstra's assessment of its financial impact, can be found in sections 4 and 5, respectively.

1.1 TELSTRA'S BUSINESS TODAY

Telstra is Australia's leading full service telecommunications and information services company. It offers a wide range of fixed and mobile telecommunications, and information products and services across Australia and overseas.

Telstra is a vertically integrated business. This means that Telstra uses its own network infrastructure to provide retail services. In addition, Telstra provides wholesale services to other telecommunications retailers, who then provide services, including voice, broadband and data services, to their own end user customers.

Telstra also has a significant presence in the Australian advertising and media sectors through Sensis, BigPond® and its interest in FOXTEL. In addition, Telstra controls, or has interests in, a number of international operations in the telecommunications sector, primarily in New Zealand, Hong Kong and China. Telstra's business structure is illustrated in Figure 1.

Telstra owns and operates the following network infrastructure across Australia:

- **The Copper Network,** which connects to most homes and businesses in Australia, enabling Telstra and other providers to supply a range of voice, broadband and data services. Telstra's Copper Network is Australia's largest local access network and its extensive coverage underpins Telstra's historical

FIGURE 1: TELSTRA'S BUSINESS STRUCTURE

Telstra

Wholesale

Provides the following services to other retailers:
- Fixed access and resale services
- Backhaul and transmission services
- Mobile transmission services

Retail

Provides the following services to end user customers:
- Fixed line voice (PSTN)
- Fixed broadband
- Mobile voice
- Mobile broadband
- Business IP and data
- Network Applications and Services (NAS)

Asia

Controls or has interests in operations mainly in Hong Kong and China, including:
- Asia/Pacific managed services carriage
- CSL New World
- Advertising and content related businesses in China

Media

Includes advertising, directories search and information services, through:
- Sensis
- IPTV
- Resale of FOXTEL pay TV services
- BigPond Media
- Trading Post

Network Infrastructure

Telstra owns its own network infrastructure including:
- Copper Network
- HFC Cable Network
- Backhaul fibre network
- Next IP™ core fibre network
- Wireless networks (includes Next G® network)
- Other networks and submarine cables serving international operations

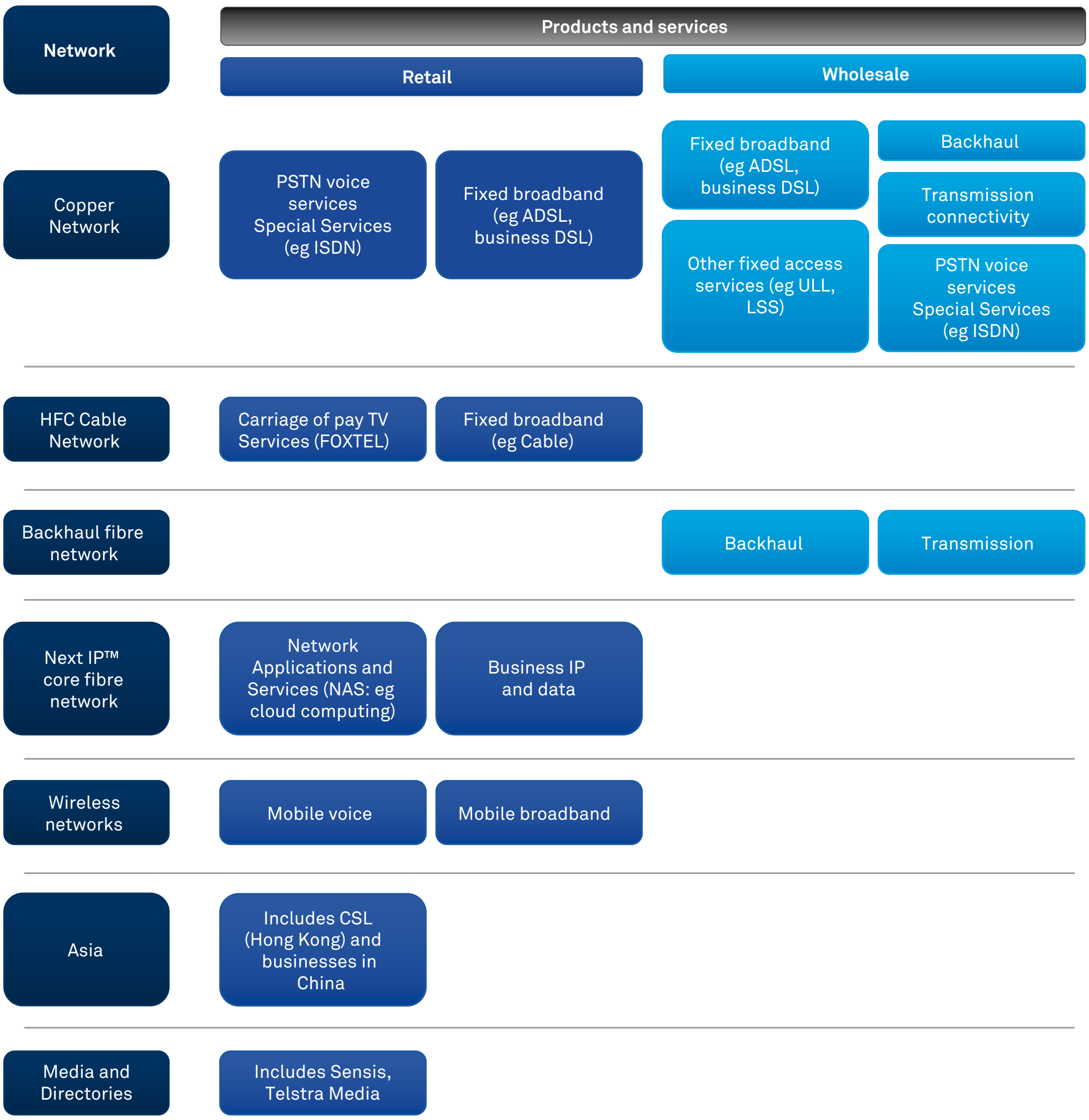
Note: Further details on Telstra's products and services are set out in Annexure 3.

obligation to make voice services and payphones reasonably accessible to all Australians (the Universal Service Obligation).

- **The HFC Cable Network,** which covers the majority of metropolitan areas in the cities of Melbourne, Sydney, Gold Coast, Brisbane, Adelaide and Perth, enabling Telstra to provide carriage of pay TV Services (FOXTEL) and cable broadband services with peak data speeds of 30 megabits per second in those areas (and up to 100 megabits per second in parts of Melbourne where the network has been upgraded).
- **The backhaul fibre network,** which consists of predominantly optical fibre plus radio and satellite links and transports retail and wholesale voice and data traffic between key aggregation points for both fixed and wireless networks around Australia.
- **The Next IP™ core fibre network,** which is the largest fully integrated Internet Protocol core network in Australia, supporting fixed and wireless technologies. Telstra's Next IP™ core fibre network allows Telstra to provide business grade applications and services to Telstra's business, enterprise and government customers.
- **Wireless networks,** which provide both mobile voice and mobile broadband services, including those offered on Telstra's Next G® mobile broadband network, which is geographically one of the world's largest 3G networks, covering 99% of the Australian population. Telstra has also started rolling out a 4G wireless network using LTE technology.

Figure 2 illustrates how Telstra utilises its network infrastructure to provide its products and services to retail and wholesale customers.

FIGURE 2: TELSTRA'S PRODUCTS, SERVICES AND NETWORKS



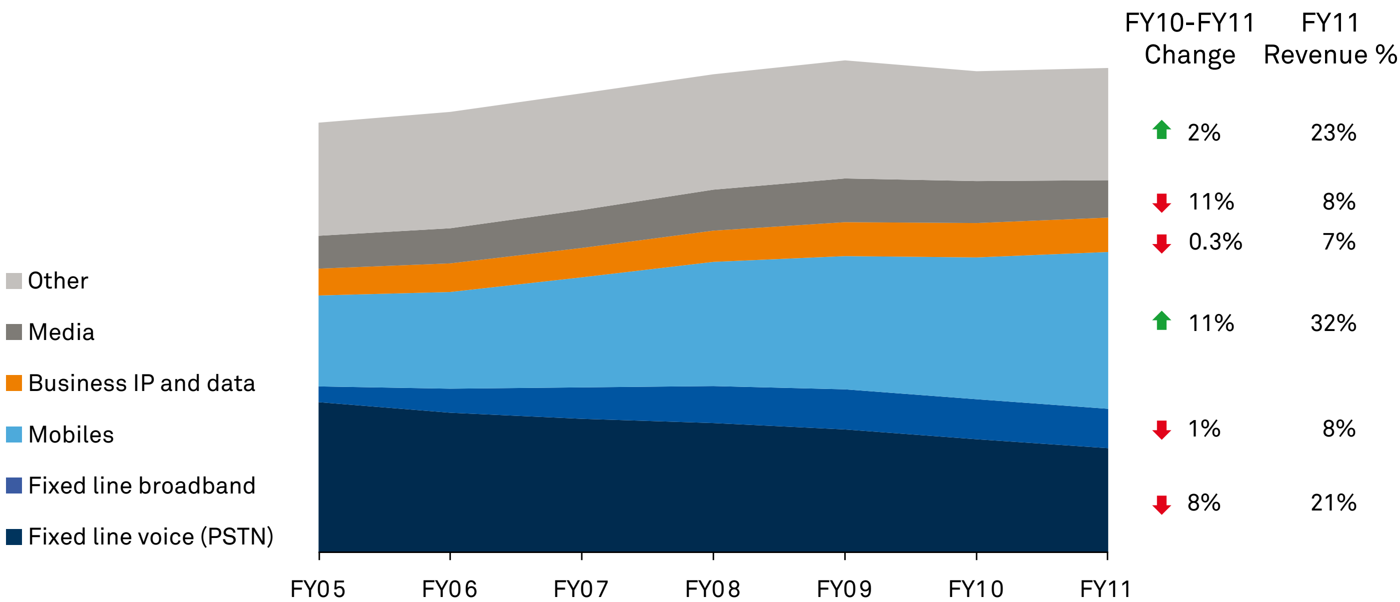
Telstra has generated significant revenues from this diversified portfolio of retail and wholesale products, but the nature of those revenues is changing considerably as technology and customer preferences evolve.

Historically, the core service of the telecommunications industry has been the provision of fixed line voice products (PSTN products) to homes and businesses. However, with the advent of the internet and high speed mobile services, the telecommunications industry has seen rapid growth in customer use of mobile devices, the internet and social media. As a result, revenue from fixed line voice products has declined since 2005, while mobile voice and broadband revenues have increased significantly over the same period.

Figure 3 illustrates the continuing trend toward mobility and the impact on Telstra's revenue mix, with Telstra revenues from mobile services exceeding fixed line voice revenues for the first time in the financial year ended 30 June 2009.

Telstra has responded to developments in technology and changing customer preferences by investing to maintain its market leadership position and generate new products and revenue streams. However, it is now faced with new challenges and opportunities as a result of the introduction of the Government's broadband and competition policy initiatives.

FIGURE 3: TELSTRA'S REVENUE TRENDS



Source: Telstra FY2011 Financial Highlights, 11 August 2011; "Other" includes NAS, Asian Business Operations, TelstraClear, Pay TV Services.
Note: This figure includes both retail and wholesale revenue.

1.2 THE GOVERNMENT'S BROADBAND AND COMPETITION POLICY INITIATIVES

In 2009, the Government announced two major policy initiatives, the effect of which will change fundamentally the structure and regulation of the telecommunications industry in Australia.

The first policy initiative was the establishment of a new Commonwealth owned company, NBN Co, to build and operate the NBN to provide fibre connections capable of carrying voice and high speed broadband services to 93% of Australian homes and businesses, and wireless and satellite connections to the remaining 7%. The Government has since taken various steps to achieve this objective. These steps include the funding of NBN Co and the introduction of legislation to support NBN Co's objectives and network rollout. Further, NBN Co has now commenced the rollout of the NBN. It has recruited its own workforce, entered into key construction contracts and started providing services in a small number of trial regions.

The second policy initiative was the introduction and subsequent passage of the CCS Act in late 2010. The CCS Act provides a framework for Telstra to voluntarily structurally separate. If Telstra does not structurally separate, the CCS Act requires the functional separation of Telstra. This is explained in more detail in the following section 1.3.

A timeline is set out in Figure 4, outlining NBN Co milestones and key Government policy initiatives.

1.3 TELSTRA'S CHOICES UNDER THE CCS ACT

If Telstra does not elect to undergo voluntary structural separation, the CCS Act provides that Telstra must undergo mandatory functional separation and also that the Minister will have the power to implement a legislative prohibition preventing Telstra from bidding for the next major release of wireless spectrum.

The only way that Telstra can have certainty that it will avoid the Minister implementing the legislative spectrum prohibition is to choose to voluntarily structurally separate, and to either:

- give further undertakings to divest its HFC Cable Network and its 50% equity interest in FOXTEL; or
- obtain waivers from the Minister regarding the requirement to divest the HFC Cable Network and its FOXTEL interest.

Telstra has sought to address this by lodging a Structural Separation Undertaking, which does not take effect unless the Minister grants the divestiture waivers.

Both voluntary structural separation and mandatory functional separation are costly and complex initiatives and it is unlikely that Telstra would have chosen to implement either initiative had it not been required to do so by legislation. Telstra's choices under the CCS Act are illustrated in Figure 5.

FIGURE 4: NBN CO MILESTONES AND KEY GOVERNMENT POLICY INITIATIVES

NBN Co milestones

7 April 2009: The Government announced the establishment of NBN Co, to build and operate a new National Broadband Network

25 July 2009: The Government appointed Mike Quigley as CEO of NBN Co

July 2010: NBN Co announced its first customer connection in Midway Point, Tasmania

December 2010: NBN Co released the NBN Co Corporate Plan and a Product and Pricing Overview for Access Seekers

May 2011: NBN Co announced the connection of its first mainland retail customers in Armidale, NSW

1 June 2011: NBN Co confirmed contracts with Ericsson for the building of a next generation fixed wireless network and with Silcar for a fibre rollout to premises in Queensland, NSW and the ACT

Timeline of NBN Co milestones and key Government policy initiatives

15 September 2009: The Government announced proposed reforms to telecommunications regulation, including:

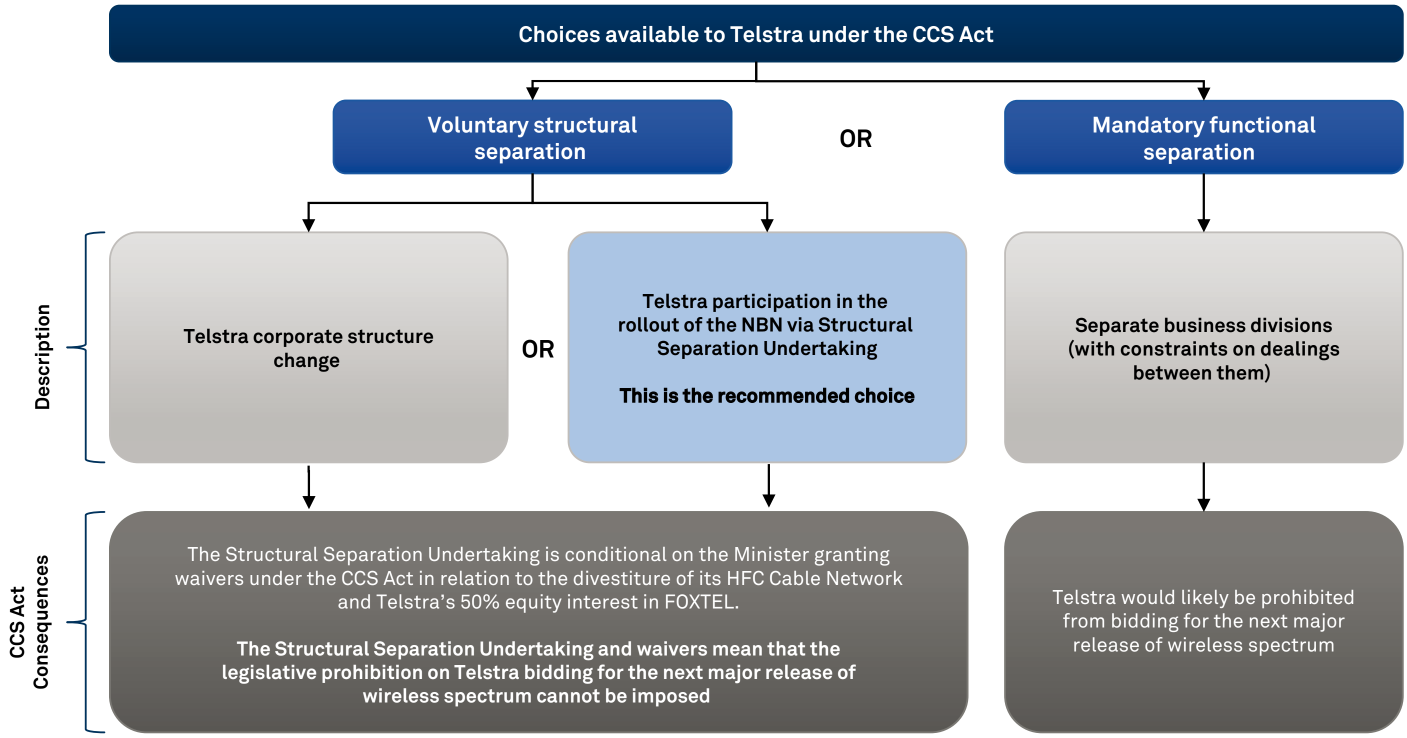
- mechanisms to either encourage or require Telstra to undergo greater separation of certain parts of its networks, wholesale and retail businesses;
- potential divestiture of FOXTEL and HFC Cable Network assets; and
- limitations on future wireless spectrum acquisition

26 and 29 November 2010: *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010* (the CCS Act) passed by Parliament. This Act implemented the reforms proposed on 15 September 2009

25 and 28 March 2011: *National Broadband Network Companies Bill 2010* and *Telecommunications Legislation Amendment (National Broadband Network Measures—Access Arrangements) Bill 2010* passed by Parliament. These Acts contain measures to support the rollout of the NBN and ensure that NBN Co will primarily operate on a wholesale-only basis and provide access to all access seekers without discrimination

Government policy initiatives

FIGURE 5: TELSTRA'S CHOICES UNDER THE CCS ACT



VOLUNTARY STRUCTURAL SEPARATION

While the CCS Act does not prescribe a form of structural separation, it broadly requires Telstra to cease supplying fixed line services to customers using a network it controls. Potential ways in which Telstra could implement structural separation include:

- changing its corporate structure (for example, by sale or demerger of some of its networks or businesses so that Telstra's fixed networks (unless exempt) would be owned by a separate legal entity to its customer facing businesses); or
- participating in the rollout of the NBN by disconnecting progressively Copper Services and HFC Broadband Services, and ceasing to operate services on the Copper Network or provide broadband services on its HFC Cable Network within the NBN Fibre Footprint.

If Telstra decided to change its corporate structure, it would expect to incur significant separation and other costs depending on the form of separation implemented.

If Telstra participates in the rollout of the NBN, it would also incur costs (for example, to establish new reporting measures to apply in the interim period before full structural separation is achieved), but the impact of these costs would not be material.

Telstra proposes to participate in the rollout of the NBN and has submitted the Structural Separation Undertaking to the ACCC. If the ACCC accepts the Structural Separation Undertaking, Telstra will undergo structural separation and avoid the implementation of the legislative prohibition under the CCS Act that would otherwise prevent it from bidding for the next major release of wireless spectrum. The regulatory undertakings submitted by Telstra to the ACCC are explained in more detail in sections 1.4 and 4.4.

MANDATORY FUNCTIONAL SEPARATION

If Telstra does not undergo voluntary structural separation, it must undergo mandatory functional separation. This would require Telstra to implement a separate business division for its retail businesses and another business division for its wholesale business and network services, and is likely to require new systems and processes to ensure (and demonstrate to any external oversight) that both:

- internal transactions (between Telstra's retail and network/wholesale business divisions); and
- external transactions (between Telstra's network/wholesale business and other retailers),

are conducted in an equivalent and transparent manner. While Telstra would retain ownership of its networks, the separate management, reporting and operating regimes would greatly restrict the flow and sharing of information, staff, functions and assets between the retail and network/wholesale business divisions.

If Telstra undergoes this form of separation, it would expect to incur approximately $1 billion of costs over the next five years. These costs would relate largely to establishing new IT systems and duplicating business processes to support and maintain separate business divisions.

SPECTRUM PROHIBITION

If Telstra does not undergo voluntary structural separation, it is likely that Telstra would be prohibited from bidding for the next major release of wireless spectrum. This prohibition, if imposed, would significantly impair Telstra's ability to efficiently roll out the next stage of wireless technology needed to best meet expected growth in customer demand for high capacity mobile services and would have adverse consequences for the growth of its mobiles business.

1.4 TELSTRA'S RESPONSE AND THE PROPOSED TRANSACTION

The choices available to Telstra under the CCS Act were critical in shaping Telstra's response to the introduction of the NBN. While Telstra supports the Government's vision to deliver affordable, high speed broadband, the Government's policy initiatives and associated regulatory reforms will have significant implications for the way Telstra conducts certain parts of its fixed line business. In particular, Telstra considers that these initiatives will:

- have adverse consequences for Telstra's fixed line business, in particular the loss to NBN Co of wholesale revenues and the higher cost of accessing the NBN Fibre Network compared with using Telstra's networks for certain services; and
- fundamentally change the way that Telstra operates its fixed line businesses by mandating the way that its wholesale and retail businesses interact with each other.

The Government's policy initiatives are not expected to have a direct or material impact on some of Telstra's other businesses such as Media (for example, Sensis and BigPond Media) and its Asian Business Operations.

The Government's policy initiatives will result in a net loss of value of Telstra overall, irrespective of whether Telstra participates in the rollout of the NBN. Given this overall adverse effect, the Directors therefore undertook an extensive assessment process to ensure the best outcome for Telstra and Telstra Shareholders in these circumstances.

The Directors have determined that the best course of action for Telstra is to co-operate with NBN Co and the Government by participating in the rollout of the NBN. This decision was made following consideration of the options realistically available to Telstra in light of the Government's policy initiatives, including options that did not involve participating in the rollout of the NBN. This process involved an assessment of the regulatory and commercial implications of each option, as well as extensive negotiations with NBN Co to establish an acceptable basis for Telstra's possible participation in the rollout of the NBN. In undertaking this analysis, Telstra also considered the consequences of the rollout of the NBN not being completed as planned or being cancelled.

The Directors have assumed that the Government will proceed with the rollout of the NBN irrespective of whether Telstra Shareholders approve the Proposed Transaction. This assumption is consistent with public statements made by the Government.

On 23 June 2011, Telstra entered into a series of conditional agreements with NBN Co and the Commonwealth (referred to as the Definitive Agreements). The Proposed Transaction involves the implementation of the Definitive Agreements by Telstra (subject to the Conditions Precedent being satisfied or waived). The Definitive Agreements, together with regulatory undertakings given to the ACCC and associated Government policy commitments, create the framework for Telstra's participation in the rollout of the NBN.

NBN CO AGREEMENTS

Under the NBN Co Agreements, Telstra has agreed to:

- disconnect progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out. Telstra will be entitled to receive payments from NBN Co for the Copper Services and HFC Broadband Services it disconnects at those premises;
- acquire wholesale products from NBN Co, in line with agreed feature and price commitments, to enable Telstra to supply fixed voice, data and broadband services to customer premises in the NBN Fibre Footprint; and
- provide NBN Co with long-term access to large volumes of certain types of its infrastructure, including Dark Fibre Links, Exchange Rack Spaces and Ducts in return for payments from NBN Co over an assumed average period of 30 years. Telstra will continue to own this infrastructure, but will also provide NBN Co with initial access to Lead-in Conduits, which will then be transferred by Telstra to NBN Co for an agreed price as lead-in fibre is installed by NBN Co into the Lead-in Conduit.

COMMONWEALTH AGREEMENTS

The Commonwealth has also agreed to a package of measures that provide value to Telstra. These measures include increased funding for Telstra's provision of the USO, as well as funding for certain customer migration costs and migration of payphones to the NBN Fibre Network as it is rolled out.

In addition, the Government has made policy commitments to:

- implement reforms to the USO, including the establishment of TUSMA to assume responsibility for the USO as the NBN Fibre Network is rolled out; and
- make NBN Co responsible for installing fibre in new developments of 100 or more premises which reach the relevant approval stage after 1 January 2011 as well as in smaller developments in areas that the NBN Fibre Network will reach within 12 months as it is being rolled out. This transfer of responsibility

from Telstra to NBN Co is expected to allow Telstra to realise significant future cost savings.

REGULATORY UNDERTAKINGS

As part of the Proposed Transaction, Telstra has submitted a Structural Separation Undertaking to the ACCC in which it commits to undergo structural separation in respect of all premises within the NBN Fibre Footprint which have been disconnected in accordance with the Definitive Agreements as at the Designated Day. Further details on the Structural Separation Undertaking are set out in section 4.4.

Under the Structural Separation Undertaking, Telstra has also committed to various interim equivalence and transparency measures which relate to the supply by Telstra of certain Regulated Services to its wholesale customers. These measures, which are consistent with the Government's policy, do not amount to functional separation but extend the existing regulatory and compliance requirements Telstra is required to meet and introduce some new commitments, such as in relation to the pricing of wholesale ADSL 2+ services. These measures will apply until the Designated Day.

Importantly, the Structural Separation Undertaking is conditional on the Minister granting waivers under the CCS Act in relation to the divestiture of its HFC Cable Network and its 50% equity interest in FOXTEL. Together, the Structural Separation Undertaking and the waivers mean that, if the Structural Separation Undertaking is accepted, the express legislative prohibition under the CCS Act on Telstra bidding for the next major release of wireless spectrum, which is considered necessary for Telstra to best continue the growth of its mobiles business, cannot be imposed.

CONDITIONS PRECEDENT

A number of Conditions Precedent must be satisfied or waived for the Proposed Transaction to proceed, including:

- the ACCC's acceptance of Telstra's proposed Structural Separation Undertaking and approval of the Draft Migration Plan;
- separate private rulings made by the Commissioner of Taxation relevant to Telstra and NBN Co confirming the intended tax treatment of elements of the Proposed Transaction; and
- approval of the Proposed Transaction by Telstra Shareholders.

On 29 July 2011, Telstra lodged the Structural Separation Undertaking and Draft Migration Plan with the ACCC. Telstra is working closely with the ACCC with a view to obtaining acceptance of the Structural Separation Undertaking and Draft Migration Plan before the Meeting.

FURTHER INFORMATION

Further details on the Definitive Agreements, the Structural Separation Undertaking and the Draft Migration Plan are set out in section 4.

Section 6 provides further information on the Conditions Precedent and section 6.2.2 provides information on the status of the key outstanding Conditions Precedent.

If Telstra Shareholders approve the Proposed Transaction, it is still possible that it may not proceed if outstanding Conditions Precedent are not satisfied or waived by the required time. Section 6.2.3 provides information about what will happen if the Conditions Precedent are not satisfied or waived.

2. DIRECTORS' RECOMMENDATION AND EVALUATION OF THE PROPOSED TRANSACTION

This section of the Explanatory Memorandum sets out:

- the Directors' unanimous recommendation;
- the expected impact of the Proposed Transaction on Telstra's businesses and how Telstra operates;
- the Independent Expert's opinion; and
- the implications if Telstra Shareholders do not approve the Proposed Transaction.

2.1 DIRECTORS' RECOMMENDATION

The Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution to approve the Proposed Transaction.

The Directors consider that the Proposed Transaction is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and separate parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra given current Government policy.

In particular, the Directors consider that the Proposed Transaction should provide Telstra with:

- a better overall financial outcome, contributing to sustainable free cashflow generation in the medium term;
- a more stable regulatory environment in which to operate, allowing Telstra to focus on its customers; and
- greater strategic flexibility, enabling Telstra to maintain its strong focus on identified key areas of growth, simplify its business and concentrate on the needs of its customers.

The Proposed Transaction also provides certain protections for Telstra in the event of a change in Government policy.

Having determined that the best course of action for Telstra was to participate in the rollout of the NBN by implementing the Proposed Transaction, the Directors appointed the Independent Expert to review the Proposed Transaction. The Directors' recommendation is supported by the conclusions of the Independent Expert, whose report is set out in Annexure 1. The Independent Expert has concluded that the Proposed Transaction is in the best interests of Telstra and Telstra Shareholders and that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion greater than under the best available alternative. The Independent Expert's assessment is made on a post-tax net present value basis as at June 2011. Further detail on the Independent Expert's assessment of the Proposed Transaction is set out in section 2.4.

2.2 KEY CONSIDERATIONS

2.2.1 EXPECTED VALUE OF THE PROPOSED TRANSACTION

Telstra expects the Proposed Transaction and associated Government policy commitments to deliver to it approximately $11 billion in post-tax net present value (NPV) as at 30 June 2010, subject to a range of dependencies and assumptions. This value does not include broader benefits which Telstra may gain from the Definitive Agreements and which are hard to quantify. Further, it is not an assessment of the overall impact of the Proposed Transaction on the underlying value of Telstra.

The $11 billion in post-tax net present value comprises approximately:

- $4.0 billion from NBN Co for Disconnection Payments and sale of Lead-in Conduits;
- $5.0 billion from NBN Co for Infrastructure Access Payments; and
- $2.0 billion attributed to Commonwealth contributions and costs avoided including for housing estate fibre provisioning responsibilities, commitments for TUSMA funding for certain migration costs, staff retraining and NBN Co's public education campaign funding.

This value will not be in the form of an upfront payment but rather is the present value of consideration and benefits to be received over many years. Figure 6 illustrates the cashflow profile of the payments Telstra expects to receive from NBN Co as the NBN Fibre Network is rolled out, based on the estimated rollout profile of the NBN Fibre Network as set out in the NBN Co Corporate Plan.

Telstra also expects to incur some costs to meet its infrastructure commitments to NBN Co and migrate customers onto the NBN Fibre Network. This includes an estimated incremental $0.5 billion of costs over 10 years relating to operational expenses brought forward. These are accelerated customer migration costs borne as a consequence of the rollout of the NBN Fibre Network and costs in relation to necessary work on infrastructure required by NBN Co. Given this represents less than 1% of Telstra's likely total operating expenditure over the same 10 year period, Telstra expects to be able to account for these incremental costs within existing expenditure profiles by achieving savings in other areas of its business.

Telstra will also incur a further approximately $0.9 billion of capital expenditure for necessary work on infrastructure and customer migration costs, as well as approximately $0.6 billion of operational expense for necessary work on infrastructure and maintenance activities. These costs are within Telstra's existing capital expenditure programs and operating expense targets and substitute for costs Telstra would otherwise incur. As such, they are not considered incremental to Telstra's current operations.

All of the above cost estimates are on a post-tax net present value basis as at June 2010.

Further information on the value of the Proposed Transaction and associated costs is set out in section 5.

2.2.2 A BETTER FINANCIAL OUTCOME

Overall, the Proposed Transaction is expected to contribute to sustainable free cashflow generation in the medium term, providing Telstra with greater financial flexibility and a stronger balance sheet than under the best available alternative given current Government policy.

The impacts of the Proposed Transaction will differ for each of Telstra's major businesses, as explained below.

2.2.2.1 TELSTRA'S FIXED LINE BUSINESS

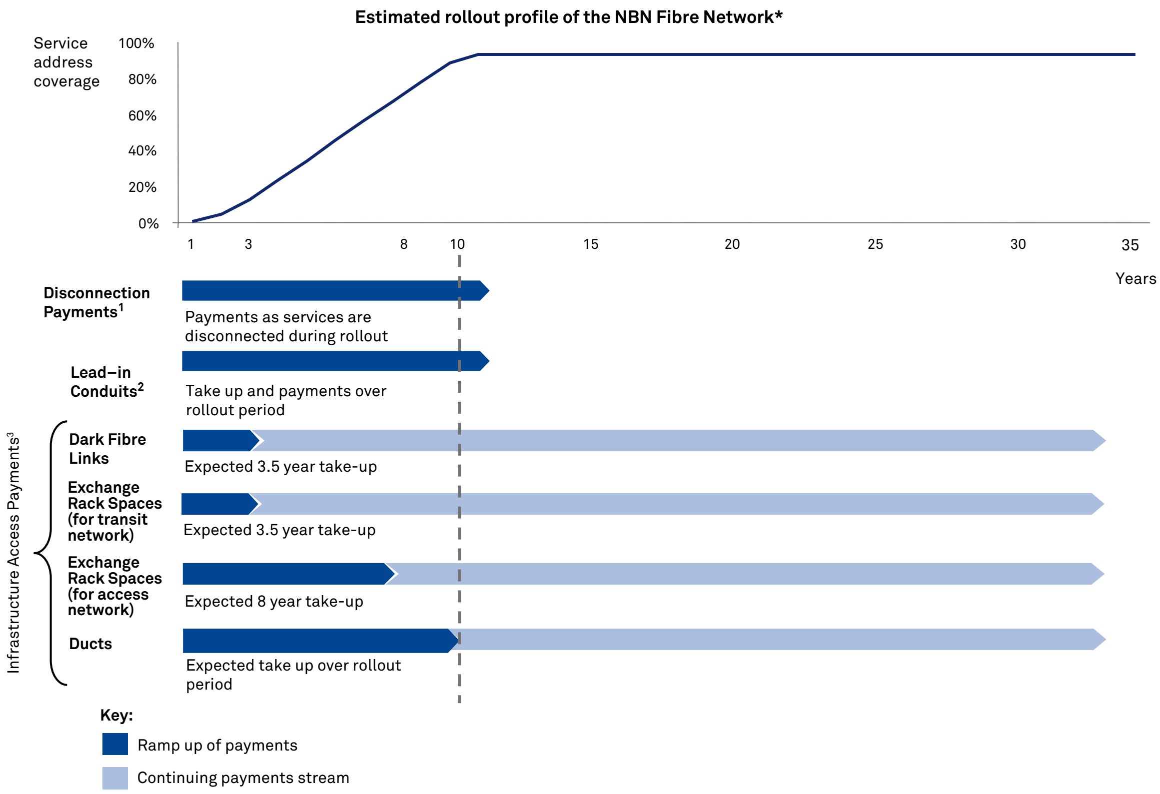
As illustrated in section 1.1, Telstra has experienced a decline in its fixed line voice revenues particularly since 2005 and the introduction of the NBN is expected to accelerate this decline.

While Telstra will lose much of its fixed line voice and broadband wholesale business as many of its wholesale customers move their business directly onto the NBN Fibre Network, it expects to save on future operating costs in relation to its Copper Network and HFC Cable Network as it reduces its use of these networks over time. Nonetheless, as Telstra will need to make access payments to NBN Co to provide most fixed line services to its customers using the NBN, it expects that margins on fixed line retail revenues will be reduced overall.

However, relative to other options, the Proposed Transaction is expected to deliver a better financial outcome for Telstra through:

- **Disconnection Payments that will help partially offset the loss of fixed line earnings and free cashflow:** Telstra will receive Disconnection Payments from NBN Co in respect of the disconnection of Copper Services and HFC Broadband Services provided to premises in the NBN Fibre Footprint;
- **A significant uplift to Telstra's infrastructure business:** NBN Co will be a new and significant customer as it accesses large volumes of certain types of Telstra's infrastructure on a long-term basis. Telstra will continue to own its infrastructure (apart from Lead-in Conduits) and will receive significant earnings and cashflow through Infrastructure Access Payments and the sale of Lead-in Conduits; and

FIGURE 6: ILLUSTRATIVE CASHFLOW PROFILE FOR PAYMENTS FROM NBN CO OVER MODELLING PERIOD



Note 1: Timing of Disconnection Payments is expected to lag the rollout of the NBN Fibre Network by up to 18 months, and will be affected by certain other mechanisms as per the Definitive Agreements. This is set out in further detail in section 4.
Note 2: Timing of payments for Lead-in Conduits may lag the rollout of the NBN Fibre Network.
Note 3: All Infrastructure Access Payments are expected over an assumed average period of 30 years.

*Estimated rollout profile of the NBN Fibre Network as set out in the NBN Co Corporate Plan.

- **Payments received and costs avoided through the Commonwealth package and other Government policy commitments:** As part of the Commonwealth package, Telstra will receive funding for the retraining of certain of its maintenance and engineering staff, payments from TUSMA for delivery of certain public interest services, such as the USO, and benefit from NBN Co undertaking a public information and education campaign. Telstra also expects to benefit through avoiding costs as a result of the Government policy commitment to transfer housing estate fibre provision responsibilities to NBN Co.

Importantly, as the rollout of the NBN Fibre Network progresses, Telstra's fixed line customers may consider which service provider they will use for NBN services. During the migration of voice and broadband services onto the NBN Fibre Network, Telstra will have the opportunity to attract new retail customers, but will also be faced with the challenge of retaining its existing retail customer base. Telstra believes it is well positioned in an NBN environment, given the strength of its existing customer relationships, its ability to leverage its economic scale and the reach of its operations, and the breadth of its product and service portfolio.

2.2.2.2 TELSTRA'S OTHER BUSINESSES

Telstra will continue to have the right to retain and operate other key networks such as its wireless networks, Next IP™ core fibre network and backhaul fibre network. However, the NBN may have implications for some of Telstra's businesses that use these networks.

In particular, Telstra's mobiles business may be negatively affected by the opportunity the NBN presents to other mobile carriers to improve their backhaul arrangements or to offer wireless only products as a substitute for NBN-based products.

The NBN may also lead to new opportunities and increased competition for some of Telstra's businesses such as IP and data, NAS, IPTV and pay TV services. Competition in markets in which these businesses operate may increase as other service providers use the NBN to deliver competing products and services. At the same time, Telstra also has the opportunity to use the NBN to provide innovative products and services through these business lines.

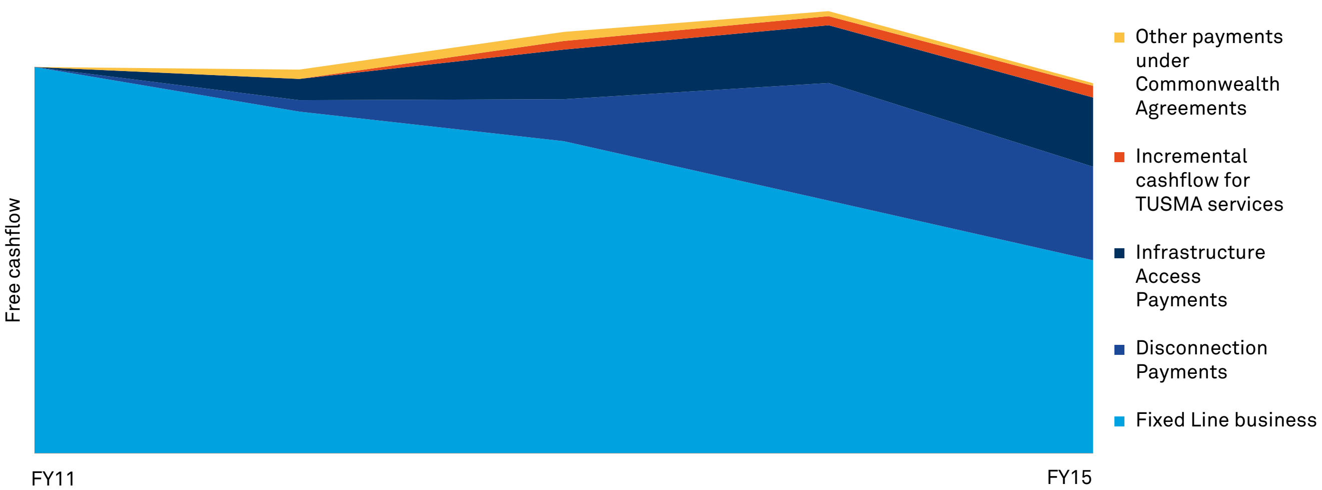
Telstra's other businesses such as its Asian Business Operations are expected to remain broadly unaffected by the introduction of the NBN.

2.2.2.3 SUSTAINABILITY OF TELSTRA'S CASHFLOW

Given the above benefits, while the Proposed Transaction is not expected to have a material impact on Telstra's financial results in the financial year ending 30 June 2012, it is expected to contribute to sustainable free cashflow generation by Telstra in the medium term.

Figure 7 provides an illustration of the expected trends in the composition of Telstra's fixed line business free cashflow, including payments received under the Proposed Transaction. As can be seen, payments and benefits received under the Proposed Transaction are expected to help offset the decline in free cashflow from the fixed line business in the medium term. At the same time, Telstra will focus on continuing to grow its mobiles business and other businesses, and expects these businesses to continue to contribute to sustainable free cashflow generation in the medium term.

FIGURE 7: ILLUSTRATIVE TREND OF TELSTRA'S FIXED LINE BUSINESS FREE CASHFLOW AND PAYMENTS RECEIVED UNDER THE PROPOSED TRANSACTION*



* The illustrative trend of the free cashflow excludes acquisitions, sales and investments, including any associated with acquisition of additional wireless spectrum. It also excludes certain benefits Telstra expects to achieve as a result of Government commitments (for example, funding of a public information campaign), including avoidance of certain costs associated with migration of services and certain payments which are not material. Further, the illustrative trends of the "Disconnection Payments", "Infrastructure Access Payments" and "Other payments under the Commonwealth Agreements" are dependent on the rollout of the NBN proceeding as set out in the NBN Co Corporate Plan. Further details are set out in section 5.

2.2.3 A MORE STABLE REGULATORY ENVIRONMENT

As part of the Proposed Transaction, Telstra has submitted an undertaking to the ACCC in which it commits to undergo structural separation in respect of all premises within the NBN Fibre Footprint which have been disconnected pursuant to the Definitive Agreements.

Telstra has also committed to various interim equivalence and transparency measures which relate to the supply by Telstra of certain Regulated Services to its wholesale customers and specified comparable retail services supplied by its retail business units. These measures are an extension of the existing regulatory and compliance requirements Telstra is required to meet, but also introduce some additional measures. The interim equivalence and transparency measures will apply until the Designated Day.

If the ACCC accepts Telstra's Structural Separation Undertaking and the Draft Migration Plan, and these documents come into force, Telstra will:

- have certainty in relation to the form of separation that will apply to its fixed line businesses;
- avoid the anticipated adverse costs and complexity associated with mandatory functional separation;
- have certainty that the Minister cannot impose the legislative prohibition under the CCS Act that would otherwise prevent Telstra from bidding for the next major release of wireless spectrum, which is considered necessary for Telstra to best continue the growth of its mobiles business; and
- retain its HFC Cable Network and its 50% equity interest in FOXTEL.

Unless there is significant legislative change, the Proposed Transaction is expected to provide Telstra with greater medium and long-term regulatory certainty than under the best available alternative. This is because:

- competition concerns over Telstra's vertical integration have been consistently identified as a major justification for the current level of access regulation of Telstra, so Telstra's voluntary structural separation should result in a lower risk of access regulation than under the best available alternative where Telstra remains vertically integrated; and
- Telstra will be compensated if a change in the scope of its USO responsibilities occurs after the commencement date of the TUSMA Agreement (being the later of 1 July 2012 or the date the Conditions Precedent are satisfied or waived).

The Proposed Transaction is also expected to provide Telstra with greater regulatory certainty relative to the best available alternative given current Government policy in the interim period up to the Designated Day:

- the Structural Separation Undertaking sets out the measures that will apply to Telstra to ensure equivalence and transparency around the supply of Regulated Services during this interim period. The ACCC cannot exercise its access powers in a manner which prevents Telstra complying with the Structural Separation Undertaking; and
- the Final Migration Plan deals with matters concerning the timing of, and processes involved in, the disconnection of Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out. Once a matter is dealt with in the Final Migration Plan, it is not possible for the ACCC to later impose additional regulatory obligations on Telstra in relation to the same matter (except to the extent this is provided for in the Final Migration Plan itself), during the life of the Final Migration Plan.

2.2.4 GREATER STRATEGIC FLEXIBILITY

Compared with other realistically available options given current Government policy, the greater regulatory certainty and the better financial outcome expected to be delivered by the Proposed Transaction will provide Telstra with greater strategic flexibility. Telstra's strategic focus, and its future in an NBN environment, is described in greater detail in section 2.3.

2.2.5 PROTECTIONS IN THE EVENT OF A CHANGE IN POLICY

An important consideration by the Directors has been the protection of Telstra Shareholders, as far as practicable, from the risks associated with changes in Government policy, including a possible change of Government. In particular, the Directors considered the potential implications for Telstra should the rollout of the NBN Fibre Network cease before it is completed. If this occurs, Telstra may not receive some of the cashflow or the benefit of some of the cost savings it otherwise expects to receive under the Proposed Transaction and the interim equivalence and transparency commitments in the Structural Separation Undertaking would continue. There are, however, four key protections on which Telstra can rely.

- **Long-term contractual commitments from NBN Co for certain infrastructure:** NBN Co will still be required to pay Telstra access payments under the long-term contract for infrastructure in use or subject to a confirmed order at the time the rollout ceases, except in certain circumstances.
- **A rollout termination payment of up to $500 million:** NBN Co has agreed, subject to limited exceptions, to compensate Telstra up to $500 million if, having reached a minimum of 20% of NBN Co's fibre coverage target (93% of premises), the rollout ceases. The amount payable scales down as NBN Co rolls out the NBN Fibre Network beyond 20% of the coverage target.

- **Protection against automatic termination of certain elements of the Government package:** The TUSMA Agreement (as a whole) cannot be automatically terminated if the rollout of the NBN Fibre Network has passed 20% of NBN Co's 93% coverage target. Instead, it requires the parties to renegotiate the TUSMA Agreement based on certain principles and, if they cannot agree, for arbitration in accordance with those principles.
- **The right to continue to operate Telstra's existing fixed line businesses in areas where the NBN Fibre Network has not been rolled out:** Telstra will be able to continue to generate earnings and cashflow from the ongoing operation of the Copper Network and HFC Cable Network in areas where the rollout of the NBN Fibre Network has not occurred.

Further details on these protection mechanisms are set out in section 3.4.5(c).

2.3 TELSTRA'S FUTURE IN AN NBN ENVIRONMENT

Telstra has been preparing to operate in an NBN environment since the NBN policy was announced in April 2009, and believes it is well positioned to address the challenges and pursue the opportunities of operating in an NBN environment for the following reasons:

- Telstra's existing strategic priorities and competitive strengths will continue to be relevant in an NBN environment;
- the NBN will accelerate existing trends with which Telstra is familiar and to which it is already responding; and
- the Proposed Transaction and the rollout of the NBN will create new opportunities for Telstra.

2.3.1 TELSTRA'S PRIORITIES

Telstra has already implemented significant initiatives to become a more sales, marketing and service led company. Accordingly, Telstra is focused on four key priorities:

- to improve customer satisfaction;
- to retain and grow its customer base;
- to simplify its business; and
- to develop new growth opportunities in Media, NAS and its Asian Business Operations.

2.3.2 TELSTRA'S STRATEGIC FOCUS AND COMPETITIVE STRENGTHS

Telstra believes that its competitive strengths provide a strong foundation from which it can pursue its strategic priorities as Telstra transitions to the NBN Fibre Network. In particular:

- **Comprehensive customer base and brand strength:** Telstra's comprehensive customer base and its understanding of customer needs, as well as the extensive recognition and reach of the Telstra brand, are expected to assist it to achieve a high level of customer retention during the transition to the NBN Fibre Network.
- **Scale in terms of economics and national reach:** Telstra's ability to leverage its economic scale, through initiatives aimed at improving service delivery, improving productivity and reducing costs, should enable it to achieve a competitive cost position as a Retail Service Provider on the NBN Fibre Network. Telstra's national scale and reach of operations should also continue to be a critical point of differentiation, particularly for business and enterprise customers.
- **Breadth of products:** Telstra's wide range of products and services, coupled with its experience in delivering voice and data services, should position it strongly to compete with other Retail Service Providers offering services on the NBN Fibre Network. Telstra is uniquely positioned in the Australian telecommunications market in having strengths across a broad product portfolio, including Media, NAS, and mobile services. In an NBN environment, Telstra still expects to have the largest range of products available, with an increasing focus on media and content, NAS and integration with wireless. This will be a key competitive advantage for Telstra as few of its competitors are expected to be able to match Telstra's offerings.
- **Deep engineering and design expertise:** While Telstra will largely cease operating its Copper Network, engineering excellence will still be critical in Telstra's businesses. As business and home solutions become more complex, Telstra's understanding of technology will be important in creating user-friendly services that deliver customer needs. Telstra's deep engineering and design capability will be critical to achieving superior performance from its core IP network, delivering high quality solutions for its mobile and corporate customers, and supporting the expansion of its media business.

2.3.3 ACCELERATING EXISTING TRENDS

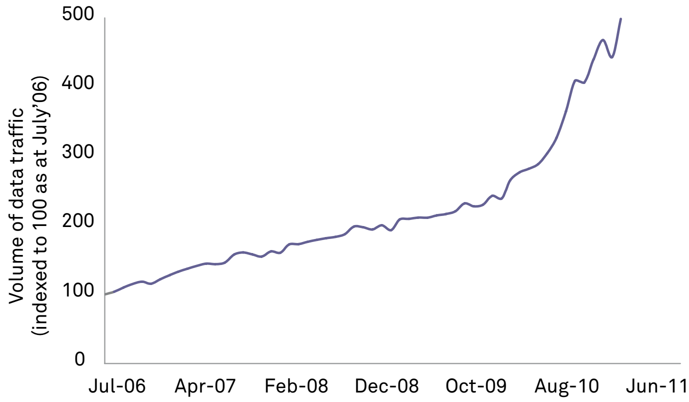
Telstra believes the introduction of the NBN will accelerate existing market trends in telecommunications. Telstra is already responding to these trends to maximise the available benefits and minimise adverse consequences. These trends include:

- **Ongoing decline in fixed line voice revenue and the rise of "next generation" voice:** Telstra has been experiencing a decline in its fixed line voice business for a number of years, consistent with trends in many international markets, and is already experiencing increased customer demand for the next generation of voice services, such as VOIP and video conferencing. Telstra believes the NBN will accelerate these trends and that it is well positioned to respond to these changing market dynamics.

Moreover, under the Proposed Transaction, Telstra will receive consideration for, among other things, ceasing to provide fixed line voice services on its own networks and for providing NBN Co with access to certain types of Telstra's infrastructure which Telstra will continue to own.

- **Shift towards product bundling:** Telstra offers a wide range of products and services to its customers as a bundle (or a package of services) to maximise the customer relationship and enhance the customer experience. For example, Telstra has increased its offering of bundled fixed voice and broadband services. Retail Service Providers, such as Telstra, are likely to use the NBN and their own wireless networks to offer more bundled products in order to enhance the customer experience and maximise the value generated. However, it is also possible that customers may elect to acquire basic broadband connectivity from one Retail Service Provider, and select a personalised range of voice and other applications from various other Retail Service Providers.
- **Differentiation through content and devices:** Voice and broadband products have increasingly become commoditised in the telecommunications industry. Many service providers offer similar packages and similar devices (such as smartphones and tablet computers) with their service offerings. In response, Telstra has actively sought to differentiate its products from others through higher levels of service, access to content and unique devices (for example, T-Box®, T-Hub®). Telstra believes these areas of differentiation will become even more valuable in an NBN environment.
- **Rapid growth of data usage:** Consumer use of data-based products (such as broadband) has grown substantially in recent years, as evidenced by the 80% growth in broadband data traffic per user on the Copper Network in the financial year ended 30 June 2011. Further growth is likely to be stimulated by demand for data intensive services such as video-on-demand and the emergence of "cloud computing", which provides consumers with on-demand access to a shared pool of computing resources (such as software and data) from any network device (such as a laptop computer or smartphone). Telstra believes "cloud computing" is a substantial opportunity and has already made commitments to deliver enhanced "cloud computing" services to its customers. The rollout of the NBN Fibre Network will likely further accelerate this trend. Telstra's use of the NBN Fibre Network means that it can meet customer demand without having to invest substantial capital preparing its Copper Network or HFC Cable Network in anticipation of increased demand. In effect, the Proposed Transaction transfers some of this demand risk from Telstra to NBN Co. Moreover, Telstra will retain its Next IP™ core fibre network to provide core network capacity for this ongoing trend.

FIGURE 8: TELSTRA'S FIXED BROADBAND TRAFFIC GROWTH



- **Changes in the competitive landscape:** The telecommunications industry is a competitive industry with many operators. The NBN is likely to change the competitive landscape as some consumers may change service providers when moving onto an NBN-based product or service and new entrants may emerge, possibly in regional areas. Telstra already operates in a highly competitive environment and is well positioned to respond to changes in the competitive landscape.

2.3.4 OPPORTUNITIES FOR TELSTRA

Telstra also believes the rollout of the NBN and Telstra's participation through the Proposed Transaction will generate opportunities for Telstra. These include:

- **Opportunities to differentiate which require less capital:** The use of the NBN will give Telstra the opportunity to provide new applications and services over the NBN. This will allow Telstra to expand its NAS business and use its product development expertise to bring new products and services to customers without the need for substantial network-based capital investment.
- **Opportunity to further simplify Telstra's operating model:** Under the Proposed Transaction, Telstra will transition to becoming a network reseller on a large scale for the first time. Although there are likely to be complexities arising during the build and operate phase of the NBN Fibre Network, it provides Telstra with an opportunity to further redesign and simplify its operating model in order to generate significant cost savings and performance improvements. Telstra believes this simplification is essential for it to maintain and improve its competitiveness.
- **Customer retention and opportunities during migration period:** The migration of services onto the NBN Fibre Network will create significant challenges and opportunities for Telstra, as it seeks to retain its existing retail customers and attract new retail customers. Telstra believes it is well positioned in an NBN environment, given the depth of its existing customer relationships, its ability to leverage its economic scale and the reach of its operations and the breadth of its product and service portfolio.

- **New applications and ventures:** Telstra will focus on incubating innovation across new digital applications, including the NBN Fibre Network.

While the Proposed Transaction is expected to provide benefits and opportunities for Telstra, it also involves a number of material risks and operational challenges. The material risks associated with the Proposed Transaction are set out in section 3.4.

2.4 INDEPENDENT EXPERT'S OPINION

The Independent Expert has concluded that the Proposed Transaction is in the best interests of Telstra and Telstra Shareholders.

2.4.1 INDEPENDENT EXPERT'S APPROACH

The Independent Expert's primary analysis has been to assess the merits of the Proposed Transaction relative to the alternatives available to Telstra in light of the rollout of the NBN and the recent legislative changes. Based on a discounted cashflow analysis, the Independent Expert has concluded that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion greater than under the best available alternative. The Independent Expert's assessment is made on a post-tax net present value basis as at June 2011.

The approach adopted by the Independent Expert in its assessment of the Proposed Transaction is similar to that taken by the Directors in their assessment of the Proposed Transaction compared with the best available alternative given current Government policy. In both cases, the assessment takes into account the value delivered to Telstra by the Proposed Transaction and associated Government policy commitments. The Directors, however, used some different assumptions compared with those used by the Independent Expert.

The material differences in the assumptions and the difference in the overall approach adopted are:

- **option to operate the Copper Network and broadband services on the HFC Cable Network:** the Directors adopted a different approach to that of the Independent Expert to assess the loss of value attributable to the fact that Telstra will no longer have the option to operate the Copper Network and broadband services on the HFC Cable Network in the NBN Fibre Footprint;
- **prohibition from bidding for wireless spectrum and other potential regulatory imposts:** the Independent Expert has assumed a lesser impact than Telstra has in relation to the prohibition on Telstra from bidding for the next major release of wireless spectrum and other potential regulatory imposts Telstra may face if it did not elect to undergo voluntary structural separation;
- **rollout of the NBN:** while Telstra has assumed that the rollout of the NBN Fibre Network will proceed as set out in the NBN Co Corporate Plan, the Independent Expert has assumed that there will be an extension or delay; and
- **cost of capital:** Telstra has assumed a cost of capital of 10%, which is consistent with its internal weighted average cost of capital. The Independent Expert has assumed a cost of capital of 9%.

Finally, the Independent Expert has used a different valuation date to that used in internal analysis by Telstra. Telstra has discounted all cashflows to the time of signing of the Financial Heads of Agreement in June 2010 to facilitate direct comparison with the terms agreed and the assessment undertaken at that time. The Independent Expert has discounted all cashflows to June 2011. The use of different valuation dates does not have a material impact on the assessment of the Proposed Transaction relative to the best available alternative.

2.4.2 OTHER KEY CONCLUSIONS DRAWN BY THE INDEPENDENT EXPERT

The Independent Expert has also drawn two other key conclusions following its assessment of the Proposed Transaction:

- if the rollout of the NBN Fibre Network is not completed as planned, Telstra Shareholders would still be better off if they approved the Proposed Transaction; and
- even if the likelihood of the NBN being terminated early were materially increased by Telstra Shareholders not approving the Proposed Transaction, the expected value of Telstra (based on probability weighted decision tree analysis) if the Proposed Transaction is implemented is greater than under the next best alternative.

A full copy of the Independent Expert's Report is set out in Annexure 1.

2.5 WHAT WILL HAPPEN IF TELSTRA SHAREHOLDERS DO NOT APPROVE THE PROPOSED TRANSACTION?

The Proposed Transaction is conditional on Telstra Shareholder approval.

If Telstra Shareholders do not approve the Proposed Transaction, it will not proceed and Telstra will not participate in the rollout of the NBN (other than by providing NBN Co with access to certain infrastructure on an agreed, and/or potentially regulated, basis).

Importantly, the Government has stated that the rollout of the NBN will still proceed even if Telstra Shareholders do not approve the Proposed Transaction.

In addition, if the Proposed Transaction does not proceed, Telstra:

- will not receive payments from NBN Co on the scale anticipated under the Proposed Transaction;
- will not realise the value it has attributed to the Commonwealth Agreements and associated Government policy commitments (including the benefits of the revised USO arrangements), which Telstra has assessed as having a post-tax net present value of $2 billion;
- will continue for a period of 10 years to provide NBN Co with access to Telstra infrastructure that is in use and certain other infrastructure that has been ordered by NBN Co during the interim period from signing of the Definitive Agreements until it is determined that the Proposed Transaction will not proceed;
- would expect to undergo mandatory functional separation, resulting in expected significant separation costs in the order of $1 billion over the next five years and reduced strategic flexibility;
- would likely be prohibited from bidding for the next major release of wireless spectrum, which would be expected to have adverse consequences for Telstra's mobiles business;
- may be subject to adverse regulatory imposts, which could include the ACCC exercising its powers under the Competition and Consumer Act to compulsorily require Telstra to grant NBN Co access to parts of Telstra's infrastructure (for example, Exchange Rack Spaces or Ducts) on defined terms and conditions, and/or more stringent regulation of Telstra's Universal Service Obligation, the Customer Service Guarantee and Priority Assistance arrangements; and
- will be more reliant on its own infrastructure to compete, which may be constrained by legislative restrictions on superfast broadband networks. Current legislation provides that if, after 1 January 2011, a superfast broadband network is built or extended, or any existing network that was not operating with a download speed normally exceeding 25 megabits per second at that date, is upgraded to become a superfast broadband network, that network has to be operated on a wholesale-only basis and wholesale broadband services supplied on terms regulated by the ACCC.

The Independent Expert has assessed that the value of Telstra if it does not participate in the rollout of the NBN would be approximately $4.7 billion less than if the Proposed Transaction is implemented. This is on a post-tax net present value basis as at June 2011.

In light of the above, the Directors currently believe that Telstra's best course of action in these circumstances would be to continue to operate its networks and upgrade them where feasible, in order to compete with NBN Co. In particular, Telstra may further upgrade the HFC Cable Network to deliver high speed broadband and voice services, and could consider expansion. While Telstra would expect to generate additional earnings from the HFC Cable Network, it would incur additional upgrade costs. There may also be greater uncertainty in the Australian telecommunications industry, and for Telstra, as NBN Co's competitive strategies in such an environment are presently unknown.

3. IMPORTANT CONSIDERATIONS, ADVANTAGES, DISADVANTAGES AND RISKS

This section of the Explanatory Memorandum contains important information that Telstra Shareholders should consider before deciding whether or not to vote in favour of the Resolution to approve the Proposed Transaction.

This section contains:

- important considerations for Telstra Shareholders (set out in section 3.1);
- advantages of the Proposed Transaction (set out in section 3.2);
- disadvantages of the Proposed Transaction (set out in section 3.3); and
- material risks associated with the Proposed Transaction (set out in section 3.4).

3.1 IMPORTANT CONSIDERATIONS FOR TELSTRA SHAREHOLDERS

3.1.1 DIRECTORS' RECOMMENDATION

The Directors unanimously recommend that Telstra Shareholders vote in favour of the Resolution to approve the Proposed Transaction. In forming this view, the Directors have considered the advantages, disadvantages and material risks associated with the Proposed Transaction.

Section 2.1 contains further details about the Directors' recommendation.

3.1.2 INDEPENDENT EXPERT'S CONCLUSION

The Independent Expert has concluded that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion (post-tax net present value as at June 2011) greater than under the best available alternative, and that the Proposed Transaction is in the best interests of Telstra and Telstra Shareholders.

The Independent Expert's views are summarised in section 2.4. The Independent Expert's Report is set out in Annexure 1.

3.2 ADVANTAGES OF THE PROPOSED TRANSACTION

The Proposed Transaction is expected to provide Telstra with a better financial outcome, delivering approximately $11 billion in post-tax net present value to Telstra

The Proposed Transaction and associated Government policy commitments are expected to deliver approximately $11 billion in post-tax net present value to Telstra as at June 2010, subject to a range of dependencies and assumptions. This value does not include broader benefits which Telstra may gain from the Definitive Agreements and which are hard to quantify. This value will not be in the form of an upfront payment, but is the present value of consideration and benefits to be received over many years. Further, it is not an assessment of the overall impact of the Proposed Transaction on the underlying value of Telstra, which has been separately considered by the Independent Expert in its assessment of the Proposed Transaction.

The $11 billion in post-tax net present value comprises approximately:

- $4.0 billion from NBN Co for Disconnection Payments and sale of Lead-in Conduits;
- $5.0 billion from NBN Co for Infrastructure Access Payments; and
- $2.0 billion attributed to Commonwealth contributions and costs avoided, including for housing estate fibre provisioning responsibilities, commitments for TUSMA funding for certain migration costs, staff retraining and NBN Co's public education campaign funding.

The Proposed Transaction is therefore expected to contribute to sustainable free cashflow generation in the medium term, which will provide Telstra with greater financial flexibility than under the best available alternative given current Government policy.

The Proposed Transaction should provide Telstra with greater regulatory certainty

If the Proposed Transaction proceeds, Telstra will undertake voluntary structural separation pursuant to the Structural Separation Undertaking. Accordingly, if the ACCC accepts Telstra's Structural Separation Undertaking and Draft Migration Plan, and these documents come into force, Telstra will:

- have certainty in relation to the form of separation that will apply to its fixed line businesses;
- avoid the anticipated adverse costs and complexity associated with mandatory functional separation as outlined in section 1.3;
- have certainty that the Minister cannot impose the legislative prohibition under the CCS Act that would otherwise prevent Telstra from bidding for the next major release of wireless spectrum, which is considered necessary for Telstra to best continue the growth of its mobiles business; and
- retain its HFC Cable Network and its 50% equity interest in FOXTEL.

Unless there is significant legislative change, the implementation of the Proposed Transaction is also expected to provide Telstra with greater medium and long-term regulatory certainty than under the best available alternative. This is because:

- competition concerns over Telstra's vertical integration have been consistently identified as a major justification for the current level of access regulation of Telstra, so once Telstra has achieved full voluntary structural separation, it should face less risk of access regulation than under the best

available alternative where Telstra remains vertically integrated; and
- Telstra would be compensated if a change in the scope of its USO responsibilities occurs after the commencement of the TUSMA Agreement (being the later of 1 July 2012 or the date the Conditions Precedent are satisfied or waived).

The Proposed Transaction is also expected to provide Telstra with greater regulatory certainty in the interim period to the Designated Day:

- the Structural Separation Undertaking sets out various equivalence and transparency measures that will apply to Telstra in relation to the supply of certain Regulated Services to its wholesale customers during this interim period. The ACCC cannot exercise its access powers in a manner which prevents Telstra complying with the Structural Separation Undertaking; and
- the Final Migration Plan deals with matters concerning the timing of, and processes involved in, the disconnection of Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out. Once a matter is dealt with in the Final Migration Plan, it is not possible for the ACCC later to impose additional regulatory obligations on Telstra in relation to the same matter (except to the extent this is provided for in the Final Migration Plan itself), during the life of the Final Migration Plan.

Telstra expects to benefit from this more stable regulatory environment.

The Proposed Transaction is complementary to Telstra's current strategy and will provide greater flexibility

The Directors consider that the Proposed Transaction will allow Telstra to focus on implementing its corporate strategy and capturing the opportunities that flow from doing so. The Proposed Transaction reinforces Telstra's current strategy to strive to service and meet the needs of customers, continue to simplify its business and pursue existing and new growth opportunities in Media, NAS and its Asian Business Operations. Some of these opportunities will be made possible by the introduction of the NBN.

The Proposed Transaction should allow Telstra to bid for future wireless spectrum

If the ACCC accepts the Structural Separation Undertaking lodged by Telstra and if the Minister grants Telstra the waivers from divestiture of the HFC Cable Network and its 50% equity interest in FOXTEL (which are both effectively preconditions to the Proposed Transaction proceeding), Telstra will avoid the risk that the Minister could impose the legislative prohibition under the CCS Act to prevent Telstra from bidding for the next major release of wireless spectrum. This will mean that Telstra will not be prohibited under the CCS Act from bidding for, or otherwise acquiring, certain next generation wireless spectrum when it becomes available. Access to this spectrum is considered necessary for Telstra to efficiently roll out LTE or 4G wireless technology in order to meet expected growth in customer demand for such services. Any prohibition from access to this spectrum would have a material adverse impact on Telstra's future mobiles business, as outlined in section 1.3.

The Proposed Transaction provides Telstra with protections in the event that the rollout of the NBN Fibre Network ceases before its completion

The Definitive Agreements contain mechanisms that will afford Telstra some protection in the event that NBN Co's rollout of the NBN Fibre Network ceases before it is completed or is much slower than expected. If this occurs, there are four key protections on which Telstra can rely:

- long-term contractual commitments by NBN Co to pay for certain infrastructure in use or subject to a confirmed order at the time the rollout ceases, except in certain circumstances;
- a rollout termination payment from NBN Co of up to $500 million if, having reached a minimum of 20% of NBN Co's current fibre coverage target (93% of premises), the rollout ceases or is very slow (subject to limited exceptions). The amount payable scales down as NBN Co rolls out the NBN Fibre Network beyond 20% of that target;
- if the rollout of the NBN Fibre Network has passed 20% of NBN Co's fibre coverage target (93% of premises), protection against automatic termination of certain elements of the TUSMA Agreement, such as the payments for the supply of USO services, through the obligation to renegotiate the TUSMA Agreement based on certain principles and if agreement cannot be reached, provides for arbitration in accordance with those principles; and
- retention of cashflow as a result of Telstra being able to continue to operate its existing fixed line businesses in areas where the NBN Fibre Network has not been rolled out.

3.3 DISADVANTAGES OF THE PROPOSED TRANSACTION

The assessed value of the Proposed Transaction and associated Government policy commitments is subject to a range of dependencies and assumptions and cannot be guaranteed

If the Proposed Transaction is implemented, Telstra expects that it and the associated Government policy commitments will deliver to it approximately $11 billion in post-tax net present value. This value is subject to a range of dependencies and assumptions over the life of the Definitive Agreements. Among other things, they include:

- NBN Co proceeding with the rollout of the NBN Fibre Network in accordance with the NBN Co Corporate Plan; and
- Telstra providing NBN Co with access to infrastructure in accordance with fitness standards and timetables specified in the Definitive Agreements.

Due to these dependencies and assumptions, the value finally delivered to Telstra by the Proposed Transaction and the associated Government policy commitments may vary from the approximately $11 billion in post-tax net present value.

The Proposed Transaction will require Telstra to incur customer migration and infrastructure remediation costs

If the Proposed Transaction is implemented, Telstra also expects to incur some costs to meet its infrastructure commitments to NBN Co and migrate customers onto the NBN Fibre Network. This includes an estimated incremental $0.5 billion of costs over 10 years relating to operational expenses brought forward. These are accelerated customer migration costs borne as a consequence of the rollout of the NBN Fibre Network and costs in relation to necessary work on infrastructure required by NBN Co. Given this represents less than 1% of Telstra's likely total operating expenditure over the same 10 year period, Telstra expects to be able to account for these incremental costs within existing expenditure profiles by achieving savings in other areas of its business.

Telstra will also incur a further approximately $0.9 billion of capital expenditure for necessary work on infrastructure and customer migration costs, as well as approximately $0.6 billion of operational expense for necessary work on infrastructure and maintenance activities. These costs are within Telstra's existing capital expenditure programs and operating expense targets and substitute for costs Telstra would have otherwise incurred. As such, they are not considered incremental to Telstra's current operations.

All of the above cost estimates are on a post-tax net present value basis as at June 2010. Further details on these costs are set out in section 5.4.

The Proposed Transaction will mean that Telstra will no longer operate Copper Services and HFC Broadband Services in areas where the NBN Fibre Network is rolled out

If the Proposed Transaction is implemented, Telstra will no longer operate Copper Services and HFC Broadband Services in areas where the NBN Fibre Network is rolled out. Instead, Telstra will be heavily reliant on the NBN Fibre Network for the provision of fixed line services to its wholesale and retail customers and may not be able to negotiate the network changes needed to meet the future requirements of its customers, its regulatory obligations or its obligations under the TUSMA Agreement.

There is significant operational complexity and risk involved in implementing the Proposed Transaction

There is considerable operational complexity and risk involved in implementing the Proposed Transaction. In particular, under the NBN Co Agreements, Telstra is required to disconnect Copper Services and HFC Broadband Services progressively in line with the rollout of the NBN Fibre Network. Further, payments from NBN Co to Telstra for access to large volumes of certain Telstra infrastructure are subject to Telstra meeting the agreed timetable and fitness standards specified in the Definitive Agreements. In order for Telstra to meet its obligations under the Definitive Agreements, considerable operational focus and significant management attention and oversight will be required.

3.4 MATERIAL RISKS ASSOCIATED WITH THE PROPOSED TRANSACTION

The Proposed Transaction involves a number of material risks that Telstra Shareholders should consider before deciding whether or not to approve the Proposed Transaction.

In addition to the risks associated with the Proposed Transaction, there are a number of risks which relate to Telstra generally. These risks already exist for Telstra Shareholders through their ownership of Telstra Shares and are not described in this section.

The material risks associated with the Proposed Transaction and currently known to Telstra fall into the following broad categories:

Category	Where to find more information
Risks to completion of the Proposed Transaction	Section 3.4.1
Regulatory risks	Section 3.4.2
Risks to Telstra's performance of its obligations under the Definitive Agreements and regulatory undertakings, and possibility of increased costs	Section 3.4.3
Risks to underlying assumptions supporting Telstra's assessment of the Proposed Transaction	Section 3.4.4
Risks to expected payments	Section 3.4.5
NBN Co performance risks	Section 3.4.6

This is not an exhaustive list of the risks associated with the Proposed Transaction and should be considered in conjunction with other information disclosed in this Explanatory Memorandum, including:

- important considerations for Telstra Shareholders (set out in section 3.1);
- the "Advantages of the Proposed Transaction" and the "Disadvantages of the Proposed Transaction" (set out in sections 3.2 and 3.3); and

- any forward looking statements in this Explanatory Memorandum and the cautionary statement regarding forward looking statements on page i.

These risks have been identified as material because they may materially adversely affect the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance if it implements the Proposed Transaction. Further, risks unknown to Telstra and other risks, currently believed to be immaterial, could prove to be material.

Telstra may mitigate some of the risks described below by using appropriate systems and processes. Many of the risks are, however, outside of Telstra's control.

3.4.1 RISKS TO COMPLETION OF THE PROPOSED TRANSACTION

a. A regulator may require Telstra to accept terms less favourable than those described in this Explanatory Memorandum, to secure the satisfaction of a Condition Precedent

A number of Conditions Precedent, including Telstra Shareholder approval, must be satisfied or waived by the End Date for the Proposed Transaction to proceed.

As at the date of this Explanatory Memorandum, the key outstanding Conditions Precedent are:

- acceptance by the ACCC of the Structural Separation Undertaking and approval by the ACCC of the Draft Migration Plan, in a form acceptable to both Telstra and NBN Co; and
- separate ATO private rulings relevant to Telstra and NBN Co confirming the intended tax treatment of elements of the Proposed Transaction.

These key Conditions Precedent are explained in more detail below. A description of all outstanding Conditions Precedent as at the date of this Explanatory Memorandum is set out in section 6.2.1.

If the key Conditions Precedent are not satisfied or waived, the Proposed Transaction will not proceed. Telstra will update Telstra Shareholders on any material developments relating to the status of the outstanding Conditions Precedent through announcements to the ASX.

Structural Separation Undertaking and Draft Migration Plan

The acceptance of the Structural Separation Undertaking and approval of the Draft Migration Plan by the ACCC is required. Prior to doing so, the ACCC may request changes to those documents before giving its approval. For example, the ACCC may request additional interim equivalence and transparency requirements (described in section 4.4.2.2) in Telstra's Structural Separation Undertaking, or may seek to impose additional requirements in the Draft Migration Plan, such as requiring Telstra to assume a greater role in managing the migration process on behalf of wholesale customers, or which otherwise constrain Telstra's ability to compete to a greater extent than that described in this Explanatory Memorandum. This may materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's operations and/or its financial position and performance.

ATO tax rulings

The ATO may not issue the private ruling sought by Telstra or may issue a ruling in a form that does not satisfy the relevant Condition Precedent. In that event, Telstra will face a decision whether to waive the relevant Condition Precedent, and if so, there is a risk that the Proposed Transaction may proceed on terms that are less favourable to Telstra than those outlined in this Explanatory Memorandum. Further, the ATO may not issue the private ruling sought by NBN Co or may issue a ruling in a form that is unacceptable to NBN Co. In that event, if NBN Co did not waive the relevant Condition Precedent, Telstra would be reliant on NBN Co resolving this issue before the Proposed Transaction could proceed. This may materially adversely affect the value of the Proposed Transaction to Telstra.

3.4.2 REGULATORY RISKS

Descriptions of the Commonwealth Agreements and the Regulatory Undertakings referred to in this section 3.4.2 are set out in sections 4.3 and 4.4 of this Explanatory Memorandum.

a. Telstra faces risks associated with having to comply with the Structural Separation Undertaking and Final Migration Plan

When the Structural Separation Undertaking comes into force, these commitments will be legally binding and, in addition to remedies set out in the Structural Separation Undertaking, the ACCC can seek remedies to enforce them in the Federal Court of Australia.

If a breach is proved, the Court may direct Telstra to comply with the Structural Separation Undertaking or the Final Migration Plan or impose severe remedies such as fines of up to $10 million, orders to dispose of assets or to prevent Telstra from paying dividends and other remedies the Court considers appropriate (although such severe penalties would only be applied in the case of very significant breaches). This could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's operations and/or its financial position and performance.

An overview of the Structural Separation Undertaking, including the interim equivalence and transparency requirements, is set out in section 4.4.

b. Despite the TUSMA Agreement, Telstra faces risks from continuing to be the retail provider of last resort of Standard Telephone Services

Under the TUSMA Agreement, Telstra will be required to use the NBN Fibre Network to fulfil the obligations of the universal service provider, including after the regulatory obligation for the supply of the underlying infrastructure has shifted to TUSMA. There is a risk that Telstra, in fulfilling this obligation, could be adversely affected given:

- the Government retains powers to control Telstra's retail prices and can decrease those prices, which could reduce Telstra's revenues from providing Standard Telephone Services. The Government has announced it does not intend to change the current retail price controls in a way that adversely affects Telstra and if it does, it will renegotiate the TUSMA Agreement so that Telstra is no worse off. However, this is only a policy announcement and the Government of the day may not be bound by it; and
- NBN Co could increase or restructure its prices for the access services which Telstra uses to supply Standard Telephone Services, which could increase Telstra's costs of providing those services. The Government's policy commitment on retail price controls does not extend to ensuring Telstra has flexibility under the retail price controls to recover an increase in NBN Co's access prices.

If Telstra's revenues from providing Standard Telephone Services decrease and/or its costs of providing those services increase, this may materially adversely affect the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance.

Telstra is also currently subject to a USO industry levy. The Government's current policy is to introduce a new industry levy on a basis that is similar to the existing USO industry levy. However, the Government may change the USO industry levy in a way that materially adversely affects the value of the Proposed Transaction to Telstra, Telstra's operations and/or its financial position and performance.

c. Changes to regulation may adversely affect the value to Telstra of the NBN arrangements

There is a regulatory regime that provides the framework for the arrangements between NBN Co and Telstra. The Government of the day could change that regime by (among other things) amending the relevant legislation, changing ministerial instruments, applying additional licence conditions on Telstra or other exercises of ministerial discretion. Decisions of a regulator could also have the effect of changing the regulatory regime (together, "regulatory change"). It is not possible to predict with any certainty whether there could be such a change and, if so, what form it could take or its impact on Telstra.

For example, regulatory change could:

- prevent or impose additional conditions on Telstra in disconnecting premises from its Copper Network and HFC Cable Network in a manner that impacts on Telstra's ability to receive payments from NBN Co and/or the timing of those payments;
- impose additional equivalence or separation requirements on Telstra, which could impose further constraints on Telstra's ability to compete effectively; and/or
- constrain or prevent Telstra from bidding for certain wireless spectrum or sufficient quantities of wireless spectrum (including under the Radiocommunications Act).

In certain circumstances, a regulatory change that materially adversely affects Telstra's costs gives Telstra and NBN Co a right to renegotiate the NBN Co Agreements. If the parties are unable to agree on the changes, then, ultimately, the parties will have the right to terminate one or all of the agreements.

Changes to NBN regulation could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's operations and/or its financial position or performance.

3.4.3 RISKS TO TELSTRA'S PERFORMANCE OF ITS OBLIGATIONS UNDER THE DEFINITIVE AGREEMENTS AND REGULATORY UNDERTAKINGS, AND POSSIBILITY OF INCREASED COSTS

a. Telstra may not be able to meet its delivery obligations under the Definitive Agreements, the Structural Separation Undertaking or the Final Migration Plan or there may be unforeseen difficulties in meeting those obligations

Various obligations are placed on Telstra under the Definitive Agreements, the Structural Separation Undertaking and the Final Migration Plan. Telstra needs to implement an effective and extensive work program to ensure it is able to meet those obligations. The size and complexity of this work program means that there are risks that:

- Telstra will be unable to meet its obligations to the agreed fitness standards or within the required time period, resulting in Telstra being exposed to increased costs and penalties (including monetary compensation to NBN Co);
- Telstra may not be entitled to receive certain payments from NBN Co for delivery of access to its infrastructure;
- the costs incurred in implementing the work program may be higher than anticipated; and
- the processes Telstra will need to adopt may hinder its competitiveness more than currently expected.

Importantly, Telstra will put in place new systems and processes to allow it to manage the transition from access provider to access seeker. Telstra currently operates as a vertically integrated provider of services on its Copper Network and HFC Cable Network. If the Proposed Transaction is implemented, Telstra will become a Retail Service Provider that seeks access to services on the NBN Fibre Network. While Telstra may have to make this transition regardless of whether the

Proposed Transaction is implemented, Telstra will need to put in place the required systems and processes in a shorter timeframe under the Proposed Transaction. There is a risk that Telstra will be unable to manage efficiently this transition from access provider to access seeker.

Some other examples of the obligations that will require additional work from Telstra are described below:

- Telstra must meet agreed timetable and fitness standards for providing large scale access to Telstra's infrastructure to NBN Co. Telstra needs to undertake a significant amount of work on infrastructure in light of these obligations. If Telstra does not meet these obligations, the payments received by Telstra from NBN Co for infrastructure access may be lower than expected and penalties (including monetary compensation to NBN Co) may be imposed on Telstra under the Definitive Agreements in certain circumstances. Telstra has estimated the amount of work required to deliver access to the expected quantities of infrastructure to the agreed fitness standards. However, the infrastructure is substantial and the amount of required work to meet its contractual obligations may be greater or more expensive than anticipated; and
- Telstra and NBN Co have agreed to develop a number of new systems and processes to implement the Proposed Transaction. The unprecedented nature and scale of the Proposed Transaction means there is a risk that those systems and processes do not operate as anticipated or the costs incurred by Telstra in developing them are higher than anticipated.

If Telstra cannot meet its delivery obligations under the Definitive Agreements, the Structural Separation Undertaking or the Final Migration Plan, or there are unforeseen difficulties in meeting those obligations, this could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's operations, Telstra's earnings and/or Telstra's financial position and performance.

b. The costs Telstra incurs to maintain the residual Copper Network may be higher than Telstra anticipates

If the Proposed Transaction is implemented, Telstra must for 20 years maintain the Copper Network in areas outside the NBN Fibre Footprint where it has not been disconnected under the Subscriber Agreement where the Copper Network is connected as at 1 July 2012. Parts of the Copper Network in these areas may deteriorate and require replacement or upgrade, potentially resulting in an adverse effect on Telstra's profitability. Telstra can terminate the Standard Telephone Service module of the TUSMA Agreement after 15 years, which would remove the obligation to maintain the Copper Network, but Telstra would no longer receive the fixed $230 million per annum payment (described in section 5.3). If Telstra's maintenance costs are higher than it has anticipated, this may materially adversely affect Telstra's financial position and performance.

3.4.4 RISKS TO UNDERLYING ASSUMPTIONS SUPPORTING TELSTRA'S ASSESSMENT OF THE PROPOSED TRANSACTION

a. Customer preferences may adversely affect Telstra's ability to generate earnings using NBN products

Telstra currently generates earnings and cashflow from servicing customers connected to its Copper Network and HFC Cable Network. If the Proposed Transaction is implemented, Telstra will disconnect Copper Services and HFC Broadband Services provided to premises in the NBN Fibre Footprint and will instead offer services on the NBN Fibre Network. There is a risk that Telstra may lose some customers it currently expects it will be able to retain during migration to the NBN Fibre Network. This may occur for a range of reasons including, for example, customers choosing a different service provider for NBN-based services or customers choosing not to use a fixed line service at all and to use a mobile service instead. This may materially adversely affect Telstra's ability to generate earnings, and, consequently, the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance.

b. Assumptions upon which the Directors' assessment was based may prove to be incorrect

The Directors consider that the Proposed Transaction is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and require separation of parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra given current Government policy.

However, the Directors' assessment of the options, including in relation to the advantages and disadvantages of the Proposed Transaction and the best available alternative given current Government policy, has been based on a number of assumptions. While the assumptions have been rigorously tested and are believed by the Directors to be reasonable, there is no guarantee that these assumptions will prove correct.

Actual outcomes may differ from those assumed by the Directors. For example, the Directors' assumptions may have:

- underestimated the negative impact upon Telstra of the changes to the way it will operate certain parts of its fixed line business should the Proposed Transaction proceed;
- overestimated the benefits the Proposed Transaction delivers to Telstra; and/or
- underestimated the benefits and/or overestimated the disadvantages of the best available alternative.

In addition, unforeseen changes, such as superior technologies replacing and/or enhancing voice or broadband technology or the introduction of new types of competitors, products and services, may adversely affect the Directors' assessment and conclusion. If the Directors' assessment is so affected, this could materially adversely affect the value of the Proposed Transaction to Telstra, and the difference in Telstra's value under the Proposed Transaction compared to that under the best available alternative given current Government policy.

c. NBN access prices may increase more than Telstra anticipates

Telstra will make payments to NBN Co for access to the NBN Fibre Network to be able to provide Telstra customers with NBN-based voice, broadband and enterprise products. If the prices that NBN Co charges Retail Service Providers (such as Telstra) for that access increase more than Telstra anticipates, the cashflow that Telstra generates from reselling NBN-based products and services may be less than Telstra currently expects.

NBN Co has given Telstra certain commitments for the terms of supply of the Basic Service Offering (BSO) for the term of the Access Deed, including price. NBN Co's commitments are described in more detail in section 4.2.2.6.

However, NBN Co can increase the amount it charges Telstra for its BSO during the term of the Access Deed in certain circumstances, including where the ACCC regulates a higher price for the BSO or the Minister makes a determination in accordance with statutory powers that requires a higher price. As a result, Telstra's costs to access the BSO (and thereby, the NBN Fibre Network) may increase. Additionally, while the Access Deed places some restrictions on NBN Co's ability to levy additional charges for certain product sets, NBN Co may seek, and the ACCC may agree to, additional charges for products outside of these product sets. This may also increase Telstra's access costs and Telstra may not be able to recover this through increased retail prices.

If NBN Fibre Network access prices increase more than Telstra anticipates, Telstra's costs will be higher than it anticipates and this may materially adversely affect the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance.

d. Telstra may incur liability to end users and other third parties in relation to the disconnection of Copper Services and HFC Broadband Services

If the Proposed Transaction is implemented, Telstra will be required to disconnect Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint in a Rollout Region at the relevant Disconnection Date where customers have not agreed to migrate to the NBN Fibre Network. This disconnection may occur without customer consent and will extend to telephony services which end users may use to make emergency calls.

If Telstra is required to disconnect premises where no substitute NBN Fibre Network service is in place, or if there is a material interruption to services between disconnection of the Telstra service on the Copper Network and commencement of Telstra services on the NBN Fibre Network, Telstra may breach its Universal Service Obligation, the TUSMA Agreement or the Customer Service Guarantee and be exposed to liability in tort (including for personal injury or death if end users are unable to use their telephone service to call emergency services) and in contract. Telstra may have to incur additional costs and this could materially adversely affect the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance.

e. Telstra may incur additional costs if it is required to install fibre-ready facilities in new housing developments

Proposed legislation requires developers to install fibre-ready facilities into new housing developments. If the proposed legislation is not passed by Parliament, developers will not be required by law to install fibre-ready facilities in all new housing developments. In such circumstances, Telstra, as the primary universal service provider for the whole of Australia, would have to provide services to end users. Telstra may incur additional costs if it is required to provide these services. If Telstra is required to install fibre-ready facilities in new housing developments, it will have to incur additional costs to do so and this may materially adversely affect its financial position and performance.

f. Cessation of supply of broadband services on the HFC Cable Network may not be non-discriminatory as Telstra anticipates

On 23 June 2011, NBN Co and Optus announced that they had entered into an agreement to progressively migrate customers on Optus' hybrid fibre coaxial (HFC) network to the NBN as it is rolled out and that, once migration is completed, Optus will decommission the parts of its HFC network that do not provide ongoing support for mobile infrastructure and business customers. The announcement noted that the agreement was conditional on ACCC approval and satisfactory rulings from the ATO and contained various termination rights, including rights relating to agreeing an implementation plan and the market environment in which the NBN is expected to operate.

There is a risk that the ACCC may not approve this agreement. The implementation of the agreement between NBN Co and Optus is not a Condition Precedent to the Proposed Transaction. If it is not approved (or does not come into effect for some other reason), Optus may continue to service customers on its HFC network within the NBN Fibre Footprint. In these circumstances, the Proposed Transaction would still proceed (subject to the Conditions Precedent being satisfied or waived) and Telstra would be required to disconnect Copper Services and HFC Broadband Services provided to premises in the NBN Fibre Footprint at the relevant Disconnection Date. If this occurred, and Optus was successful in developing and marketing its HFC broadband services in competition with services provided using other existing networks and/or the NBN, there is a risk that there could be a material adverse effect on the value of the Proposed Transaction to Telstra, Telstra's earnings and its financial position and performance.

3.4.5 RISKS TO EXPECTED PAYMENTS

a. Telstra may receive lower than expected payments for disconnecting premises

Telstra's valuation of the Proposed Transaction is based on its estimate of the number of service addresses it will disconnect from commercial Copper Services and HFC Broadband Services (being services for which Telstra is paid as part of a bona fide arrangement with its residential, business, enterprise and government customers) during the rollout of the NBN Fibre Network. The actual number of these service addresses which Telstra ultimately disconnects will depend on a range of factors. Those factors include the number of these service addresses that currently exist and how this will change over time reflecting, for example, which of these addresses become wireless only households or otherwise cease to have an active fixed line service. If the number of these service addresses Telstra disconnects is less than estimated, the payments received by Telstra will be lower, which could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's earnings and its financial position and performance.

b. Telstra may receive lower than expected payments if levels of wireless substitution are higher than estimated

NBN Co has agreed to make payments to Telstra to disconnect progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out. If a relevant person at the premises has a wireless service directly or indirectly provided by Telstra at a specified time after the Disconnection Date for the Rollout Region in which the premises are located and, at that time, those premises are not connected to the NBN Fibre Network, then Telstra will not be entitled to receive a payment for disconnecting those premises (known as "wireless substitution"). However, if these premises connect to the NBN Fibre Network within three years after the Disconnection Date, Telstra will receive the payment for disconnection of these premises.

Telstra has estimated the number of premises which may be affected by wireless substitution and taken account of this estimate in its assessment of the Proposed Transaction. However, there are a range of factors which will affect the assumptions supporting this estimate. The critical assumptions relate to the number of premises that take up a connection to the NBN Fibre Network and the level of mobile service penetration through the course of the rollout. Wireless substitution could also increase if the process of migration to the NBN Fibre Network encounters difficulties or if the NBN Fibre Network does not operate reliably. If the levels of wireless substitution are higher than estimated, the payments received by Telstra may be lower.

If the payments Telstra receives for disconnecting premises are lower than it has anticipated, this could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's earnings and its financial position and performance.

c. There may be delays in, or a permanent cessation of, the rollout of the NBN Fibre Network

The value of the Proposed Transaction to Telstra depends, among other things, on NBN Co proceeding with the rollout of the NBN Fibre Network in accordance with the NBN Co Corporate Plan. NBN Co has stated that it expects the rollout to take less than 10 years; however, NBN Co is not contractually committed under the Definitive Agreements to a rollout schedule and has discretion under the Definitive Agreements in relation to the density of its rollout. This may be affected to the extent Government policy requires coverage (see section 4.3.2.2).

If the rollout of the NBN Fibre Network is much slower than planned or ceases early, some payments to Telstra will not occur, or could be reduced or delayed, thereby reducing the aggregate net present value of those payments.

In particular:

- Disconnection Payments will be delayed if the rollout is slower than planned, and the total amount of those payments Telstra receives will be less than anticipated if the rollout ceases early;
- if there is a slower rollout or the rollout ceases early, this may reduce the revenue attributable to aspects of the Infrastructure Services Agreement; and
- if the rollout ceases early because of a change in Government policy, NBN Co will also be entitled to cancel orders for certain transit network infrastructure, such as Dark Fibre Links and Exchange Rack Spaces that do not form part of a completed Transit Ring and that have not carried live traffic. As a result, the payments Telstra receives from NBN Co for providing it with this infrastructure may be lower than Telstra currently anticipates.

If the payments Telstra receives from NBN Co are lower than Telstra has anticipated, this could materially adversely affect the value of the Proposed Transaction to Telstra, Telstra's earnings and its financial position and performance.

However, in these circumstances:

- if the rollout ceases early or is slower than agreed minimum thresholds, subject to limited exceptions, Telstra will be entitled to receive compensation from NBN Co as follows:

Extent of rollout at relevant time against NBN Co's 93% premises coverage target	Compensation paid to Telstra (subject to limited exceptions)
Less than 20%	Nil
Between 20% and 99.9% target	Up to $500 million, with the amount reducing as the rollout increases
100%	Nil

- the lower value from the Proposed Transaction will be offset by the cashflow Telstra expects to receive from the ongoing operation of its Copper Network and HFC Cable Network in those areas where the rollout of the NBN Fibre Network has not occurred, and any ongoing payments it will receive from NBN Co under the terms of the Infrastructure Services Agreement; and
- if the rollout ceases early, Telstra will not be required under the Competition and Consumer Act to undertake voluntary structural separation in the remainder of the intended NBN Fibre Footprint, but the interim equivalence and transparency commitments in the Structural Separation Undertaking would continue to apply up to the Designated Day. Telstra will also continue to be subject to the requirement to operate and maintain its existing Copper Network in those areas where the NBN Fibre Network will no longer be rolled out (although, in this event, Telstra may be subject to additional adverse regulatory imposts).

3.4.6 NBN CO PERFORMANCE RISKS

a. NBN Co may not provide Telstra with the services necessary to enable Telstra to fulfil its regulatory and contractual obligations

NBN Co has committed to provide a Basic Service Offering to support telephony services on the NBN Fibre Network. However, NBN Co is not presently required to provide a Basic Service Offering that meets the service levels and standards that Telstra is required to meet to satisfy its own regulatory and contractual obligations.

There is a risk that NBN Co may not provide Telstra with the services necessary (or may not provide a service to the required standard) to enable Telstra to meet its regulatory or contractual obligations (including Telstra's fulfilment of the USO). The Definitive Agreements provide that Telstra is not required to undertake any disconnections until a set of initial upfront disconnection triggers (representing minimum capabilities) have been met by the NBN Fibre Network. In addition, if, during the course of disconnecting premises in a Rollout Region, the level of complaints about the migration of customers to the NBN Fibre Network or the receipt of NBN services reaches or is reasonably anticipated to reach certain unacceptable levels, then there is a process in place under which the disconnection date for that Rollout Region may be extended in order to enable Telstra and NBN Co to address the underlying root causes of the complaints.

There is a risk that Telstra may, nevertheless, lose some customers it expects to be able to retain during migration to the NBN Fibre Network and be exposed to liability and additional costs. In addition, Telstra's reputation may be adversely affected if Telstra is unable to meet its regulatory or contractual obligations because of NBN Co's failure to provide a necessary service (or provide a service to the required standard). For example, if NBN Co does not supply fibre infrastructure in new developments, or if any of its fibre infrastructure both within and outside of new developments becomes inoperable, Telstra will need to supply infrastructure to enable end users in the relevant areas to receive voice telephony and payphone services in accordance with the USO. If Telstra incurs additional costs as a result of NBN Co's failure to provide a necessary service, this may materially adversely affect the value of the Proposed Transaction to Telstra and/or Telstra's financial position and performance.

4. DESCRIPTION OF THE DEFINITIVE AGREEMENTS AND REGULATORY UNDERTAKINGS

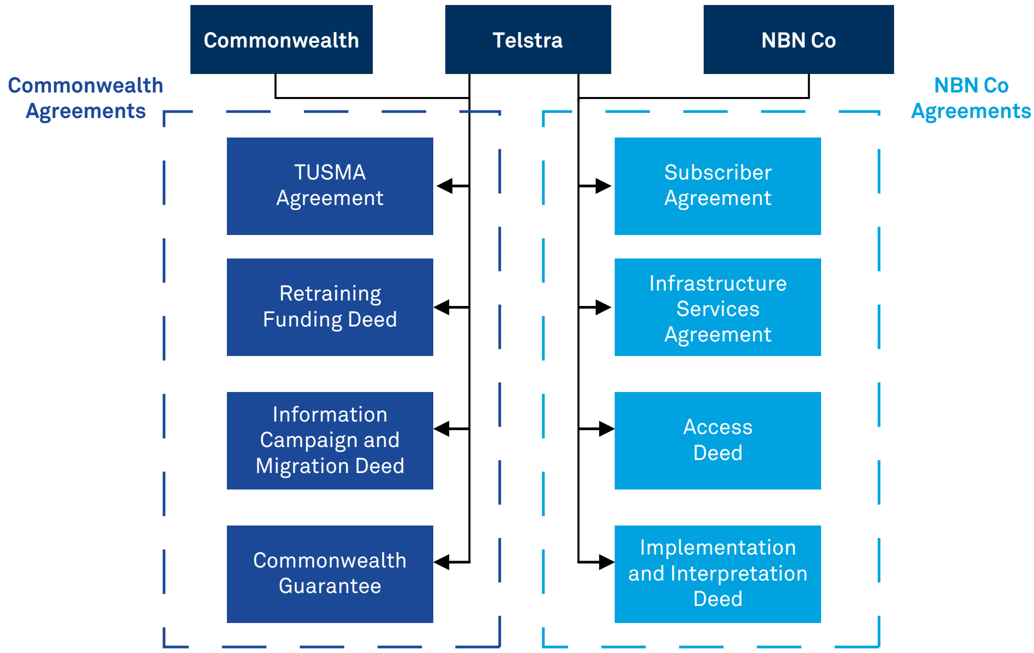
4.1 OVERVIEW

On 23 June 2011, Telstra entered into conditional Definitive Agreements with NBN Co and the Commonwealth. The Definitive Agreements are eight separate but interdependent agreements that, together with the Structural Separation Undertaking and Final Migration Plan, create a framework for Telstra's participation in the rollout of the NBN through the Proposed Transaction.

A number of Conditions Precedent, set out in the Definitive Agreements, must be satisfied or waived for the Proposed Transaction to proceed. Details of the outstanding Conditions Precedent as at the date of this Explanatory Memorandum, the parties' obligations in respect of them and the status of the key outstanding Conditions Precedent, are set out in section 6.2.

Figure 9 provides an overview of the Definitive Agreements and shows the contractual relationships between the parties.

FIGURE 9: OVERVIEW OF THE DEFINITIVE AGREEMENTS



4.2 NBN CO AGREEMENTS

4.2.1 OVERVIEW

There are four key agreements between Telstra and NBN Co in relation to the Proposed Transaction. These are referred to in this Explanatory Memorandum as the NBN Co Agreements.

An overview of the NBN Co Agreements is set out below. A detailed summary of each NBN Co Agreement is set out in Annexure 2.

Agreement	Overview
Subscriber Agreement	Deals with the disconnection by Telstra of Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out, as well as Telstra's commitment, subject to limited exceptions, to exclusively use the NBN Fibre Network to provide fixed line connections to such premises.
Infrastructure Services Agreement	Sets out the terms on which Telstra will provide access to infrastructure and related services to NBN Co.
Access Deed	Sets out NBN Co's high level commitments to Telstra in respect of the terms of supply of NBN Co's Basic Service Offering and the charging for certain wholesale supply services.
Implementation and Interpretation Deed	Sets out the Conditions Precedent and various interim arrangements. It also contains common framework provisions, which apply across the various NBN Co Agreements.

4.2.2 KEY COMMITMENTS UNDER THE NBN CO AGREEMENTS

An overview of the key commitments under the NBN Co Agreements is set out below.

4.2.2.1 DISCONNECTION OF SERVICES

Telstra and NBN Co have agreed that Telstra will disconnect progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out.

NBN Co has stated that the rollout of the NBN Fibre Network will occur on a Rollout Region by Rollout Region basis, with each Rollout Region expected by it to cover approximately 3,000 premises. In broad terms, Telstra has agreed to disconnect Copper Services and HFC Broadband Services provided to premises in the NBN Fibre Footprint in a Rollout Region within 18 months of NBN Co declaring that region to be Ready for Service (which cannot happen until at least 90% of the premises in the NBN Fibre Footprint in that Rollout Region are passed by the NBN Fibre Network). Telstra has no obligation to disconnect, and will not receive payment for any disconnections of, non-premises (for example, traffic lights).

Once a Rollout Region has been declared Ready for Service by NBN Co, a migration period of 18 months will commence, during which Retail Service Providers can place orders for connections of customers to the NBN Fibre Network (which NBN Co will arrange), and retail and wholesale customers can request the disconnection of their Copper Services and HFC Broadband Services in migrating to the NBN Fibre Network.

The Disconnection Date is the date on which Telstra is obliged to commence permanent disconnection of all remaining Copper Services and HFC Broadband Services provided to premises in the relevant Rollout Region that are passed by the NBN Fibre Network, subject to the limited exceptions discussed below. This requirement applies on a non-discriminatory basis to both Telstra retail services and wholesale services, including ULLS and Line Sharing Services. The disconnection obligation applies to all premises within a Rollout Region that are passed by the NBN Fibre Network as at the Disconnection Date, whether or not those premises are actually connected to the NBN Fibre Network or are NBN Serviceable at that time. The permanent disconnection process must be completed within a short, specified period after the Disconnection Date.

Copper Network lines connecting premises in a Rollout Region that are passed by the NBN Fibre Network can continue to be used to provide services after the Disconnection Date in the following limited circumstances:

- for a specified period, for continued provision of pre-existing Copper Services and HFC Broadband Services where a connection order for the NBN Fibre Network has been made for the relevant premises but has not been fulfilled as at the Disconnection Date; and
- for a range of retail and wholesale Special Services, which will be disconnected over a longer timeframe, depending on factors such as suitable fibre alternative products becoming available on the NBN Fibre Network.

If premises are in a Rollout Region but are not passed by the NBN Fibre Network, they are not subject to the disconnection process and Telstra may continue to provide fixed line services to those premises using any network (including the Copper Network and the HFC Cable Network). These premises will, however, generally be subject to Telstra's copper continuity obligations, which are explained in section 4.3.2.2.

4.2.2.2 FIXED LINE NETWORK PREFERENCE

Subject to a limited number of exceptions, Telstra has agreed that it will use the NBN Fibre Network exclusively as the fixed line connection to premises in the NBN Fibre Footprint for a 20 year period from the commencement of the NBN Co Agreements. This means that following the Disconnection Date in respect of a Rollout Region, Telstra will only use the NBN Fibre Network to provide fixed line Carriage Services to its customers' premises in the NBN Fibre Footprint, unless one of the exceptions applies. In this way, as the NBN Fibre Network is rolled out, NBN Co is expected to become the network provider of choice to provide fixed line services to customer premises in the NBN Fibre Footprint.

Telstra and NBN Co have agreed to a number of exceptions to the network preference described above, including:

- where Telstra provides certain point to point fibre services, subject to giving NBN Co a right of first refusal to provide those services;
- where Telstra provides interim fibre services including in respect of areas covered by the Government's greenfields policy. Generally speaking, these interim fibre services are subject to the same disconnection obligations as Copper Services and HFC Broadband Services; and
- fixed line connections between Telstra network elements.

As part of the network preference, Telstra has agreed that, except in limited circumstances including transitional arrangements for existing projects, it will not build or operate passive optical network fibre infrastructure for the 20 year term of the network preference.

Outside the NBN Fibre Footprint, Telstra may continue to use the Copper Network or HFC Cable Network, or build or operate passive optical network fibre infrastructure, as the fixed line connection to premises. Telstra also has no obligation to use the NBN Fibre Network as the fixed line connection to non-premises (for example, traffic lights).

4.2.2.3 WIRELESS PROMOTION

Telstra and NBN Co have agreed certain restrictions in order to support the fixed line network preference described in section 4.2.2.2. In particular, Telstra has agreed not to promote wireless services as a substitute for fibre-based services for a 20 year period from the commencement of the NBN Co Agreements. Telstra considers that, notwithstanding the potential risk of this restriction, it will continue to be able to promote and grow its wireless business effectively. For example, Telstra can promote wireless as a complement to fibre-based services, as a bundle with fibre-based services or as a stand-alone service (but not as a substitute for a fibre-based service). Telstra otherwise remains free to compete in the market for the supply of wireless services and to promote its wireless services as competitive with those of other wireless carriers.

4.2.2.4 USE OF TELSTRA INFRASTRUCTURE

Telstra and NBN Co have agreed the terms on which Telstra will provide long-term access to certain infrastructure and related services to NBN Co in order to facilitate the rollout and operation of the NBN Fibre Network. This includes making certain information and infrastructure available to NBN Co on an interim basis pending the satisfaction or waiver of the Conditions Precedent.

Telstra will provide NBN Co with long-term access to three types of infrastructure – Dark Fibre Links, Exchange Rack Spaces and Ducts (as well as associated Duct infrastructure including pits and manholes). Telstra will also provide NBN Co with initial access to Lead-in Conduits, with ownership to transfer to NBN Co upon installation of lead-in fibre. The processes by which each of the different infrastructure types will be ordered, provisioned and maintained is set out below.

Telstra has also agreed to provide ongoing maintenance and repair of Dark Fibre Links, Exchange Rack Spaces, Ducts and associated Duct infrastructure in accordance with agreed service levels. However, Telstra has no service level obligations to maintain or repair Lead-in Conduits.

Ducts

Ducts and associated Duct infrastructure will generally be provisioned on a Rollout Region by Rollout Region basis. Ducts are pipes which accommodate telecommunications cables. They are generally located underground and are accessed via pits and manholes. Manholes and pits are underground vaults that connect Ducts.

For each Rollout Region to which NBN Co chooses to roll out using Telstra's Ducts, NBN Co will give Telstra an indicative network design showing where it proposes to deploy fibre, which Ducts it intends to use for that fibre, and the extent of work required to bring the Ducts up to the agreed fitness standards. That design will be based on extensive planning information that Telstra will provide to NBN Co regarding Telstra's Ducts. Telstra may review that design; for example, to show NBN Co where it might adopt a different route to better use Telstra's Ducts. NBN Co may then inspect the Ducts it intends to use to develop a detailed design for that Rollout Region.

Based on that detailed design, Telstra will then undertake the works required to bring the Ducts up to the agreed fitness standards. Telstra must complete these works within an agreed period. If Telstra does not complete this work by the agreed time, NBN Co may, in certain circumstances, choose to do the work itself at Telstra's expense and Telstra may also be exposed to other monetary compensation to NBN Co.

Exchange Rack Spaces and Dark Fibre Links

The Infrastructure Services Agreement contains a provisional list of the Exchange Rack Spaces and Dark Fibre Links which Telstra will make available to NBN Co. The provisional list is to be finalised in the Initial Rollout Plan to be agreed by Telstra and NBN Co. It is a Condition Precedent that Telstra and NBN Co agree an Initial Rollout Plan. Section 6 provides further information on the Conditions Precedent.

Exchange Rack Spaces are spaces within Exchange Buildings in which telecommunications equipment can be installed. Dark Fibre Links are optical fibres over which telecommunications services can be carried when connected to appropriate equipment.

Approximately 60% of the Exchange Rack Spaces and all of the Dark Fibre Links which Telstra will provide to NBN Co under the Infrastructure Services Agreement are required by NBN Co for its transit network. These will be delivered by Telstra to NBN Co over the first three and a half years from execution of the Definitive Agreements. The Initial Rollout Plan will also include the Exchange Rack Spaces required for NBN Co's access network, to be provided over NBN Co's planned 10 year rollout period.

Telstra has agreed to perform work to enable Exchange Rack Spaces and Dark Fibre Links that are listed in the Initial Rollout Plan (or in any subsequent rollout plan agreed under the Infrastructure Services Agreement) to meet certain agreed standards. These works are generally required to be performed by the delivery dates set out in that rollout plan before the infrastructure is delivered to NBN Co.

Lead-in Conduits

Similar to Ducts, NBN Co will generally install fibre cables in Lead-in Conduits on a Rollout Region by

Rollout Region basis. However, unlike Ducts, Telstra is not required to undertake any works to bring the Lead-in Conduits up to the agreed fitness standards.

Lead-in Conduits are telecommunications conduits (usually narrower in diameter than an ordinary duct) from a pit or manhole in the street to a customer's premises (this will differ slightly if the premises are an apartment building, office building or other structure).

Once NBN Co has installed its fibre cable in the Lead-in Conduit, the Lead-in Conduit becomes the property of NBN Co. Telstra has no maintenance obligations for the Lead-in Conduit after that transfer of ownership. For ongoing maintenance and installation of cables in the Lead-in Conduit, Telstra and NBN Co will need to follow agreed operational processes. Once Telstra transfers ownership of a Lead-in Conduit to NBN Co, NBN Co will permit Telstra to access the transferred Lead-in Conduit at no charge.

4.2.2.5 PAYMENTS FOR DISCONNECTION AND ACCESS TO INFRASTRUCTURE

Under the NBN Co Agreements, NBN Co has agreed to make payments to Telstra:

- to disconnect progressively Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint as the NBN Fibre Network is rolled out; and
- to provide NBN Co with access to certain parts of Telstra's infrastructure and related services.

Telstra will receive payments from NBN Co in respect of premises in Rollout Regions in the NBN Fibre Footprint as the NBN Fibre Network rolls out to those regions and as those premises are disconnected in accordance with the Subscriber Agreement. Payment is on a per premises basis and is based on various criteria, including:

- the number of lines to the premises disconnected;
- whether or not commercial services (being services for which Telstra is paid as part of bona fide arrangements with its residential, business, enterprise and government customers) were provided to those lines (and, if so, the types of service provided on those lines);
- the time at which the disconnection occurs; and
- whether or not wireless substitution has occurred and, in that and limited other cases, whether or not the premises have connected to the NBN Fibre Network.

Because of the 18 month migration period for a Rollout Region (which cannot happen until at least 90% of the premises in the NBN Fibre Footprint in that Rollout Region have been passed by the NBN Fibre Network), Disconnection Payments will tend to lag the rollout of the NBN Fibre Network by up to 18 months.

Telstra will also receive payments for providing NBN Co with access to certain parts of Telstra's infrastructure and related services to facilitate the rollout of the NBN Fibre Network. Under the Infrastructure Services Agreement, NBN Co has committed to pay for, and Telstra has committed to make available within specified timeframes, certain minimum quantities of infrastructure that meet the agreed fitness standards. These minimum quantities reflect scale access to large volumes of usage, and availability of each type of infrastructure. These quantities can be reduced under certain circumstances.

The payment and availability commitments are based on incentive mechanisms known as "Provide-or-Pay" (or "PoP") and "Take-or-Pay" (or "ToP"). The PoP is an incentive mechanism to encourage Telstra to maximise the amount of infrastructure it makes available to NBN Co up to the agreed minimum quantities. The ToP is a mechanism to encourage NBN Co to maximise the use of the infrastructure that Telstra makes available up to the agreed minimum quantities. There is, however, no ToP for the Exchange Rack Spaces and Dark Fibre Links required by NBN Co for its transit network (the "backbone" or core of the NBN Fibre Network). The ToP/PoP mechanism may be adjusted in the event of an early cessation of rollout, or upon termination of the Infrastructure Services Agreement.

4.2.2.6 SUPPLY OF WHOLESALE SUPPLY SERVICES BY NBN CO

As the NBN Fibre Network is rolled out, Telstra will increasingly purchase wholesale supply services from NBN Co for resale to Telstra's customers. NBN Co has made a number of high level commitments to Telstra in respect of the terms of supply for NBN Co's Basic Service Offering and the charging for certain wholesale supply services. The high level commitments made by NBN Co apply for a period of five years.

NBN Co has made commitments in respect of the composition of its Basic Service Offering, the price of the Basic Service Offering and the charging for certain wholesale supply services. The commitments include the following:

- NBN Co must not charge Telstra more than a specified amount ($24 plus applicable taxes) per month per service for the supply of its Basic Service Offering; and
- NBN Co must not make any submissions to the ACCC seeking, or include in a special access undertaking, a price for the Basic Service Offering that is more than the specified amount referred to above.

However, if certain regulatory related events occur (including if the regulated price for the Basic Service Offering is increased), then NBN Co may increase the price of the Basic Service Offering in a manner consistent with those events.

As at the date of this Explanatory Memorandum, Telstra and NBN Co have not agreed the actual terms under which NBN Co will supply, and Telstra will acquire, wholesale products. The actual terms of supply that will apply to Telstra's purchase of services from NBN Co will be agreed in the ordinary course of Telstra's dealings with NBN Co or, if an agreement cannot be reached when NBN Co commences commercial supply to Telstra, the terms of NBN Co's published standard form of access agreement.

4.2.2.7 PERMANENT CESSATION OR VERY SLOW ROLLOUT OF THE NBN FIBRE NETWORK

Telstra and NBN Co have agreed the arrangements that will apply if there is a permanent cessation of rollout or a very slow rollout of the NBN Fibre Network.

If a permanent cessation of rollout or very slow rollout occurs, NBN Co has agreed, subject to limited exceptions, to compensate Telstra for Telstra being left with a geographically dispersed network. This compensation is on a sliding scale from a maximum of $500 million (if the event occurs when NBN Co's fibre rollout has reached 20% of NBN Co's current coverage target of 93% of premises in Australia) reducing to zero (if the event occurs when NBN Co's rollout has reached that current coverage target). Telstra will not receive compensation if the event occurs before the rollout has reached that 20% threshold. If this occurs, Telstra will be able to continue to operate its existing fixed line businesses in areas where the NBN Fibre Network has not been rolled out.

Additionally, if there is a permanent cessation of rollout of the NBN Fibre Network, NBN Co remains contractually committed to pay Telstra for certain infrastructure. Different infrastructure types are treated differently in the event of a permanent cessation of rollout by NBN Co, and the cause of permanent cessation also gives rise to different outcomes. Further details on these protection mechanisms are set out in section 3.4.5(c).

4.2.2.8 FRAMEWORK PROVISIONS

Telstra and NBN Co have agreed a number of important framework provisions, which operate across the various arrangements between them in relation to the Proposed Transaction.

These include:

- obligations on Telstra and NBN Co generally to act in accordance with an agreed standard of good faith in exercising rights and performing obligations under the agreements;
- a detailed liability regime that sets out commercially agreed limits (and exclusions from those limits) on the respective liabilities of Telstra and NBN Co to each other under the Proposed Transaction;
- agreed procedures to manage the resolution of any disputes between the parties;
- obligations on each of Telstra and NBN Co in respect of confidential information of the other, including an obligation on each of them to implement information security procedures designed to ensure that it does not improperly use confidential information obtained by it;
- reciprocal rights in relation to intellectual property provided by each of the parties in connection with the Proposed Transaction;
- a process that, if triggered by the affected party, will result in an amendment to the Subscriber Agreement if Telstra or NBN Co engages in certain activities that have the effect of substantially affecting the business of the affected party in particular markets. The relevant markets in which activity by NBN Co could result in this process being triggered by Telstra are the market for mobiles and the market for the supply of retail services to consumers, business or governments in Australia;
- provisions allowing each party to terminate the NBN Co Agreements for certain types of breaches of the agreements by the other or for the occurrence of an insolvency event in relation to the other. There is also provision for Telstra to terminate the NBN Co Agreements if certain changes of control of NBN Co occur, to enable Telstra to respond to any potential privatisation of NBN Co that may occur in accordance with the existing legislation; and
- reciprocal rights to call for the provision of financial security for the obligations of a party if its credit rating falls below agreed thresholds (and, in the case of NBN Co, if the Commonwealth Guarantee of its obligations under the NBN Co Agreements is no longer in effect).

Importantly, the arrangements also provide a regime for dealing with the parties' ability to implement the Proposed Transaction if there is a change in law or if any of the provisions of the NBN Co Agreements become illegal.

4.3 COMMONWEALTH AGREEMENTS

4.3.1 OVERVIEW

There are four key agreements between Telstra and the Commonwealth in relation to the Proposed Transaction. These are referred to in this Explanatory Memorandum as the Commonwealth Agreements. An overview of the Commonwealth Agreements is set out below. A summary of each Commonwealth Agreement is set out in Annexure 2.

Agreement	Overview
TUSMA Agreement	Sets out the terms on which Telstra will perform, and be paid for performing, certain public interest services.
Retraining Funding Deed	Sets out the arrangements under which the Commonwealth will provide funding to Telstra to enable Telstra to retrain certain employees.
Information Campaign and Migration Deed	Sets out the key residual commitments and payments to be met directly by the Commonwealth, including a commitment from the Commonwealth to arrange for NBN Co to conduct a public education campaign that informs end users about the migration process.
Commonwealth Guarantee	A guarantee by the Commonwealth in favour of Telstra in relation to NBN Co's payment and performance obligations under the Implementation and Interpretation Deed, the Subscriber Agreement, the Infrastructure Services Agreement and the Access Deed.

4.3.2 KEY COMMITMENTS UNDER THE COMMONWEALTH AGREEMENTS

An overview of the key commitments under the Commonwealth Agreements and associated Government commitments is set out below.

4.3.2.1 PROVISION OF USO AND EMERGENCY CALL SERVICE

The Commonwealth has made a policy statement that it intends to establish TUSMA (the Telecommunications Universal Service Management Agency) to assume progressively the regulatory responsibility for the delivery of the USO and, potentially, other public interest obligations. The USO is the obligation currently placed on Telstra to ensure that Standard Telephone Services, payphones and prescribed carriage services are reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business.

The transfer of regulatory responsibility from Telstra to TUSMA is expected to occur as described below:

- on 1 July 2014, TUSMA will assume regulatory responsibility for:
  - the USO for payphones; and
  - the USO for Standard Telephone Services in all areas that have been reached by the existing NBN Fibre Footprint at that date (in addition to areas outside the Government's announced final NBN Fibre Footprint of 93%); and
- thereafter, it is expected that TUSMA will progressively assume regulatory responsibility for the USO for Standard Telephone Services as the NBN is rolled out in other areas within the NBN Fibre Footprint.

Although regulatory responsibility is expected to be transferred progressively to TUSMA, from 1 July 2012 Telstra will be required under the TUSMA Agreement to fulfil the USO (as well as the Emergency Call Service) throughout Australia. As Telstra presently performs these obligations as part of its regulatory obligations, Telstra expects to continue to provide these services on a business as usual basis. Telstra has agreed to use the NBN Fibre Network to fulfil the USO for Standard Telephone Service if requested by a customer whose premises is NBN connected inside the NBN Fibre Footprint.

The effect of including these obligations in the TUSMA Agreement is that:

- in areas where regulatory responsibility has transferred to TUSMA, Telstra has a contractual obligation to fulfil the USO for TUSMA; and
- in areas where regulatory responsibility has not transferred to TUSMA, Telstra is providing a contractual commitment to comply with its regulatory obligations to fulfil the USO.

The TUSMA Agreement contains mechanisms to ensure that Telstra is not subject to contractual remedies if it is also subject to regulatory remedies in relation to a breach of the TUSMA Agreement.

4.3.2.2 COPPER CONTINUITY COMMITMENT

Telstra has agreed to provide a copper continuity commitment. This means that, subject to certain exceptions, Telstra must not disconnect any service address from the Copper Network for the term of the TUSMA Agreement where there is a connection (including an inactive connection) at that service address as at 1 July 2012.

The exceptions include where a service address is disconnected pursuant to the Subscriber Agreement or where (subject to an annual cap on the number of service addresses that can be disconnected) there is serious degradation of the copper line. Where an exception does not apply, Telstra will continue to maintain the Copper Network and other relevant infrastructure to enable Telstra to deliver Standard Telephone Services to end users. The copper line will also be available for wholesale services.

The copper continuity commitment may therefore constrain Telstra's ability to rationalise its Copper Network and realise efficiencies in the following ways:

- The NBN Fibre Footprint in a Rollout Region may not cover all premises in that region. As a result, Telstra may not be able to fully rationalise the Copper Network in a Telstra exchange serving area that is covered by that Rollout Region. If that occurred, Telstra could incur higher costs than anticipated to maintain its remaining Copper Network.

  However, in broad terms, NBN Co is contractually prevented from supplying commercial (that is, non-trial) wholesale services in a Rollout Region until 90% of premises in the intended NBN Fibre Footprint in that region are passed by the NBN Fibre Network. In all cases, until that 90% coverage requirement is met and NBN Co notifies Telstra that the Rollout Region is Ready for Service, the requirement for Telstra to disconnect Copper Services and HFC Broadband Services supplied to premises in the NBN Fibre Footprint in that region does not commence and Telstra retains responsibility for the USO. Further, NBN Co would not be able to achieve its coverage target of 93% of premises in Australia by allowing significant coverage "holes". This risk will also be mitigated to the extent that the Government requires NBN Co to ensure that the NBN Fibre Footprint covers all or most of the premises in a Rollout Region in urban areas and regional towns.
- In areas outside of the NBN Fibre Footprint where the Copper Network has not been disconnected under the Subscriber Agreement, Telstra will need to maintain and operate the Copper Network for a period of up to 20 years. As the Copper Network is ageing, this may require investment by Telstra. The TUSMA Agreement provides some safeguards that moderate this risk, including a 10 year technology review that may decide the Standard Telephone Service is more cost effectively delivered over alternative technologies (which may allow Telstra to close the Copper Network) and Telstra's right to terminate its contractual Standard Telephone Services and copper continuity obligations under the TUSMA Agreement after 15 years by providing two years notice. In addition, the payments that Telstra will receive under the TUSMA Agreement for the supply of the USO for Standard Telephone Services are in part consideration for Telstra maintaining the Copper Network for this purpose.

4.3.2.3 CUSTOMER MIGRATION COSTS

The Commonwealth has agreed that TUSMA will fund certain customer costs for migration to the NBN Fibre Network. This applies to voice-only retail customers and priority assistance customers who have not migrated six months before the Disconnection Date in each Rollout Region.

This funding will be provided to meet the cost of Telstra performing certain customer management tasks for these customers as well as to fund Telstra (or a third party) to install necessary in-house wiring for these customers if they have not acquired a broadband service from Telstra within three months after connecting to the NBN Fibre Network. If agreed with TUSMA, TUSMA will also provide funding for the development of a technological solution so that public interest services (services supplied to traffic lights and public alarms) can be migrated from the Copper Network to the NBN Fibre Network. Under the Information Campaign and Migration Deed, the Commonwealth has also agreed to contribute funding in the event that Telstra is unable to recover certain other migration costs, in limited circumstances.

4.3.2.4 PAYPHONE MIGRATION COSTS

The Commonwealth has agreed that when the NBN is deployed in an area, TUSMA will be responsible for funding the migration (either to the NBN Fibre Network or to an alternative technology) of each payphone in that Rollout Region which Telstra is required to maintain under the TUSMA Agreement. Alternatively, TUSMA may elect to supply a substitute payphone, in which case the TUSMA Agreement will allow Telstra to close down the payphone that has been substituted, provided Telstra complies with its regulatory requirements.

4.3.2.5 FUNDING FOR RETRAINING OF STAFF

The Retraining Funding Deed sets out the terms on which the Commonwealth will provide funding for Telstra to retrain certain staff. The relevant staff are those whose roles are currently linked to the operation of the Copper Network and the HFC Cable Network, or who otherwise may face redundancy as a result of the rollout of the NBN Fibre Network over time, unless redeployed in Telstra's business.

Within six months of executing the Retraining Funding Deed, Telstra is required to submit an initial training plan for approval by the Commonwealth. If Telstra has provided an initial budget plan and the initial training plan has been approved by the Commonwealth (which may not be unreasonably withheld or delayed), the Commonwealth will pay $100 million (plus GST) to Telstra. Telstra must subsequently develop rolling three year training plans for approval by the Commonwealth. All expenditure of funds must occur in accordance with approved training plans and the terms of the Retraining Funding Deed.

4.3.2.6 KEY RESIDUAL COMMITMENTS AND PAYMENTS

There are a series of residual contractual commitments given directly by the Commonwealth, which relate to the valuation of the Proposed Transaction. These include commitments to:

- arrange for NBN Co to conduct a public education campaign that informs end users about the nature and timing of the rollout of the NBN Fibre Network in their area, including the actions that a customer will need to take to continue to receive services and the consequences for a failure to take that action, such as mandatory disconnection; and
- make certain residual payments to Telstra, including in the event Telstra is unable to recover costs of migration in limited circumstances.

4.3.2.7 COMMONWEALTH GUARANTEE OF PAYMENTS FROM NBN CO

The Commonwealth has provided a guarantee to Telstra for the payments required to be paid by NBN Co to Telstra in connection with the NBN Co Agreements. The obligations of the Commonwealth under the Commonwealth Guarantee will take effect once the NBN Co Agreements have themselves become binding in accordance with their express terms (for example, all Conditions Precedent have either been satisfied or waived). The amount the guarantee covers is capped at an amount that represents Telstra's current estimate of NBN Co's potential aggregate liabilities to Telstra, at any given time while the Commonwealth Guarantee is on foot and in circumstances where NBN Co, for some reason, does not meet its commitments to Telstra out of its available net assets.

4.3.2.8 EFFECT OF A PERMANENT CESSATION OF ROLLOUT ON COMMONWEALTH AGREEMENTS

Telstra and the Commonwealth have agreed the arrangements that will apply if there is a permanent cessation of rollout of the NBN Fibre Network. If a permanent cessation of rollout occurs:

- either party may terminate the TUSMA Agreement if the rollout of the NBN Fibre Network has not passed 20% of NBN Co's 93% coverage target. However, if the rollout of the NBN Fibre Network has passed 20% of that target, the parties are required to attempt to renegotiate the TUSMA Agreement according to certain principles and if agreement cannot be reached, provision for an arbitration in accordance with those principles;
- either party may terminate the Retraining Funding Deed, and the Commonwealth will be entitled to be repaid the funding which at the time is not currently committed for expenditure; and
- the Commonwealth may terminate the Information Campaign and Migration Deed.

4.4 REGULATORY UNDERTAKINGS

4.4.1 OVERVIEW OF THE STRUCTURAL SEPARATION UNDERTAKING AND FINAL MIGRATION PLAN

The Structural Separation Undertaking is the document that Telstra has given to the ACCC on 29 July 2011 in which Telstra undertakes to structurally separate by committing that, for all premises within the NBN Fibre Footprint that have been disconnected pursuant to the Definitive Agreements as at the Designated Day, Telstra will not supply services to those premises using the Copper Network and HFC Cable Network (other than exempt services including Pay TV Services on the HFC Cable Network). It is also the document in which Telstra commits to implement new measures to ensure interim equivalence and transparency around the supply of certain wholesale products.

The Final Migration Plan will form part of the Structural Separation Undertaking. The Final Migration Plan will set out the steps Telstra will take to cease the supply of Copper Services and HFC Broadband Services, and to commence to supply services to retail customers using the NBN Fibre Network. Telstra has given a Draft Migration Plan to the ACCC. Once a Draft Migration Plan is accepted by the ACCC, it will become the Final Migration Plan.

4.4.1.1 BACKGROUND AND PURPOSE

The CCS Act, enacted in December 2010, requires Telstra to either:

- give a structural separation undertaking; or
- undergo mandatory functional separation. It is anticipated that mandatory functional separation would involve a level of separation within Telstra's business (network, wholesale, and retail) that would require significant changes to its current structures, systems and processes.

4.4.1.2 KEY APPROVALS

It is a Condition Precedent that the Structural Separation Undertaking and the Draft Migration Plan (both in a form approved by NBN Co and Telstra) must be accepted by the ACCC and come into force. The Proposed Transaction will not proceed unless these and all other Conditions Precedent are satisfied or waived. A summary of the status of the key outstanding Conditions Precedent as at the date of this Explanatory Memorandum is set out in section 6.2.2. The risks associated with the fact that these key Conditions Precedent remain outstanding are described in section 3.4.1(a).

Telstra will update Telstra Shareholders on any material developments relating to the status of the Structural Separation Undertaking and Draft Migration

Plan through announcements to the ASX. Telstra's announcements are available on www.asx.com.au and on Telstra's website at www.telstra.com

The Structural Separation Undertaking itself is also subject to:

- ACCC approval of the Draft Migration Plan; and
- the passage of the Resolution; and
- the Minister granting waivers in respect of the divesture by Telstra of its HFC Cable Network and its 50% equity interest in FOXTEL.

4.4.2 TELSTRA'S STRUCTURAL SEPARATION UNDERTAKING

The Structural Separation Undertaking comprises two main operative parts:

- Telstra's structural separation commitment that, for all premises within the NBN Fibre Footprint that have been disconnected pursuant to the Definitive Agreements as at the Designated Day, Telstra will not supply services to those premises using the Copper Network and HFC Cable Network (other than exempt services including Pay TV Services on the HFC Cable Network); and
- measures to provide for equivalence and transparency in relation to the supply of Regulated Services to wholesale customers until the Designated Day.

If the Structural Separation Undertaking is accepted by the ACCC, it cannot be withdrawn by Telstra.

4.4.2.1 SCOPE OF THE COMMITMENT TO STRUCTURALLY SEPARATE

As noted above, the extent of Telstra's structural separation commitment is that, for all premises within the NBN Fibre Footprint from which Copper Services and HFC Broadband Services have been disconnected pursuant to the Subscriber Agreement as at the Designated Day, Telstra will not supply services to those premises using the Copper Network and HFC Cable Network (other than exempt services including Pay TV Services on the HFC Cable Network). The Networks and Services and Exemption Instrument will also allow Telstra to continue to supply services to premises that have been passed by the NBN Fibre Network, or to reconnect those premises, after the Designated Day in limited circumstances which are permitted under the Definitive Agreements (such as where there is a material unavailability of the NBN Fibre Network or where Telstra is supplying a Special Service).

4.4.2.2 INTERIM EQUIVALENCE AND TRANSPARENCY

The Structural Separation Undertaking includes measures to provide for equivalence and transparency in relation to the supply by Telstra of Regulated Services to wholesale customers (but will not apply to services supplied by Telstra using the NBN Fibre Network).

These arrangements will automatically replace Telstra's current operational separation regime. They will commence to apply on the date the Structural Separation Undertaking comes into force and will continue to apply up to the Designated Day, irrespective of whether the rollout of the NBN Fibre Network ceases early. Some of the equivalence and transparency commitments will, however, be phased in so that they do not commence until two months after the Structural Separation Undertaking comes into force (or, if later, when the Definitive Agreements take effect).

The key components of the new regime can be broadly divided into "price" and "non-price" commitments.

Price commitments

The price equivalence commitments in the Structural Separation Undertaking comprise the following elements:

- Telstra will publish a "rate card" with reference prices for a set of Regulated Services. The reference price for declared services will be the regulated price set by the ACCC. For the wholesale ADSL 2+ product, the reference price will be calculated based on a new "retail minus avoidable cost" approach which pegs Telstra's price for wholesale ADSL 2+ services to the average retail BigPond ADSL 2+ price. A different reference price may apply to wholesale ADSL 2+ in regional and metropolitan areas. The ACCC or Telstra can trigger a review of the wholesale ADSL 2+ pricing mechanism after three years or more.
- Telstra will use its primary internal management accounting system (the Telstra Economic Model), to produce a quarterly report for the ACCC which will set out Telstra's revenues and costs on a per unit basis and, to the extent that wholesale and retail products utilise the same inputs, the costs of those inputs will be allocated equivalently. Where the internal wholesale price for a product bundle differs from the revenues received from external wholesale prices for the same bundle, Telstra will explain the reason for the difference to the ACCC. While there is no automatic correction of the difference, future regulated pricing reviews are likely to consider potential ways the regulated prices and internal wholesale prices can be aligned.

Non-price commitments

Telstra's non-price interim and transparency commitments include:

- **specific and court enforceable commitments** to use equivalent activation and fault rectification processes for wholesale customer requests or which are capable of delivering to specific performance levels;
- **an option for wholesale customers to receive automatic payment of service level rebates** where Telstra fails to meet committed service levels and the

aggregate difference between Telstra's wholesale and retail performance varies by 2% or more (in negative terms) for the relevant quarter (with mechanism to ensure that wholesale customers cannot "double dip" if they have existing contractual rebate entitlements or wish to claim a contribution under the wholesale CSG regime);

- **a new accelerated internal investigation process** to require expeditious resolution of non-price equivalence complaints by wholesale customers, with mechanisms which allow the wholesale customer to unilaterally escalate the complaint to the Independent Telecommunications Adjudicator at prescribed points where it is not satisfied with the outcomes of the process;
- appointment of an **Independent Telecommunications Adjudicator** to be approved by the ACCC. The Independent Telecommunications Adjudicator will have the power to make **binding determinations on either party** to the relevant dispute and there will be no right of appeal. Determinations, however, will be subject to an aggregate annual monetary cap of $10 million, while a per event soft cap of $1 million can only be exceeded if the Independent Telecommunications Adjudicator demonstrates that the direction is necessary, is the least cost solution and is proportionate to the issue to be resolved;
- the continuation of specific **information security** requirements to ensure the protection of confidential information of wholesale customers. Other than nationally aggregated information or information Telstra derives from another source, Telstra must not disclose sub-national aggregated information to its retail business units unless, with ACCC approval, it makes it available to wholesale customers simultaneously;
- the maintenance of the existing **information equivalence** rules in place under Telstra's operational separation regime, plus a number of new commitments to provide information to wholesale customers about certain major network modernisations and upgrades;
- commitments to **minimum functionality and service availability for wholesale customer IT systems.** The service availability commitment is set at 98% (excluding planned downtime) and will be subject to payment of service level rebates if Telstra fails to meet this commitment (see above);
- **DSL product equivalence commitments** which require that where Telstra develops new network capability (delivered as a layer 2 connection service) which is used to support enhanced DSL product functionality, or where Telstra offers a mass market naked DSL product, Telstra must also make an equivalent wholesale version of the network capability upgrade or naked DSL product available to wholesale customers;
- **tighter organisational arrangements** to keep separate "retail", "wholesale" and "network services" business units, which include certain constraints about the incentive remuneration that can be offered to employees who work for a wholesale or network services business unit as well as constraints about the functions that can be performed by retail, wholesale and network services business units (for example, retail business units cannot perform network planning or wholesale pricing functions and field staff within the network services business units cannot market Telstra services to end users of wholesale customers);
- the continuation of **quarterly reporting** to the ACCC against the equivalence and transparency metrics and additional commitments to investigate and resolve issues if a result shows an "equivalence gap" or variance of 2% or more;
- the continuation of oversight by Telstra's existing **Director of Equivalence** role, which will continue to report to the Board Audit Committee; and
- the continuation of **annual compliance reporting** to the ACCC as well as a **new commitment to consult with the ACCC in relation to Telstra's compliance program.**

4.4.3 THE DRAFT MIGRATION PLAN

4.4.3.1 BACKGROUND

As provided in the legislative framework for structural separation, Telstra has submitted a Draft Migration Plan for approval by the ACCC, which sets out actions that Telstra will take in order to cease the supply of Copper Services and HFC Broadband Services and to commence the supply of services using the NBN Fibre Network (including how it will set a timetable for doing so). Once approved by the ACCC, the Final Migration Plan provides regulatory certainty because the ACCC is not able to regulate under Part XIC of the Competition and Consumer Act in relation to matters that it covers.

Telstra is not able to withdraw a Final Migration Plan, which takes effect as if it formed part of the Structural Separation Undertaking.

4.4.3.2 MIGRATION PLAN PRINCIPLES

The ACCC must accept the Draft Migration Plan if it complies with a set of Migration Plan Principles, which were made by the Minister on 23 June 2011 and which include the principle of equivalence in the processes used to disconnect retail and wholesale services.

The Migration Plan Principles can be accessed at http://www.dbcde.gov.au/broadband/national_broadband_network/telecommunications_regulatory_reform

4.4.3.3 OVERVIEW OF DRAFT MIGRATION PLAN

The Draft Migration Plan recognises that Telstra's role is primarily limited to the disconnection of Copper and HFC Broadband Services and that the timetable for disconnection is linked, under the Definitive Agreements, to NBN Co's rollout schedule. By defining the scope of Telstra's role in this way (i.e. focused on disconnection only), the Draft Migration Plan limits the extent to which the ACCC can impose further regulatory obligations on Telstra such as requiring it to manage the migration process on behalf of its wholesale customers or to require Telstra to keep in place or reactivate its Copper Network or HFC Cable Network in order to provide interim or other services in the event of technical or other failures of the NBN Fibre Network.

Other key features of the Draft Migration Plan are:

- to the extent that it is reasonable and practicable to do so, Telstra will use its existing "business as usual" processes, systems and interfaces for disconnecting customers;
- Telstra will not supply a new copper service to premises where the NBN service qualification process shows that the premises are capable of being connected to the NBN (that is, the premises are "NBN Serviceable");
- subject to limited exceptions, the Draft Migration Plan dovetails with both the Definitive Agreements and Structural Separation Undertaking by requiring Telstra to have completed the final disconnection of all premises within the NBN Fibre Footprint that have been disconnected under the Subscriber Agreement by the Designated Day;
- the Draft Migration Plan also adopts the same list of Special Services, for which different disconnection arrangements will be used – where timing will depend either on NBN Co's development of an acceptable alternative fibre product or when Telstra ceases to supply the relevant class of special service through its standard product exit processes;
- the Draft Migration Plan requires Telstra to agree with the ACCC and put in place information security processes that ensure that it does not use or disclose information of wholesale customers or NBN Co, that Telstra obtains in the course of undertaking its disconnection activities, to gain or exploit an unfair advantage over its wholesale customers; and
- Telstra agrees to use NBN Co's standard wholesale broadband agreement and related processes for the purpose of connecting customers to the NBN.

Consistent with the Definitive Agreements, the Draft Migration Plan requires disconnection of all remaining Copper Services and HFC Broadband Services (that are not Special Services) at the Disconnection Date in each Rollout Region. There are safeguards to manage risks associated with mandatory disconnection, including a Commonwealth funded migration program for voice-only customers under the TUSMA Agreement and a requirement under the Draft Migration Plan to provide "soft dial tone" to allow access to emergency calls for 20 business days after the Disconnection Date. In addition, given the high level of mobile penetration in Australia, many customers who are mandatorily disconnected will have access to a mobile service to make calls, including to emergency services, until they arrange for connection to the NBN Fibre Network.

4.4.3.4 VARIATION OF THE FINAL MIGRATION PLAN

There are a number of processes which are anticipated by the Migration Plan Principles but which Telstra needs time to develop. The Draft Migration Plan therefore sets out a process for Telstra to develop and agree these required measures with the ACCC within six months of the Draft Migration Plan being approved.

The ACCC and the Independent Telecommunications Adjudicator (established under the Structural Separation Undertaking) may also direct Telstra to vary its processes and systems under the Final Migration Plan, where they do not continue to comply with the Migration Plan Principles. The Independent Telecommunications Adjudicator can also hear disputes or complaints raised by wholesale customers in relation to actions taken by Telstra under the Final Migration Plan.

In giving a direction to Telstra to vary the Final Migration Plan, the ACCC or the Independent Telecommunications Adjudicator cannot interfere with a number of key elements of the Proposed Transaction, including preventing or delaying Telstra from disconnecting regions or Special Services. There are also financial caps of $1 million per matter and $10 million in any year that apply to decisions made under the Final Migration Plan.

5. VALUATION OF THE PROPOSED TRANSACTION

This section summarises the key components of the value that Telstra attributes to the Proposed Transaction. This value has been assessed on the basis of a number of assumptions, with the key assumptions being tested against a range of sensitivities and outcomes. The assumptions reflect Telstra's current best estimate of possible outcomes.

The Independent Expert has also assessed the value of the Proposed Transaction. Taking into account its own assessment of the value delivered to Telstra under the Proposed Transaction (the details of which are included in section 5 of the Independent Expert's Report) as well as the consequential impacts on Telstra's business operations, it has concluded that the value of Telstra if the Proposed Transaction proceeds is approximately $4.7 billion (post-tax net present value as at June 2011) greater than under the best available alternative.

The approach adopted by the Independent Expert in its assessment is similar to that taken by the Directors in their assessment of the Proposed Transaction compared with the best available alternative given current Government policy. In both cases, the assessment takes into account the value delivered to Telstra by the Proposed Transaction and associated Government policy commitments. The Directors, however, used some different assumptions compared with those used by the Independent Expert.

The Independent Expert's full evaluation of the Proposed Transaction is set out in section 5 of the Independent Expert's Report, which is set out in Annexure 1.

5.1 VALUATION OVERVIEW

Telstra expects the Proposed Transaction and associated Government policy commitments to deliver to it approximately $11 billion in post-tax net present value (NPV) as at June 2010, subject to a range of dependencies and assumptions. This value does not include broader benefits which Telstra may gain from the Definitive Agreements and which are hard to quantify. Further, it is not an assessment of the overall impact of the Proposed Transaction on the underlying value of Telstra, which has been separately considered by the Independent Expert in its assessment of the Proposed Transaction. This value will not be in the form of an upfront payment, but is the present value of consideration and benefits to be received over many years.

Telstra expects to incur some costs to meet its infrastructure commitments to NBN Co and migrate customers onto the NBN Fibre Network. This includes an estimated incremental $0.5 billion of costs over 10 years relating to operational expenses brought forward. These are accelerated customer migration costs borne as a consequence of the rollout of the NBN Fibre Network and costs in relation to necessary work on infrastructure required by NBN Co. Given this represents less than 1% of Telstra's likely total operating expenditure over the same 10 year period, Telstra expects to be able to account for these incremental costs within existing expenditure profiles by achieving savings in other areas of the business.

Telstra will also incur a further approximately $0.9 billion of capital expenditure for necessary work on infrastructure and customer migration, as well as approximately $0.6 billion of operational expense for necessary work on infrastructure and maintenance activities. These costs are within Telstra's existing capital expenditure programs and operating expense targets and substitute for costs Telstra would otherwise incur. As such, they are not considered incremental to Telstra's current operations.

All of the above cost estimates are on a post-tax net present value basis as at June 2010. Further details on these costs are set out in section 5.4.

The values ascribed to the components of the Proposed Transaction (illustrated in Figure 10) have been assessed using a discounted cashflow valuation methodology. A net present value calculation seeks to bring the nominal value of future cashflow to a value at a single point in time by discounting these cashflows at a discount rate reflective of the risks associated with that cashflow and the time when it will be received. This is considered the most appropriate valuation methodology given the extended timeframe over which the NBN Fibre Network is to be rolled out and the long-term nature of many of the financial impacts of the Proposed Transaction. The values are presented post-tax to reflect the value to Telstra after it pays corporate tax upon receipt of the payments.

FIGURE 10: THE APPROXIMATE POST-TAX NPV OF THE PROPOSED TRANSACTION

Component	Approx. post-tax NPV ($bn, as at June 2010)	Discount rate applied	Cashflow modelling period
Payments from NBN Co			
Disconnection Payments and sale of Lead-in Conduits[1]	4.0	10%	10 years
Infrastructure Access Payments	5.0	10%	Average of 30 years
Payments/value from the Commonwealth			
TUSMA services	0.7	8%	Up to 20 years
Housing estate fibre provision responsibilities	0.3	10%	Ongoing
Other Government policy commitments	1.0	10%	Various over scheduled 10 year rollout
Approximate post-tax NPV of Proposed Transaction	**11.0**		

Note 1: While the sale of Lead-in Conduits is covered in the Infrastructure Services Agreement, it is included in the Disconnection Payments component of the table since it relates to assets or services that Telstra will not control once the NBN Fibre Network is built.

The values set out in Figure 10 depend on key assumptions, including:

- a discount rate of 10% has been applied to Disconnection Payments and Infrastructure Access Payments as well as to costs saved as a result of housing estate fibre provision responsibilities and cashflow associated with other Government policy commitments. This rate was adopted as it is consistent with Telstra's internal weighted average cost of capital and is regarded as a reasonable proxy for the risk associated with these estimated cashflows;
- a discount rate of 8% was applied for payments received for TUSMA services, reflecting the lower risk of these cashflows;
- the values are discounted to the time of signing of the Financial Heads of Agreement in June 2010 to facilitate direct comparison with terms agreed at that time;
- many of the payments to be received, and costs to be saved or avoided, are expected to occur in line with the rollout of the NBN Fibre Network. For the purposes of assessing the value, the rollout profile of the NBN Fibre Network, as presented in the NBN Co Corporate Plan, has been adopted; and
- the value of Disconnection Payments in particular is dependent to some extent on customer preferences. This is described in more detail in section 5.2.

Details on the assumptions underpinning the value of agreements with NBN Co and the Commonwealth and the costs of implementation are set out in further detail in sections 5.2 and 5.3.

5.2 VALUE OF THE NBN CO AGREEMENTS

Telstra has attributed value to the NBN Co Agreements as outlined below.

Disconnection Payments and sale of Lead-in Conduits

As the NBN Fibre Network is rolled out, Telstra will receive payment for progressively disconnecting Copper Services and HFC Broadband Services that are provided to premises in the NBN Fibre Footprint. These payments will be made following the disconnection of premises and are not linked to CPI. The value of these payments is therefore expected to be related to the number of premises connected to Copper Services and HFC Broadband Services as the NBN Fibre Network is rolled out and may be affected by the speed of the rollout.

Telstra will not be entitled to a Disconnection Payment for premises if, at a specified time after the Disconnection Date in the relevant Rollout Region:

- the premises are not connected to the NBN Fibre Network; and
- a relevant person at the premises has a wireless service directly or indirectly provided by Telstra.

However, if that premises subsequently connects to the NBN Fibre Network within three years after the Disconnection Date for the relevant Rollout Region, Telstra will then be entitled to a Disconnection Payment. A consequence of this mechanism is that the actual value of the Disconnection Payments which Telstra receives will be subject to risks associated with customer preferences. The Directors had regard to this in assessing the value of the Disconnection Payments.

Telstra will also receive payments for Lead-in Conduits acquired by NBN Co as part of the rollout of the NBN Fibre Network. The agreed payment per Lead-in Conduit is linked to CPI.

The Disconnection Payments and payments for sale of Lead-in Conduits are expected to be made broadly in line with the progressive rollout of the NBN Fibre Network. As set out in section 4.2.2.5, the Disconnection Payments will lag the rollout of the NBN Fibre Network by up to 18 months. Telstra expects that the annual total of Disconnection Payments and payments for Lead-in Conduits will increase up to 2014 as the rollout of the NBN Fibre Network gains momentum, and then be relatively constant throughout the remainder of NBN Co's scheduled 10 year rollout. Telstra expects that not all premises will have existing Lead-in Conduits that are fit for NBN Co's purposes and which therefore may be acquired by NBN Co.

Infrastructure Access Payments

Telstra will receive payments for providing NBN Co with long-term access to certain parts of its infrastructure and related services, namely Dark Fibre Links, Exchange Rack Spaces and Ducts and associated Duct infrastructure. These payments are for access to Telstra's infrastructure as Telstra will retain ownership of the underlying infrastructure.

The expected take-up rates of Telstra infrastructure by NBN Co are broadly linked to the rollout of the NBN Fibre Network but vary according to individual infrastructure elements. The total of Infrastructure Access Payments are therefore likely to increase over the 10 years of the scheduled rollout commensurate with increasing access and use of Telstra infrastructure, and then increase only with CPI for the remainder of the Infrastructure Services Agreement term (which has an initial term of a minimum of 35 years, with two options for NBN Co to extend by 10 more years each). This is expected to result in payments for access to infrastructure being received over an average 30 year period. All Infrastructure Access Payments under the Infrastructure Services Agreement are linked to CPI.

In order to build out its transit network, NBN Co has sought access to certain parts of Telstra's transit infrastructure (comprising all of the Dark Fibre Links and approximately 60% of Exchange Rack Spaces) in the early stages of the rollout. These elements are expected to be taken up by NBN Co within the first three and a half years of its rollout. The remaining elements of access infrastructure (comprising Ducts and the remaining required Exchange Rack Spaces) will be taken up over the rollout period of the NBN Fibre Network.

NBN Co has committed to use and pay for minimum levels of infrastructure and Telstra has committed to make available minimum levels of infrastructure within agreed timeframes and at agreed fitness standards. To the extent that these commitments are not met, penalties may apply for the party not meeting its commitment.

5.3 VALUE OF THE COMMONWEALTH AGREEMENTS

Telstra has attributed value to the Commonwealth Agreements and certain Government policy commitments, as demonstrated in Figure 10. These comprise:

- ***TUSMA services:*** these include payments to Telstra for delivery of certain public interest services such as the USO and the Emergency Call Service. From 1 July 2012, and for a term of 20 years, TUSMA must make the following payments to Telstra:

  a. $230 million annually (not indexed to CPI) for supply of Standard Telephone Service Universal Service Obligations, subject to certain adjustments;
  b. $40 million annually (not indexed to CPI) for the contractual obligation to supply, install and maintain payphones, subject to certain adjustments; and
  c. Any recovery of costs Telstra incurs in supplying the Emergency Call Service, up to a cap of $20 million annually (not indexed to CPI).

  These payments to Telstra will be funded by a combination of levy contributions and direct funding from the Commonwealth. The funding from the Commonwealth will be $50 million in each of the financial years ending 30 June 2013 and 30 June 2014, and $100 million for each subsequent financial year. Telstra will be required to contribute its share of any industry levies that are implemented for this purpose, based on "eligible revenue principles" as currently used for the USO levy scheme.

  In assessing the value of this arrangement, Telstra has considered the incremental cashflow it would receive from additional USO funding under this new arrangement relative to the cashflow it would otherwise have expected to receive from the existing USO levy scheme. The incremental cashflow is also net of the additional contributions Telstra will make as part of the USO scheme. The Commonwealth will provide additional USO funding which, during the first two years of TUSMA's operations, will offset any increase in contributions by industry, but not Telstra's contributions;

- ***New real estate fibre provision responsibilities:*** a policy statement released by the Minister on 9 December 2010 provided that NBN Co would be responsible for providing fibre to new developments from 1 January 2011 within or adjacent to areas in which the NBN Fibre Network has been rolled out. Subsequent to this, another policy statement was released by the Minister which provides that the responsibility for new developments will be as follows:
  - NBN Co will be responsible for deploying fibre in all new developments of any size approved after 1 January 2011, which are within an existing Rollout Region or within a Rollout Region to be deployed in the following 12 months;
  - if the new development is within the planned NBN Fibre Footprint, but the deployment of the NBN Fibre Network in the area is more than 12 months away, NBN Co will be responsible for all developments of 100 premises or more while Telstra will be responsible for developments of less than 100 premises. The developments in which Telstra deploys infrastructure then will be covered by the disconnection arrangements under the Definitive Agreements when the NBN Fibre Network is deployed in the area;
  - Telstra will be responsible for all new developments of any size outside the NBN Fibre Footprint; and
  - Telstra will continue to be responsible for the provision of USO services in all developments, including use of the NBN Fibre Network, as provided by the TUSMA Agreement.

Up to 1 January 2011, the Government's policy was that Telstra was responsible for providing infrastructure and services to all new developments across Australia (irrespective of whether it was less than 100 premises). This transfer of responsibility to NBN Co within the NBN Fibre Footprint will allow Telstra to realise significant future cost savings. Projected cost savings are based on historical spending on new housing estates and forecast spend as per Telstra's planned capital expenditure program. Capital expense borne by Telstra in provisioning for estates with less than 100 premises are expected to be offset by mandated contributions from developers for pit and pipe infrastructure and by Disconnection Payments from NBN Co when it passes those sites with the NBN Fibre Network; and

- ***Other Government policy commitments:*** these include various other payments to, or costs avoided by, Telstra under the Commonwealth Agreements and associated Government policy commitments, including:
  - costs avoided due to TUSMA's funding of certain customer costs for migration to the NBN Fibre Network. This applies to voice-only retail customers and priority assistance customers who have not yet migrated six months before the Disconnection Date in each Rollout Region;
  - when the NBN Fibre Network is deployed in an area, costs avoided due to TUSMA's funding of the migration (either to the NBN Fibre Network or to an alternative technology) of each payphone in that Rollout Region which Telstra is required to maintain under the TUSMA Agreement;
  - payments received from the Commonwealth for Telstra to retrain certain staff whose roles are currently linked to the operation of the Copper Network and the HFC Cable Network, or who otherwise may face redundancy as a result of the rollout of the NBN Fibre Network over time, unless redeployed in Telstra's business; and
  - costs avoided due to the Commonwealth arranging for NBN Co to conduct a public education campaign that informs end users about the nature and timing of the rollout of the NBN Fibre Network in their area, including the actions that a customer will need to take to continue to receive services and the consequences for a failure to take that action.

The profile of payments and costs avoided is expected to be broadly in line with the profile of migration of customers from the Copper Network and HFC Cable Network onto the NBN Fibre Network.

The Commonwealth has also provided a guarantee to Telstra for the payments required to be paid by NBN Co to Telstra in connection with the NBN Co Agreements. The obligations of the Commonwealth under the Commonwealth Guarantee will take effect once the NBN Co Agreements have themselves become binding in accordance with their express terms (for example, all Conditions Precedent have either been satisfied or waived). The amount the guarantee covers is capped at an amount that represents Telstra's current estimate of NBN Co's potential aggregate liabilities to Telstra, at any given time while the Commonwealth Guarantee is on foot and in circumstances where NBN Co, for some reason, does not meet its commitments to Telstra out of its own available assets.

5.4 IMPLEMENTATION COSTS AND IMPACT

In its provision of services to NBN Co under the Definitive Agreements, Telstra expects to incur the following cash expenditure:

- approximately $0.5 billion of incremental operational expenses brought forward and spread over 10 years. These are customer migration costs borne as a consequence of the rollout of the NBN Fibre Network and costs in relation to the necessary work on infrastructure required by NBN Co. Given this represents less than 1% of Telstra's likely total operating expenditure over the same 10 year period, Telstra expects to be able to account for these incremental costs within existing expenditure profiles by achieving savings in other areas of its business;
- approximately $0.9 billion of capital expenditure for necessary work on infrastructure and customer migration costs. These costs fall within Telstra's existing planned capital expenditure programs. Telstra regularly plans for technological changes and customer migration onto evolving technological platforms and networks Telstra may upgrade or roll out. Given that Telstra will instead now migrate these services onto the NBN Fibre Network, these costs substitute for costs Telstra would otherwise have incurred and are therefore not considered incremental to Telstra's current operations; and
- approximately $0.6 billion of operating expense for work on infrastructure maintenance activities. Telstra routinely projects such costs on an ongoing basis in order to maintain its infrastructure regardless of the Proposed Transaction. As such, these costs replace costs that Telstra would otherwise incur and are therefore not considered incremental to Telstra's current operations.

All of the above cost estimates are on a post-tax net present value basis as at June 2010.

6. KEY STEPS AND APPROVALS

6.1 TELSTRA SHAREHOLDER APPROVAL

In order for the Proposed Transaction to proceed, it must be approved by Telstra Shareholders.

Telstra Shareholders are being asked to vote on the Resolution to approve the Proposed Transaction at the Meeting scheduled to be held on Tuesday, 18 October 2011. As the Resolution is an ordinary resolution, the voting majority required is more than 50% of Telstra Shareholders present and voting at the Meeting (either in person, directly or by proxy).

6.2 OTHER CONDITIONS PRECEDENT

In addition to the requirement to obtain Telstra Shareholder approval, the Definitive Agreements contain other Conditions Precedent that must also be satisfied or waived by 5.00pm on 20 December 2011 (unless the parties otherwise agree) in order for the Proposed Transaction to proceed.

Telstra and NBN Co must file all necessary notices and applications to government agencies in order for the Conditions Precedent to be satisfied, and are otherwise required to use reasonable endeavours and co-operate with each other to seek that the Conditions Precedent are satisfied by the date of the Meeting. However, neither party is required to take any action where its directors reasonably consider that the particular action is inconsistent with their duties as directors.

The Conditions Precedent that are outstanding as at the date of this Explanatory Memorandum are set out below.

6.2.1 OUTSTANDING CONDITIONS PRECEDENT AS AT THE DATE OF THIS EXPLANATORY MEMORANDUM

As at the date of this Explanatory Memorandum, the following Conditions Precedent are outstanding:

- approval by each of Telstra's and NBN Co's shareholders of the Proposed Transaction;
- ACCC acceptance of a Structural Separation Undertaking and approval of a Draft Migration Plan in a form approved by Telstra and NBN Co and those documents come into force in accordance with the Telecommunications Act;
- the Commonwealth amending legislation or establishing other arrangements to implement its greenfields policy, in a form acceptable to Telstra and NBN Co;
- the Commonwealth introducing legislation considered necessary or desirable by the Commonwealth and NBN Co to facilitate NBN Co's rollout, in a form acceptable to Telstra and NBN Co;
- separate ATO private tax rulings relevant to each party that confirm the tax treatment of elements of the Proposed Transaction being acceptable to Telstra and NBN Co respectively;
- if NBN Co notifies Telstra prior to the satisfaction or waiver of the Conditions Precedent of a change to its stated intention to roll out fibre to 93% of premises in Australia, Telstra being satisfied that the change of intention does not adversely affect Telstra; and
- the parties agreeing an Initial Rollout Plan establishing a program for the handover of specified infrastructure under the Infrastructure Services Agreement over the course of NBN Co's rollout.

6.2.2 STATUS OF KEY OUTSTANDING CONDITIONS PRECEDENT

Set out below is the status of the key outstanding Conditions Precedent as at the date of this Explanatory Memorandum. Telstra will update Telstra Shareholders on any material developments relating to the status of the outstanding Conditions Precedent through announcements to the ASX. Telstra's announcements are available on www.asx.com.au and on Telstra's website at www.telstra.com. Telstra may also issue a supplementary information document – see section 7.2 for further information on the circumstances in which Telstra will issue a supplementary information document.

The risks associated with the fact that these key Conditions Precedent remain outstanding are described in section 3.4.1(a).

6.2.2.1 TELSTRA'S STRUCTURAL SEPARATION UNDERTAKING AND DRAFT MIGRATION PLAN

On 29 July 2011, Telstra lodged the Structural Separation Undertaking and Draft Migration Plan with the ACCC. On 1 August 2011, the ACCC announced its intention to undertake a 28 day public consultation process on the Structural Separation Undertaking and Draft Migration Plan, commencing once the ACCC is in a position to issue a discussion paper. Telstra will work closely with the ACCC during the consultation process, seeking to resolve any issues raised as part of that process, with a view to obtaining acceptance of the Structural Separation Undertaking and approval of the Draft Migration Plan before the Meeting. If this does not occur, Telstra may nonetheless seek Telstra Shareholder approval at the Meeting. However, commencement of the Definitive Agreements would still be subject to acceptance by the ACCC of the Structural Separation Undertaking and approval of the Draft Migration Plan, and satisfaction or waiver of any other outstanding Conditions Precedent.

6.2.2.2 TAX RULING FROM THE COMMISSIONER OF TAXATION

Telstra has met with the ATO, on behalf of the Commissioner of Taxation, on a number of occasions to discuss the Proposed Transaction. Telstra has also lodged a private ruling application with the ATO consistent with the above Condition Precedent. As at the date of this Explanatory Memorandum, this Condition Precedent remains unsatisfied.

6.2.3 END DATE (AUTOMATIC TERMINATION) AND INTERIM ACCESS

If any of the Conditions Precedent have not been satisfied (or otherwise waived) by 5.00pm on 20 December 2011, the Implementation and Interpretation Deed will automatically terminate unless Telstra and NBN Co otherwise agree. If the Implementation and Interpretation Deed automatically terminates, the remaining NBN Co Agreements will not become binding on the parties and the Commonwealth Agreements will not come into full effect.

If the Implementation and Interpretation Deed automatically terminates on the End Date, the interim arrangements under which NBN Co obtains access to Telstra's infrastructure before the Infrastructure Services Agreement becomes effective will survive, along with certain other provisions.

6.2.4 OTHER INFORMATION CONCERNING CONDITIONS PRECEDENT

In its announcement of 23 June 2011, Telstra noted in connection with the Conditions Precedent that it had requested that NBN Co confirm that NBN Co had arrangements in place to ensure the cessation of supply by Telstra of certain products occurs in a non-discriminatory way. That confirmation has been provided and the relevant condition has now been satisfied. On that same date, NBN Co and Optus announced that they had entered into an agreement to progressively migrate customers on Optus' hybrid fibre coaxial (HFC) network to the NBN as it is rolled out and that, once migration is completed, Optus will decommission the parts of its HFC network that do not provide ongoing support for mobile infrastructure and business customers. Optus and NBN Co stated that they expected the initial migration of customers to NBN infrastructure would commence in 2014 and be completed in up to four years across Optus' entire HFC footprint. The announcement noted that the agreement was conditional on ACCC approval and satisfactory rulings from the ATO and contained various termination rights, including rights relating to agreeing an implementation plan and the market environment in which the NBN is expected to operate.

Based on publicly available information, if this agreement comes into full effect and is implemented as described, Telstra anticipates that by the end of the rollout of the NBN Fibre Network, both Telstra and Optus will be using the NBN Fibre Network to supply fixed broadband services required by residential and small business customers currently served using their respective HFC networks.

7. ADDITIONAL INFORMATION FOR TELSTRA SHAREHOLDERS

7.1 TAXATION IMPLICATIONS

Irrespective of whether the Proposed Transaction is implemented, it will not have any taxation implications for Telstra Shareholders.

However, there will be a considerable number of tax implications for Telstra if the Proposed Transaction is approved and implemented. In order for Telstra to have a high degree of certainty surrounding the income tax consequences over the life of these arrangements, it is a Condition Precedent that the ATO issue a private ruling to Telstra confirming the intended tax treatment of elements of the Proposed Transaction.

The status of this Condition Precedent as at the date of this Explanatory Memorandum is set out in section 6.2.2.

7.2 SUPPLEMENTARY INFORMATION

Telstra will issue a supplementary document if, between the date of this Explanatory Memorandum and the Meeting, it becomes aware of:

- a material statement in this Explanatory Memorandum that is false or misleading;
- a material omission from this Explanatory Memorandum; or
- a significant change affecting a matter included in this Explanatory Memorandum.

Depending on the nature and timing of the changed circumstances, Telstra may circulate and publish any supplementary document by one or more of:

- placing an advertisement in a prominently published newspaper which is circulated generally throughout Australia;
- posting the supplementary document on Telstra's website at www.telstra.com; or
- making an announcement to the ASX (Telstra's announcements are available on www.asx.com.au and on Telstra's website at www.telstra.com).

7.3 QUESTIONS

This Explanatory Memorandum provides detailed information that all Telstra Shareholders should read in relation to the Proposed Transaction.

If you have any questions or require further information, you can call the Telstra information line on 1300 88 66 77 (within Australia) or +61 2 8280 7756 (outside Australia) on weekdays between 8.30am and 7.30pm (Sydney time).

If you are in any doubt as to what you should do, you should discuss this document with your professional adviser.

8. CONSENTS, DISCLAIMERS AND OTHER DISCLOSURES

8.1 CONSENT TO BE NAMED

The following parties have given and have not, before the date of this Explanatory Memorandum, withdrawn their written consent to be named in this Explanatory Memorandum in the form and context in which they are named:

- Grant Samuel as Independent Expert;
- Link Market Services Limited as Telstra Share Registry;
- Macquarie Capital (Australia) Limited;
- UBS AG;
- Gresham Advisory Partners Limited;
- Mallesons Stephen Jaques;
- Gilbert + Tobin;
- Freehills;
- Ernst & Young; and
- PricewaterhouseCoopers.

8.2 CONSENT TO THE INCLUSION OF INFORMATION

This Explanatory Memorandum contains statements made by, or statements said to be based on statements made by, Grant Samuel as the Independent Expert. Grant Samuel has given and has not, before the date of this Explanatory Memorandum, withdrawn its written consent to the inclusion of its statements and report, and the references to those statements and report in the form and context in which they are included in this Explanatory Memorandum.

8.3 DISCLAIMERS

Each of the parties named above as consenting parties:

- has not authorised or caused the issue of this Explanatory Memorandum;
- does not make, or purport to make, any statement in this Explanatory Memorandum or any statement on which a statement in this Explanatory Memorandum is based, other than Grant Samuel in relation to the Independent Expert's Report; and
- to the maximum extent permitted by law, expressly disclaims and takes no responsibility for any statements in, or omissions from, this Explanatory Memorandum.

8.4 DISCLOSURE OF INTERESTS

In accordance with their obligations under the Corporations Act, each of the Directors advises the Telstra board on an ongoing basis of any interests which may potentially conflict with those owed to Telstra.

The Chairman has notified the Telstra board of her position as a director of Macquarie Group Limited, the holding company of one of the financial advisers to Telstra in relation to the Proposed Transaction. The Chairman was not involved in any matters concerning the selection of Macquarie Capital (Australia) Limited, or negotiation of the terms of its engagement, by Telstra. Directors (other than the Chairman) who are members of Telstra's NBN Committee and/or the NBN Due Diligence Committee receive fees additional to their standard directors' fees for their additional services (at the approved rate for such additional work).

8.5 FEES PAID TO ADVISERS

Telstra and the Telstra board required professional advice to assist it to assess the Proposed Transaction.

Accordingly, Telstra and/or the Telstra board retained the following key advisers in relation to the negotiation, analysis, consideration and valuation of the Proposed Transaction, the obtaining of regulatory approvals and the preparation of this Explanatory Memorandum:

Financial advisers

- Macquarie Capital (Australia) Limited
- UBS AG
- Gresham Advisory Partners Limited

Legal advisers

- Mallesons Stephen Jaques
- Gilbert + Tobin
- Freehills

Accountants

- Ernst & Young (as auditors)
- PricewaterhouseCoopers

Telstra also retained Grant Samuel to provide the Independent Expert's Report.

The total amount of fees payable to these advisers and the Independent Expert for services provided from the commencement of Telstra's consideration of the Proposed Transaction in 2009 to the completion of the Proposed Transaction, if Telstra Shareholders approve the Proposed Transaction and all other Conditions Precedent are satisfied or waived, will be approximately \$87 million. Approximately 26% of this amount will only be payable if the Proposed Transaction is completed.

9. DEFINED TERMS

3G	third generation mobile network technology designed to further expand the bandwidth and functionality of existing mobile telephony systems beyond second generation technologies. The most common standards for 3G wireless are defined by the standards bodies 3GPP and 3GPP2.
4G	fourth generation mobile network technology that will provide faster data speeds, high quality video conferencing and faster response times when using mobile applications (such as smartphones and tablets) as an evolution beyond 3G standards.
ACCC	Australian Competition and Consumer Commission.
Access Deed	the Access Deed between Telstra and NBN Co dated 23 June 2011, a summary of which is set out in Annexure 2.
ADSL	asymmetric digital subscriber line, a high speed broadband technology that provides access to the internet. It allows high speed data to be carried over copper network phone lines either alone or in conjunction with a PSTN telephone service.
ADSL 2+	a broadband service provided over the Copper Network which extends the capability of the basic ADSL service to a maximum line speed of 24 Mbps.
Asian Business Operations	Telstra's Asian business operations, including CSL Hong Kong (Hong Kong's leading mobile operator), China-based search and advertising businesses and Reach submarine cable network.
ASX	ASX Limited (ABN 98 008 624 691), or the market operated by it as the context requires.
ATO	Australian Taxation Office.
Basic Service Offering (or BSO)	certain product components and features which form part of NBN Co's basic voice and data offering to Retail Service Providers and resellers over the NBN Fibre Network, that include 12 Mbps downlink and 1 Mbps uplink speeds at peak information rates (that is, best efforts internet with no quality of service commitments).
Carriage Service	a service for carrying communications by means of guided and/or unguided electromagnetic energy.
CCS Act	*Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010* (Cth).
Commonwealth	the Commonwealth of Australia.
Commonwealth Agreements	the Commonwealth Guarantee, the Information Campaign and Migration Deed, the Retraining Funding Deed and the TUSMA Agreement.
Commonwealth Guarantee	the deed of guarantee made by the Commonwealth in favour of Telstra dated 23 June 2011, a summary of which is set out in Annexure 2.
Competition and Consumer Act	*Competition and Consumer Act 2010* (Cth).
Conditions Precedent	the list of conditions precedent set out in the Implementation and Interpretation Deed, which must be satisfied or waived before the Definitive Agreements (other than the Implementation and Interpretation Deed) come into full effect.
Copper Network	Telstra's copper-based customer access network, which is used to deliver standard voice telephony and broadband services.
Copper Services and HFC Broadband Services	retail and wholesale telephony, data, broadband and access services provided by Telstra on the Copper Network and/or the HFC Cable Network (but not Pay TV Services on the HFC Cable Network).
Corporations Act	*Corporations Act 2001* (Cth).
CPI	the consumer price index.

Customer Service Guarantee	under the Customer Service Guarantee, carriage service providers are required to meet performance standards and provide users with financial compensation when these standards are not met. The standard specifies timeframes for the connection of specified services, the repair of faults and the attendance of appointments by service providers.
Dark Fibre	optical fibre owned or leased by, or licensed to, Telstra or a Related Entity of Telstra, which is not connected to electronic equipment used to manage the physical transfer of data over an optical fibre link.
Dark Fibre Link	length of Dark Fibre between certain points.
DBCDE	Department of Broadband, Communications and the Digital Economy.
Definitive Agreements	the Commonwealth Agreements and the NBN Co Agreements, which (other than the Implementation and Interpretation Deed) will not come into full effect unless each of the Conditions Precedent are satisfied or waived in accordance with their terms.
Designated Day	1 July 2018, unless the Minister, by written instrument, specifies another day.
Director	a director of Telstra.
Disconnection Date	except in limited circumstances, the date falling 18 months after a Rollout Region is declared Ready for Service.
Disconnection Payments	payments Telstra will receive for progressively disconnecting premises in the NBN Fibre Footprint connected to Copper Services and HFC Broadband Services.
Draft Migration Plan	a draft migration plan submitted by Telstra to the ACCC under Subdivision B of Division 2 of Part 33 of the Telecommunications Act, being a migration plan that is yet to be approved by the ACCC.
DSL	digital subscriber line. The generic term for high speed data services provided over copper access lines. A range of technology standards including ADSL, BDSL and VDSL fall into the DSL category.
Duct	a tubular structure usually underground used to house communications cables and equipment owned or controlled by Telstra or a Related Entity of Telstra (but does not include a pit, manhole or Lead-in Conduit).
Emergency Call Service	an emergency call service as defined in the Telecommunications Act.
Employee Share Plan Participant	a participant in the Telstra Employee Share Ownership Plan 1997, Telstra Employee Share Ownership Plan 1999, Telstra OwnShare Plan or Telstra DirectShare Plan.
End Date	20 December 2011.
Exchange Building	a building (or any part of a building) owned or leased by, or licensed to, Telstra or a Related Entity of Telstra that houses telecommunications switching equipment or a particular building or enclosure nominated by Telstra as an Exchange Building.
Exchange Rack Space	a rack space in an Exchange Building.
Explanatory Memorandum	this document, which forms part of the Notice of Meeting.
Fibre-to-the-Premises	a communications network technology that involves connecting homes and businesses with an optical fibre cable which can be used to provide a range of high speed broadband services and phone services.
Final Migration Plan	a final migration plan as defined in section 577BE of the Telecommunications Act, being a Draft Migration Plan which has been approved by the ACCC in accordance with the Telecommunications Act.
Financial Heads of Agreement	the non-binding Financial Heads of Agreement signed by Telstra and NBN Co in June 2010, which provided the framework for the Definitive Agreements to be negotiated.
FOXTEL	the Australian subscription television business of that name, in which Telstra has a 50% equity interest.

Government	the Commonwealth Government.
Government Agency	any government or any government department, governmental, semi-governmental, administrative, fiscal, investigative, review or regulatory body, department, commission, authority, tribunal or agency.
Grant Samuel	Grant Samuel & Associates Pty Limited (ABN 28 050 036 372).
HFC Cable Network	Telstra's hybrid fibre coaxial cable network, which delivers high speed broadband services and Pay TV Services.
Implementation and Interpretation Deed	the Implementation and Interpretation Deed between Telstra and NBN Co dated 23 June 2011, a summary of which is set out in Annexure 2.
Independent Expert	Grant Samuel.
Independent Expert's Report	the report of the Independent Expert, a copy of which is set out in Annexure 1 to this Explanatory Memorandum.
Independent Telecommunications Adjudicator	the person appointed by Telstra and the ACCC to undertake investigations and make determinations as provided for in the Structural Separation Undertaking.
Information Campaign and Migration Deed	the Information Campaign and Migration Deed between Telstra and the Commonwealth dated 23 June 2011, a summary of which is set out in Annexure 2.
Infrastructure Access Payments	payments Telstra will receive for providing access to certain parts of its infrastructure, including Dark Fibre Links, Exchange Rack Spaces and Ducts.
Infrastructure Services Agreement	the Infrastructure Services Agreement between Telstra and NBN Co dated 23 June 2011, a summary of which is set out in Annexure 2.
Initial Rollout Plan	a plan that establishes a program for the handover of Dark Fibre Links and Exchange Rack Spaces under the Infrastructure Services Agreement over the course of the rollout of the NBN Fibre Network.
Internet Service Provider	an entity, such as a company, that provides the link between a customer and the internet by means of a dial-up or broadband service.
IP	internet protocol.
IPTV	internet protocol television.
ISDN	integrated services digital network, a digital service providing switched and dedicated integrated access to voice and data over copper or optical access networks.
Lead-in Conduit (or LIC)	a pipe owned or leased by, or licensed to, Telstra or a Related Entity of Telstra that runs from a pit, manhole or pole to the premises, or nearby to that premises, and is typically underground.
Line Sharing Services (or LSS)	services which enable service providers to use the Copper Network to provide certain broadband services while Telstra provides standard voice services over the same copper line.
LTE (also referred to as 4G)	a next generation wireless technology capable of higher data rates and network capacity to support the evolving demand for mobile applications such as internet access and high definition video over smartphones, personal computers and tablets.
Media	Telstra's media and directories operations including FOXTEL, Sensis (and its advertising and information services subsidiaries), BigPond Media and Trading Post.
Meeting	the annual general meeting of Telstra to be held on 18 October 2011.
Migration Plan Principles	means the principles set out in the Telecommunications (Migration Plan Principles) Determination 2011, made by the Minister under subsection 577BB(1) of the Telecommunications Act.
Minister	Minister for Broadband, Communications and the Digital Economy.

NAS	network applications and services.
NBN (National Broadband Network)	the national telecommunications network, comprised of the NBN Fibre Network, wireless and satellite technologies, owned or controlled by, or operated by or on behalf of, NBN Co or a Related Entity of NBN Co.
NBN Co	NBN Co Limited (ABN 86 136 533 741), and, where the context requires, includes NBN Co and any one or more of its Related Entities.
NBN Co Agreements	the Implementation and Interpretation Deed, the Subscriber Agreement, the Infrastructure Services Agreement, and the Access Deed.
NBN Co Corporate Plan	NBN Co Corporate Plan 2011-2013 dated 17 December 2010.
NBN Fibre Footprint	the geographic areas in which NBN Co intends to roll out the NBN Fibre Network, or the premises which are passed or intended by NBN Co to be passed by the NBN Fibre Network within one or more Rollout Regions.
NBN Fibre Network	the optical fibre telecommunications network of fibre that is owned or controlled by, or operated by or on behalf of, NBN Co or a Related Entity of NBN Co (and which has been accepted into service, ready for the provision of commercial (non-trial) NBN services).
NBN Serviceable	premises passed by the NBN Fibre Network that NBN Co has determined are serviceable by the NBN Fibre Network, as shown in the NBN Co service qualification system.
Nominee Form	the green Nominee Form for the Meeting sent to Employee Share Plan Participants.
Notice of Meeting	the notice of meeting that accompanies this Explanatory Memorandum. This Explanatory Memorandum forms a part of that notice of meeting.
NPV	net present value.
Pay TV Services	carriage services to enable subscription and/or on-demand analogue or digital cable television services (other than internet protocol-based services), provided to FOXTEL, and certain other parties under existing contracts with Telstra.
Priority Assistance	the service designed to help people with diagnosed life threatening medical conditions who depend on a reliable, fixed line home telephone service to be provided priority restoration or connection.
Proposed Transaction	Telstra implementing its obligations under the Definitive Agreements (subject to the Conditions Precedent being satisfied or waived) in support of the rollout of the NBN, as more fully set out in this Explanatory Memorandum.
Provide-or-Pay	a contractual mechanism that provides an incentive for Telstra to make available agreed minimum quantities of infrastructure.
PSTN	public switched telecommunications network, being Telstra's national fixed network delivering basic and enhanced telephone services to residential and business customers in Australia through the Copper Network.
Radiocommunications Act	*Radiocommunications Act 1992* (Cth).
Ready for Service	a Rollout Region is Ready for Service when NBN Co is ready to connect premises in that Rollout Region to the NBN Fibre Network, which will be when the NBN Fibre Network has passed at least 90% of the premises in the NBN Fibre Footprint in that Rollout Region.
Regulated Services	the services to be covered by the interim equivalence and transparency measures in a Structural Separation Undertaking as specified by the Minister in the *Telecommunications (Regulated Services Determination) (No.1)* 2011. These services include a number of specified currently declared services supplied over fixed networks (including ULLS and LSS), wholesale ADSL and access to Telstra exchange space and associated facilities.
Related Entity	for a person, each related body corporate and any entity that is controlled (as defined in section 50AA of the Corporations Act) by that person from time to time.

Resolution	the resolution set out under item 2 in the Notice of Meeting.
Retail Service Provider	retail service provider or application/content service provider that provides services to end users over the NBN and has a direct customer relationship with end users.
Retraining Funding Deed	the Retraining Funding Deed between Telstra and the Commonwealth dated 23 June 2011, a summary of which is set out in Annexure 2.
Rollout Region	a region served by the NBN Fibre Network. A Rollout Region is typically expected by NBN Co to cover approximately 3,000 premises.
Special Services	particular types of services (for example, services necessary to operate traffic lights) provided over the Copper Network which may not be disconnected on the Disconnection Date for a Rollout Region. A separate regime (with a different timeframe for disconnection) applies to disconnection of special services provided over the Copper Network. Disconnection protocols have been agreed to govern this.
SSU Guidance Instrument	the Telecommunications (Acceptance of Undertaking about Structural Separation – Matters) Instrument 2011 made by the Minister under section 577A(7) of the Telecommunications Act.
Standard Telephone Services	standard telephone service as defined in the Telecommunications Act.
Structural Separation Undertaking	Telstra's Structural Separation Undertaking given to the ACCC on 29 July 2011 under section 577A of the Telecommunications Act as contemplated by the Implementation and Interpretation Deed.
Subscriber Agreement	the Subscriber Agreement between NBN Co and Telstra dated 23 June 2011, a summary of which is set out in Annexure 2.
Take-or-Pay	a contractual mechanism that provides an incentive for NBN Co to take agreed minimum quantities of the infrastructure that Telstra makes available to NBN Co.
Tax Act	*Taxation Administration Act 1953* (Cth).
Telecommunications Act	*Telecommunications Act 1997* (Cth).
Telstra	Telstra Corporation Limited (ABN 33 051 775 556).
Telstra Share	a fully paid ordinary share in the capital of Telstra.
Telstra Shareholder	a person who is registered on the Telstra Share Register as a holder of a Telstra Share. Telstra Shareholders should refer to the Notice of Meeting that accompanies this Explanatory Memorandum to determine eligibility to vote and attend the Meeting.
Telstra Share Register	the register of Telstra Shareholders maintained under section 168 of the Corporations Act.
Telstra Share Registry	Link Market Services Limited (ABN 54 083 214 537).
Transit Ring	a grouping of Dark Fibre Links and Exchange Rack Spaces that are identified as being part of the same transit ring in the Initial Rollout Plan (or in any subsequent rollout plan agreed under the Infrastructure Services Agreement). This grouping is based on the design of NBN Co's transit network which typically involves a series of related Dark Fibre Links and Equipment Rack Spaces forming all or part of a ring-like pattern.
TUSMA	Telecommunications Universal Service Management Agency, being the entity to be established by the Commonwealth to manage agreements that implement the Commonwealth's reform of the USO and delivery of public interest telecommunications services. TUSMA is expected to assume progressively regulatory responsibility for the provision of the USO.
TUSMA Agreement	the Telecommunications Universal Services Management Agency (TUSMA) Agreement between Telstra and the Commonwealth dated 23 June 2011, a summary of which is set out in Annexure 2.

ULLS	unconditioned local loop service, being a service provided by Telstra which allows carriage service providers direct access to premises using the copper between the end user and the telephone exchange. This enables carriage service providers to directly compete for customers and offer a range of telephony and data services.
USO	universal service obligation, being the obligation to ensure that Standard Telephone Services, payphones and prescribed carriage services are reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business. Telstra is presently the sole universal service provider.
Voting Form	the blue voting form for the Meeting sent to Telstra Shareholders.

GRANT SAMUEL

GRANT SAMUEL & ASSOCIATES

LEVEL 19 GOVERNOR MACQUARIE TOWER
1 FARRER PLACE SYDNEY NSW 2000
GPO BOX 4301 SYDNEY NSW 2001
T: +61 2 9324 4211 / F: +61 2 9324 4301
www.grantsamuel.com.au

31 August 2011

The Directors
Telstra Corporation Limited
Level 41
242 Exhibition Street
Melbourne VIC 3000

Dear Directors

Proposed Transaction with NBN Co Limited and the Commonwealth

1 Introduction

Enhanced access to high speed broadband services throughout Australia has been an accepted objective of public policy for much of the past decade. In 2008, the Commonwealth Government ("the Commonwealth") announced a plan to develop a national broadband network with a minimum speed of 12 megabits per second ("Mbps") available to at least 98% of premises nationally. Telstra Corporation Limited ("Telstra") and five other parties tendered proposals to the government in response to a request to provide the network infrastructure.

However, the Commonwealth terminated the tender process in April 2009 and instead announced a plan to proceed with the development of its own high speed network, the National Broadband Network ("NBN"). The Commonwealth established a wholly owned corporation, NBN Co Limited ("NBN Co"), as the vehicle to roll out and operate the NBN. The NBN's fibre network is planned to reach 93% of premises across Australia, with the remaining 7% to be serviced by fixed wireless or satellite services. The fibre network will offer speeds of up to 100 Mbps and the wireless/satellite services will offer a minimum of 12 Mbps. NBN Co will operate only at a wholesale level, selling network access to retail service providers, including Telstra, which will, in turn, market internet, telephony and other services to residential, business and institutional customers. The total cost of the NBN was initially estimated to be approximately $43 billion and NBN Co is currently in the early stages of the roll out.

In parallel with the establishment of the NBN, the Commonwealth developed legislation designed to incentivise Telstra to separate its fixed line networks from its retail business. The Commonwealth Parliament passed the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act ("CCS Act") in November 2010. If Telstra does not structurally separate its fixed line networks to the satisfaction of the Minister for Broadband, Communications and the Digital Economy ("the Minister"), the Minister has power to impose a legislative prohibition on Telstra bidding for the next major tranches of wireless spectrum (the 700 and 2600 megahertz ("MHz") bands) to be released by the government once analogue television is phased out (referred to as the "Digital Dividend spectrum"). Telstra's wholesale business would also be required to be functionally separated from the retail business (with new transfer pricing and governance regimes).

Against the background of these developments, Telstra, NBN Co and the Commonwealth have been negotiating a proposal which would involve Telstra participating in the roll out of the NBN and at the same time enable it to meet the structural separation requirements of the CCS Act ("the Proposal"). In essence, Telstra will disconnect its copper and HFC[1] broadband networks,

[1] Hybrid Fibre Coaxial cable. This network passes approximately 2.7 million premises. Its primary role is to deliver the FOXTEL pay television service but it also used to deliver a broadband service.

migrate fixed line services to the NBN and provide access to elements of its infrastructure to NBN Co. The Proposal is designed to result in significant benefits for both NBN Co and Telstra:

- NBN Co benefits from materially lower deployment costs and, together with the arrangements announced by NBN Co and Optus, it ensures that virtually all fixed line voice and broadband subscribers throughout Australia who are within the NBN fibre footprint will utilise the NBN;
- Telstra receives substantial payments from NBN Co over a number of years and receives additional value through other arrangements with the Commonwealth; and
- Telstra's progressive exit from the operation of its copper and HFC networks within the NBN fibre footprint will meet the structural separation requirements of the CCS Act, thereby allowing it to participate in the Digital Dividend spectrum auctions.

Non binding financial heads of agreement with NBN Co were signed in June 2010 and definitive agreements were executed in June 2011.

The Proposal is subject to the approval of Telstra shareholders. In connection with that approval, Telstra has engaged Grant Samuel & Associates Pty Limited ("Grant Samuel") to prepare an independent expert's report ("the Report") setting out its opinion as to whether or not the Proposal is in the best interests of Telstra and its shareholders. The Report will accompany the Notice of Meeting and Explanatory Memorandum to be sent to Telstra shareholders. This letter contains a summary of Grant Samuel's opinion and main conclusions.

2 Details of the Proposal

There are three key elements to the Proposal:

(i) Migration of Services to the NBN

Telstra will progressively disconnect voice and broadband services from its existing copper and HFC networks and migrate them to the NBN as it is rolled out. NBN Co's corporate plan envisages that its network will be rolled out over the period from 2011 to 2022. Once the network has passed 90% of premises within a defined rollout region and NBN Co has declared that region ready for service, Telstra will begin to disconnect its copper and HFC broadband services in that region. Eighteen months after a rollout region is declared ready for service, all copper and HFC broadband services provided to premises in that region will be permanently disconnected[2] except to the extent needed to provide certain limited types of services (e.g. special services such as ISDN which will be disconnected over a longer time period). Telstra will retain all its existing fibre backhaul and other networks (e.g. in CBD locations).

In return, Telstra will receive a one time payment per active service address as each one is disconnected over the 18 month migration period for each rollout region ("PSAA payments"). There are clawback arrangements if, a certain time after the end of that 18 month migration period, the individual customers are Telstra wireless subscribers and did not connect to the NBN but with further rights for Telstra to win back the payment. From the time of connection to the NBN, Telstra (and other retailers) will pay NBN Co a

[2] Disconnection of the HFC network is only disconnection of the broadband services provided on the HFC network. Pay television services (FOXTEL and for certain other parties under existing contracts) will continue to be delivered over this network.

monthly access fee for each customer, the quantum of which is dependent on the service plan customers select.

The progressive shut down of much of its fixed line network operations will generate significant cost savings for Telstra. Telstra will however incur other costs as a result of the migration including:

- installation and customer communication costs. Telstra (and other retailers) may need to install new equipment in customer's premises (although self installation will also be possible);
- redundancy costs, although these will be reduced to some extent through retraining and redeployment; and
- business systems and information technology costs.

(ii) Access to Telstra Infrastructure

Telstra will give NBN Co access to elements of Telstra's network infrastructure including dark fibre links (for backhaul), rack spaces in selected exchanges (where NBN Co will install equipment), ducts (through which to lay the fibre cable from the exchange) and lead-in conduits (for final delivery to premises).

In return, Telstra will receive infrastructure access payments for each of these elements for an assumed average of 30 years except for the lead-in conduits which will be transferred to NBN Co for a once off payment (as lead-in fibre is installed by NBN Co into the conduit).

Telstra will be required to upgrade and maintain this infrastructure during the period of ongoing access by NBN Co.

(iii) The Government Package

New regulatory and other arrangements have been agreed with the Commonwealth ("the Government Package"), including:

- relief from the primary Universal Service Obligation ("USO"). The Commonwealth will establish a new entity ("TUSMA") to progressively take over the USO. Telstra, along with other industry participants and the Commonwealth, will make financial contributions to TUSMA which will distribute the funds to Telstra and any other USO service providers. Telstra will be contracted to provide the vast majority of USO services to retail customers (e.g. voice services to the 7% of premises that NBN Co will service through wireless or satellite) for which it will be paid by TUSMA. The effect of these arrangements is expected to be a net increase in payments to Telstra under the USO;
- relief from the responsibility to install fixed lines to new housing developments ("greenfields obligations") with 100 or more premises;
- a $100 million retraining fund to be provided by the Commonwealth; and
- other arrangements regarding retailer migration costs and communication costs.

Telstra has also lodged a Structural Separation Undertaking and a Draft Migration Plan with the Australian Competition and Consumer Commission ("ACCC") in accordance with the CCS Act. If the undertaking is approved by the ACCC and comes into force:

- Telstra will have satisfied the structural separation test; and

- waivers to be issued by the Minister will mean that the legislative power to impose the prohibition on Telstra acquiring Digital Dividend spectrum will fall away and Telstra will be able to retain ownership of the HFC network and the 50% equity interest in FOXTEL (although the Minister will continue to have rights under the Radiocommunications Act to limit the ability of any party, including Telstra, to participate in spectrum auctions).

Approval by the ACCC and the Ministerial waivers are condition precedents to implementation of the Proposal.

3 Summary of Opinion

In Grant Samuel's opinion, the Proposal is in the best interests of Telstra and its shareholders. There is a significant degree of uncertainty about the potential impact of the NBN as well as uncertainty about other factors such as the future political and regulatory environments and the pace of technology developments in the telecommunications sector. Nevertheless, Telstra shareholders are likely to be better off if they approve the Proposal than if they do not.

The merits of the Proposal can only be meaningfully assessed relative to the alternatives available to Telstra in light of the NBN roll out and the recent legislative changes. The status quo is temporary.

Grant Samuel's primary analysis compares the relative impacts of approval or rejection of the Proposal assuming that the NBN proceeds as planned and that the present regulatory regime continues. If the Proposal is approved, Telstra will co-operate in the roll out of the NBN, provide access to infrastructure and migrate its fixed line services to the NBN in return for cash payments and other benefits ("the Co-operate scenario"). If shareholders do not approve the Proposal, then Telstra's only real choice is to compete with the NBN. In this case ("the Compete scenario"), Telstra would:

- **not receive any payments from NBN Co for disconnection or payments for lead-in conduits. Payments for infrastructure access would be very substantially lower as Telstra would give NBN Co only limited access to its infrastructure to the extent required by law;**
- **further develop its own high speed broadband capacity (by upgrading the HFC network) and maintain the copper network as long as practicable. Telstra would sell NBN services to customers if there was demand (e.g. outside the HFC network footprint);**
- **likely be subject to the legislative prohibition on acquiring 700 and 2600 MHz spectrum;**
- **not receive the benefits that form part of the Government Package. For example, Telstra would not receive the increased contributions to the cost incurred by Telstra in delivering the USO; and**
- **be forced to functionally separate its fixed line wholesale business, requiring material investment of capital and business resources.**

These alternative scenarios form the basis of the analysis. The analysis shows that, if the NBN is built, Telstra shareholders will be substantially better off in net present value ("NPV") terms if Telstra co-operates rather than competes. Under the Base Case assumptions, the incremental NPV from co-operation is $4.7 billion, equivalent to 38 cents per share. This differential is primarily attributable to the value of the payments by NBN

Co and the value of the arrangements with the Commonwealth as well as other benefits from not competing (avoiding the Digital Dividend spectrum prohibition and functional separation costs). These benefits are partly offset by the adverse impact of the Proposal on Telstra's operating earnings and cash flows.

Importantly, the incremental NPV resulting from co-operation remains substantial even under a wide range of alternative assumptions (e.g. assumptions as to the timing of the NBN roll out or the extent of market share losses in a competitive environment).

Competition also involves other significant risks which have not been quantified in this analysis. It is likely that Telstra would face a more adverse regulatory environment if the Proposal is rejected. Aside from regulation of the access pricing regime, various elements of the broader regulatory regime (e.g. service levels) give considerable discretion to the Minister.

The second part of Grant Samuel's analysis recognises that in fact there is uncertainty about the ultimate development of the NBN itself, particularly in view of the divergent policy positions of the two major political parties. If there is a change of government, it is conceivable that the NBN roll out could be terminated or substantially modified. However, the relevant issue is whether voting for or against the Proposal would give the better outcome for Telstra shareholders. The Base Case analysis shows that if the NBN is terminated, shareholders will still be better off if they had approved the Proposal primarily because of the combined effect of the payments from NBN Co in the Co-operate scenario and the regulatory consequences of rejection in the Compete scenario. Moreover, approval of the Proposal does not inhibit Telstra's ability to participate in any alternative national broadband plan.

The more complex consideration is that, in Grant Samuel's view, rejection of the Proposal would increase the likelihood that the NBN roll out will be terminated or severely restricted because it would increase the cost of the NBN to the Commonwealth, potentially delay the roll out and substantially reduce the subscriber base of the NBN. Whether that increase in likelihood justifies the adverse effects and downside risks is a fundamental question for shareholders. A decision by Telstra shareholders to reject the Proposal would be only one of many factors that would influence any future government decision to abandon or modify the NBN plan and is unlikely to be the determining factor. The ultimate outcome will also depend on a variety of other factors including:

- **the timing of any federal election and the election result;**
- **the evolution of the Coalition's telecommunications policy and, in particular, the nature of any alternative national broadband plan that is finally adopted;**
- **the state of the Commonwealth budget at that time;**
- **NBN Co's performance to date and the extent to which it has spent funds or made commitments to do so; and**
- **technological developments.**

There is a high level of uncertainty with a wide range of possible outcomes dependent on a large number of variables. Nonetheless, a simple decision tree analysis indicates that even if a decision to reject the Proposal by itself materially increased the probability of the NBN being terminated, the expected value of the Co-operate scenario still exceeds that of the Compete scenario. Further:

- **the Compete scenario includes a number of favourable assumptions (e.g. as to NBN penetration and the impact of spectrum prohibition);**
- **there are substantial downside risks in the Compete scenario not included in the financial analysis, in particular the risks of greater regulatory imposts; and**
- **there is no reason to believe that the Coalition would unwind any of the adverse regulatory provisions that would already be in effect as a consequence of rejection of the Proposal.**

In any event, it is more appropriate to base a decision about the Proposal on the current reality that the NBN is being rolled out and the legislative regime that is in place rather than speculative possibilities.

There are a number of other factors that have not been quantified and are not reflected in the financial analysis. For example, Telstra will benefit from greater regulatory certainty if the Proposal is implemented and will avoid the risks and downsides of the Compete scenario. There are also disadvantages and risks but these are outweighed by the benefits and advantages particularly the expected value gain.

4 Key Conclusions

- **The best way to analyse the Proposal is to compare the financial impact of approval to the financial impact of rejection. If the Proposal is rejected, Telstra will have to compete with NBN Co**

  The merits of the Proposal can only be meaningfully assessed relative to the alternatives available to Telstra and its shareholders. The choice is not between the Proposal and returning to the previous status quo in which the NBN did not exist as the telecommunications landscape has already fundamentally changed in two respects:

  - the Commonwealth has established NBN Co and, in the absence of a material change in circumstances, the NBN will be progressively rolled out across Australia. NBN Co has already made substantial progress in the roll out including detailed planning, the establishment of a number of test sites and an initial roll out in Tasmania. In short, the NBN is a competitive reality that Telstra must deal with whether the Proposal is implemented or not; and
  - the CCS Act, which was passed in December 2010, has a number of significant adverse consequences for Telstra if the Proposal is not implemented. At its most basic level, the legislation seeks to force Telstra to structurally separate its fixed line networks (where it is the dominant participant) from its retail and other activities. If Telstra does not structurally separate then it must functionally separate and is likely to be barred from participating in any auction of the Digital Dividend spectrum needed for the efficient deployment of next generation (4G/LTE) wireless services[3]. The legislation also introduces other changes that apply if Telstra does not structurally separate including changes to the USO and other customer obligations.

  It is Grant Samuel's view that the best way to analyse the Proposal is, in the first instance, to assume that the NBN proceeds as planned and that the present regulatory regime continues. In these circumstances, shareholders realistically have two options:

[3] Under the CCS Act, the prohibition on Telstra bidding for spectrum is not automatic but is at the discretion of the Minister. For the purposes of the Report, Grant Samuel has assumed that in these circumstances the Minister would exercise the power to impose the prohibition.

- approve the Proposal, implement structural separation and co-operate with NBN Co; or
- reject the Proposal and compete directly with NBN Co and bear the consequences of the recent legislative changes.

Given this framework, the relevant issue for shareholders is not the value of Telstra per se or even the value of the payments to be received from NBN Co and the value of the arrangements with the Commonwealth. Rather, the key issue for shareholders is whether the value of Telstra if the Proposal is implemented is likely to be greater than the value of Telstra if it competes with the NBN. The analysis supporting an informed decision therefore needs to capture the impact of either decision on Telstra's business operations as well as the value of the transaction with NBN Co and the Commonwealth.

For the purposes of the analysis, two scenarios have been considered:

- ***The Co-operate Scenario***

  In this scenario, the Proposal is implemented and Telstra receives the stream of payments from NBN Co and the value from arrangements with the Commonwealth. Telstra retains the HFC network (for the provision of FOXTEL services) and its equity interests in FOXTEL and participates in the Digital Dividend spectrum auctions. It is assumed Telstra wins an appropriate share of this spectrum; and

- ***The Compete Scenario***

  If the Proposal is not approved, Telstra will have little choice but to compete with the NBN. It is assumed that:

  - Telstra does not receive any of the PSAA payments for disconnection or payments for the transfer of lead-in conduits. It will receive some limited payments for infrastructure access but at much reduced levels compared to the Co-operate scenario as Telstra would provide only very limited access to its infrastructure as required by existing laws (e.g. ducts under the facilities access regime); and
  - Telstra competes with NBN Co in the most effective and efficient way possible. This would involve:
    - upgrading the HFC network within its existing footprint and adding voice capability to compete directly with the NBN service;
    - maintaining the copper network as a cost efficient service for customers for as long as practicable. Telstra may choose to migrate retail services to the NBN where demand justified (particularly outside the HFC network footprint); and
    - enhancing wireless services to the extent possible under the spectrum restrictions that prevent it acquiring Digital Dividend spectrum.

  Telstra would be required to undertake functional separation and not obtain any of the benefits of the revised USO regime (or any other elements of the Government Package).

In both scenarios it is assumed that the NBN is fully rolled out (albeit not necessarily with the same timing as NBN Co's plan).

- **The financial analysis allows the value of the difference between forecast cash flows in the Co-operate and the Compete scenarios to be estimated**

  Over the past two years, Telstra has developed detailed financial models of its business in order to assess the impact of the Proposal and other alternative transactions. The models are based on the business plan to 2014 which has been extrapolated to 30 June 2030. The detailed assumptions have been developed by Telstra in conjunction with operations staff and checked against internal cost or other benchmarks where possible.

  Grant Samuel has used these financial models as the basis for its analysis but has made changes to key underlying assumptions to reflect its judgement on certain matters and to better reflect the purposes of the analysis. The analysis focuses on the difference between the Co-operate and Compete scenarios (rather than absolute values) because this is the critical factor for shareholders.

  The major assumptions adopted by Grant Samuel in the Base Case analysis include the following:

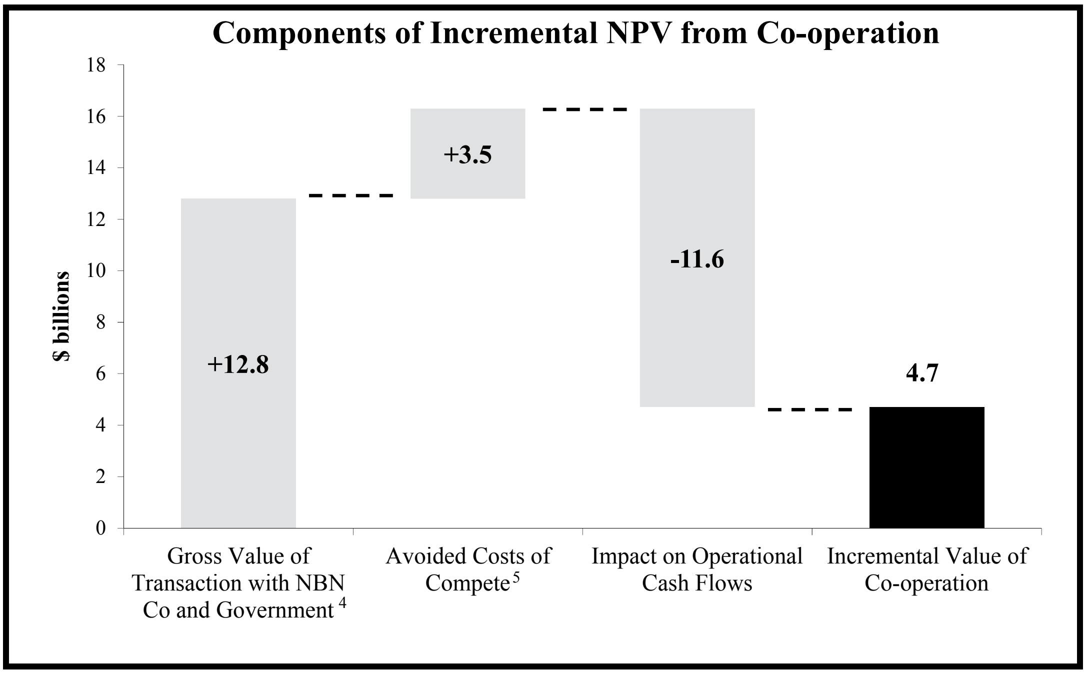
  - the NBN roll out is two years longer than NBN Co's published profile and the Compete scenario is also delayed by one further year;
  - the PSAA payments from NBN Co for disconnection allow for increasing wireless substitution prior to the NBN roll out and for further substitution at the time of migration. The share of the voice market held by mobile only premises is assumed to be 27.5% by the end of the roll out (FY24);
  - while Telstra will seek to retain all customers, it is assumed Telstra voice customers with an alternative internet service provider ("ISP") will choose the ISP to provide the new NBN service. Accordingly, Telstra's voice market share converges to its broadband share;
  - Telstra's broadband share is assumed to remain relatively stable at around 40% but is slightly higher in the Compete scenario (primarily because of the HFC upgrade);
  - wireless substitution in the broadband market increases to approximately 14% by FY24;
  - revenues per customer decline over the forecast period;
  - in the Compete scenario:
    - NBN Co obtains approximately 35% of all service addresses by FY24; and
    - the Digital Dividend spectrum prohibition reduces Telstra's mobile revenues in each year by a percentage factor that starts in FY16 and peaks at 20% in FY25 (and remains at 20% thereafter).

    Arguably, these assumptions may favour the Compete scenario but that only serves to reinforce the robustness of the outcome; and
  - functional separation costs total more than $1 billion.

  The after tax cash flows were discounted at 9%. The assumptions adopted in the analysis are discussed in more detail in Section 5.3 of the Report and in Appendix 3.

- **The NPV benefit of co-operation is approximately $5 billion**

  Under the Base Case assumptions, the Co-operate scenario produces an NPV that is $4.7 billion (equivalent to 38 cents per share) greater than the NPV of the Compete scenario. The components of the NPV of the incremental cash flows are shown below:



  The nature of the Proposal is such that the absolute level or accuracy of the calculated NPV should be of less concern to shareholders. The critical issue is that the analysis demonstrates that the NPV of the Co-operate scenario exceeds the NPV of the Compete scenario by a sufficient margin to mean that the conclusion that implementing the Proposal will be value accretive in most circumstances is robust.

  A sensitivity analysis (see Section 5.3.3 of the Report) showed that the incremental NPV from co-operation remained significantly positive under a variety of alternative assumptions. A relatively extreme set of circumstances would be required for the Compete scenario to have an NPV greater than the Co-operate scenario.

- **It is however conceivable that if there is a change of government, the NBN will not be completed as currently planned. If the NBN is not completed, Telstra is likely to be better off if shareholders have approved the Proposal**

  The financial analysis set out above is on the basis that the NBN roll out to 100% of premises would be completed and that the current regulatory regime remains in place. Grant Samuel believes this to be the most appropriate basis for the analysis. However, there is uncertainty about the ultimate development of the NBN itself, particularly in view of the divergent policy positions of the two major political parties. In reality, there is a wide range of possible outcomes and completion of the NBN in accordance with its current

[4] This value is before associated costs (remediation and maintenance of infrastructure, migration, redundancies etc). The NPV of $12.8 billion differs from Telstra's estimate of $11 billion primarily because Grant Samuel has used a lower discount rate (9% compared to 10%) and because it is calculated as at 30 June 2011 (compared to 30 June 2010). In addition, Grant Samuel has utilised different assumptions (e.g. as to roll out).

[5] Comprises the cost of functional separation and the impact of the Digital Dividend spectrum prohibition.

plan is only one of them. If there is a change of government, it is conceivable that the NBN roll out could be terminated or substantially modified. For example, the Shadow Minister for Communications and Broadband outlined an alternative approach in a recent public address under which the NBN roll out would be stopped and the remaining areas would be upgraded by the private sector through a tender process.
A decision to permanently cease the NBN roll out (without any alternative broadband plan) would substantially increase the value of Telstra. However, the relevant issue is whether, even allowing for this possibility, voting for or against the Proposal would give the better outcome.

If the Proposal is approved but the NBN roll out is subsequently terminated, Telstra will:

- have received infrastructure access payments and will have a contractual right to continue to receive a proportion of those payments (in part based on the extent of the NBN rollout) for the remainder of the term of the Infrastructure Services Agreement even if the NBN roll out is terminated;
- have received PSAA payments for premises disconnected from the copper or HFC broadband networks up to that point;
- be able to participate in the Digital Dividend spectrum auctions and may well have done so by the time of termination; and
- have been relieved of much of its greenfields obligations and the regulatory USO to the extent the NBN has been rolled out.

Telstra will also be able to continue to operate its copper network and HFC networks in areas not covered by the NBN. It could pursue its own enhanced broadband strategy in these areas which revolves around a least cost approach utilising whichever technologies best service each particular market.

On the other hand, if the Proposal is rejected and Telstra competes with the NBN it should have migrated a lower number of services on to the NBN at the time the roll out is terminated. However, it will not have received the payments that it would have received for disconnection of all services within the NBN roll out area and will be entitled to much lower payments for access to its infrastructure. Moreover, in these circumstances:

- Telstra would have been prohibited from bidding for the Digital Dividend spectrum; and
- the other adverse elements of the regulatory regime will have been put in place. Telstra will be likely to have been required to commence functional separation and incur the related costs and inefficiencies. It is also exposed to greater regulatory risk in areas where there is ministerial discretion.

Detailed financial analysis of the full consequences of termination is not possible, not least because the details of any alternative plan (such as a scaled back broadband roll out) and its economic consequences for Telstra are unknown. However, a high level, simplified analysis does provide a basis for assessing the position. Two situations were considered:

- the NBN is completed; and
- the NBN roll out is terminated on 30 June 2014 with no alternative national broadband plan. In the Co-operate scenario, it is assumed that Telstra is required to functionally separate from FY15 in lieu of the structural separation achieved by the Proposal. In the Compete scenario, the regulatory imposts of the CCS Act remain as there is no reason to believe they would be amended in Telstra's favour.

Using the Base Case assumptions, the NPV of the Co-operate scenario is still approximately $5 billion greater than the Compete scenario if the NBN roll out is assumed to be terminated in 2014 (see Section 5.4 of the Report). This differential in NPV remains positive if termination of the roll out is assumed to occur at any other date. In addition, this analysis does not take into account any of the additional regulatory risks in the Compete scenario.

Just as importantly, approval of the Proposal does not mean that Telstra's ability to participate in any alternative broadband plan will be adversely impacted.

Grant Samuel's conclusion is that if the NBN roll out is terminated, Telstra is likely to be better off if shareholders had approved the Proposal.

- **The more complex issue to evaluate is whether rejection of the Proposal increases the likelihood of the NBN roll out being abandoned to such an extent that it justifies the adverse effects of rejection**

  Rejection of the Proposal would increase the likelihood of the NBN roll out being abandoned (or severely restricted) because it would adversely affect the NBN's underlying economics to a substantial extent:

  - there would be a material increase in the NBN's roll out cost without access to Telstra's infrastructure (except as available under law);
  - NBN Co would face delays because it would need to find alternative means to roll out its network; and
  - NBN would face having a substantially lower number of subscribers than otherwise, at least for a prolonged period, if Telstra is successful in retaining its existing subscribers (using enhanced ADSL, upgraded HFC broadband or other wireless solutions).

  The NPV if the Proposal is rejected and the NBN roll out is terminated in 2014 exceeds the NPV if it is approved and the NBN is completed (albeit only by a relatively small margin and only if termination occurs in 2016 or earlier). This value outcome raises the question as to whether that increase in likelihood of abandonment if shareholders reject the Proposal justifies the downside effects. At the outset, it is important to recognise that a decision to reject the Proposal would be only one factor in any decision by a future government to terminate the NBN roll out. The ultimate outcome will also depend on a variety of other factors including:

  - the timing of federal elections and the election result. Conventional timing would see the next federal election being held in mid to late 2013. An early election may provide more scope for the NBN to be terminated as less of the roll out will have occurred. The nature of the election outcome would also have an impact (e.g. margin of victory, composition of the Senate);
  - the evolution of Coalition policy. A formal policy release is unlikely until closer to the next election. In this context:
    - the policies of political parties reflect a range of influences. Significant changes in policies are not uncommon as circumstances change;
    - a focus for the Coalition has been the preparation of a cost/benefit analysis of the NBN (or a broader analysis of the most cost effective solution to delivering fast broadband). The conclusion of such an analysis is unknowable at this point in time but is likely to have a major impact on Coalition decision making. In this context:

- any decision relating to the NBN is complex and involves far reaching consequences. Decisions are likely to be made well after any election;
- the more the NBN is rolled out the more the cost/benefit analysis is likely to favour completion as costs become sunk; and
- NBN Co may target many of the most commercially attractive regions as early as possible. Coalition policy recognises the need for government subsidies for areas that would not be commercially viable;

- outright abandonment with no alternative plan for remaining areas is unlikely as the Coalition is also committed to enhancement of broadband capacity, particularly in regional areas. A lower cost modified plan for the remaining areas is more likely; and
- there is no reason to believe that the Coalition would unwind any of the adverse regulatory provisions (e.g. spectrum bidding prohibition, functional separation) that would already be in effect if the Proposal is rejected;

- the state of the Commonwealth budget at the time;
- the performance of NBN Co up to that point (progress, cost etc) and the level of financial commitments in place; and
- technological developments in broadband delivery.

In summary, there is little certainty with a wide range of possible outcomes dependent on a large number of variables, few of which can be forecast with confidence. The extent to which rejection of the Proposal increases the likelihood of stopping the NBN is impossible to quantify.

However, a simple decision tree analysis may provide some insight. Using the two alternative situations above (completion vs termination in 2014) and their related value outcomes, the analysis indicates that even if rejection of the Proposal by itself dramatically increased the probability of termination (from, say 20% to 80%), the expected (probability weighted) value from approving the Proposal is still greater than rejecting it (see Section 5.4 of the Report).

In any event:

- the probabilities are in reality likely to be much closer together (than 20% and 80%) in which case the expected incremental NPV of co-operation increases further;
- the NPVs in the roll out termination cases are a "best case" as they do not allow for any adverse impact on Telstra earnings from an alternative national broadband plan;
- the Compete scenario includes some favourable assumptions (e.g. NBN penetration, spectrum prohibition impact); and
- the downside risks of rejection are significant, particularly the prospects of additional regulatory imposts.

- **Other alternatives were considered by Telstra but did not produce a superior outcome**

Over the course of the last two years as the NBN has evolved and the CCS Act progressed, Telstra has considered a number of alternative proposals, including:

- demerger of the networks business; and
- sale of the copper network to NBN Co.

However, each of these were considered by Telstra to have significant drawbacks compared to the Proposal and were ultimately discarded.

- **Overall, the advantages of the Proposal outweigh the disadvantages. Accordingly, in Grant Samuel's opinion, the Proposal is in the best interests of Telstra and its shareholders**

  The primary advantage or benefit of the Proposal is that it is expected to be cash flow and NPV positive for Telstra shareholders compared to the alternative of rejecting the Proposal. This conclusion holds even if the NBN roll out is terminated.

  In addition, there are a number of other factors that have not been quantified and are not reflected directly in the financial analysis. They include the following:

  Advantages and Benefits

  - greater regulatory certainty and less regulatory intervention;
  - enhanced financial flexibility;
  - a cost structure with a much higher proportion of variable costs;
  - underpinning the transformation to a more flexible, service oriented business (through gradual elimination of fixed line network operations);
  - better negotiating position if the Commonwealth wants to change the NBN business plan; and
  - avoided disadvantages and risks of competing with the NBN including:
    - impacts of the Digital Dividend spectrum prohibition beyond the level in the financial analysis;
    - increased regulatory imposts particularly around service standards, the USO and access to Telstra networks and infrastructure;
    - additional competitive pressure (NBN Co as well as existing retail competition); and
    - management distraction.

  Costs, Disadvantages and Risks

  - loss of the benefits from being an integrated retailer and network operator;
  - regulatory risks arising from the Proposal such as potential legislative or regulatory changes that adversely impact the arrangements set out in the Structural Separation Undertaking (including the interim equivalence and transparency arrangements) and in the Final Migration Plan;
  - delivery of agreed infrastructure to NBN Co (and the cost of doing so);
  - implementation of the migration program and the development of new business and IT systems;
  - compliance with obligations under agreements with NBN Co and the Structural Separation Undertaking;
  - dependence on the NBN for service delivery and continued network development; and
  - disputes or other issues under the ongoing contracts with NBN Co.

In summary, Grant Samuel believes that while the costs, disadvantages and risks of the Proposal are not inconsequential, they are outweighed by the benefits and advantages, in particular the expected value gain.

5 Other Matters

This report is general financial product advice only and has been prepared without taking into account the objectives, financial situation or needs of individual Telstra shareholders. Accordingly, before acting in relation to their investment, shareholders should consider the appropriateness of the advice having regard to their own objectives, financial situation or needs. Shareholders should read the Explanatory Memorandum issued by Telstra in relation to the Proposal.

Voting for or against the Proposal is a matter for individual shareholders, based on their own views as to value, their expectations about future market conditions or other events and their particular circumstances including risk profile, liquidity preference, investment strategy, portfolio structure and tax position. Shareholders who are in doubt as to the action they should take in relation to the Proposal should consult their own professional adviser.

Similarly, it is a matter for individual shareholders as to whether to buy, hold or sell securities in Telstra. This is an investment decision independent of a decision on whether to vote for or against the Proposal upon which Grant Samuel does not offer an opinion. Shareholders should consult their own professional adviser in this regard.

Grant Samuel has prepared a Financial Services Guide as required by the Corporations Act, 2001. The Financial Services Guide is included at the beginning of the Report.

This letter is a summary of Grant Samuel's opinion. The Report from which this summary has been extracted is attached and should be read in conjunction with this summary.

The opinion is made as at the date of this letter and reflects circumstances and conditions as at that date.

Yours faithfully
GRANT SAMUEL & ASSOCIATES PTY LIMITED

Grant Samuel & Associates

Financial Services Guide
and
Independent Expert's Report
in relation to the proposed transaction with NBN Co Limited and the Commonwealth

Grant Samuel & Associates Pty Limited
(ABN 28 050 036 372)

31 August 2011

GRANT SAMUEL & ASSOCIATES

LEVEL 19 GOVERNOR MACQUARIE TOWER

1 FARRER PLACE SYDNEY NSW 2000

GPO BOX 4301 SYDNEY NSW 2001

T: +61 2 9324 4211 / F: +61 2 9324 4301

www.grantsamuel.com.au

Financial Services Guide

Grant Samuel & Associates Pty Limited ("Grant Samuel") holds Australian Financial Services Licence No. 240985 authorising it to provide financial product advice on securities and interests in managed investments schemes to wholesale and retail clients.

The Corporations Act, 2001 requires Grant Samuel to provide this Financial Services Guide ("FSG") in connection with its provision of an independent expert's report ("IER") which is included in a document ("Disclosure Document") provided to members by the company or other entity ("Entity") for which Grant Samuel prepares the IER.

Grant Samuel does not accept instructions from retail clients. Grant Samuel provides no financial services directly to retail clients and receives no remuneration from retail clients for financial services. Grant Samuel does not provide any personal retail financial product advice to retail investors nor does it provide market-related advice to retail investors.

When providing IERs, Grant Samuel's client is the Entity to which it provides the Report. Grant Samuel receives its remuneration from the Entity. In respect of the IER for Telstra Corporation Limited ("Telstra") in relation to the proposed transaction with NBN Co Limited ("the Report"), Grant Samuel will receive a fixed fee of $2.8 million plus reimbursement of out-of-pocket expenses for the preparation of the Report (as stated in Section 6.3 of the Report).

No related body corporate of Grant Samuel, or any of the directors or employees of Grant Samuel or of any of those related bodies or any associate receives any remuneration or other benefit attributable to the preparation and provision of the Report.

Grant Samuel is required to be independent of the Entity in order to provide an IER. The guidelines for independence in the preparation of IERs are set out in Regulatory Guide 112 issued by the Australian Securities & Investments Commission on 30 March 2011. The following information in relation to the independence of Grant Samuel is stated in Section 6.3 of the Report:

> *"Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with Telstra, NBN Co or the Commonwealth Government that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Proposal.*
>
> *Grant Samuel advises that a related company, Grant Samuel Property Pty Limited, has provided tenancy advisory services to NBN Co over the past two years. Fees for these assignments totalled $118,000. There is no current assignment or relationship with NBN Co.*
>
> *Grant Samuel commenced analysis for the purposes of this report in March 2011 prior to the execution of definitive agreements. Grant Samuel did not participate in the negotiating or setting of the terms of, the Proposal. Its only role has been the preparation of this report.*
>
> *Grant Samuel will receive a fixed fee of $2.8 million for the preparation of this report. This fee is not contingent on the outcome of the Proposal. Grant Samuel's out of pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.*
>
> *Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by the ASIC on 30 March 2011. "*

Grant Samuel has internal complaints-handling mechanisms and is a member of the Financial Ombudsman Service, No. 11929. If you have any concerns regarding the Report, please contact the Compliance Officer in writing at Level 19, Governor Macquarie Tower, 1 Farrer Place, Sydney NSW 2000. If you are not satisfied with how we respond, you may contact the Financial Ombudsman Service at GPO Box 3 Melbourne VIC 3001 or 1300 780 808. This service is provided free of charge.

Grant Samuel holds professional indemnity insurance which satisfies the compensation requirements of the Corporations Act, 2001.

Grant Samuel is only responsible for the Report and this FSG. Complaints or questions about the Disclosure Document should not be directed to Grant Samuel which is not responsible for that document. Grant Samuel will not respond in any way that might involve any provision of financial product advice to any retail investor.

Table of Contents

THIS PAGE HAS BEEN LEFT BLANK INTENTIONALLY

1 Introduction

1.1 Background

Enhanced access to high speed broadband services throughout Australia has been an accepted objective of public policy for much of the past decade. In 2008, the Commonwealth Government ("the Commonwealth") announced a plan to develop a national broadband network with a minimum speed of 12 megabits per second ("Mbps") available to at least 98% of premises nationally. Telstra Corporation Limited ("Telstra") and five other parties tendered proposals to the government in response to a request to provide the network infrastructure. Telstra submitted a non conforming bid.

However, the Commonwealth decided not to select any tender and terminated the process in April 2009. Instead, it announced a plan to proceed with the development of its own high speed network, the National Broadband Network ("NBN") adopting a Fibre to the Premises ("FTTP") model. The Commonwealth established a wholly owned corporation, NBN Co Limited ("NBN Co"), as the vehicle to roll out and operate the NBN. The NBN's fibre network is planned to reach 93% of premises across Australia, with the remaining 7% to be serviced by fixed wireless or satellite services. The fibre network will initially offer speeds of up to 100 Mbps and the wireless/satellite services will offer 12 Mbps. NBN Co will operate only at a wholesale level, selling network access to retail service providers, including Telstra, which will, in turn, offer internet, telephony and other services to residential, business and institutional customers. The total cost of the NBN was initially estimated to be approximately $43 billion and NBN Co is currently in the early stages of the roll out.

In parallel with the establishment of the NBN, the Commonwealth developed legislation designed to incentivise Telstra to separate its fixed line wholesale business from its retail business. The Commonwealth Parliament passed the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act ("CCS Act") in December 2010. If Telstra does not structurally separate its fixed line network to the satisfaction of the Minister for Broadband, Communications and the Digital Economy ("the Minister"), the CCS Act gives the Minister the power to impose a legislative prohibition on Telstra bidding for the next major tranches of wireless spectrum (the 700 and 2600 megahertz ("MHz") bands) to be released by the government once analogue television is phased out (referred to as the "Digital Dividend spectrum"). The legislation requires that if it does not structurally separate, Telstra must undertake a full functional separation of its wholesale and retail businesses. In addition, the legislation requires that, even if it does structurally separate, Telstra must also divest its HFC network[1] and its equity interest in FOXTEL in order to be able to bid for the Digital Dividend spectrum unless the Minister grants a waiver.

1.2 Overview of the Proposal

Against the background of these developments, Telstra, NBN Co and the Commonwealth have negotiated a proposal which would involve Telstra participating in the roll out of the NBN and, at the same time, enable it to meet the structural separation requirements of the CCS Act ("the Proposal"). In essence, Telstra will disconnect its copper and HFC broadband networks, migrate fixed line services to the NBN and provide access to elements of its infrastructure to NBN Co. The Proposal is designed to result in significant benefits for both NBN Co and Telstra:

[1] Hybrid Fibre Coaxial cable. This cable network passes approximately 2.7 million premises. It delivers the FOXTEL pay television service and a Telstra broadband service.

- NBN Co benefits from materially lower development costs and, together with the arrangements announced between NBN Co and Optus, it ensures that virtually all fixed line voice and broadband subscribers throughout Australia who are within the NBN fibre footprint will utilise the NBN;
- Telstra receives substantial payments from NBN Co over a number of years (for subscriber disconnection and for infrastructure access) and receives additional value through other arrangements with the Commonwealth; and
- Telstra's progressive exit from the operation of its copper and HFC networks within the NBN fibre footprint will meet the structural separation requirements of the CCS Act, thereby allowing it to participate in the auctions for the Digital Dividend wireless spectrum.

Non binding financial heads of agreement with NBN Co were signed in June 2010 and definitive agreements with NBN Co and the Commonwealth were executed in June 2011.

There are three key elements to the Proposal:

(i) Migration of Services to the NBN

In essence, Telstra will progressively disconnect voice and broadband services from its existing copper and HFC networks and migrate them to the NBN as it is rolled out. The copper network and the HFC broadband network in the NBN fibre footprint will then be permanently disconnected[2] except to the extent needed to provide certain limited types of services over the copper network (e.g. special services which will be disconnected over a longer time period).

In return, Telstra will (subject to the assessment of a number of criteria in each case) receive a one time payment for each premises when it is disconnected from the copper or HFC broadband networks (subject to certain clawback arrangements). From the time of connection to the NBN, Telstra (and other retailers) will pay NBN Co a monthly access fee for each customer, the quantum of which is dependent on the service level.

(ii) Access to Telstra Infrastructure

Telstra will give NBN Co long term access to elements of its network infrastructure including dark fibre links, rack spaces in selected exchanges, ducts and lead-in conduits. Telstra will receive regular infrastructure access payments for each of the first three elements. The lead-in conduits will be transferred to NBN Co in return for a once off payment (as lead-in fibre is installed by NBN Co into the conduit). Telstra will be required to upgrade this infrastructure and maintain it during the term of the Infrastructure Agreement.

(iii) The Government Package

Supply arrangements have been agreed with the Commonwealth and it has announced new regulatory arrangements ("the Government Package"), including:

---

2 Disconnection of the HFC network is only disconnection of the broadband services provided on the HFC network. Pay television services (FOXTEL and for certain other parties under existing contracts) will continue to be delivered over this network.

- progressive relief from Universal Service Obligation ("USO") regulation, although Telstra will still deliver USO related services under a long term contract for which it will be reimbursed;
- relief from the responsibility to install fixed lines to new housing developments ("greenfields obligations") exceeding 100 lots; and
- other contributions towards retraining of staff, retail customer migration costs and communications costs.

Further details of the Proposal are set out in Section 4 of this Report.

1.3 Approvals

Telstra has lodged a Structural Separation Undertaking and a Draft Migration Plan with the Australian Competition and Consumer Commission ("ACCC") in accordance with the CCS Act.

Approval of the Structural Separation Undertaking and the Draft Migration Plan by the ACCC means that when these documents come into force:

- Telstra will satisfy the structural separation provisions of the CCS Act;
- waivers to be issued by the Minister will mean that Telstra cannot be prohibited under the CCS Act from bidding for, or otherwise acquiring, wireless spectrum in the 700 or 2600 MHz bands when it becomes available (although the Minister will continue to have rights under the Radiocommunications Act to limit the ability of any party, including Telstra, to participate in spectrum auctions); and
- Telstra can retain ownership of the HFC network and the 50% equity interest in FOXTEL.

Acceptance of the Structural Separation Undertaking and Draft Migration Plan is a condition precedent to the Proposal and Telstra is working with the ACCC with a view to obtaining acceptance before the shareholding meeting to approve the Proposal.

The Proposal is also conditional on approval by Telstra shareholders and the satisfaction of other conditions precedent, the most important of which are the receipt of satisfactory rulings by Telstra and NBN Co from the Australian Taxation Office.

2 Scope of the Report

2.1 Purpose of the Report

The directors of Telstra have decided to seek the approval of shareholders for the Proposal. Although there is no requirement for an independent expert's report, the directors of Telstra have engaged Grant Samuel & Associates Pty Limited ("Grant Samuel") to prepare an independent expert's report setting out whether, in its opinion, the Proposal is in the best interests of Telstra and its shareholders and to state the reasons for that opinion ("the Report"). The Report will accompany the Notice of Meeting and Explanatory Memorandum ("Explanatory Memorandum") to be sent to shareholders by Telstra.

This report is general financial product advice only and has been prepared without taking into account the objectives, financial situation or needs of individual Telstra shareholders. Accordingly, before acting in relation to their investment, shareholders should consider the appropriateness of the advice having regard to their own objectives, financial situation or needs. Shareholders should read the Explanatory Memorandum issued by Telstra in relation to the Proposal.

Voting for or against the Proposal is a matter for individual shareholders based on their views as to value, their expectations about future market conditions and their particular circumstances including risk profile, liquidity preference, investment strategy, portfolio structure and tax position. Shareholders who are in doubt as to the action they should take in relation to the Proposal should consult their own professional adviser.

Similarly, it is a matter for individual shareholders as to whether to buy, hold or sell shares in Telstra. This is an investment decision independent of a decision to vote for or against the Proposal upon which Grant Samuel does not offer an opinion. Shareholders should consult their own professional adviser in this regard.

2.2 Basis of Evaluation

The Australian Securities & Investments Commission ("ASIC") has issued Regulatory Guide 111 which establishes guidelines in respect of independent expert's reports under the Corporations Act. ASIC Regulatory Guide 111 differentiates between the analysis required for control transactions and other transactions. In the context of control transactions (whether by takeover bid, by scheme of arrangement, by the issue of securities or by selective capital reduction or buyback), the expert is required to distinguish between "fair" and "reasonable". A proposal that was "fair and reasonable" or "not fair but reasonable" would be in the best interests of shareholders.

For most other transactions, the expert is required to weigh up the advantages and disadvantages of the proposal for shareholders. This involves a judgement on the part of the expert as to the overall commercial effect of the proposal, the circumstances that have led to the proposal and the alternatives available. The expert must weigh up the advantages and disadvantages of the proposal and form an overall view as to whether the shareholders are likely to be better off if the proposal is implemented than if it is not. If the advantages outweigh the disadvantages, the proposal would be in the best interests of shareholders.

In this case, the Proposal consists of a number of arrangements which constitute the framework under which Telstra can participate in the roll out of the NBN and is not a control transaction. Accordingly, Grant Samuel has evaluated the Proposal by assessing the overall impact on the shareholders of Telstra and formed a judgement as to whether the expected advantages and benefits outweigh any costs, disadvantages and risks that might result.

In forming its opinion as to whether the Proposal is in the best interests of Telstra and its shareholders, Grant Samuel has considered the following:

- the terms of the Proposal and their expected impact on Telstra and its shareholders;
- the anticipated impact on the operating and financial performance of Telstra if the Proposal is implemented and if it is not;
- the value implications of the anticipated future financial performance of Telstra if the Proposal is implemented and if it is not;
- any other advantages and benefits arising from the Proposal;
- the costs, disadvantages and risks of the Proposal; and
- potential alternative transactions to the Proposal.

2.3 Sources of the Information

The following information was utilised and relied upon, without independent verification, in preparing this report:

Publicly Available Information

- the Explanatory Memorandum (including earlier drafts);
- annual reports of Telstra for the three years ended 30 June 2010 and the full year financial results for the year ended 30 June 2011;
- annual reports of NBN Co for the period ended 30 June 2009 and the year ended 30 June 2010;
- NBN Co's Business Case Summary, Corporate Plan (2011-2013) of 17 December 2010 and Product and Pricing Overview of December 2010;
- the published summary of Greenhill Caliburn's Review of NBN Co's Corporate Plan;
- the Commonwealth Government's Statement of Expectations for the NBN and the Commonwealth Government's NBN Implementation Study;
- press announcements and other statements, papers and instruments (e.g. migration principles) released by the Minister relating to Telstra, NBN Co and the telecommunications industry;
- press releases, public announcements, media and analyst presentation material and other public filings by Telstra and NBN Co including information available on its website; and
- brokers' reports and recent press articles on Telstra, NBN Co and the telecommunications industry.

Non Public Information provided by Telstra

- the legal agreements executed between Telstra, NBN Co and the Commonwealth;
- cash flow models of Telstra's business including projections for Telstra's business operations in various scenarios; and

- other confidential documents including board papers, internal presentations and working papers (prepared internally and by advisers to Telstra).

Grant Samuel has held discussions with, and obtained information from, senior management of Telstra and its advisers but has not held discussions with representatives of NBN Co or the Commonwealth.

2.4 Limitations and Reliance on Information

Grant Samuel believes that its opinion must be considered as a whole and that selecting portions of the analysis or factors considered by it, without considering all factors and analyses together, could create a misleading view of the process underlying the opinion. The preparation of an opinion is a complex process and is not necessarily susceptible to partial analysis or summary.

Grant Samuel's opinion is based on economic, sharemarket, business trading, financial and other conditions and expectations prevailing at the date of this report. These conditions can change significantly over relatively short periods of time. If they did change materially, subsequent to the date of this report, the opinion could be different in these changed circumstances.

This report is also based upon financial and other information provided by Telstra and its advisers. Grant Samuel has considered and relied upon this information. Telstra has represented in writing to Grant Samuel that to the best of Telstra's knowledge the information provided by it was accurate and not misleading by omission or otherwise (and, except to the extent that it comprises legal privilege or confidential undertakings, was complete). Grant Samuel has no reason to believe that any material facts have been withheld.

The information provided to Grant Samuel has been evaluated through analysis, inquiry and review to the extent that it considers necessary or appropriate for the purposes of forming an opinion as to whether the Proposal is in the best interests of Telstra shareholders. However, Grant Samuel does not warrant that its inquiries have identified or verified all of the matters that an audit, extensive examination or "due diligence" investigation might disclose. While Grant Samuel has made what it considers to be appropriate inquiries for the purposes of forming its opinion, "due diligence" of the type undertaken by companies and their advisers in relation to, for example, prospectuses or profit forecasts, is beyond the scope of an independent expert. In this context, Grant Samuel advises that it is not in a position nor is it practicable to undertake its own "due diligence" investigation of the type undertaken by accountants, lawyers or other advisers.

Accordingly, this report and the opinions expressed in it should be considered more in the nature of an overall review of the anticipated commercial and financial implications rather than a comprehensive audit or investigation of detailed matters.

An important part of the information used in forming an opinion of the kind expressed in this report is comprised of the opinions and judgement of management. This type of information was also evaluated through analysis, inquiry and review to the extent practical. However, such information is often not capable of external verification or validation.

Preparation of this report does not imply that Grant Samuel has audited in any way the management accounts or other records of Telstra. It is understood that the accounting information that was provided was prepared in accordance with generally accepted accounting principles and in a manner consistent with the method of accounting in previous years (except where noted).

The information provided to Grant Samuel included cash flow models for Telstra's business operations for the period commencing 1 July 2010. The model was prepared by Telstra and its advisers and is based on the internal management plan for the period up to 30 June 2014, which has been extrapolated to 30 June 2030.

Telstra is responsible for the information contained in the cash flow model ("the forward looking information"). Grant Samuel has considered and, to the extent deemed appropriate, relied on this information for the purposes of its analysis. In relation to the cash flow models, the major assumptions underlying the forward looking information were reviewed by Grant Samuel in the context of current economic, financial and other conditions. It should also be recognised that such projections are inherently uncertain. In the case of Telstra this uncertainty is exacerbated by a number of factors including:

- the long term nature of the cash flow impacts from the Proposal;
- the complexity of Telstra's underlying business;
- the pace of technological change in the telecommunications industry;
- the difficulty of estimating the impacts (e.g. on penetration, market share, revenues and costs) of a fundamental change in industry structure (the development of NBN) and its consequences for Telstra's operations and those of other industry participants; and
- the unpredictability of future regulatory changes and their impacts.

Subject to these limitations, Grant Samuel considers that, based on the inquiries it has undertaken and only for the purposes of its analysis for this report (which do not constitute, and are not as extensive as, an audit or accountant's examination), there are reasonable grounds to believe that the forward looking information has been prepared on a reasonable basis. In forming this view, Grant Samuel has taken the following factors into account:

- Telstra is a mature business with sophisticated management and financial reporting processes;
- the financial projections have been developed over a two year period by a large project team involving both Telstra executives and external advisers;
- the overarching model is underpinned by several detailed "feeder" models prepared by Telstra operational staff expert in those fields;
- key assumptions and variables adopted by Telstra have been subject to detailed internal review by management and to overall consideration by the Telstra Board. Where practicable, as part of management's review cost assumptions or variables have been benchmarked to Telstra's own cost structures (e.g. direct variable cost percentages) or experiences (e.g. HFC roll out cost). In the course of that review, management's assessments of market related variables (e.g. market share or wireless penetration) have been tested against external forecasts where available;
- the cash flow models were independently reviewed for Telstra by an accounting firm for mathematical accuracy and correct application of assumptions; and
- the assumptions underlying the Telstra model were reviewed for Telstra by an external adviser for reasonableness.

In any event, Grant Samuel has made adjustments to the assumptions behind the cash flow forecasts for the purposes of its analysis, reflecting its own judgements on certain matters.

The directors of Telstra have decided not to include the cash flow forecasts in the Explanatory Memorandum and therefore they have not been disclosed in this report although this report does disclose the incremental changes in cash flows under various assumptions.

Grant Samuel has no reason to believe that the forward looking information reflects any material bias, either positive or negative. However, the achievability of such forecasts is not warranted or guaranteed by Grant Samuel. Future profits and cash flows are inherently uncertain. They are predictions by management of future events that cannot be assured and are necessarily based on assumptions, many of which are beyond the control of the company or its management. Actual results may be significantly more or less favourable.

As part of its analysis, Grant Samuel has reviewed the sensitivity of net present values to changes in key variables. The sensitivity analysis isolates a limited number of assumptions and shows the impact of variations to those assumptions. No opinion is expressed as to the probability or otherwise of those variations occurring. Actual variations may be greater or less than those modelled. In addition to not representing best and worst outcomes, the sensitivity analysis does not, and does not purport to, show the impact of all possible variations to the business model. The actual performance of the business may be negatively or positively impacted by a range of factors including, but not limited to:

- changes to the assumptions other than those considered in the sensitivity analysis;
- greater or lesser variations to the assumptions considered in the sensitivity analysis than those modelled; and
- combinations of different variations to a number of different assumptions that may produce outcomes different to the combinations modelled.

In forming its opinion, Grant Samuel has also assumed that:

- matters such as title to assets, compliance with laws and regulations and contracts in place are in good standing and will remain so and that there are no material legal proceedings, other than as publicly disclosed;
- the information set out in the Explanatory Memorandum sent by Telstra to its shareholders is complete, accurate and fairly presented in all material respects;
- the publicly available information relied on by Grant Samuel in its analysis was accurate and not misleading;
- the Proposal will be implemented in accordance with its terms; and
- the legal mechanisms to implement the Proposal are correct and will be effective.

To the extent that there are legal issues relating to assets, properties, or business interests or issues relating to compliance with applicable laws, regulations, and policies, Grant Samuel assumes no responsibility and offers no legal opinion or interpretation on any issue.

3 Background Information

3.1 Telstra

(i) Business Profile

Telstra is Australia's leading telecommunications and information services company. It was incorporated as an Australian public limited liability company wholly owned by the Commonwealth in November 1991 under the name Australian Telecommunications Corporation, although its origins date back to the early 1900s. Telstra was initially listed on the Australian Stock Exchange ("ASX") on 17 November 1997 following the sale by the Commonwealth of a 33.3% stake in the company. The Commonwealth later sold in public offerings or transferred to the Future Fund the entirety of its remaining holding in Telstra. The company is now listed on the ASX and the New Zealand Stock Exchange and had a market capitalisation of approximately $38 billion as at 26 August 2011.

Telstra owns and operates Australia's most extensive fixed and mobile telecommunications network infrastructure and offers fixed and mobile voice and data services directly to consumers, businesses and institutions as well as wholesale services to third party retail service providers. Telstra's primary telecommunications services include:

- fixed line telephony through the Public Switched Telephone Network ("PSTN");
- fixed line broadband internet access over the HFC network and by way of Asymetric Digital Subscriber Line ("ADSL") services over the copper network;
- wireless voice and data ("mobiles");
- network application, internet and data services ("IP and Data"); and
- integrated telecommunications services for business and institutional customers.

Other Telstra products and services include:

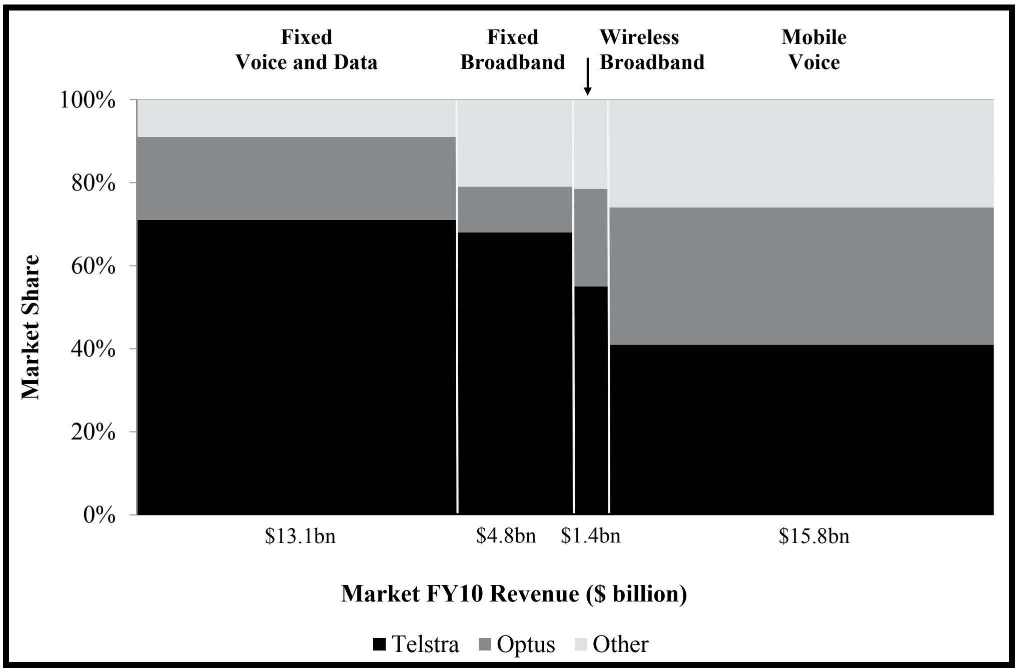
- advertising, search and information services through its wholly-owned Australian subsidiary Sensis;
- cable distribution of pay television (for FOXTEL); and
- IPTV and resale of the FOXTEL service.

Telstra also owns a 50% stake in the subscription television provider FOXTEL[3]. Telstra's overseas operations include the Telstra International global networks and managed services business, TelstraClear Limited (a wholly-owned subsidiary that provides a full suite of telecommunications services to the New Zealand market), a 76.4% stake in CSL New World (a Hong Kong mobile services provider), search and advertising businesses in China and various other interests.

[3] In addition to receiving distributions for its stake in FOXTEL, Telstra also earns revenue from providing access to its HFC network to FOXTEL for delivery of FOXTEL's television service to subscribers.

(ii) Telecommunications Market

Telstra is the largest participant in the Australian telecommunications industry. Based on 2010 industry revenue of $35 billion[4], Telstra has an aggregate 57% market share of the wholesale and retail markets (fixed voice, fixed broadband, fixed data, wireless broadband, mobile voice and wholesale). Telstra's market share in the main market segments is illustrated below.



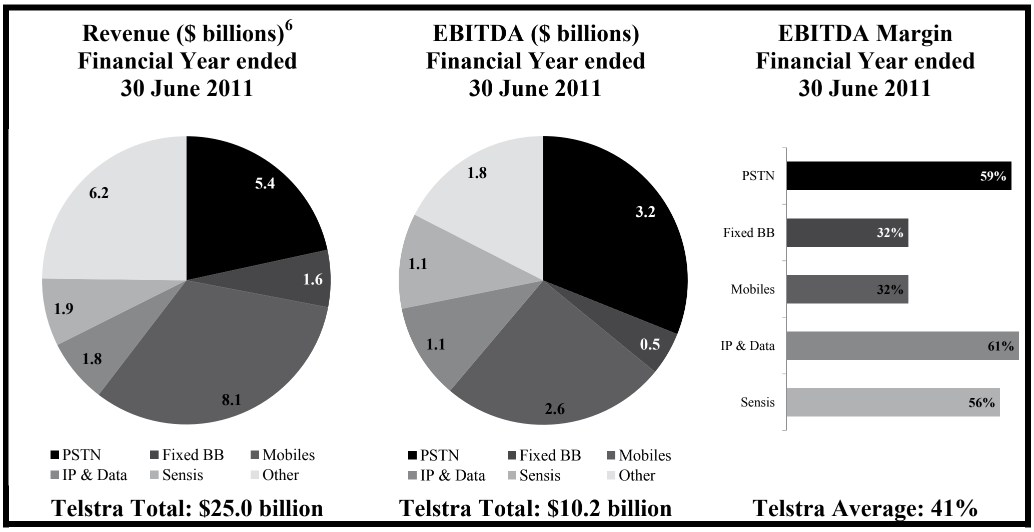
Source: NBN Co[4]

(iii) Telstra Financial Profile

The following diagram sets out a breakdown of Telstra's revenue, EBITDA and EBITDA margins for the financial year ended 30 June 2011 ("FY11")[5]:

4 NBN Corporate Plan 2011-2013 (17 December 2010) pg 31.

5 Other fixed revenue includes ISDN products (Integrated Services Digital Network which allows the simultaneous digital transmission of voice, video, data, and other network services over the PSTN), premium calling products, customer premises equipment, other fixed telephony revenue, intercarrier access services and wholesale broadband services. Other revenue includes revenue from Business Services and applications, CSL New World, TelstraClear, the bundling of pay TV and various other revenues.



Source: Telstra

Revenues and earnings from PSTN services have been in decline for many years due to competitive price pressures (assisted by regulatory developments), loss of market share and other factors such as mobile substitution. Nevertheless, it remains the largest single contributor to Telstra's earnings and generates very attractive margins as Telstra captures both wholesale and retail margins from the vast majority of customers. Analyst forecasts generally show a continuing decline in earnings from PSTN services over the foreseeable future.

On the other hand, broadband services, particularly wireless broadband, have shown growth in recent years which is expected to continue as the demand for data grows. Forecasters generally expect very strong growth in wireless data demand through the development of new devices and applications.

(iv) Telstra Infrastructure

The key elements of Telstra's infrastructure for its domestic fixed line businesses are:

- a core high capacity fibre transmission network between major centres throughout Australia;
- metropolitan fibre rings that directly connect business customers in major population centres (for both voice and data services);
- a fibre network (including ducts) that connects the core network to Telstra's network of exchanges;
- approximately 5,000 exchanges and sub exchanges together with associated equipment (switches etc);
- a copper access network that connects exchanges to individual premises (primarily residential) and delivers both standard voice services and ADSL broadband. At 30 June 2011 Telstra operated 8.4 million standard fixed lines (and a further 1.0 million ULL lines). This network includes the ducts that

[6] PSTN revenue and EBITDA reflect both the retail and wholesale business. Fixed broadband revenue and EBITDA reflect only the retail business. Mobiles revenue and EBITDA reflect both the retail and wholesale business.

physically carry the copper lines as well as lead-in conduits or other connections (e.g. aerial) that constitute the last link to the premises (from the lines running down the streets); and

- the HFC network which passes approximately 2.7 million premises mainly in the Sydney, Melbourne and Brisbane metropolitan areas. The network delivers the FOXTEL pay television service and broadband services.

As Telstra has the only telecommunications network that provides access to virtually every address in Australia it is required by law to provide wholesale access to its copper network for other retail service providers ("retailers") and internet service providers ("ISPs"). These retailers compete directly with Telstra's retail arm. Wholesale access is usually provided on one of three bases:

- wholesale line rental and wholesale broadband – the retailer is supplied with a PSTN and/or ADSL broadband service from Telstra and resells it to the customer;
- unconditioned local loop ("ULL") – the retailer accesses only the copper wire from the exchange to the customer's premises. The retailer installs its own digital subscriber line access multiplexers ("DSLAMs") and other necessary equipment at the exchanges and organises its own backhaul to/from the exchange. Voice services may be provided using the retailer's own PSTN switch equipment or Voice over Internet Protocol ("VoIP") technology; and
- line sharing service ("LSS") – the customer has a PSTN connection from Telstra and the retailer purchases an LSS device to offer a broadband service provided by the retailer's own DSLAMs to its customers.

Telstra also provides transmission services to wholesale customers.

Telstra's mobile network is a nationwide network under the "NextG" brand that operates a variety of voice and data services at various levels:

- 2G and 2.5G services (based on GSM and GPRS technologies) using the 900 MHz and 1800 MHz spectrum bands; and
- 3G services (based on W-CDMA technologies) using the 850 MHz and 2100 MHz spectrum bands.

Telstra has also recently commenced operation of its 4G network based on Long Term Evolution ("LTE") technology using the 1800 MHz spectrum band. It is anticipated that these services would also be delivered on 700 and 2600 MHz spectrum bands when they become available (assuming it has access to these bands).

Telstra's mobile infrastructure comprises over 7,400 base stations and the network reaches approximately 99% of the Australian population.

Telstra holds licences to blocks of spectrum in the 850, 900, 1800 and 2100 MHz bands from the Commonwealth.

(v) Operating Statistics

Key operating statistics for Telstra's Australian operations are summarised below:

Telstra – Key Statistics – As at 30 June 2011						
	PSTN	ISDN[7]	ULL	LSS	Fixed BB	Mobile
Retail						
- Access lines/SIOs (000's)	7,158	-	-	-	2,413	12,223
- Access lines/SIOs (market share)	72%	-	-	-	45%	43%
- ARPU[8] per month ($)	54	-	-	-	57	47
Wholesale						
- Access lines/SIOs (000's)	1,212	-	1,001	725	869	74
- ARPU[8] per month ($)	42	-	-	-	36	-
Total						
- Access lines/SIOs (000's)	8,370	408	1,001	725	3,282	12,297
- ARPU[8] per month ($)	52	-	-	-	51	47

Source: Telstra

3.2 NBN Co

NBN Co is a wholly owned subsidiary of the Commonwealth, established by the Government on 9 April 2009.

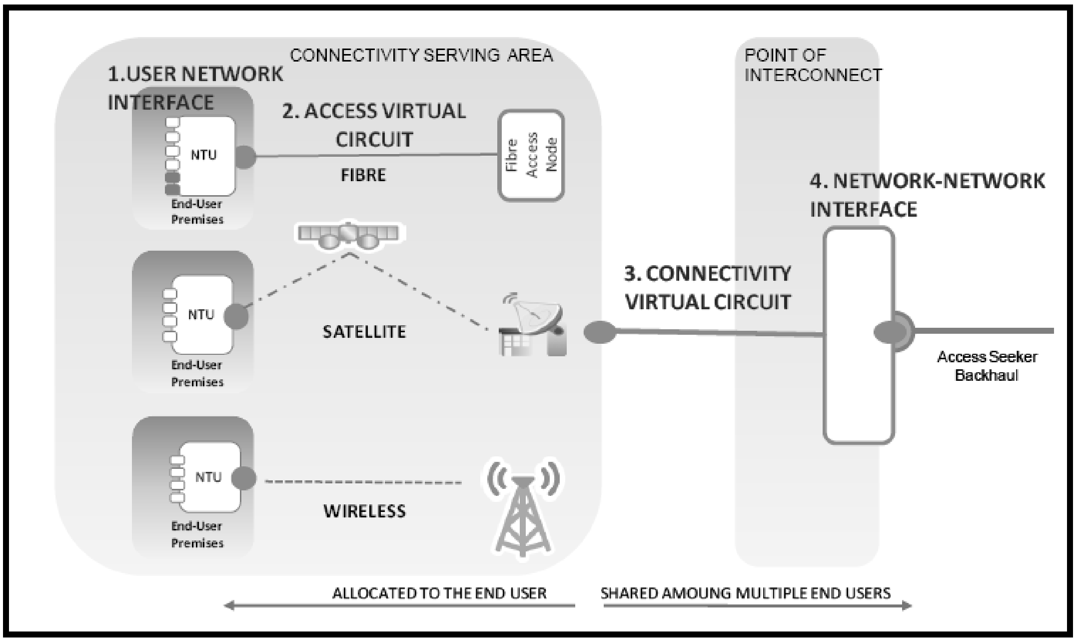
The NBN is planned to bring broadband access to 100% of Australian premises using three technologies – 93% of premises will be connected with fibre using FTTP (i.e. fibre all the way to individual premises), 4% with fixed wireless services and the remaining 3% with satellite based services.

NBN Co is a wholesale only business that will provide a physical carriage network from 121 Points of Interconnect ("PoI") spread across the country that will be capable of connecting to each of the approximately 10 million premises. Telstra and other retailers will provide the actual service to individual residential, business and institutional (e.g. schools, hospitals) customers including any equipment needed at the customer's premises beyond the connection point such as handsets together with billing and support services. Retailers will pay NBN Co for the carriage of traffic between the PoI and the customer but will take responsibility for, and bear the cost of, carriage on their own networks (or through third parties) from the PoI.

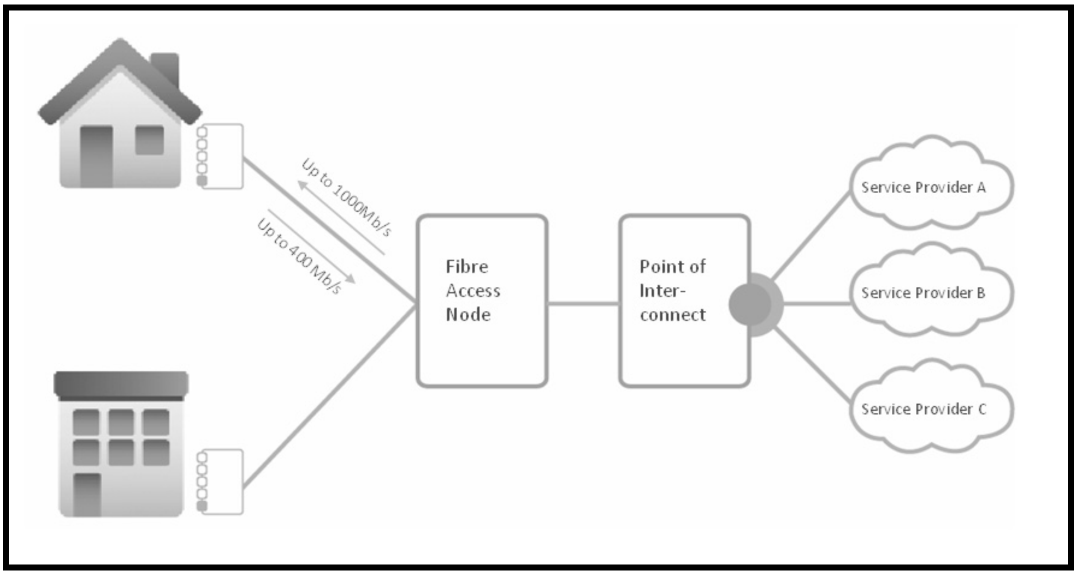
7 Telstra sells some of its copper network capacity to service providers who provide ISDN basic rate access services to, or establish networks for, their customers (Frame Relay, ATM, DDS).

8 Average Revenue per User.

This structure is illustrated below:



Source: NBN Co



Source: NBN Co

The fibre service is primarily for data but will incorporate a dedicated channel available for voice telephony (there will be no voice only product). Accordingly, customers will require only one provider of broadband and telephony services. The fixed wireless or satellite services to the remaining 7% are data only services[9] but, in accordance with Telstra's commitments in the Government Package, customers can still chose to be supplied by Telstra with a separate telephone service over a copper line[10].

[9] Data services could include voice carriage services such as VoIP.

[10] Where lines are in place at 1 July 2012 with some limited exceptions such as lines damaged in natural disasters.

NBN Co has committed to delivering:

- download speeds of up to 100 Mbps to the 93% of premises connected using FTTP; and
- download speeds of 12 Mbps to the 7% connected via fixed wireless and satellite.

NBN Co will offer a variety of wholesale products, including:

- a 12 Mbps downstream and 1 Mbps upstream entry-level offer across each of the fibre, wireless and satellite networks; and
- a suite of fibre products. Four traffic classes, or quality of service levels, will be available, ranging from a "best efforts" service (where the stated speed is a peak rate under ideal circumstances) to a committed information rate service (where the availability of the stated speed is guaranteed).

For the entry level offer, NBN Co will provide uniform, national wholesale pricing for interconnection at any of the designated PoIs, regardless of the delivery technology, the location of the users and the number of accounts opened by each retailer (i.e. no volume discounts will be offered). In its Product and Pricing Overview for Access Seekers (December 2010), NBN Co released estimated pricing for retailer access to the NBN (via the PoIs), depending on speed, traffic class and the reach and size of the interface between the backhaul network and end user network. The pricing structure and pricing levels have been chosen in order to achieve:

- viability for NBN Co, based on a target internal rate of return ("IRR"), which should be in excess of the cost of public debt rates; and
- viability for retail service providers based on their assumed cost structures and assumed retail pricing.

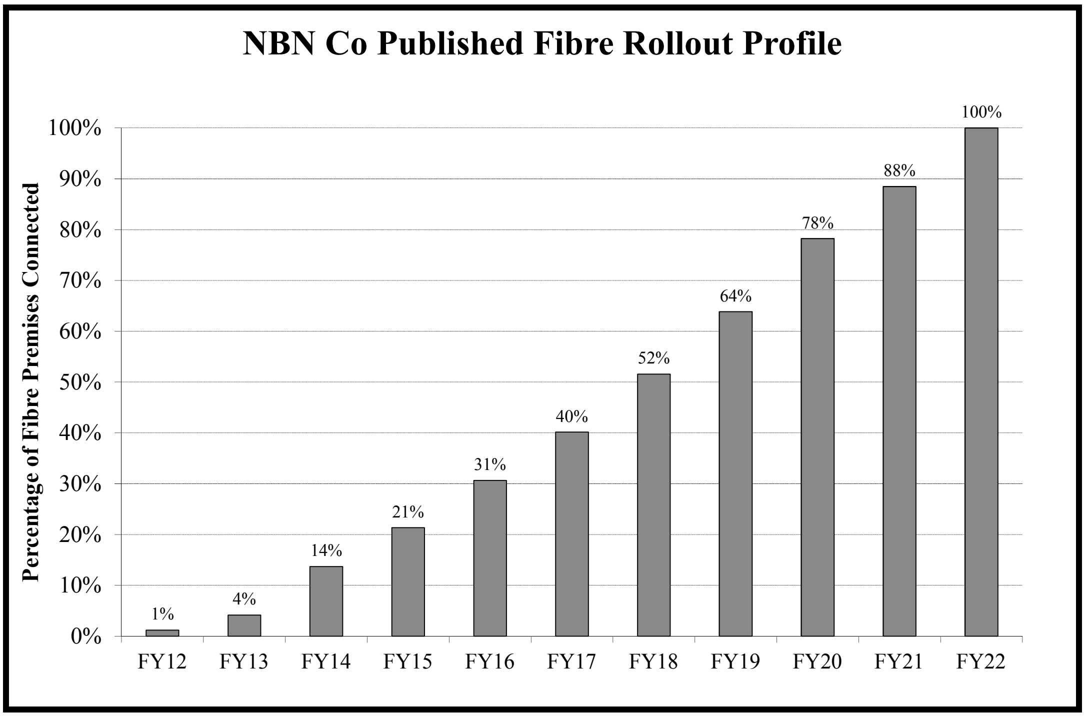
The IRR is sensitive, in particular, to the rate of take up of NBN services and the take up of NBN products at different speeds and overall connectivity capacity usage.

NBN Co's network will support a variety of end uses which could be provided by a wide range of retailers. The flexibility of options available for access to the NBN is expected to lower barriers to entry for retailers, which NBN Co believes will increase competition in both major population centres and regional areas.

NBN Co expects the construction of the NBN to take approximately ten years to reach all premises. NBN has already begun testing, with the roll out of the network in eight First Release Sites (five on mainland Australia and three in Tasmania). An additional 14 sites on mainland Australia have been marked as Second Release Sites. Using the experiences gleaned from the roll out of the First Release Sites and Second Release Sites, volume roll out is expected to commence in 2011. Key stages in the process can be seen in the following table:

NBN Roll Out Timeline		
Date	**Stage**	**Description**
Apr 2011	Start Customer Trial	Capability to connect at least one mainland based retail service providers (retailers) with trial customers offering a free subset of products to test preparedness. All NBN Co support with manual processes.
Sep 2011	Ready for First Commercial Service	Capability to fulfil, activate and assure a limited number of products with multiple retailers and up to 6 per cent of premises passed. Supported with a combination of basic semi-automated and manual processes.
May 2012	Ready for Business as Usual Roll out	Capability to fulfil, activate and assure an increased number of products with multiple retailers and up to 19 per cent of premises passed. Supported with a combination of advanced semi-automated and manual processes.
Dec 2012	Ready for Market	Fully automated systems, no limitation in activating as a percentage of premises passed. Multiple retailers certified; critical volume available and predictable. Operations capability can fulfil and assure the NBN Co suite of products at scale.

The chart below details the NBN's published roll out profile of the fibre network. Roll out of the NBN is planned to conclude in FY22.



Source: NBN Co Corporate Plan (2011 – 2013). The percentages in the chart above are estimates based on NBN Co's target fibre premises to be connected each year as set out in the NBN Co Corporate Plan.

Over the last few months, NBN Co has announced that it has let a number of significant contracts relating to the development of the NBN including contracts relating to:

- the fixed wireless network (design, build, operate);
- systems integration;

- equipment supply (racks, transmission equipment, fibre, network connectivity, aggregation);
- data centres; and
- fibre roll out (construction).

3.3 Regulatory Environment

The telecommunications industry in Australia is highly regulated. As the leading industry participant, Telstra's operations are affected by a large number of regulations. The planned introduction of the NBN has involved a number of changes to legislation which will (and in some cases already do) impact Telstra, as well as other industry participants. Network access, competition, pricing and the USO are all areas that have been or will be subject to substantial change with the introduction of the NBN.

(i) Overview of Regulation Prior to Recent Changes

The Telecommunications Act was introduced to provide the regulatory framework for Carriers, Carriage Service Providers and Content Service Providers and provides the basis of the legislative system to which recent legislative changes have been introduced to allow for the function of NBN Co. The ACCC and the Australian Communications and Media Authority ("ACMA") are responsible for the regulation of the telecommunications industry.

ACMA was formed in July 2005 from the merger of the Australian Communications Authority and the Australian Broadcasting Authority and is responsible for consumer, licensing and technical matters. A large number of roles fall under the auspices of the ACMA, including issuing carrier licenses, regulation of service providers, monitoring delivery of the USO and the costs of this delivery as well as the implementing and setting of customer service guarantees.

The ACCC regulates competition in the industry and has access, pricing, monitoring and reporting functions, as well as roles regarding the prevention and prosecution of anti-competitive and misleading conduct in the telecommunications industry. A key element in competition policy is enabling other retail service providers to make use of Telstra's network on a wholesale basis on reasonable terms. Access to networks and services is not a general right in the telecommunications industry, unless the relevant service is a Declared Service, in which case the owner of the network ("access provider") is required to provide access to the access seeker (normally an ISP or other retailer of telecommunications services). Currently, Declared Services include:

- digital set-top unit service (FOXTEL);
- domestic PSTN originating access;
- domestic PSTN terminating access;
- mobile terminating access service;
- line sharing service;
- local carriage service;
- unconditioned local loop service;
- wholesale line rental; and
- domestic transmission capacity service.

Under the previous regime, the ACCC operated a negotiate/arbitrate access regime. If the parties could not agree on the terms of access to a declared service either party could notify the ACCC of a dispute. The ACCC would then arbitrate the dispute and set out the terms and conditions of access between the two parties.

The Telecommunications Act also includes a facilities access regime under which other carriers have the right to access Telstra infrastructure (such as ducts and exchanges) for an access fee. Telstra is required to maintain these facilities but there would be limits on any requirement to remediate them for individual users.

The ACCC reviews the pricing practices of Telstra, in particular, as the largest industry participant. In 2010, the ACCC conducted a review of Telstra's retail price control arrangements, and on 24 June 2010, the Minister approved the continuation of the operation of price controls on Telstra until 30 June 2012.

Telstra is currently designated as the principal universal service provider for the purposes of the Telecommunications (Consumer Protection and Service Standards) Act, which means Telstra is obliged to provide basic voice telephony, prescribed carriage services and payphone services across Australia, on an equitable basis that is reasonably accessible to all people.

Under its role as primary universal service provider, Telstra is required to provide ACMA with a universal service policy statement and marketing plan for ACMA's approval. These documents detail Telstra's intentions regarding the fulfilment of its USO, including Telstra's position statement on providing these services to the disabled, remote indigenous and islander communities, and to those who require priority assistance.

Telstra receives contributions towards the cost of carrying out its role as primary universal service provider from all telecommunication carriers. Although it is in the Minister's power to expand the funding base so that it includes carriage service providers as well as telecommunication carriers, this has not yet been done. ACMA determines the contribution that each carrier will make as a USO levy, and this amount is related to the eligible revenues of that carrier (and its related parties) as a proportion of the total eligible revenue of all carriers. In the year to 30 June 2010 Telstra received contributions of $55 million towards total ministerially capped costs of $145 million.

Telstra is also the sole digital data service provider, responsible under separate obligations related to the USO, called the digital data service obligation ("DDSO") and the Special DDSO. The DDSO seeks to ensure that digital data services (essentially ISDN) are available equitably.

(ii) Recent Regulatory Changes

The CCS Act, which was passed by the Commonwealth Parliament on 29 November 2010, requires Telstra to choose between either structurally separating its fixed networks from its retail fixed line business or functionally separating its wholesale fixed line business and network from its retail activities. The Act also includes changes to the USO and customer service guarantee, extends the obligation to provide priority assistance to people with life threatening illnesses to service providers other than Telstra and increases the ACCC's power with regard to access and pricing.

Separation

Structural separation is not fully defined in the legislation and could be achieved in a number of different ways. In essence, structural separation would mean that by the "designated day" (30 June 2018 or a later date specified by the Minister), Telstra's fixed network and retail and wholesale service activities would have to be split out from each other, for example into two independently owned businesses (e.g. through a sale or demerger) or, as will be the case under the Proposal, Telstra closing down its fixed networks.

The Minister has power to exempt specified fixed services and networks from the scope of the structural separation requirement. As part of the Proposal, the Minister has effectively exempted all of Telstra's fixed networks except for the copper network and the HFC network within the footprint of the NBN fibre network as it stands on the designated day.

If Telstra fails to give an undertaking to structurally separate that is accepted by the ACCC and comes into force, there are two primary consequences under the CCS Act:

- Telstra will be required to functionally separate its wholesale business and its fixed network from its retail business. While Telstra would maintain ownership of the network, there would need to be separate management and organisational arrangements as well as separate financial systems and reporting for the retail and wholesale/network businesses. The flow of information, sharing of staff and resources and co-operation between the two units would be severely restricted. Telstra's retail business would be required to acquire services from Telstra's wholesale/network arm on the same basis as any other service provider; and
- the Minister will have the power to exclude Telstra from acquiring or using any of the Digital Dividend spectrum in the 700 and 2600 MHz bands which has been earmarked for the further development of next generation mobile and wireless broadband services. These bands will provide substantially increased capacity for mobile and wireless services.

If the structural separation is implemented:

- the CCS Act still gives the Minister power to impose the legislative prohibition preventing Telstra from bidding for, or acquiring, Digital Dividend spectrum, unless either Telstra has given undertakings to divest its HFC network and its 50% equity interest in FOXTEL or the Minister believes that Telstra's structural separation sufficiently addresses concerns about Telstra's market power and grants waivers (which are conditions precedent to Telstra's Structural Separation Undertaking coming into force); and
- the Minister still retains other rights under the Radiocommunications Act to prevent any party, including Telstra, from participating in spectrum auctions.

It should be noted that if Telstra does not undertake to structurally separate, while it would be at risk of being barred from bidding for, or acquiring, Digital Dividend spectrum, it does not have to undertake to divest its stake in FOXTEL or its HFC network.

Operational Impacts

Following the introduction of the CCS Act, the ACCC can now declare (after holding a public inquiry) that access to certain telecommunication services must be given on prescribed terms to access seekers under Part XIC of the Competition and Consumer Act (previously the Trade Practices Act). This differs from prior legislation, which gave less power to the ACCC and was a negotiate/arbitrate regime. The ACCC can now also set default prices and other terms relating to access in cases where access is declared ("access determinations"). Access determinations can be interim or final. The ACCC also has the power to vary or revoke declarations (after holding a public inquiry) and to grant exemptions from standard access obligations for Declared Services.

Access determinations are intended to create the benchmark upon which parties seeking access to a service can rely upon if they are unable to negotiate alternative terms of access. If there are commercial agreements in place between an access seeker and an access provider, the terms of the commercial agreement will override the access determinations to the extent of any inconsistency (until such agreements expire). The changes introduced by the CCS Act aim to reduce delays and provide certainty for access seekers regarding prices, terms and conditions.

Final access determinations were made on 20 July 2011for the following declared (fixed line) services:

- unconditioned local loop service;
- wholesale line rental;
- line sharing services;
- domestic PSTN originating access;
- domestic PSTN terminating access; and
- local carriage service.

A key aspect of the interim determination was setting of wholesale line rental rates at \$22.84 per month and local carriage services at 8.9 cents per call. These rates are below rates currently charged by Telstra (particularly the local carriage service) but provide some certainty as these rates will apply for a period of three years from 1 July 2011.

Final access determinations will ultimately be released to replace the interim arrangements relating to these Declared Services.

The changes to the USO under the CCS Act include Ministerial control over the characteristics and performance standards that the primary USO provider (i.e. Telstra) must comply with in relation to providing its USO services. Additionally, the USO provider must satisfy its obligation via standard voice services rather than with mobile or VoIP services, unless a number of criteria, including prior written notice to the customer, are met.

The customer service guarantee standards have also been impacted by the introduction of the CCS Act, with breaches of minimum benchmarks subject to new civil penalties. The Minister now also has the ability to establish customer service guarantee timeframes for connections and repair that will be applicable to wholesale service providers. Express agreement will need to be obtained in the future if a provider wishes to treat a customer as having waived their customer service guarantee rights and customers must be informed of the consequences of waiving these rights.

The Commonwealth has also publicly announced that the USO will be subject to further substantive change if the Proposal is implemented (see Section 4).

(iii) Regulation of NBN Co

NBN Co is governed by the Telecommunications Act, the National Broadband Network Companies Act ("NBN Companies Act") and the Competition and Consumer Act (in particular, through amendments made to that Act by the Telecommunications Legislation Amendment (National Broadband Network Measures - Access Arrangements) Act ("NBN Operations Act")) which were passed by the Commonwealth Parliament in March 2011.

The legislation regulates the ownership (and possible eventual sale) and operations of NBN Co, as well as covering access, transparency, reporting and non-discrimination obligations in relation to NBN Co's role as the supplier of wholesale national broadband services (e.g. inability to deny access to any retailer). The NBN Operations Act also sets out technical and open access obligations to other companies that own networks which may compete with the NBN.

Several aspects of these Acts have been controversial. "Anti cherry picking" regulations will mean that companies that develop superfast broadband networks[11] built, upgraded or amended after 1 January 2011 which principally service residential or small business customers must operate on an open access, wholesale-only basis. Legislative amendments have authorised a nationally flat pricing structure for NBN access. The Commonwealth's Statement of Expectations requires nationally uniform pricing for NBN Co's entry level service of 12 Mbps across its fibre wireless and satellite networks. Higher speed services are only required to be uniform in price across geography within that delivery technology (e.g. the wholesale price for a 100 Mbps fibre service may differ from that of a 100 Mbps satellite service, if such a service is provided). NBN Co is also permitted to retail directly to certain organisations, such as utilities and transport authorities.

The ACCC will have oversight of pricing and access to the NBN and has been involved in the decision as to the number of PoIs in the network. Through the ACCC's involvement in the NBN planning process, the number of PoIs has increased from 14 to 121.

NBN Co has stated that it intends to lodge a Special Access Undertaking for the ACCC's approval, which will outline its approach to granting network access and pricing. The ACCC will then have six months to accept or reject the undertaking, unless time extensions are granted.

11 Defined as being capable of providing a download transmission speed which is normally more than 25 Mbps.

4 Details and Impacts of the Proposal

The Proposal represents the combined effect of eight separate but interdependent legal agreements between Telstra, NBN Co and the Commonwealth as well as the Structural Separation Undertaking and the Draft Migration Plan. The agreements and their consequences are described in more detail in the Explanatory Memorandum. From a commercial perspective there are three key elements:

(i) Migration of Services to the NBN

NBN Co's corporate plan envisages that its network will be rolled out over the period from 2011 to 2022. Telstra will disconnect its fixed voice and broadband services (both retail and wholesale) currently using Telstra's copper and HFC networks as the NBN is progressively rolled out. The disconnection of these services is largely governed by the Subscriber Agreement.

Once the NBN has passed 90% of premises within a defined roll out region (typically around 3,000 premises), it can be declared "ready for service". Telstra and other retailers will compete for the provision of new NBN based telecommunications services to customers within that region. As customers sign up for and install the new service, Telstra will be notified by its retail arm or by other retail service providers and will disconnect the existing copper based services and HFC broadband services (although the HFC network will continue to deliver pay television services). After 18 months from the ready for service date, Telstra will permanently disconnect all remaining copper and HFC broadband services provided to premises within that roll out region, except to the extent needed to provide certain limited types of services (e.g. special services such as ISDN which will be disconnected over a longer time period). Telstra will continue to provide a basic telephony service to the 7% of the population that will receive the NBN through wireless or satellite (predominantly through the copper network). Telstra will retain all its existing fibre backhaul and other fibre networks (e.g. in CBD locations).

While the final disconnection of all premises within a roll out region[12] after 18 months is designed to force Telstra retail and wholesale customers to migrate their service to the NBN, it does not mean that they will do so or that they will remain customers of Telstra:

- the NBN delivers an integrated voice and broadband service (for an access fee paid to NBN Co). Accordingly, there is likely to be intense competition between retail service providers before the switchover particularly for customers that have a Telstra voice service but use an alternative ADSL broadband service provider, as those customers will need to elect only one service provider for the bundle;
- retail customers can elect to have no NBN service in which case they will have no fixed line telecommunication services (e.g. they choose to rely only on wireless or mobile services); and
- retail service providers and ISPs presently buying services from Telstra's wholesale arm will cease to be Telstra customers and will purchase their carriage service from NBN Co. Telstra will be able to compete for their retail customers.

In exchange for disconnecting premises, Telstra will receive from NBN Co a one-off payment (that is not indexed) for each disconnected premises ("PSAA payments"). In

[12] Except those covered by the USO or other special arrangements within that area.

aggregate, the payments equate to a total benefit of approximately $4.0 billion in net present value terms[13]. The following conditions apply:

- the consideration is payable upon disconnection of premises;
- clawback arrangements will result in Telstra reimbursing NBN Co if, at a specified time after the 18 month migration period for the relevant roll out region, the relevant customers for the premises are Telstra wireless customers but the premises did not connect to the NBN; and
- Telstra has the rights to earn back the PSAA payment for these non connected premises if they subsequently connect to the NBN within a specified period.

From the time of connection to the NBN, Telstra will pay NBN Co a monthly access fee for each Telstra retail customer using the NBN, dependent on which service Telstra acquires to meet the customers requirements. NBN Co has committed to supply the basic NBN service offering (with 12 Mbps and 1 Mbps uplink speeds) for at least five years and will not charge more than the set price of $24 per month per subscriber[14] for the basic offering for that five year period[15] (subject to certain taxes and regulatory related exceptions). In connection with the basic service offering and certain other products, NBN Co has also agreed not to levy charges for “standard installations” (as defined in the agreements between Telstra and NBN Co) and to limit charges to incremental cost for non standard installations.

Telstra will continue to operate its copper and HFC networks in each roll out region as it currently does until the NBN is rolled out in that region and will continue to operate the copper and HFC networks within that region in certain limited ways (e.g. to provide special services such as ISDN, or to provide FOXTEL pay television services).

Other key provisions of the agreements include the following:

- NBN Co has complete discretion as to where and when it rolls out the NBN but will provide non binding 3 month and 12 month forecasts before declaring a roll out region ready for service;
- Telstra must exclusively use the NBN for fixed line connections to premises within the NBN fibre footprint for a period of 20 years (subject to limited number of exceptions);
- Telstra is prohibited from promoting wireless services as a substitute for NBN fibre services for a period of 20 years but is able to market wireless services generally and against competitors;
- there are separate arrangements for the disconnection of special services (e.g. ISDN);
- once permanently disconnected, Telstra may not reconnect the copper or HFC broadband capability within the NBN fibre footprint except in limited circumstances (e.g. if NBN Co ceases operations or becomes insolvent); and
- NBN Co will compensate Telstra if there is a permanent cessation or very slow roll out of the NBN (as defined in the agreements). The payment is $500 million if

13 As estimated by Telstra (based on after tax cash flows). Includes the value of payments for lead-in conduits (part of the infrastructure arrangements).

14 $24 per month covers the Access Virtual Circuit (“AVC”) and User Network Interface (“UNI”) components. NBN customers will also be subject to additional costs such as Connectivity Virtual Circuit (“CVC”) charges.

15 Telstra and NBN have not yet entered a detailed supply agreement. However, the Access Deed sets out certain high level undertakings by NBN Co.

cessation or slow down occurs when the NBN fibre network reaches 20% of NBN Co's current coverage target of 93% of premises nationally. This payment is scaled down pro rata until the network reaches the final 93% targeted level.

There is no payment if the event occurs prior to the NBN fibre network reaching the 20% level.

The progressive shutdown of much of its fixed line network operations will generate significant cost savings for Telstra. Telstra will however incur other costs as a result of the migration, including:

- installation and customer communication costs. Telstra (and other retailers) may need to install new equipment in customer's premises (although self-installation will also be possible);
- redundancy costs, although these will be reduced to some extent through retraining and redeployment; and
- business systems and information technology costs.

(ii) Access to Telstra Infrastructure

Telstra will give NBN Co access to various elements of its network infrastructure including dark fibre links, rack spaces in exchanges, ducts (and associated duct infrastructure such as pits and manholes) and lead-in conduits. Telstra and NBN have established joint working groups to address the associated technical issues in detail and physical feasibility studies to finalise the planning is underway. In return for providing access to infrastructure, Telstra will receive either once-off or regular access payments expected to represent a total net present value benefit of approximately $5.0 billion to Telstra[16] (but before associated remediation and other costs). Telstra is to provide access to the following infrastructure components:

- dark fibre links (measured in kilometres) essentially for backhaul between NBN Co's PoIs and exchanges. Telstra is responsible for the upgrade (to agreed fitness standards) of the dark fibre;
- rack spaces to be made available by Telstra in selected exchanges for the installation of equipment by NBN. Telstra will bear the costs of upgrading the exchanges and making rack spaces available to the required standards and for ongoing maintenance;
- ducts (measured in kilometres) that will mainly carry fibre from exchanges to connection points at street level, as well as the necessary pits and manholes that access the ducts at regular intervals. Telstra will be responsible for the remediation and maintenance of the ducts to fitness standards agreed with NBN Co; and
- lead-in conduits for final delivery to premises. While the conduits must meet a specified standard, Telstra has no remediation or ongoing service based obligations in relation to conduits.

Key features of these agreements include the following:

- the access for the first three elements (dark fibre links, rack spaces and ducts) is by way of long term licence to access and use that infrastructure. Telstra will receive

[16] As estimated by Telstra (based on after tax cash flows). Excludes the value of payments for lead-in conduits which are included under migration payments.

infrastructure access payments for an assumed average of 30 years. The infrastructure access payments are indexed to inflation;

- the lead-in conduits will be transferred to NBN Co in return for a once off payment per conduit (indexed) as lead-in fibre is installed by NBN Co into the conduit. Post transfer to NBN Co, Telstra has an ongoing right to also use the conduits (e.g. for FOXTEL services on the HFC network) at no cost;
- the infrastructure can be segmented into two groups:
  - transit infrastructure – dark fibre and approximately 60% of exchange rack spaces; and
  - access infrastructure – the remaining exchange rack spaces, ducts and lead-in conduits.

  Transit infrastructure has been specifically identified (with a small buffer) and orders for all of it have been placed subject to implementation of the Proposal. This infrastructure is expected to be provided to NBN Co within three and a half years.

  Access infrastructure will be provided to NBN Co as the NBN is rolled out.

  NBN Co has committed to pay for and Telstra has committed to make available certain minimum quantities of each element of infrastructure. The agreement includes provide-or-pay ("PoP") provisions (for infrastructure elements) and take-or-pay ("ToP") provisions (for access infrastructure) to help ensure Telstra provides the minimum quantities and NBN Co utilises them. There is no ToP for transit infrastructure because there are committed orders for that infrastructure. The PoP for transit infrastructure is assessed at the end of December 2014. The ToP and PoP for access infrastructure is assessed when NBN Co reaches roll out completion (93% fibre footprint roll out). The PoP mechanism includes a discount effect, as well as lower payments because of reduced volumes.

  NBN Co can obtain additional quantities on the same terms although Telstra has no obligation to provide additional dark fibre links and there are some changes to remediation provisions for some infrastructure; and
- the infrastructure access payments are committed from the time of provisions of access to the infrastructure until the end of the term of the agreement. Accordingly, even if there is a permanent cessation of the NBN, NBN Co will be required to continue to make payments in respect of all infrastructure supplied up to the time of cessation (except where NBN Co has cancellation rights as described below). In respect of access infrastructure, if more than 20% of the fibre roll out target is passed at the time of permanent cessation, the ToP/PoP mechanism will be brought forward to the permanent cessation date and there will be a pro rating (based on the extent of the roll out) of the ToP/PoP provision with the ongoing infrastructure access payments reset to these levels. There are adjustments if permanent cessation is due to changes in government policy which mean that any incomplete fibre rings and associated rack spaces can be cancelled. There are other provisions covering a very slow roll out (as defined, based on specified milestones). These arrangements are described in more detail in the Explanatory Memorandum.

(iii) The Government Package

In addition to commercial arrangements entered into with NBN Co, the Proposal also involves a number of arrangements with the Commonwealth.

The Commonwealth has stated that it intends to establish a new entity, the Telecommunications Universal Service Management Agency ("TUSMA") to progressively assume regulatory responsibility for, and to administer, the USO as the NBN fibre network is rolled out. Telstra, along with other industry participants and the Commonwealth, will make financial contributions to TUSMA which will make payments under contract to Telstra for performing the USO. Specific features of these arrangements include the following:

- Telstra will contract with TUSMA (and, in the interim period prior to its establishment, the Commonwealth) to provide a standard telephone service nationwide (including on behalf of TUSMA where it has assumed regulatory responsibility for the USO) as follows:
  - in relation to the 7% of premises not passed by the NBN fibre network, Telstra will act as both the network provider and the retail provider of last resort. These services will be predominantly provided by the copper network and, for most premises in these areas that are connected to the copper network as at 1 July 2012, Telstra will have an obligation to continue using the copper network to supply standard telephone services in fulfilment of the USO for the term of the agreement. Some of these premises could be located within fibre service areas (but outside the NBN fibre footprint), which could potentially require Telstra to maintain a copper network from an exchange to serve a small number of premises; and
  - in relation to the 93% of premises passed by fibre, Telstra will act as the retailer of last resort and will be required to supply the standard telephone service using the NBN fibre network.

  The pricing to customers of these services is governed by separate existing regulation;
- Telstra will receive an annual payment of $230 million per annum (not indexed) for undertaking the standard telephone service USO obligations nationwide. The arrangements include additional reimbursement if the scope of the USO is subsequently expanded after contract commencement;
- the Commonwealth has announced that the regulatory responsibility for the USO will progressively shift to TUSMA from 1 July 2014, initially in relation to the 7% areas to be served by NBN fixed wireless and satellite and then progressively in the 93% areas to be served by fibre as fibre is rolled out in those areas and the copper network is disconnected (subject to Telstra meeting certain performance hurdles);
- in the areas where the regulatory responsibility has not shifted to TUSMA, Telstra will continue to be the regulated primary USO provider but will also be contractually obligated under the TUSMA Agreement to fulfil the USO (but on the new financial terms). This agreement remains on foot if TUSMA does not come into existence. The regulatory reforms, including the establishment of TUSMA, require legislation to be passed at a future date. While this is not certain, the terms of TUSMA Agreement (which will be with the Commonwealth until TUSMA is established) mean that while Telstra would not be relieved of the regulatory obligations of the USO if the legislation is not passed, the financial elements (i.e. the payments to Telstra) would remain at the new contracted levels;
- Telstra will continue to operate the public payphone network in compliance with the USO relating to the supply of payphones for an annual payment of $40 million (not inflation indexed);

- a mandatory 10 year technology review will assess whether there are alternative technologies that could provide the standard telephone or payphone services on a more cost effective basis;
- if TUSMA is satisfied that a technological solution is needed to transfer certain public interest services (such as traffic lights) onto the NBN fibre network, it must fund either Telstra or a third party to develop a solution (subject to the parties reaching agreement on the terms of R&D funding); and
- Telstra will supply the Emergency Call Service for which it can recover its costs up to $20 million per annum. TUSMA will issue a tender for a new provider within five years after contract commencement.

The effect of these arrangements is a net increase in the payments for the USO received by Telstra compared to its current position.

Other components of the Government Package include the following:

- the Commonwealth has announced that Telstra will not be responsible for providing fixed network infrastructure to connect certain greenfields developments. During the roll out of the NBN, an estimated additional 1.3 million premises will be built in Australia. Over this period, the Commonwealth has announced that NBN Co will be responsible for laying fibre into and connecting housing estate developments with 100 or more planned premises in advance of its fibre roll out and all new developments (irrespective of the number of planned premises) within current roll out regions or roll out regions to be deployed in the next 12 months. Telstra will be responsible for connecting up any developments with less than 100 lots as well as recent developments that have not been connected by NBN Co (which initially became responsible for all housing estate developments from 1 January 2011). Telstra expects that these smaller developments will be connected with copper, or another non fibre solution, and will be switched to fibre as the NBN is rolled past;
- Telstra will receive funding of $100 million from the Commonwealth to undertake retraining of its staff with the aim of enabling their redeployment within Telstra, particularly in delivering any contracts Telstra may win to provide the development or construction services to NBN Co. Redeployment of staff will also allow Telstra to save on redundancy costs;
- the Government will procure NBN Co to undertake a public information campaign which is expected to result in cost savings for Telstra;
- the Commonwealth will provide funding to Telstra to undertake certain tasks which will be targeted at migrating eligible customers that acquire only a voice service on the copper network before they are disconnected, and in some cases to pay certain costs of any in-house wiring that is needed to connect that customer to a voice service using the NBN fibre network; and
- the Commonwealth will pay certain other migration costs of Telstra in limited circumstances.

Telstra has also lodged a Structural Separation Undertaking and a Draft Migration Plan with the ACCC for approval.

The Draft Migration Plan sets out the basis on which Telstra will disconnect its copper and HFC services as the NBN is rolled out and commence the supply of fixed line carriage services using the NBN. It includes detailed disconnection processes and various commitments by Telstra. The plan has been prepared to satisfy the Migration Plan Principles published by the Minister. The plan must be approved by the ACCC following which it becomes the Final Migration Plan. The ACCC cannot use its powers under Part XIC of the Competition and Consumer Act to impose further regulatory imposts on Telstra where the applicable matter is covered by the Final Migration Plan. Telstra must not lodge a variation of a Final Migration Plan with the ACCC without the approval of NBN Co.

The Structural Separation Undertaking sets out the basis on which Telstra will structurally separate and therefore meet the requirement under the CCS Act. Key features include:

- the undertaking applies only to the copper and HFC networks. It does not include existing fibre networks (e.g. in CBD locations) or pay television on the HFC network and there are also limited exemptions for other services to the extent their continued supply is permitted under the Subscriber Agreement (such as special services);
- the undertaking is to structurally separate by the designated day (1 July 2018 but this date can be extended by the Minister to accommodate any delay in the NBN roll out);
- in the event of permanent cessation of the NBN roll out, the obligation applies only to areas within the NBN fibre footprint where the copper and HFC networks have been disconnected under the Subscriber Agreement as at the designated day;
- Telstra will implement measures to provide for equivalence and transparency in the supply by Telstra of certain products to its wholesale customers until the designated day. Essentially, measures require Telstra to implement specified organisational, service quality, information security and dispute resolution process in relation to certain wholesale access services supplied over the copper network in areas prior to the NBN fibre service being installed; and
- it is a condition that the Minister issues waivers that effectively allow Telstra to bid for or acquire Digital Dividend spectrum while retaining ownership of the HFC network and the 50% equity interest in FOXTEL.

5 Evaluation of the Proposal

5.1 Summary

In Grant Samuel's opinion, the Proposal is in the best interests of Telstra and its shareholders. There is a significant degree of uncertainty about the potential impact of the NBN as well as uncertainty about other factors such as the future political and regulatory environments and the pace of technology developments in the telecommunications sector. Nevertheless, Telstra shareholders are likely to be better off if they approve the Proposal than if they do not.

The merits of the Proposal can only be meaningfully assessed relative to the alternatives available to Telstra in light of the NBN roll out and the recent legislative changes. The status quo is temporary.

Grant Samuel's primary analysis compares the relative impacts of approval or rejection of the Proposal assuming that the NBN proceeds as planned and that the present regulatory regime continues. If the Proposal is approved, Telstra will co-operate in the roll out of the NBN, provide access to infrastructure and migrate its fixed line services to the NBN in return for cash payments and other benefits ("the Co-operate scenario"). If shareholders do not approve the Proposal, then Telstra's only real choice is to compete with the NBN. In this case ("the Compete scenario"), Telstra would:

- not receive any payments from NBN Co for disconnection or payments for lead-in conduits. Payments for infrastructure access would be very substantially lower as Telstra would give NBN Co only limited access to its infrastructure to the extent required by law;
- further develop its own high speed broadband capacity (by upgrading the HFC network) and maintain the copper network as long as practicable. Telstra would sell NBN services to customers if there was demand (e.g. outside the HFC network footprint);
- likely be subject to the legislative prohibition on acquiring 700 and 2600 MHz spectrum;
- not receive the benefits that form part of the Government Package. For example, Telstra would not receive the increased contributions to the cost incurred by Telstra in delivering the USO; and
- be forced to functionally separate its fixed line wholesale business, requiring material investment of capital and business resources.

These alternative scenarios form the basis of the analysis. The analysis shows that, if the NBN is built, Telstra shareholders will be substantially better off in net present value ("NPV") terms if Telstra co-operates rather than competes. Under the Base Case assumptions, the incremental NPV from co-operation is $4.7 billion, equivalent to 38 cents per share. This differential is primarily attributable to the value of the payments by NBN Co and the value of the arrangements with the Commonwealth as well as other benefits from not competing (avoiding the Digital Dividend spectrum prohibition and functional separation costs). These benefits are partly offset by the adverse impact of the Proposal on Telstra's operating earnings and cash flows.

Importantly, the incremental NPV resulting from co-operation remains substantial even under a wide range of alternative assumptions (e.g. assumptions as to the timing of the NBN roll out or the extent of market share losses in a competitive environment).

Competition also involves other significant risks which have not been quantified in this analysis. It is likely that Telstra would face a more adverse regulatory environment if the Proposal is rejected. Aside from regulation of the access pricing regime, various elements of the broader regulatory regime (e.g. service levels) give considerable discretion to the Minister.

The second part of Grant Samuel's analysis recognises that in fact there is uncertainty about the ultimate development of the NBN itself, particularly in view of the divergent policy positions of the two major political parties. If there is a change of government, it is conceivable that the NBN roll out could be terminated or substantially modified. However, the relevant issue is whether voting for or against the Proposal would give the better outcome for Telstra shareholders. The Base Case analysis shows that if the NBN is terminated, shareholders will still be better off if they had approved the Proposal primarily because of the combined effect of the payments from NBN Co in the Co-operate scenario and the regulatory consequences of rejection in the Compete scenario. Moreover, approval of the Proposal does not inhibit Telstra's ability to participate in any alternative national broadband plan.

The more complex consideration is that, in Grant Samuel's view, rejection of the Proposal would increase the likelihood that the NBN roll out will be terminated or severely restricted because it would increase the cost of the NBN to the Commonwealth, potentially delay the roll out and substantially reduce the subscriber base of the NBN. Whether that increase in likelihood justifies the adverse effects and downside risks is a fundamental question for shareholders. A decision by Telstra shareholders to reject the Proposal would be only one of many factors that would influence any future government decision to abandon or modify the NBN plan and is unlikely to be the determining factor. The ultimate outcome will also depend on a variety of other factors including:

- the timing of any federal election and the election result;
- the evolution of the Coalition's telecommunications policy and, in particular, the nature of any alternative national broadband plan that is finally adopted;
- the state of the Commonwealth budget at that time;
- NBN Co's performance to date and the extent to which it has spent funds or made commitments to do so; and
- technological developments.

There is a high level of uncertainty with a wide range of possible outcomes dependent on a large number of variables. Nonetheless, a simple decision tree analysis indicates that even if a decision to reject the Proposal by itself materially increased the probability of the NBN being terminated, the expected value of the Co-operate scenario still exceeds that of the Compete scenario. Further:

- the Compete scenario includes a number of favourable assumptions (e.g. as to NBN penetration and the impact of spectrum prohibition);
- there are substantial downside risks in the Compete scenario not included in the financial analysis, in particular the risks of greater regulatory imposts; and

- there is no reason to believe that the Coalition would unwind any of the adverse regulatory provisions that would already be in effect as a consequence of rejection of the Proposal.

In any event, it is more appropriate to base a decision about the Proposal on the current reality that the NBN is being rolled out and the legislative regime that is in place rather than speculative possibilities.

There are a number of other factors that have not been quantified and are not reflected in the financial analysis. For example, Telstra will benefit from greater regulatory certainty if the Proposal is implemented and will avoid the risks and downsides of the Compete scenario. There are also disadvantages and risks but these are outweighed by the benefits and advantages particularly the expected value gain.

5.2 Approach to Evaluation

In considering the Proposal, shareholders need to recognise that it is not a question of whether the Proposal provides "fair compensation" for the impact of the NBN on Telstra. NBN Co has been already established by the government unilaterally and the NBN is being rolled out irrespective of any actions by Telstra. In this respect, the damage has been done and any consequent loss of value has already occurred. The issue for shareholders is simply whether the Proposal now before them is better than the alternatives currently available to Telstra. Moreover, the choice is not between the Proposal and returning to the previous status quo in which the NBN did not exist as the telecommunications landscape has already fundamentally changed in two respects:

- in the absence of a material change in circumstances, the NBN will be progressively rolled out across Australia. NBN Co has already made substantial progress in the roll out including detailed planning, the establishment of a number of test sites and an initial roll out in Tasmania and on the mainland. In short, the NBN is a competitive reality that Telstra must deal with whether the Proposal is implemented or not; and
- the CCS Act, which was passed in December 2010, has a number of significant adverse consequences for Telstra that will come into effect if the Proposal is not implemented. At its most basic level, the legislation seeks to force Telstra to voluntarily structurally separate its wholesale fixed line business from its retail and other activities. If Telstra does not voluntarily structurally separate then it:
  - must functionally separate which means that, while it can maintain ownership of the copper network, its business must have separate governance, management systems and reporting as well as a transparent transfer pricing regime; and
  - will be at risk that the Minister will impose a legislative prohibition on Telstra participating in any auction of the Digital Dividend spectrum needed for the efficient deployment of next generation wireless services and from acquiring the spectrum through any other indirect means[17]. It is expected that this spectrum will begin to be auctioned in late 2012 as analogue television is phased out.

[17] Under the CCS Act, the prohibition on Telstra bidding for spectrum is not automatic but is at the discretion of the Minister. For the purposes of the Report, Grant Samuel has assumed in these circumstances (i.e. where Telstra has elected not to structurally separate either through the Proposal or by other means) the Minister would exercise the power to impose the prohibition. Even if Telstra elected to undertake structural separation through a means other than the Proposal it is possible that the Minister would also exercise the prohibition.

It is Grant Samuel's view that the best way to analyse the Proposal is, in the first instance, to assume that the NBN proceeds as planned and that the present regulatory regime continues. In these circumstances, Telstra shareholders realistically have two options:

- approve the Proposal, implement structural separation and co-operate with NBN Co; or
- reject the Proposal and compete directly with NBN Co and bear the consequences of the recent legislative changes.

While there may be other options such as do nothing or demerge, they are not as attractive as competing directly with NBN Co with the surrounding circumstances.

Given this framework, the relevant issue for shareholders is not the value of Telstra per se or even the value of the payments to be received from NBN Co and the value of the arrangements with the Commonwealth. Rather, the key issue for shareholders is whether the value of Telstra if the Proposal is implemented is likely to be greater than the value of Telstra if it competes with the NBN.

The analysis supporting an informed decision therefore needs to capture much more than just the value of the transaction with NBN Co and the Commonwealth (even net of related costs such as remediation). A decision to either approve or reject the Proposal has significant and far reaching consequences for Telstra's business operations as it impacts everything from corporate strategy and market dynamics to operating costs and capital expenditure. All of these factors need to be taken into account in order to estimate the net effect of the Proposal for shareholders.

As the consequences for Telstra's business operations of approving or rejecting the Proposal arise progressively over more than 10 years (and vary substantially from year to year) it is not meaningful to analyse the impacts in terms of a single year (e.g. incremental earnings per share analysis). The best way to capture the full effect of the choice is to estimate the differences over the long term between the future cash flows of approving or rejecting the Proposal and to use a discounted cash flow ("DCF") analysis to assess the value implications for shareholders.

For the purposes of the analysis, two scenarios have been considered:

- **The Co-operate Scenario**

  In this scenario, the Proposal is implemented. This means that:

  - Telstra will progressively disconnect copper and HFC broadband services and migrate them to the NBN as the NBN is rolled out in return for payments. Ultimately all existing Telstra copper or HFC broadband customers whose premises are within the NBN fibre footprint will utilise the NBN except for those that elect not to have any fixed line service (e.g. wireless/mobile only homes), those who receive special services (until they are subsequently disconnected) and those serviced through alternative technologies. However, Telstra will not necessarily retain all those customers as they may switch to alternative retail service providers (but at the same time may also win customers). In relation to this element of its business (i.e. consumer fixed line services), within the NBN fibre footprint, Telstra will essentially be only a retailer (reselling NBN services) and will be in much the same position as its competitors (including acquiring NBN services on the same terms);

- NBN Co will access and use the Telstra infrastructure in exchange for payments over an assumed average of 30 years (and possibly more);
- the changes to the USO, greenfields development obligations and other regulatory arrangements will occur; and
- Telstra will retain ownership of the HFC network (for the provision of FOXTEL services) and its equity interests in FOXTEL and is able to participate in the Digital Dividend spectrum auctions. It is assumed that Telstra wins an appropriate share of this spectrum in order to maintain its capacity in this rapidly growing market.

- **The Compete Scenario**

  In this scenario, the Proposal is rejected and Telstra competes with the NBN (for network connections). It is assumed that:

  - Telstra continues to operate its copper and HFC networks and will seek to retain its customers on those networks to the maximum extent possible; and
  - Telstra competes with NBN in the most effective and efficient way possible. This would involve:
    - immediately upgrading the HFC network within its existing footprint to a new standard (DOCSIS 3.0) and adding voice capability to compete directly with the NBN service (extension beyond the current footprint is presently considered uneconomic by Telstra);
    - maintaining the copper network as a cost efficient service for customers for as long as practicable. Telstra may migrate retail services to the NBN where demand justified (e.g. outside the HFC network footprint); and
    - enhancing wireless services to the extent possible under any spectrum restrictions imposed by the Minister.

  In these circumstances, Telstra would:

  - not receive any of the PSAA payments from NBN Co for disconnection or payments for the transfer of lead-in conduits;
  - provide NBN Co with limited access to its infrastructure (as required by law[18]) and receive substantially reduced access payments;
  - not be relieved from its existing USO regulatory obligation and USO payments would not increase;
  - retain its obligation to build copper lines to new housing developments;
  - not receive any other contributions from the Commonwealth;
  - as the Minister will decide to impose the legislative prohibition on spectrum under the CCA Act, not be able to acquire Digital Dividend spectrum (i.e. blocks within the 700 and 2600 MHz bands);
  - be required to undertake functional separation; and
  - face increased regulatory pressure as a result of the changes to the legislation.

18 NBN Co would have certain rights to access Telstra's infrastructure (such as ducts) under the current facilities access regime within the Telecommunications Act (but without any rights for remediation).

In both scenarios it is assumed the NBN is fully rolled out (albeit not necessarily with the same timing as NBN Co's plan).

The financial analysis models the incremental cash flows of the two scenarios over the period to 30 June 2030 and determines the NPV of the incremental cash flows. A sensitivity analysis then considers alternative business assumptions in order to assess the robustness of the conclusion.

It is critical to understand the limitations of this kind of analysis. Long term forecasts for any business are difficult to determine with reliability. In this case, there are significant issues which make forecasting even more difficult:

- the development of the NBN represents a fundamental reshaping of the telecommunications industry in Australia. Telstra's business model (and cost structure) will change dramatically as will the competitive dynamics facing Telstra and other industry participants. In these circumstances, it is not possible to determine how key aspects of the business (e.g. market share) will be impacted with a high degree of confidence. There are no international precedents that provide a useful guidance;
- the impact from a regulatory change such as spectrum prohibition is difficult to assess. In addition, Telstra faces the risk of significant further (but indeterminate) regulatory imposts if the Proposal is rejected which could have a material impact on ongoing operating costs; and
- the telecommunications industry is subject to technological change that materially impacts the business (e.g. the development of new applications that alter data demand patterns or the potential development of far more efficient wireless technologies). These are inherently unpredictable at least over the longer term.

Accordingly, there is inevitably a large element of judgement involved in selecting appropriate assumptions for each of the scenarios and any long term financial analysis should be treated with a healthy degree of caution.

On the other hand, the nature of the Proposal is such that the absolute level or accuracy of the NPV calculation should be of less concern to shareholders. The critical issue for shareholders is that the analysis demonstrates that the NPV of the Co-operate scenario exceeds the NPV of the Compete scenario by a sufficient margin to mean that the conclusion that implementing the Proposal will be value accretive under most circumstances is robust. In this respect, the sensitivity analysis is at least as important as the Base Case analysis.

The second part of Grant Samuel's analysis recognises that there is uncertainty about the ultimate development of the NBN. In particular, it is conceivable that a change of government at the next election could result in material changes to NBN Co's business plan. The analysis considers the nature and possible impact of this uncertainty on the value equation for Telstra shareholders and the implications for the decision as to whether to approve the Proposal or not. This is necessarily a relatively high level analysis but it is an important component of the decision for shareholders.

5.3 Financial Analysis of Primary Scenarios

5.3.1 Overview

Grant Samuel's financial analysis is based on detailed financial models that have been developed by Telstra and its advisers over a two year period with extensive input from operational management. In addition:

- the models have been reviewed for Telstra by an accounting firm to ensure mathematical accuracy and correct application of assumptions; and
- the assumptions underlying the models have been reviewed for Telstra by an external adviser for reasonableness.

Following its own review of the assumptions, Grant Samuel made a number of changes to certain key assumptions reflecting its judgement on certain matters or to better suit the purposes of the analysis.

The models project Telstra's cash flows from 1 July 2011 to 30 June 2030. They are based on Telstra's detailed business plan to 30 June 2014 which is extrapolated on a high level basis to 30 June 2030. The models then incorporate the incremental impact on cash flow of each scenario (including effects on penetration, market share and revenues and costs) as well as regulatory impacts.

The cash flows are calculated on an ungeared, after tax basis. Grant Samuel calculated a terminal value as at 30 June 2030 and discounted the cash flows to an NPV at 30 June 2011.

The analysis involves the determination of a Base Case as well as a sensitivity analysis which examines the impact of alternative sets of assumptions.

Telstra is a complex business. The full suite of financial models incorporates thousands of individual assumptions and it would not be helpful or relevant to set out these assumptions in detail. The key assumptions adopted in the analysis that, in Grant Samuel's view, are important to understanding the analysis and/or have a material impact on the NPV outcomes (i.e. the differential between the two scenarios) are summarised in this Report.

In this context:

- for most operating assumptions (e.g. broadband penetration) it is not the absolute value of the parameter that is critical. Rather, it is the nature and extent of any differences between the assumptions adopted in the two scenarios;
- for the purposes of comprehensibility in this Report a number of the assumptions are described in terms of an overall parameter (e.g. market share or ARPU). However, it should be recognised that these parameters are the product of much more detailed modelling. For example, ARPUs are based on a number of product tiers for different types of customer segments (typically by extent of usage) which are then weighted by the proportion of customers in those segments in that year. Similarly, the variables change year by year but rather than specifying every annual change, the differences in those variables as of today and FY24 (being the assumed end of the NBN roll out period) are identified; and

- certain assumptions have not been set out in detail at the request of Telstra for reasons of commercial sensitivity.

The selection of most assumptions in a forecast cash flow model involves a degree of judgement. As the essential question for shareholders is whether co-operation is better than competing, Grant Samuel has in some cases selected assumptions that, if anything, err on the side of supporting the Compete case relative to the Co-operate case.

5.3.2 Assumptions

General modelling assumptions adopted by Grant Samuel include:

- a discount rate of 9.0%. The discount rate represents an estimate of the overall weighted average cost of capital ("WACC") for Telstra. The basis for this discount rate is set out in Appendix 2. A cost of equity capital of 10% was calculated using the Capital Asset Pricing Model ("CAPM"). Combined with the cost of debt the resulting WACC was calculated to be 8.7%. The calculated WACC of 8.7% was rounded up to 9% reflecting:
  - the imprecision of any estimate of the cost of equity capital (see Appendix 2); and
  - Grant Samuel's view that there is significant anecdotal evidence that investors have repriced risk upwards since the global financial crisis in a manner not adequately captured by models such as CAPM. Alternative models for determining the cost of equity capital would also support higher rates. For example, the perpetuity formula can be restated such that:

    Cost of equity = Dividend Yield *plus* Long Term Dividend Growth Rate

    Telstra is currently trading at a dividend yield of approximately 9%. If the cost of equity using CAPM of 10% is correct, the market must be assuming long term nominal dividend growth of 1%. Higher dividend growth rates would imply a WACC greater than 9%.

  There is a question as to whether the cost of capital for Telstra's fixed line business is different from the cost of capital for Telstra as a whole. This is probably true but the imprecision of the CAPM calculations (including the variability of data and inherent statistical errors) means that it is not realistic to determine a different cost of capital for this segment of the business with any meaningful reliability.

  A number of the transaction cash flows are lower risk cash flows than Telstra's normal business (e.g. access payments for infrastructure or the USO contract payments) and therefore it is arguable that a lower discount rate should be applied to these cash inflows. While they are lower risk, Grant Samuel believes the better (and more conservative) view is that they are simply integral elements of a broader transaction which has material consequences on Telstra's business operations and they should not be separately discounted at different rates.

  There is also an argument that a higher cost of capital should be applied to the Compete scenario (see Section 5.5.2). While there is merit in this view, the same discount rate has been used in both scenarios so that the underlying cash flow differential is not confused by use of different discount rates.

In any event, given the nature of the analysis, in which the focus is the difference between the NPV of the Co-operate scenario and the NPV of the Compete Scenario, the discount rate is less critical than in a standard valuation of a business where the absolute value is of paramount importance. The sensitivity analysis examines the impact of different discount rate assumptions;

- a terminal value calculation based on the perpetuity formula assuming a perpetual growth rate in ungeared after tax cash flows from 2030 of 2% per annum;
- general inflation of 2.4% and wage inflation 1% higher; and
- a tax rate of 30%. PSAA payments, infrastructure access payments and payments for lead-in conduits are all treated as taxable income.

The major assumptions underlying the Co-operate and Compete scenarios that were adopted by Grant Samuel are set out in Appendix 3. The key points to note are:

- the NBN fibre roll out is extended by two years compared to the profile published by NBN Co to allow for the delays that typically afflict large scale infrastructure projects (the NBN is already behind plan in some aspects). A further one year delay to the roll out has been added to the Compete scenario to allow for the need for NBN Co to replan the roll out without the contracted access to Telstra's infrastructure;
- PSAA payments allow for a reduction in available premises caused by wireless substitution prior to migration and for wireless substitution during the 18 month migration period. The share of the voice market held by mobile only premises is assumed to be 27.5% by the end of the roll out period (FY24);
- while Telstra will aggressively seek to retain all customers, it is assumed for the sake of conservatism that Telstra's voice customers who have an alternative ISP will choose their ISP to provide their bundled NBN based service. Accordingly, Telstra's share of the voice market (currently approximately 80%) converges towards its broadband share over the roll out period. Telstra's share of the retail broadband market is assumed to remain relatively stable at around 40%. Broadband wireless substitution is assumed to reach approximately 14% by FY24;
- voice ARPUs decline materially (>25%) over the period to FY24 while average broadband ARPUs fall by a smaller amount (less than 15%);
- NBN access costs remain flat in nominal terms;
- operating and capital cost savings are assumed as the copper and HFC networks are progressively disconnected (with an allowance for ongoing costs in running the USO regions). Capital expenditure is governed by Telstra's 14% capital expenditure to sales ratio; and
- in the Compete scenario:
  - NBN Co obtains a share of approximately 50% of fixed lines by FY24 (equivalent to approximately 35% of all service addresses). This penetration rate for the NBN may appear low given the resources behind the NBN roll out. However, there are a number of factors that will inhibit take up in a competitive environment including:
    - inertia – existing services are generally regarded as adequate for many users at the current point in time (and may remain so for some years);

- the presence of upgraded HFC (which will generally be available prior to the NBN being rolled out); and
- pricing of the NBN service relative to PSTN/ADSL and the upgraded HFC.

In any event, for the purposes of the analysis, an NBN penetration rate at the low end is appropriate. To the extent NBN is likely to be more successful than assumed, the Compete scenario would be even less attractive relative to the Co-operate scenario;

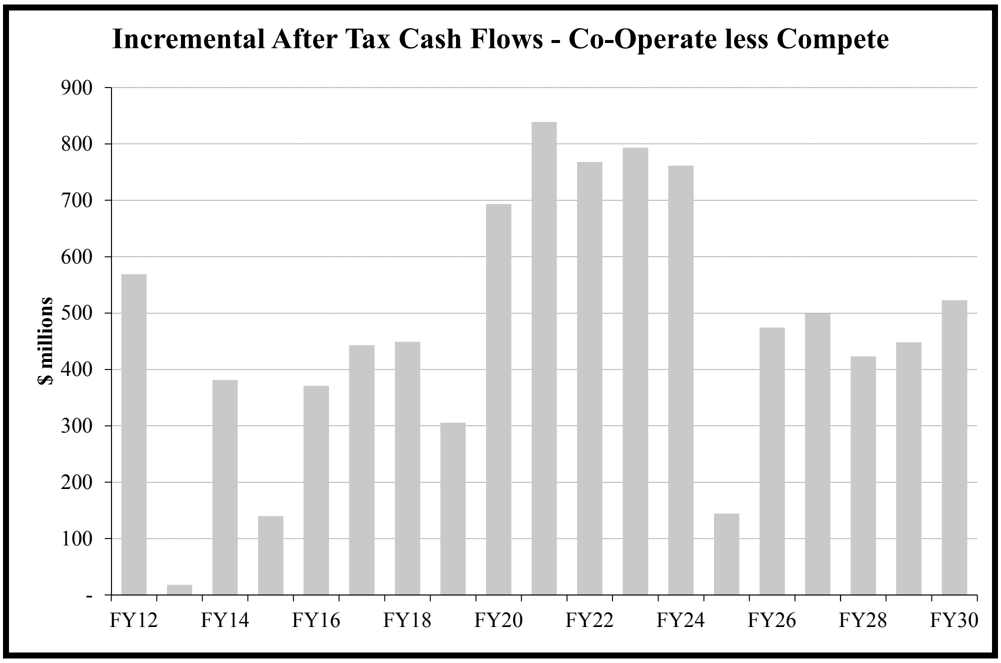
- costs of functional separation exceed $1 billion;
- HFC network upgrade costs are approximately $1 billion. HFC revenues and earnings assume that the anti cherry picking provisions in the NBN Operations Act do not apply to the upgraded HFC network. If they did apply, the NPV advantage in favour of co-operation would increase;
- the Minister imposes the Digital Dividend spectrum bidding prohibition and that this will progressively reduce Telstra's total mobile revenues by a cumulative 20% by FY25. Grant Samuel has assumed for modelling purposes that the impact is relatively moderate and that it stops at a 20% reduction on the basis that:
  - anticipated data demand growth is expected to see Digital Dividend spectrum fully utilised within 10 years (and possibly sooner);
  - Telstra is not prohibited from participating in subsequent spectrum auctions; and
  - there are actions Telstra can take to ameliorate the impact although these involve capital expenditure (e.g. more cell towers) and there may be other technological innovation over the period that enhances capacity on Telstra's existing spectrum.

  Allowance has also been made for spillover effects into Telstra's fixed line business reflecting in particular the likely impact on Telstra's ability to offer competitive bundled products.

  The impact of the prohibition on acquiring spectrum could in fact be much greater than assumed. The Digital Dividend spectrum is where the development of next generation wireless data services will be focused. An effective exclusion has potentially serious ramifications for Telstra's mobile business as well as flow on effects to other businesses. However, a relatively modest effect has been assumed for the purposes of ensuring the robustness of the conclusion.

5.3.3 NPV Outcomes and Sensitivities

Under the Base Case assumptions, the Co-operate scenario produces an NPV that is $4.7 billion (equivalent to 38 cents per share) greater than the NPV in the Compete scenario. The difference in annual after tax cash flows between the two scenarios is depicted graphically below:



The incremental cash flows directly related to the Proposal (disconnection payments, infrastructure access payments and government contributions less direct costs) have a positive value much greater than $4.7 billion. In addition, the Co-operate scenario (relative to the Compete scenario) benefits from:

- no adverse impact on wireless revenues and earnings; and
- no functional separation costs.

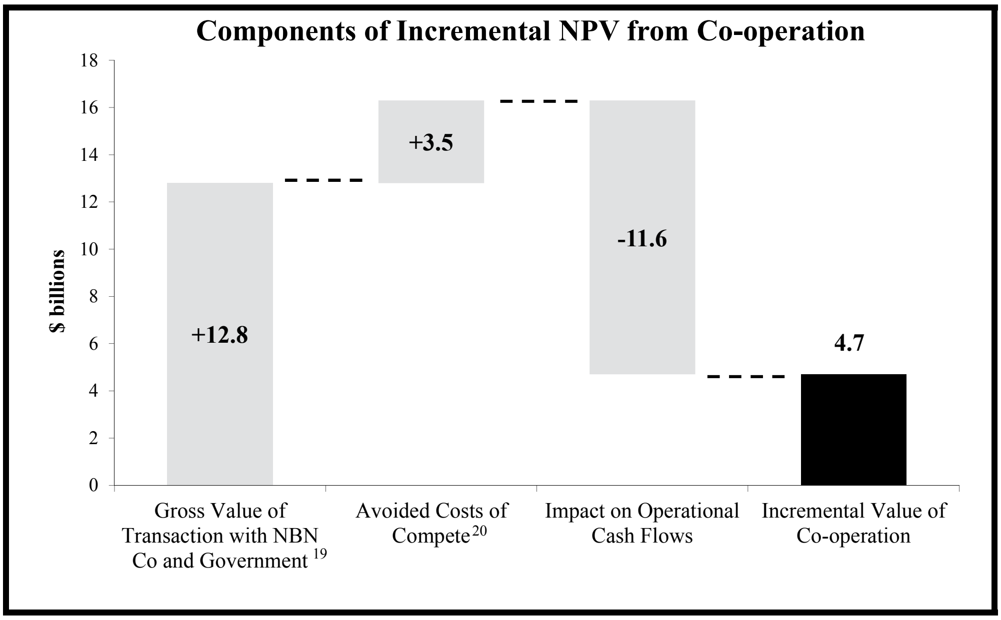
These value gains are partly offset by the long run effects (mostly adverse) on Telstra's ongoing business (relative to the Compete scenario) including the following:

- over time NBN access costs will replace Telstra's own network operating costs (copper and HFC networks). NBN access costs per customer are higher than Telstra's own costs and accordingly, Telstra's margins reduce over the roll out period;
- the loss of wholesale income from the copper network (voice and broadband);
- the loss of market share in voice services and, to a lesser extent, broadband services;
- the loss of potential income from the HFC upgrade; and
- inefficiencies in operating the residual copper network as it reduces in size.

The components of the NPV of the incremental cash flows are shown below:

[19] This value is before associated costs (remediation and maintenance of infrastructure, migration, redundancies etc). The NPV of $12.8 billion differs from Telstra's estimate of $11 billion primarily because Grant Samuel has used a lower discount rate (9% compared to 10%) and because it is calculated as at 30 June 2011 (compared to 30 June 2010). In addition, Grant Samuel has utilised different assumptions (e.g. as to roll out).

[20] Comprises the cost of functional separation and the impact of the Digital Dividend spectrum prohibition.



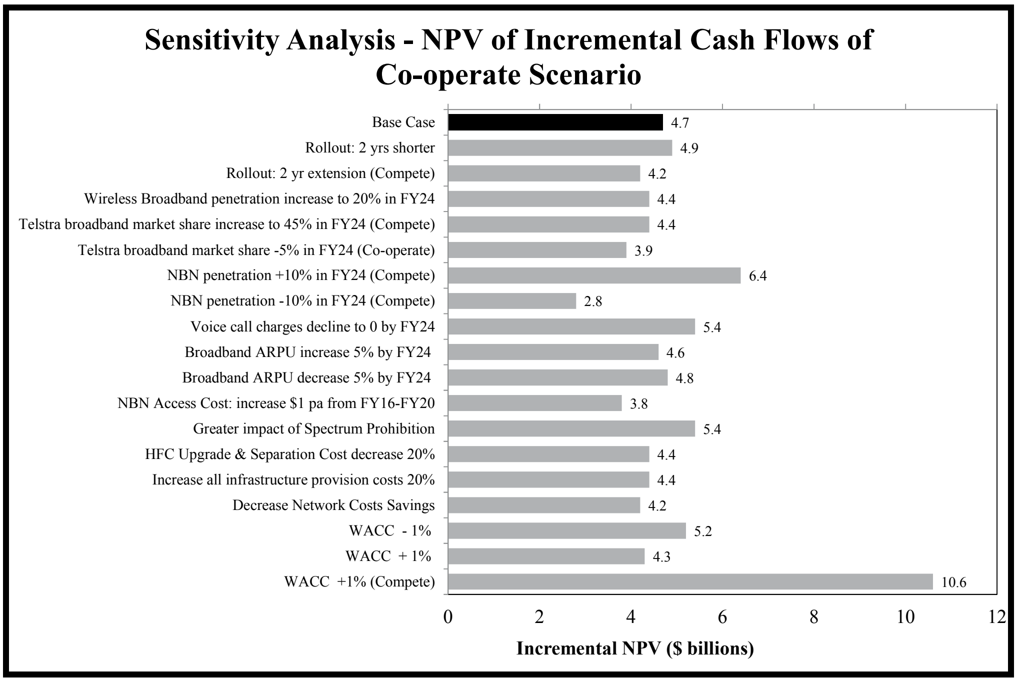
The Base Case indicates that Telstra is likely to be materially better off in NPV terms if the Proposal is approved. In view of the uncertainty attached to the financial analysis, a sensitivity analysis to assess how robust this conclusion is to alternative sets of assumptions has been undertaken.

The following table sets out a number of alternative cases that were considered:

Sensitivity Analysis – Alternative Cases	
Case	**Description**
A	NBN Roll out: (i) Co-operate scenario: NBN roll out period is the same as published by NBN Co (i.e. 2 years shorter than in the Base Case). Compete scenario: same as Co-operate (ii) Compete scenario has 2 years additional extension
B	Market Share: (i) Wireless broadband penetration as at FY24 is increased to 20% in Co-operate and Compete Scenarios (ii) Telstra's broadband market share increases to 45% by FY24 in the Compete scenario (iii) Telstra's broadband market share is 5% lower in the Co-operate scenario (iv) NBN Penetration + 10% for Compete scenario (i.e. 45% of all addresses by FY24) (v) NBN Penetration -10% for Compete scenario (i.e. 25% of all addressed by FY24)
C	ARPUs (i) Voice calling charges reduce to zero by FY24 (access charges unchanged) (ii) Broadband ARPU 5% higher by FY24 on a straight line basis (iii) Broadband ARPU 5% lower by FY24 on a straight line basis
D	NBN Access Payments (i) 5 years after commencement Base Case all NBN Access prices increase by $1 each year up to $5 in FY20 through to FY30
E	Spectrum Prohibition (i) Greater impact of spectrum bidding prohibition (mobile revenues fall by a cumulative 40% over an additional four year period)
F	Costs (i) Decrease HFC upgrade and separation costs by 20% (ii) Increase infrastructure provision costs (remediation and maintenance) by 20% (iii) Network (copper and HFC) cost savings are less than Base Case. Operating costs and capital expenditure assumed to be 10% less variable (e.g. 70% compared to 80%)

Sensitivity Analysis – Alternative Cases	
Case	**Description**
G	Discount Rate (i) WACC is 1% lower than Base Case (i.e. 8%) (ii) WACC is 1% higher than Base Case (i.e. 10%) (iii) WACC is 1% higher in Compete scenario (i.e. 10% compared to 9% in Co-operate)

The results of this analysis are summarised below:



The analysis demonstrates that if the NBN is completed, the conclusion in favour of co-operation is relatively robust. Changes to assumptions in the NBN roll out that delay or extend the timetable would result in an uplift in the absolute value to Telstra as it can maintain its existing business where it earns the full margin from existing retail customers for a longer period (and keeps its wholesale business for longer). However, this does not necessarily result in a material change in the difference between the two scenarios (i.e. delay/extension helps both). The NPV differential is also not particularly sensitive to variations in broadband pricing or changes in costs. While increased wireless penetration in broadband may have a significant adverse impact on NBN Co it does not have a material impact on the decision from Telstra's point of view as Telstra also has a substantial share of the wireless market. The NPV differential is also not particularly sensitive to a change in the discount rate except where different rates are used for each scenario (as they apply to the whole of Telstra's business). Notably, reductions in voice ARPU actually benefit the Co-operate scenario (as the share of the voice market is lower). Similarly, if the spectrum bidding prohibition impact is greater than anticipated the Co-operate scenario becomes even more value positive.

The key sensitivities are around NBN penetration in a compete environment and broadband market share. In relation to these sensitivities:

- even if Telstra was a highly effective competitor and the NBN market share by FY24 in a Compete scenario was as low as 25% (of all service addresses) the incremental NPV of the Co-operate scenario is still approximately $3 billion; and

- a 5% reduction in broadband market share in the Co-operate scenario reduces Telstra's share to approximately 35% by FY24, compared to over 40% in the Compete scenario. Future market shares in such a transformed market are inherently difficult to predict. There may be reasons that Telstra's share could be substantially lower than forecast but it is not apparent why the market share difference between the two scenarios would be substantially wider than assumed in this sensitivity. Even in this case, the impact on the NPV differential in favour of co-operation is reduced by less than $1 billion.

Perhaps the most important conclusion to draw from the financial analysis is that it would take a relatively extreme set of circumstances for the Compete scenario to be better than the Co-operate scenario.

Further, it should be noted that the Compete scenario:

- assumes a relatively low penetration is achieved by NBN Co;
- assumes a relatively modest impact from the Digital Dividend spectrum prohibition;
- makes no allowance for further regulatory imposts under the CCS Act beyond functional separation; and
- does not utilise a higher cost of capital.

Accordingly, if anything, it is likely that the NPV benefit from co-operation would be greater than the Base Case level of $4.7 billion.

5.4 Alternative Scenarios and Strategies

The financial analysis set out in Section 5.3 is on the basis that the NBN roll out to 100% of premises will be completed and that the current regulatory regime remains in place. Grant Samuel believes this to be the most appropriate basis for the analysis.

However, there is uncertainty about the ultimate development of the NBN itself, particularly in view of the divergent policy positions of the two major political parties. In reality, there is a wide range of possible outcomes and completion of the NBN in accordance with its current plan is only one of them. If there is a change of government, it is conceivable that the NBN roll out could be terminated or substantially modified and the policy of government participation in the sector abandoned. For example, on 3 August 2011, the Shadow Minister for Communications and Broadband outlined his approach to broadband development. In general terms that approach is as follows:

- the NBN fibre roll out would be halted but would continue to be operated to the extent it had been rolled out (i.e. it would not be scrapped);
- fast broadband development beyond the NBN roll out areas would be achieved through the private sector but with subsidies where necessary. The HFC networks of Telstra and Optus can provide adequate fast broadband services within their existing footprints (approximately 2.7 million premises). Beyond the HFC footprint (and the 7% served by wireless/satellite) it is anticipated that provision of upgraded services would be tendered on a regional basis with the objective of generating the most cost effective solution, probably Fibre to the Node ("FTTN") in most cases.

The government would need to provide financial assistance by way of capital or ongoing subsidy or co-investment in some less densely populated areas;

- it is recognised that Telstra is in a prime position to provide the upgraded broadband service using FTTN because of its existing ownership of the copper network (that would be needed to provide the final link from the node to the premises). However, the Coalition would require Telstra to structurally separate the (copper and HFC) network operations in order to participate in the upgrade scheme; and
- a Coalition government would consider selling NBN Co (and its partially rolled out network) to the structurally separated network company (or any other network operator).

In view of this uncertainty, Telstra has structured the Proposal so that there are a number of protection mechanisms if a change in policy does occur. If the Proposal is approved but the NBN roll out is subsequently stopped, Telstra:

- may receive a termination payment from NBN Co. The payment is $500 million if the NBN is rolled out to 20% of NBN Co's coverage target of 93% of premises, at the time of cessation and is scaled down pro rata between 20% and the 93% coverage target. There is no payment below 20% as the impact on Telstra's business would not be significant;
- will have a contractual right to continue to receive for the remainder of the term of the agreement:
  - access payments for all transit infrastructure that has been supplied and is in active use up to the point of cessation; and
  - if more than 20% of the fibre roll out target has been passed, a pro rata share (based on the proportion of the network rolled out at the point of cessation) of payments for access infrastructure (see generally Section 4(ii)); and
- the USO arrangements with TUSMA cannot be automatically terminated if the roll out exceeds 20%.

In addition, there is an important natural protection as Telstra will continue to operate its copper network and HFC networks in areas not covered by the NBN. This will mean that Telstra will continue to generate both wholesale and retail margins from its customer base in the non NBN areas (depending on the nature of an alternative national broadband plan, if any). In fact, a decision to terminate the NBN roll out could substantially increase the value of Telstra, although in reality it is unlikely Telstra would be able to revert to a "no NBN" world on a permanent basis as the new government is almost certainly going to seek to implement some form of enhanced broadband roll out across the country (even if a more constrained or cheaper option such as FTTN).

The issue for Telstra shareholders is not the protections available to Telstra but rather whether voting for or against the Proposal gives the better outcome. Telstra could expect to benefit from the continued profitability of the copper and HFC networks in the non NBN areas in both scenarios if the NBN roll out is abandoned. However, there are material differences between scenarios in those circumstances. If the Proposal is approved but the NBN fibre roll out is subsequently terminated Telstra will:

- have received payments for premises disconnected from the copper and HFC broadband networks up to that point;
- have received infrastructure access payments and will continue to receive a proportion of those for the remaining term of the agreement;

- still be able to participate in the Digital Dividend spectrum auctions and may well have already participated as the first auctions are expected in late 2012; and
- continue to be relieved of the regulatory USO in areas where the NBN has been rolled out as well as in the 7% areas served by wireless/satellite[21].

If the Proposal is rejected and Telstra competes with the NBN it will seek to retain customers on its existing networks to the maximum extent. The roll out may also be delayed or slower if the Proposal is rejected. Accordingly, it will likely have migrated a lower number of services on to the NBN at the time the NBN is stopped (compared to the Co-operate scenario). On the other hand, it will not have received any of the payments that it would have received for disconnection of customers in the NBN roll out area and will be entitled to much lower payments for the provision of access to its infrastructure. Moreover, if the Proposal is not approved:

- Telstra will have been prohibited from bidding for the Digital Dividend spectrum (assuming the Minister imposes the prohibition);
- Telstra will have been required to commence functional separation. It is also exposed to the risk of greater regulatory imposts in areas where there is ministerial discretion (e.g. customer service guarantee); and
- Telstra will have begun to incur HFC upgrade costs.

In relation to the regulatory consequences (spectrum bidding prohibition, functional separation, other impacts), there is no reason to believe that they will be amended in Telstra's favour if there is a change of government and the NBN is stopped or substantially modified.

It is difficult to undertake a precise analysis of this potential situation, not least because of the considerable uncertainty about:

- the timing of any cessation of the NBN roll out; and
- the nature of the cessation, in particular what alternative broadband proposal is developed by a new government.

However, the analysis set out below may provide a basis for assessing the position. It considers only two situations:

- the NBN is completed; and
- the NBN roll out is terminated in 2014 (i.e. within 12 months of the likely election date) with no replacement national broadband plan.

This approach has been adopted because there is no way of knowing what kind of modified alternative broadband proposal would emerge or how its economics would affect Telstra. In the first instance it would depend on which party was in power when the termination occurs (it could happen under either although it is far more likely under the Coalition). There is an array of possibilities for alternative broadband development as to technology, technology mix, the role of private sector vs public sector, development costs and impact on the existing industry. It would inevitably involve extensive consultation and negotiations between the then government and Telstra as well as other industry participants. In this context, the approach recently announced by the Shadow Minister was

[21] The TUSMA Agreement can be terminated if the NBN fibre roll out reaches less than 20% of the planned footprint. If it is beyond that level, the TUSMA Agreement cannot be terminated but a party can ask for it to be renegotiated and, if no agreement is reached, for a binding arbitration in accordance with specified principles.

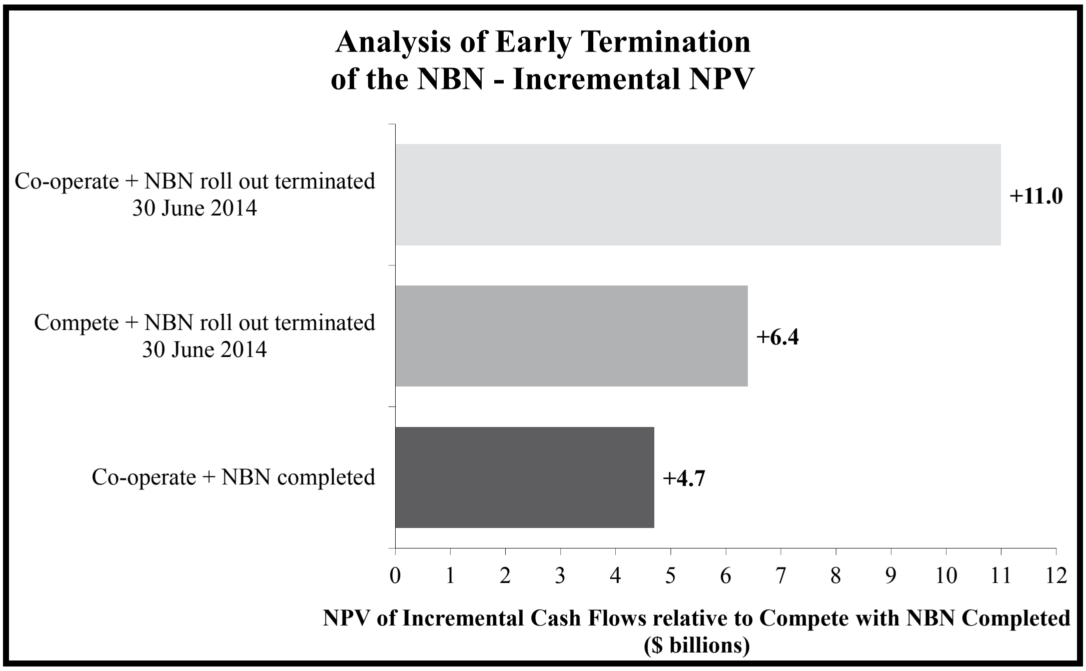
only a conceptual outline and provided no details from which any kind of meaningful financial analysis could be undertaken (e.g. the likely quantum of any subsidy). Any financial analysis would also ideally require some basis for assessing the economic consequences for any subsequent upgrade path to FTTP (e.g. capital costs, subsidies etc). In any event, it is far from certain that the Coalition would ultimately implement the proposal outlined by the Shadow Minister.

(i) Ex Post Analysis

The Base Case financial model used in Section 5.3 was amended so that:

- the NBN roll out is terminated on 30 June 2014. The NBN fibre network would be 11% rolled out in a Co-operate scenario and 3% rolled out in the Compete scenario. Accordingly, the $500 million termination payment is not applicable;
- the NBN remains operational within its footprint but an alternative broadband network is not developed beyond the NBN footprint at that point in time. Telstra continues to operate its copper and HFC networks in the non NBN areas;
- the impacts of the CCS Act, particularly the requirement to functionally separate[22] and risk of the Minister imposing the prohibition on acquiring Digital Dividend spectrum, remain in place and continue even if the NBN roll out is terminated; and
- in the Co-operate scenario, Telstra is assumed to be required to undertake full functional separation (from FY15) in lieu of the structural separation achieved under the Proposal (which would be largely incomplete if the NBN roll out is stopped at 11%)[22].

The graph below shows the incremental NPV for both the Co-operate and Compete scenarios assuming termination of the roll out in 2014 (relative to the Compete scenario with the NBN being completed). It demonstrates that the NPV of the Co-operate scenario is still materially in excess of the NPV of the Compete scenario if the NBN roll out is terminated in 2014:



22 It is conceivable that in the event of termination Telstra could be forced into some form of structural separation. The cost of structural separation would be greater than functional separation but the incremental cost would not materially alter the value differentials.

While the analysis indicates that there is a significant gain in value if the NBN roll out is terminated rather than completed:

- the analysis examines only two alternatives – completion of the NBN roll out or permanent cessation in 2014. It is a theoretical best case for Telstra shareholders. The reality is that the gain from cessation of the NBN roll out is likely to be less than presented here because it is highly likely that some form of alternative national broadband scheme would be proposed; and
- the differential in NPV between the Co-operate scenario and the Compete scenario remains positive even if termination occurs at any other date.

The key conclusion is not that termination of the roll out increases value but rather that, if the NBN roll out is terminated at a future date, Telstra is financially better off if shareholders had approved the Proposal.

Just as importantly, approval of the Proposal does not reduce or adversely impact Telstra's ability to participate in any future alternative broadband plan. For example, if a future Coalition government did pursue the kind of plan outlined by the Shadow Minister, Telstra would still be able to undertake a structural separation of its then network operations if that made economic sense at that time. The network company would be able to tender for the provision of fast broadband in areas outside of the NBN footprint and acquire NBN Co. In other words, these options are preserved whether shareholders approve or reject the Proposal.

In addition:

- alternative government broadband plans to the NBN may not necessarily materially change the NPV differential between the Co-operate and Compete scenarios; and
- Telstra may be better placed in a general sense to negotiate with the government if it has approved the Proposal (see Section 5.5).

(ii) Probabilistic Analysis

The ex post analysis above indicates that termination of the NBN roll out even under the Compete scenario may be a better value outcome than co-operating with the NBN being completed (+$6.4 billion compared to +$4.7 billion). The difference does not arise if termination occurs at later dates (i.e. beyond 2016). It also does not take into account any of the non quantified risks. Nevertheless, this value outcome raises the question of whether rejection of the Proposal might make sense for shareholders.

In Grant Samuel's view, rejection of the Proposal would increase the likelihood that the NBN roll out will be terminated (or severely restricted) because it would adversely affect its underlying economics to a substantial extent:

- there would be a material increase in the NBN's roll out cost without access to Telstra's ducts, exchanges and lead-in conduits (except as available under the facilities access regime);
- NBN Co would face delays because it would need to develop an alternative way to roll out its network. NBN Co would also not have access to Telstra's technical expertise or assistance; and

- NBN Co would face having a substantially lower number of subscribers, at least for a prolonged period, if Telstra is successful in retaining its existing subscribers (using lower cost ADSL, upgraded HFC broadband or wireless solutions).

The fundamental question is whether that increase in the likelihood of termination of the NBN roll out is worth the downside effects. The first point to note is that rejection of the Proposal by Telstra shareholders would be only one of many factors that might influence any decision by a future government to terminate the NBN roll out. The ultimate outcome will also depend on a variety of other factors including:

- the timing of federal elections and the election result. Conventional timing would see the next federal election being held in mid to late 2013. An early election may provide more scope for the NBN to be terminated as less of the roll out will have occurred. The nature of the election outcome would also have an impact. A narrow margin may limit the options of an incoming government. Similarly, if the Senate remains with the balance of power held by minorities there will be less ability to change legislation;
- the evolution of Coalition policy. At the 2010 election the Coalition policy opposed the NBN. While the Shadow Minister has recently announced an approach in relation to future broadband delivery, a formal policy release is unlikely until closer to the next election;
- the state of the Commonwealth budget at the time. A substantial budget deficit may harden the resolve to restructure the NBN in order to substantially reduce government outgoings;
- the performance of NBN Co up to that point. Key issues will include:
    - the progress of the roll out against plan;
    - costs incurred compared to the corporate plan or budget; and
    - the success in securing subscribers within the roll out area (in a Compete scenario); and
- technological developments in broadband delivery.

In relation to the Coalition's position:

- the policies of political parties reflect a range of influences. Significant changes are not uncommon as circumstances change;
- a focus for the Coalition has been the preparation of a cost/benefit analysis of the NBN. The Shadow Minister has indicated he would ask the Productivity Commission to advise on the most cost effective means of ensuring Australians have access to very fast broadband at affordable prices. The outcome of such an analysis is unknowable at this point in time but is likely to have a major impact on Coalition decision making. In this context:
    - any decision relating to the NBN is complex and involves far reaching consequences. Decisions are likely to be made well after any election;
    - the more the NBN is rolled out, the more any cost/benefit analysis is likely to favour completion of the NBN as costs become sunk. This position will also be impacted by the extent to which NBN Co has made irrevocable financial commitments at that time and any costs associated with abandonment of the roll out; and

- NBN Co may target many of the more commercially attractive regions as early as possible. Areas not covered will create political pressure to obtain a similar quality service. Coalition policy recognises the need for government subsidies for areas that would not be commercially viable.

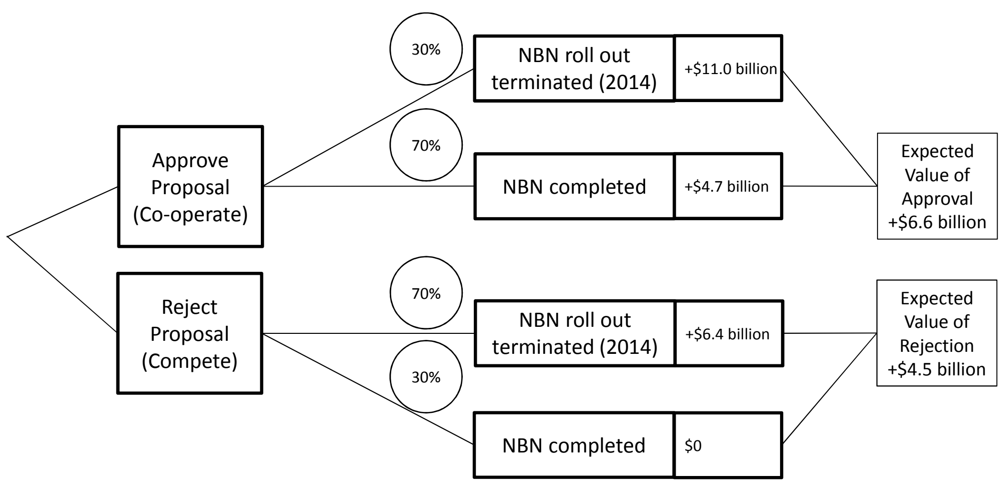
This analysis or advice may well lead to a decision different to the approach outlined by the Shadow Minister on 3 August 2011;

- outright abandonment with no alternative plan for remaining areas is unlikely as the Coalition is also committed to enhancement of broadband capacity, particularly in regional areas. A lower cost modified plan for the remaining areas is almost certain. As the Coalition also favours structural separation and competition, Telstra would not necessarily be able to participate and therefore may still face some form of national broadband competitor. Such an outcome may well be less favourable to Telstra than where the NBN is completed with the Proposal being implemented; and
- there is no reason to believe that the Coalition would unwind any of the adverse regulatory provisions (e.g. spectrum bidding prohibition, functional separation) that would already be in effect if the Proposal is rejected.

In summary, there is little certainty with a range of possible outcomes dependent on a large number of variables, few of which can be forecast with confidence. The extent to which rejection of the Proposal by itself increases the likelihood of stopping the NBN is impossible to quantify. However, what is clear is that rejection does not automatically lead to (or cause) termination. The NBN may be completed even if shareholders reject the proposal depending on election outcomes, future cost/benefit analysis and the other factors outlined above. Similarly, the NBN roll out may be terminated even if shareholders approve the Proposal.

Nevertheless, the following simple decision tree analysis may provide some insight. The analysis uses the two alternatives (completion vs termination in 2014) and the related NPV outcomes and Grant Samuel has applied probabilities of the likelihood of each occurring depending on whether or not the Proposal is approved:

Simplified Decision Tree Analysis



The outcome is that the incremental expected (i.e. probability weighted) value of the Co-operate scenario (over the Compete scenario) is $2.1 billion. Moreover:

- the probabilities that have been assigned are to some extent arbitrary but reflect odds as to election outcomes as well as judgements about potential shifts in political party positions depending on whether or not Telstra shareholders approve the Proposal.

  In reality, the shift in the probability of termination of the roll out caused by the decision of Telstra shareholders is likely to be less than 40% (i.e. 30% to 70%) but the most important conclusion from the analysis is that even if the increase in probability was as extreme as, say, 20% to 80%, the expected value of approving the Proposal (Co-operate) still exceeds the expected value of rejection (Compete);

- Telstra has no control over the timing of any government decision relating to the NBN. The timing of any roll out termination decision is unknown at this point but the value of the Compete scenario with termination only exceeds the Co-operate scenario with completion if termination occurs in 2016 or earlier;

- the values in the cases where the NBN roll out is terminated are a "best case" in so far as they assume no alternative national broadband plan. An alternative plan is likely to result in a lower value benefit for Telstra in the event of termination of the roll out making it even less likely that rejection of the Proposal would create a superior probability weighted value outcome;

- the Compete scenarios incorporate some favourable assumptions particularly in relation to NBN penetration and the impact of spectrum prohibition. A more conservative approach to these items could reduce the expected value of rejecting the Proposal materially; and

- the non-quantified adverse effects and downside risks of rejection are potentially significant. In particular, it is important to note that the Compete scenarios do not allow for any further regulatory imposts if the Proposal is rejected (see Section 5.5). However, these are a very real threat in this situation given the current government's clear preference for the Proposal to be implemented. Telstra's internal analysis indicates that in a worst case the effect could be several hundred million dollars in NPV terms.

In summary, rejecting the Proposal in the hope of increasing the prospects of terminating the NBN does not result in a higher expected NPV outcome for Telstra compared to approving the Proposal.

5.5 Analysis of Advantages and Disadvantages

5.5.1 Overview

A best interests test where there is no "control transaction" normally involves a comparison of the advantages and benefits of a proposed transaction with the costs, disadvantages and risks. These factors are weighed up to form an overall judgement as to whether shareholders are likely to be better off if the transaction is implemented or not.

The application of this framework is not straightforward in this case because of the nature of the transaction, the absence of a status quo and the inherent uncertainties (e.g. as to whether the NBN is completed). In effect, most of the advantages and disadvantages are incorporated within the financial analysis set out in Section 5.3 and the analysis set out in Section 5.4 dealing with alternative scenarios.

In this respect, the primary benefit or advantage of the Proposal is that it is expected to be cash flow and NPV positive for Telstra compared to the alternative of voting against the Proposal. Assuming the NBN is completed, the expected NPV benefit is material and, based on the analysis undertaken, reasonably robust. It is still positive even if less favourable outcomes than assumed occur. Moreover, even if the decision to reject the Proposal does increase the likelihood of the NBN being abandoned or heavily modified, the expected NPV of approving the Proposal is still higher than the alternative. This value gain for Telstra is the key issue underpinning Grant Samuel's opinion.

There are however a number of additional factors that have not been quantified and are not reflected directly by the financial analysis. Financial modelling is only ever a partial analysis of any commercial decision and will not capture some of the more strategic, intangible or inherently unpredictable factors that are difficult to quantify. These are discussed in the following sections.

In summary, Grant Samuel believes that while the costs, disadvantages and risks are not inconsequential they are outweighed by the benefits and advantages, in particular the expected value gain.

5.5.2 Advantages and Benefits

(i) Regulatory Benefits

As the incumbent telecommunications provider with a dominant position in the fixed line sector, Telstra's business is high profile and receives intense regulatory and political scrutiny. The fact that it owns the physical network that competitors must use and also operates as a retailer is a constant source of friction with retail competitors, politicians and regulators who all seek to enhance access to Telstra's network by other retail service providers and to minimise the cost of this access so as to stimulate competition. Over the years Telstra has been subject to increasingly demanding regulatory constraints.

The Proposal should significantly alter the regulatory landscape for Telstra. Telstra's vertical integration has been consistently identified as a major justification for the level of access regulation that Telstra currently faces. These concerns will be addressed because after the roll out of the NBN, Telstra would no longer have substantial fixed line network within the NBN fibre footprint (although the interim equivalence and transparency measures in the Structural Separation Undertaking will result in an increased level of regulation of the copper network while the NBN is being rolled out). Accordingly, there should eventually be a substantial reduction in the degree of regulatory oversight of Telstra and it will no longer be vulnerable to the impact of price determinations on fixed line wholesale access which:

- have been consistently downwards in direction (indeed it will now benefit to the extent such pressures force NBN to lower its prices);
- can flow on through to prices charged at retail level; and
- are unpredictable (at least in quantum).

In the fixed line market, Telstra will, for practical purposes, only be regulated as a retailer (a much less onerous and contentious regime) and will be subject only to the same requirements as its retail competitors.

In addition, the USO obligations will be far more certain. The Proposal creates a contractual arrangement with TUSMA (or the Commonwealth) where the scope of the obligation is defined and any increase in scope after contract commencement will require additional reimbursement to Telstra.

In short, the Proposal results in greater regulatory certainty and less regulatory intervention in Telstra's business.

(ii) Financial Flexibility

Implementation of the Proposal is expected to generate positive incremental cash flows compared to the alternative (rejection of the Proposal) over the next 20-30 years. The quantum varies from year to year but, on average, amounts to approximately $500 million per annum.

This higher level of cash flow provides greater financial flexibility to Telstra which could be deployed in a number of ways including:

- higher dividends than would otherwise be the case;
- alternative capital management initiatives (e.g. buybacks);
- reduced gearing; and/or
- investment in new business or technologies to enhance the implementation of Telstra's corporate strategy.

(iii) Changed Operating Cost Structure

The Proposal effectively "variablises" Telstra's cost base. At present, the costs of operating the copper and HFC networks are largely (but not completely) fixed. If the Proposal is implemented, a substantial element of Telstra's operating cost base will (ultimately) be replaced by the monthly per customer access fee payable to NBN. The access fee also varies depending on the specific service acquired by Telstra to meet the customer's requirements (i.e. it is higher for faster speed services). Accordingly, Telstra's primary input cost will become directly variable in line with revenue (to the extent revenue varies with customer numbers and service plans).

This change reduces the operating leverage and therefore the riskiness of Telstra's earnings in relation to potential changes in market share over time. This may be important in an environment where Telstra's fixed line market share will be under increasing pressure.

(iv) Business Transformation

Over the past two decades a part of Telstra's strategy has been to move towards becoming a more flexible, customer service orientated business rather than an infrastructure/engineering orientated business. The Proposal enforces that transformation in the fixed line sector by effectively eliminating Telstra's fixed line network operations, albeit:

- over the roll out period (expected to be over 10 years) rather than instantaneously;

- with some residual network operations being retained to service the USO; and
- with core fibre transmission and metropolitan fibre rings being retained.

(v) Positioning if NBN is not completed

The analysis in Section 5.4 examined the issues and value consequences related to the possibility of the NBN not being completed (for instance, if there is a change of government and policy). It is impossible to determine at this stage how such a situation would play out, particularly as to the structure or economics of any alternative broadband initiative would be put in place of the NBN.

Nevertheless, Telstra should be better positioned to negotiate with the government in such circumstances if it has implemented the Proposal and:

- co-operated with government policy initiatives;
- commenced structural separation;
- still owns and operates the copper and HFC networks and all customers in areas where the NBN has not rolled out;
- is the beneficiary of a non cancellable contract for the supply of infrastructure access;
- has new long term USO contracts in place; and
- is potentially in receipt of compensation payable by NBN Co (depending on the stage of the roll out).

If Telstra has rejected the Proposal it will have some leverage because it represents a competitive threat to any alternative national broadband plan as it should still have a large customer base on its own network and will own a high speed HFC broadband network covering 2.7 million premises. In addition, the major regulatory damage will probably already have been done (e.g. spectrum bidding prohibition and functional separation). On the other hand, it:

- will have caused NBN Co (and therefore the Commonwealth) to incur substantially increased outlays, delays and inconvenience in having to redesign its roll out plan and adversely impacted NBN Co's earnings capacity;
- will be exposed to the risk of greater regulatory imposts as the CCS Act provisions still apply. The ACCC could also broaden the scope of its regulation of Telstra's activities; and
- would be financially weaker given the lack of PSAA and infrastructure payments combined with the front ended expenditure needed on functional separation and the HFC network upgrade.

(vi) Avoided Disadvantages and Risks of Competing

Implementing the Proposal avoids a number of disadvantages and risks associated with the Compete scenario. These include:

- **Digital Dividend spectrum prohibition**. The financial modelling of the Compete scenario makes an allowance for the loss of access to this spectrum by scaling down Telstra's mobile/wireless revenues over the period by 20%. However, it is extremely difficult to reliably assess how adverse the loss of access to this spectrum would be for Telstra's business. Telstra would have limited ability to respond (e.g. by increasing cell density for existing spectrum) and the loss of its leading position in the wireless market (and very limited capacity in the new 4G segment) could have far ranging and sustained effects for Telstra. 4G services are anticipated to produce intense growth in data demand over the next decade. The 20% reduction in revenue is arguably relatively light. Telstra's internal estimates are that the effect could be greater than that modelled.

The loss of competitiveness in product offering and brand power could easily spill over into the fixed line business and enterprise services for businesses (e.g. in bundling). This risk has been factored into the financial modelling but again only to a limited extent. Even if successful participation in subsequent auctions of further spectrum in, say, 8-10 years enabled Telstra to halt the decline, recovery of market share would be challenging.

- **Increased Regulatory Imposts**. A decision to compete with the NBN is likely to see a number of very significant additional regulatory imposts on Telstra.

  Full functional separation will be required under the CCS Act. The financial model does incorporate an allowance for this in the Compete Scenario. However, there are a number of other potential changes that would be adverse to Telstra:

  - Telstra has significant commitments under the CCS Act relating to the USO and service level guarantees as well as requirements to meet reliability standards. These requirements are set at the Minister's discretion. It is not unreasonable to assume the Commonwealth will not be favourably disposed towards Telstra if the Proposal is rejected. Telstra could incur significant costs in complying with new standards or extended obligations. It could also face reduced USO levy contributions from other telecommunications companies;
  - the ACCC may set regulated access pricing for ducts at relatively low levels. This would enable NBN Co (and others) to utilise Telstra ducts on very attractive terms (albeit without any remediation obligations); and
  - the ACCC may seek to declare services such as dark fibre links and wholesale DSL.

  There is also a risk of the upgraded HFC network falling under the anti cherry picking rules as there is a risk of regulatory change to achieve it. This could force Telstra to demerge or divest the network (albeit for value) and would potentially materially reduce the returns from the upgrade as it would inevitably lead to a reduction in Telstra's share of the retail market for the service.

- **Competitive risks**. Competing with the NBN will expose Telstra to additional competitive pressures as it will be competing at both the retail and wholesale levels. The financial model allows for this but it is difficult to forecast reliably.

Telstra would have some competitive advantages against the NBN. The HFC network (when upgraded) can provide a fast broadband service similar to the NBN's initial offering (albeit only on an asymmetric basis). The ADSL service is, at least for the time being, adequate for many users and would be a lower cost service than the NBN. Other ISPs may wish to remain Telstra wholesale customers for cost competitive reasons. In addition, the NBN will not have access to Telstra's lead-in conduits. However, it is equally plausible that the NBN will be successful and that within a foreseeable time frame customers will want, or need, to be on it to support higher intensity applications. As the NBN becomes more successful, Telstra becomes more vulnerable. It will have a much more fragmented copper network which will be less efficient from an operating cost perspective and less financial capacity to invest in customer services;

- **Upfront capital expenditure**. A decision to compete will front end some very substantial costs for Telstra, primarily functional separation and HFC upgrade costs (each in the order of $1 billion). The investment case for HFC is also compromised as there will be a new direct competitor (NBN) which reduces the potential take up within the HFC footprint.

- **Management distraction**. Competing with the NBN will require considerable management resources devoted to:

  - implementation of an effective competitive strategy against the NBN;
  - implementation of full functional separation;
  - ongoing high levels of regulatory interaction; and
  - execution of HFC upgrade.

  There is therefore a significant risk of management distraction from the company's core strategic initiative of moving the business towards a customer focussed business with an emphasis on service and innovation;

- **Increased employment costs**. Direct competition with the NBN will also see Telstra and NBN (or its contractors) competing head on for staff across a range of functions (field staff, network operations, systems, management). This competition creates the risk of pushing up employment costs to levels higher than they would be otherwise; and

- **Higher cost of capital**. In a competitive environment Telstra is likely to have a higher cost of capital than it would if the Proposal is implemented.

  Debt margins would be likely to rise as the increased competitive risk would probably result in some downgrading of Telstra's credit rating (currently A with negative outlook). This would also likely lead to reduced capacity to carry debt resulting in the need for a higher proportion of higher cost equity.

  The cost of equity capital may also increase. In an intuitive sense the business would be riskier and this is likely to see equity investors apply a risk premium even if standard models for measuring the cost of equity capital such as CAPM do not directly take such factors into account (they only reflect the extent to which the share price moves in relation to the market as a whole).

5.5.3 Costs, Disadvantages and Risks

(i) Loss of Integration Benefits

As an integrated wholesale and retail telecommunications business, Telstra enjoys the benefit in making investments of capturing all of the value chain and being indifferent to where in the chain the returns are generated. If it becomes solely a fixed line retailer, some investments, which could be justified as an integrated business, will no longer support an adequate investment case.

For example, at present, investment in winning new retail customers can generate both retail and wholesale margins. If the Proposal is implemented, Telstra will only earn retail margins on new customers as the structure of NBN access costs does not allow any benefit for increasing volumes.

The integrated nature of Telstra's existing business also gives it certain natural advantages in the retail market such as:

- information about customer preferences and demand gathered by the retail business can flow back to help the network business in designing products or assessing network expansion or upgrading;
- a degree of influence over the types of products and services offered and the pace of change in the industry; and
- a perception by customers of product/service differentiation. Many customers may see Telstra as a stronger offering because it is also the network operator and therefore providing a greater sense of security as to service levels and reliability.

Certainly, competing retailers claim that Telstra's position as network operator hinders their ability to compete.

If the Proposal is implemented Telstra will become "just another retailer" reselling the NBN alongside its competitors with, at least initially, very limited product/service differentiation. In addition, it is arguable that Telstra's very large presence in the fixed line voice market underpins its brand strength with flow over benefits into broadband and even mobile. That market share is expected to decline as the NBN is rolled out. The financial analysis assumed Telstra's share of the voice market converges to its share of the broadband market. There is a risk of further erosion of market share with the overall smaller brand presence.

However, while these effects may result from the Proposal, they may also occur over time, albeit to a lesser extent, even if the Proposal is rejected because of full functional separation.

(ii) Regulatory Risks

Notwithstanding the increased regulatory certainty, the Proposal still involves exposure to a number of risks in relation to regulation of Telstra's ongoing business including the following:

- Telstra does not currently provide access to dark fibre links to third parties. Once NBN Co obtains access to dark fibre links, there is an increased risk that it could become a regulated service at rates that Telstra considers unattractive (the contract rate for NBN Co was part of an overall package);
- NBN Co could in future seek to obtain declared access prices for ducts or other infrastructure which may be at rates well below the contracted rate. However, the risk should be relatively low as seeking regulated access is a termination event under the infrastructure services agreement;
- if the NBN roll out is terminated before completion, Telstra will not complete its structural separation. Particularly, if the NBN is terminated early (say at less than 20% of its planned roll out) then there is a risk that the then government may seek to impose functional separation on Telstra as a substitute. The financial analysis in Section 5.4 assumes this to be the case; and
- the risk of increases in the USO levy to be paid by Telstra which even under the proposed new arrangements is set at the Minister's discretion.

More generally, the Commonwealth and the ACCC have very broad powers and the ability to amend regulation of the industry overriding previous regulation and contractual arrangements. A wide variety of changes could result. For example:

- declaring broadband services, services on Telstra fibre networks or generally widening the scope of the Declared Services;
- changes to the regulations around Telstra's ability to disconnect copper or HFC broadband services;
- changes to equivalence and transparency arrangements for the residual networks during the NBN roll out; and
- changes to the price and non price supply terms for declared services and facilities access determined by the ACCC.

However, a number of these risks are risks faced by Telstra in any event and are not a direct result of the Proposal.

(iii) Structural Separation Undertaking

The Structural Separation Undertaking has been submitted to the ACCC for approval. Approval, and the subsequent coming into force of the Structural Separation Undertaking, is a condition precedent to the Proposal. Telstra is working with the ACCC with a view to obtaining acceptance before the shareholding meeting to approve the Proposal.

It is possible that the ACCC may reject the Structural Separation Undertaking or, perhaps more likely, request amendments. Telstra can reject such amendments but in that case the Proposal will not proceed. In these circumstances, some kind of commercial negotiation is probable. The result may be some additional costs for Telstra. The directors of Telstra may accept such costs for the sake of the broader benefits of proceeding with the Proposal but it is reasonable to assume that they will not do so if the cost materially reduces the NPV benefit of implementation of the Proposal.

(iv) Compliance and Implementation

The Proposal imposes significant obligations on Telstra, For example, it has to:

- comply with all of the provisions of the Structural Separation Undertaking and the Final Migration Plan;
- deliver the elements of infrastructure to NBN Co in a timely fashion and fit-for-purpose; and
- maintain the infrastructure at agreed standards.

Implementation of the Proposal also requires Telstra to undertake major changes to its business processes and IT systems to incorporate the NBN.

The actual disconnection of premises is a complex task requiring close co-ordination between NBN Co and Telstra and careful execution by Telstra of its disconnection obligations. Similarly, the installation of NBN services is a massive operation requiring seamless execution by Telstra marketing staff and NBN Co.

There are risks in all of these aspects of implementation:

- obligations may not be met;
- new systems may not work effectively;
- installations and/or disconnections may prove troublesome and generate ill will with customers; and
- costs may be much higher than anticipated.

However, there is no specific reason to believe that Telstra will not be able to meet its obligations or execute the other elements effectively. There has been a substantial planning exercise in relation to infrastructure provision and the migration. The financial analysis includes sensitivities that examine the impact of higher than expected costs.

(v) Cost Structure

While the Proposal variablises Telstra's cost base:

- Telstra loses control of a large part of its cost base which will be set by a third party (NBN Co) albeit subject to regulation; and
- it reduces the degree of operating leverage on the upside. As a network operator the incremental network level operating costs of additional customers are negligible. However, Telstra will retain some operating leverage to the extent revenues grow with data or call volumes (per customer).

(vi) Dependence on NBN

If the NBN is fully rolled out, it will supply the network for Telstra's entire fixed line customer base (except in the 7% areas not passed by fibre). The access charge will represent Telstra's single largest operating cost for this business.

This situation creates a number of risks:

- while there is no reason to believe otherwise, there is no certainty that NBN will deliver a network that performs to the promised levels. Telstra has a number of obligations (e.g. under the USO) that depend on the NBN for service delivery;
- Telstra will be dependent on NBN Co to continue to enhance its products and services to meet the evolving demands of the marketplace and ensure customer satisfaction;
- the precise terms of Telstra's access to the NBN have not yet been agreed with NBN Co;
- Telstra is exposed to NBN increasing its access prices. However:
    - NBN Co has committed (subject to certain exceptions) not to increase the pricing of the AVC and UNI components of the basic service offering for an initial five year period;
    - pricing is subject to ACCC oversight; and
    - all of Telstra's fixed line competitors are likely to be in the same position (because of NBN Co's uniform pricing and non discrimination obligations) and accordingly there may well be only a limited impact on the margins Telstra is able to generate as the whole industry will need to adjust.

(vii) Financial Analysis Assumptions

The financial analysis set out in Section 5.3 and 5.4 is based on a large number of individual assumptions. There are uncertainties and risks attached to all of these assumptions. Key aspects that might materially affect the NPV outcome include:

- Telstra not winning an appropriate share of the Digital Dividend spectrum at a reasonable cost (Co-operate scenario);
- Telstra's market share of voice and broadband customers;
- the extent of wireless substitution;
- the extent of NBN penetration in the Compete scenario;
- ARPU per customer;
- the timing of the NBN roll out;
- the operating cost savings generated in closing down the copper and HFC broadband networks (Co-operate scenario);
- NBN access costs; and

- the costs of migration, new regulation (Co-operate scenario), functional separation (Compete scenario) and HFC upgrade (Compete scenario).

Many of these items are difficult to predict with confidence. However:

- where appropriate assumptions have been selected that tend to favour the Compete scenario;
- Section 5.3.3 includes a sensitivity analysis that examines the impact of changes in a number of these variables. The key conclusion is that even with material movements in these assumptions, the NPV differential in favour of co-operation remains significantly positive; and
- a number of assumptions have very little effect on the NPV differential even if they are changed significantly.

(viii) Contract Risks

The Proposal is an extraordinarily complex transaction that involves the transformation of a vast physical network across the entire country and the fundamental reshaping of an industry over a long period of time. The contracts underpinning the transaction run to over 1,800 pages.

In these circumstances, notwithstanding the care taken in legal drafting, there is a risk that during the course of the implementation over the next 10-20 years:

- there will be events or issues arising that were not foreseen at the time and are not covered by any of the contractual provisions;
- there will be disputes about the meaning or applicability of particular clauses;
- circumstances may change in ways that materially alter the impact of some provisions; and
- the financial consequences of elements of the transaction may be different to those contemplated.

The Explanatory Memorandum contains a further discussion of the risks of the Proposal.

5.6 Alternative Proposals

Since the emergence of the NBN in April 2009 and the legislative changes put forward by the Commonwealth, Telstra has examined a number of alternatives to the Proposal at various stages. These alternatives have included:

- demerger of the copper access network; and
- sale of the copper network to NBN.

In the view of Telstra, none produced a superior outcome.

A demerger of the fixed line business into a separate listed company ("Network Co") could potentially meet the structural separation requirements of the CCS Act. Network Co would be free to compete with the NBN (or be acquired by NBN Co) and Telstra would focus on retail fixed line services (as well as its mobile and other businesses) and would become an access seeker. Network Co could, theoretically, comprise:

- the copper network only;
- the copper and HFC networks; or
- the copper and HFC networks together with all fibre networks (including backhaul).

However, a demerger has a number of drawbacks that make it less attractive than the Proposal. These include:

- lack of regulatory certainty. The CCS Act gives only limited guidance as to what would meet the structural separation test. The Minister has discretion over how such a proposal would proceed through the setting of principles for the ACCC to consider. The instruments issued by the Minister in relation to the Proposal would not be relevant to a demerger and would need to be reissued. More importantly, it appears that the Minister has a preference for the Proposal because of its positive impact on the NBN. There is no certainty than an alternative demerger proposal put forward would be capable of being implemented. In any event, Telstra would face the risk of being effectively forced to divest its interest in the HFC network and FOXTEL as a waiver from the Minister would be required if it wanted to bid for, or acquire, Digital Dividend spectrum. This may not be forthcoming in these circumstances;
- in an environment where the NBN is being rolled out, Network Co may not be attractive to investors:
  - if it includes only the copper network it would be a declining business with a largely fixed cost base that would need to be managed down as revenues fell with no offsets (e.g. the PSAA payments). Development of its own fast broadband service (to compete against NBN Co) is unlikely to be feasible. Debt carrying capacity is also compromised;
  - if it includes the HFC network business, there would be substantial capital expenditure requirements in the early years (to enhance broadband capacity) that would be material in the context of Network Co and may impact the ability to pay dividends. There would also be material risks around the competitive success of the upgraded HFC broadband service; and
  - Network Co would be a business with one dominant customer (Telstra) that may not have any incentive to maintain business on the network;
- Network Co would not receive any payments as customers shifted off its network to the NBN. Equally, Telstra would have no incentive other than cost efficiency to retain customers on Network Co's network(s), so Network Co could face a rapidly declining customer base to the extent Telstra decided to encourage customers to switch to NBN based services (or wireless services); and
- the logistics of separating the network business from Telstra and creating two independent public listed companies are significant compared to the managed decommissioning within an integrated Telstra that would occur under the Proposal. It would involve, among other things, a complete reengineering of billing and other business systems (including a new system for Network Co to bill Telstra). This is likely to take a considerable period of time to implement and involve substantial cost (slightly more than the cost of full functional separation).

An outright sale of the copper network to NBN Co was also considered at an early stage but discarded.

5.7 Shareholder Decision

Voting for or against the Proposal is a matter for individual shareholders based on their views as to value, their expectations about future market conditions and their particular circumstances including risk profile, liquidity preference, investment strategy, portfolio structure and tax position. Shareholders who are in doubt as to the action they should take in relation to the Proposal should consult their own professional adviser.

Similarly, it is a matter for individual shareholders as to whether to buy, hold or sell shares in Telstra. This is an investment decision independent of a decision to vote for or against the Proposal upon which Grant Samuel does not offer an opinion. Shareholders should consult their own professional adviser in this regard.

6 Qualifications, Declarations and Consents

6.1 Qualifications

The Grant Samuel group of companies provide corporate advisory services (in relation to mergers and acquisitions, capital raisings, debt raisings, corporate restructurings and financial matters generally), property advisory services, manages specialist funds and provides marketing and distribution services to fund managers. The primary activity of Grant Samuel & Associates Pty Limited is the preparation of corporate and business valuations and the provision of independent advice and expert's reports in connection with mergers and acquisitions, takeovers and capital reconstructions. Since inception in 1988, Grant Samuel and its related companies have prepared more than 450 public independent expert and appraisal reports.

The persons responsible for preparing this report on behalf of Grant Samuel are Stephen Wilson MCom (Hons) CA (NZ) SF Fin and Stephen Cooper BCom (Hons) CA (SA) ACMA. Each has a significant number of years of experience in relevant corporate advisory matters. Tim Archer BE (Hons) BSc, Bronwyn Skinner BEc MBA, Matt Leroux M.Aero.E MBA, Nooshin Valmadre BEc LLB MBA, Sophie Whitlam BCom BSc (Melb) and Chen Lin BCom BA assisted in the preparation of the report. Each of the above persons is a representative of Grant Samuel pursuant to its Australian Financial Services Licence under Part 7.6 of the Corporations Act.

6.2 Disclaimers

It is not intended that this report should be used or relied upon for any purpose other than as an expression of Grant Samuel's opinion as to whether the Proposal is in the best interests of Telstra shareholders. Grant Samuel expressly disclaims any liability to any shareholder who relies or purports to rely on the report for any other purpose and to any other party who relies or purports to rely on the report for any purpose whatsoever.

This report has been prepared by Grant Samuel with care and diligence and the statements and opinions given by Grant Samuel in this report are given in good faith and in the belief on reasonable grounds that such statements and opinions are correct and not misleading. However, no responsibility is accepted by Grant Samuel or any of its officers or employees for errors or omissions however arising in the preparation of this report, provided that this shall not absolve Grant Samuel from liability arising from an opinion expressed recklessly or in bad faith.

Grant Samuel has had no involvement in the preparation of the Explanatory Memorandum issued by Telstra and has not verified or approved any of the contents of the Explanatory Memorandum or been involved in any part of the due diligence process in relation to the Explanatory Memorandum. Grant Samuel does not accept any responsibility for the contents of the Explanatory Memorandum (except for this report).

6.3 Independence

Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with Telstra, NBN Co or the Commonwealth Government that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Proposal.

Grant Samuel advises that a related company, Grant Samuel Property Pty Limited, has provided tenancy advisory services to NBN Co over the past two years. Fees for these assignments totalled $118,000. There is no current assignment or relationship with NBN Co.

Grant Samuel commenced analysis for the purposes of this report in March 2011 prior to the execution of definitive agreements. Grant Samuel did not participate in the negotiating or setting of the terms of, the Proposal. Its only role has been the preparation of this report.

Grant Samuel will receive a fixed fee of $2.8 million for the preparation of this report. This fee is not contingent on the outcome of the Proposal. Grant Samuel's out of pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.

Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by the ASIC on 30 March 2011.

6.4 Declarations

Telstra has agreed that it will indemnify Grant Samuel and its employees and officers in respect of any liability suffered or incurred as a result of or in connection with the preparation of the report. This indemnity will not apply in respect of the proportion of any liability found by a court to be primarily caused by any conduct involving negligence, recklessness or wilful misconduct by Grant Samuel. Telstra has also agreed to indemnify Grant Samuel and its employees and officers for time spent and reasonable legal costs and expenses incurred in relation to any inquiry or proceeding initiated by any person. Any claims by Telstra are limited to an amount equal to two times the fees paid to Grant Samuel except where Grant Samuel or its employees and officers are found to have been grossly negligent or engaged in recklessness, fraud or wilful misconduct Grant Samuel.

Advance drafts of this report were provided to Telstra and its advisers. Certain changes were made to the drafting of the report as a result of the circulation of the draft report. There was no alteration to the methodology, evaluation or conclusions as a result of issuing the drafts.

6.5 Consents

Grant Samuel consents to the issuing of this report in the form and context in which it is to be included in the Explanatory Memorandum to be sent to shareholders of Telstra. Neither the whole nor any part of this report nor any reference thereto may be included in any other document without the prior written consent of Grant Samuel as to the form and context in which it appears.

6.6 Other

The accompanying letter and the Appendices form part of this report.

Grant Samuel has prepared a Financial Services Guide as required by the Corporations Act. The Financial Services Guide is set out at the beginning of this report.

GRANT SAMUEL & ASSOCIATES PTY LIMITED

Grant Samuel & Associates

Appendix 1
Glossary

4G	Fourth generation (mobile services)
ACCC	The Australian Competition and Consumer Commission
ADSL	Asymmetric Digital Subscriber Line – a technology for the delivery of high-speed data transmission over copper phone lines
ARPU	Average revenue per user (usually expressed on a per month basis)
ASIC	Australian Securities & Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Tax Office
Carriage Service Provider	Person who supplies carriage services (such as internet) using a network
Carrier	Holder of a carrier licence (used by network owners)
Content Service Provider	Provider of broadcasting and/or on-line services
CPE	Customer premises equipment
CSG	Customer service guarantee
DSLAM	Digital subscriber line access multiplexer
Fixed BB	Fixed broadband
FTTP	Fibre To The Premises
FY[xx]	Financial year ending 30 June 20[xx]
Gbps	Gigabits per second
GPRS	General packet radio service (a 2.5G mobile technology)
Grant Samuel	Grant Samuel & Associates Pty Limited
GSM	global system for mobile communications (2G mobile technology)
HFC	Hybrid Fibre Coaxial
IP and Data	Internet and data services
IRR	Internal Rate of Return
ISDN	Integrated Services Digital Network – allows the simultaneous digital transmission of voice, video, data, and other network services over the PSTN
ISP	Internet Service Provider
LTE	Long Term Evolution (a 4G mobile technology)
Mbps	Megabits per second
NBN	National Broadband Network
NBN Co	NBN Co Limited
NPV	Net present value of after tax cash flows
NTU	Network terminating unit
NZX	New Zealand Stock Exchange
PoI	Point of Interconnect – demarcation and network connection point between carriers
PSAA payments	In exchange for disconnecting their customers, Telstra will receive from NBN Co a one-off payment for each disconnected service address
PSTN	Public Switched Telephone Network
RSP	Retail Service Provider
SIO	Service In Operation
SSS	Spectrum Sharing Services
Minister	Minister for Broadband, Communications and the Digital Economy
ULL	Unconditioned Local Loop – the copper line between an exchange and a customer, which can be rented to an ISP
USO	Universal Service Obligation
VoIP	Voice over Internet Protocol
W-CDMA	Wideband code division multiple access (a 3G mobile technology)

Appendix 2

Selection of Discount Rate

1 Overview

A discount rate of 9.0% was selected to apply to the ungeared after tax cash flows of Telstra. This rate represents the overall cost of all the capital used to fund the enterprise (equity debt and any other forms of capital), usually referred to as the weighted average cost of capital ("WACC"). There are three main elements to determination of an appropriate WACC:

- the cost of equity capital;
- the cost of debt capital; and
- the debt equity mix.

The methodologies and variables used generated a calculated WACC of 8.7%. Having regard to the substantial limitations inherent in these methodologies that impact on the reliability and accuracy of any estimate (see Section 6 of this Appendix), Grant Samuel has rounded the rate to 9.0%.

2 Cost of Equity

2.1 Formulation

The Capital Asset Pricing Model ("CAPM") was used as the basis for estimating the cost of equity. The classical formula for deriving the cost of equity using CAPM is as follows:

$$Re = Rf + \beta\,(Rm - Rf)$$

where:

Re	=	the cost of equity capital
Rf	=	the risk free rate
B	=	the beta factor
Rm	=	the expected market return
Rm – Rf	=	the market risk premium

CAPM postulates that the return required on an investment or asset can be estimated by applying to the market risk premium a measure of systematic risk described as the beta factor. The beta for an investment reflects the covariance of the return from that investment with the return from the market as a whole. Covariance is a measure of relative volatility and correlation. The beta of an investment represents its systematic risk only. It is not a measure of the total risk of a particular investment. An investment with a beta of more than one is riskier than the market (i.e. goes up or down more than the market as a whole) and an investment with a beta of less than one is less risky.

2.2 Calculations

The key variables that have been selected for Telstra were as follows:

- a risk free rate of 5.2%. This rate represents the yield to maturity on 10 year Australian government bonds on 30 June 2011;

- a market risk premium of 6.0% for the classical formulation. This is the market premium that Grant Samuel has used for 20 years and is broadly consistent with most studies that have been undertaken over considerable periods (and, for example, is consistent with that used by Australian regulators). There is an argument that the sharp downturn in equity markets during 2008 demonstrates that the market had clearly increased its equity risk premium (although this will not materially impact any of the longitudinal studies of decades of returns that are used to produce historical averages). On the other hand, there has been a strong equity market recovery since mid 2009 and earnings multiples in some markets are approaching historical averages. In Grant Samuel's view, a 6% risk premium remains within the range of reasonable estimates; and
- an equity beta of 0.8 which was determined by examining the equity beta of Telstra and its listed peer group:

Equity Beta Factors for Selected Listed Telecommunications Companies							
Company	Market Capital-isation[1] (millions)	Monthly Observations over 5 years [Ibbotson/ LBS/Barra][2]	Monthly Observations over 4 years			Weekly Observations over 2 years	
			AGSM[3]	Bloomberg[4]		Bloomberg	
				Local Index	MSCI[5]	Local Index	MSCI
Telstra	A$35,758		0.31	0.43	0.47	0.54	0.43
Australia and NZ							
Telecom NZ	NZ$4,667		0.54	1.12	0.68	1.16	0.56
Asia							
Singapore Telecom.	SGD$49,242	0.75		0.84	0.82	0.82	0.43
Korea Telecom.	KW$9,692,258	0.75		0.48	0.48	0.61	0.48
Europe							
KPN	€14,574	0.77		0.48	0.46	0.62	0.62
Deutsche Telecom	€45,368	0.77		0.54	0.49	0.81	0.85
Telia Sonera AB	SEK$197,625	0.81		0.76	0.81	0.84	0.86
British Telecom	£15,262	1.16		1.02	1.04	1.13	1.19
Telenor	NOK$141,347	0.75		1.05	1.42	0.89	1.02
Telefonica	€74,440	0.88		0.81	0.76	0.80	0.90
France Telecom	€38,183	0.79		0.58	0.56	0.76	0.85
Vodafone	£84,554	0.81		0.85	0.73	0.80	0.78
Telecom Italia	€17,104	0.88		0.66	0.75	0.86	0.99
North America							
AT&T	US$185,122	0.67		0.76	0.77	0.66	0.68
Verizon	US$103,884	0.70		0.75	0.79	0.58	0.60
Century Link	US$24,178	0.78		0.81	0.84	0.65	0.65
Rogers Communications	CAD$20,661	0.58		0.69	0.67	0.41	0.39
Bell Canada Enterprise	CAD$29,389	0.54		0.62	0.64	0.49	0.40
Spring Nextel	US$15,587	1.08		1.08	1.15	0.85	0.78
Minimum		*0.54*	*0.31*	*0.48*	*0.46*	*0.41*	*0.39*
Maximum		*1.16*	*0.54*	*1.12*	*1.42*	*1.16*	*1.19*
Median		***0.77***	***0.43***	***0.76***	***0.75***	***0.80***	***0.68***
Weighted average[6]		*0.73*	*0.01*	*0.75*	*0.74*	*0.73*	*0.73*

Source: AGSM, Ibbotson, London Business School, Bloomberg

While Telstra's own beta is relatively low, it is clear that globally most of the larger participants in the telecommunications industry evidence higher betas.

On this basis, the cost of equity is 10.0%

$$Re \quad = \quad Rf + \beta\,(Rm - Rf)$$

$$Re \quad = \quad 5.2\% + 0.8 \times 6.0\%$$

No adjustment has been included for dividend franking.

1 Based on share prices as at 30 June 2011

2 United States beta factors calculated by Ibbotson Associates ("Ibbotson") as at March 2011 over a period of 60 months using ordinary least squares regression or the Scholes-Williams technique (including lag) where the stock is thinly traded. United Kingdom beta factors calculated by London Business School ("LBS") and other beta factors are calculated by MSCI Barra, Inc. ("Barra") as at 31 May 2011 over a period of 60 months using ordinary least squares regression or the Scholes-Williams technique (including lag) where the stock is thinly traded.

3 The Australian beta factors calculated by the Australian Graduate School of Management ("AGSM") as at the March 2011 quarter over a period of 48 months using ordinary least squares regression or the Scholes-Williams technique where the stock is thinly traded.

4 Bloomberg betas have been calculated up to 30 June 2011. Grant Samuel understands that betas estimated by Bloomberg are not calculated strictly in conformity with accepted theoretical approaches to the estimation of betas (i.e. they are based on regressing total returns rather than the excess return over the risk free rate). However, in Grant Samuel's view the Bloomberg beta estimates can still provide a useful insight into the systematic risks associated with companies and industries. The figures used are the Bloomberg "adjusted" betas.

5 MSCI is calculated using local currency so that there is no impact of currency changes in the performance of the index.

6 Weighted by market capitalisation converted to Australian dollars using exchange rates on 30 June 2011.

3 Cost of Debt

Grant Samuel has assumed an overall debt margin over the risk free rate (i.e. the margin over swap rates plus the margin between swap rates and government bond rates of equivalent tenor) for Telstra of 180 basis points. This reflects the terms of recent public debt raisings by Telstra and by companies with similar ratings.

4 Debt/Equity Mix

A debt equity mix of 25.0% has been assumed. The theory determines the debt equity mix on the basis of market values not book values. The ratio selected reflects the gearing of Telstra and its listed peers over the past few years (i.e. the same period over which betas were measured):

Gearing Levels for Selected Listed Telecommunications Companies

	Net Debt/(Net Debt + Market Capitalisation)							
	Financial Year Ended					Current[7]	*4 Year Average*	*5 Year Average*
	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10			
Telstra	21.9%	19.3%	22.1%	27.8%	24.7%	24.7%	24.8%	23.7%
Australia and NZ								
Telecom NZ	29.7%	9.1%	28.2%	35.0%	39.8%	29.5%	33.1%	28.3%
Asia								
Singapore Telecom.	9.8%	8.6%	9.7%	11.8%	9.8%	7.0%	9.6%	9.4%
Korea Telecom.	44.3%	38.3%	43.8%	52.8%	41.5%	48.3%	46.6%	44.9%
Europe								
KPN	29.8%	27.7%	35.5%	42.2%	42.7%	45.7%	41.5%	38.8%
Deutsche Telecom	44.3%	42.2%	49.5%	58.4%	54.7%	51.3%	53.5%	51.2%
Telia Sonera AB	11.7%	15.0%	20.2%	23.1%	19.5%	26.1%	22.2%	20.8%
British Telecom	28.5%	22.1%	39.0%	61.6%	53.2%	38.7%	48.1%	42.9%
Telenor	23.3%	19.3%	20.6%	31.0%	16.5%	15.5%	20.9%	20.6%
Telefonica	48.3%	39.5%	37.7%	39.0%	44.1%	43.2%	41.0%	40.7%
France Telecom	51.2%	43.3%	43.1%	45.6%	46.0%	43.9%	44.6%	44.4%
Vodafone	20.1%	14.6%	24.4%	37.2%	32.6%	27.5%	30.4%	27.2%
Telecom Italia	50.7%	51.0%	60.3%	68.6%	70.0%	67.0%	66.5%	63.4%
North America								
AT&T	21.3%	18.8%	28.2%	32.1%	32.4%	25.3%	29.5%	27.4%
Verizon	29.6%	21.0%	29.6%	42.3%	40.0%	31.5%	35.9%	32.9%
Century Link	37.7%	37.3%	44.4%	48.0%	42.8%	43.7%	44.7%	43.3%
Rogers Communications	33.9%	18.4%	18.9%	32.8%	31.5%	33.4%	29.2%	27.0%
Bell Canada Enterprise	35.6%	25.9%	21.4%	32.0%	27.6%	31.3%	28.1%	27.6%
Spring Nextel	24.8%	25.5%	41.9%	54.3%	55.9%	48.3%	50.1%	45.2%
Minimum	*9.8%*	*8.6%*	*9.7%*	*11.8%*	*9.8%*	*7.0%*	*9.6%*	*9.4%*
Maximum	*51.2%*	*51.0%*	*60.3%*	*68.6%*	*70.0%*	*67.0%*	*66.5%*	*63.4%*
Median	***29.7%***	***22.1%***	***29.6%***	***39.0%***	***40.0%***	***33.4%***	***35.9%***	***32.9%***
Weighted average	*30.2%*	*25.3%*	*31.3%*	*38.8%*	*37.1%*	*33.4%*	*35.1%*	*32.2%*

Source: Company Reports, IRESS, Capital IQ, Bloomberg, Grant Samuel analysis

A ratio towards the lower end has been selected on the basis of conservatism.

7 Current gearing levels are based on the most recent balance sheet information and on sharemarket prices as at 30 June 2011.

5 Weighted Average Cost of Capital

The formula conventionally used to determine a WACC is as follows:

$$WACC = (Re \times E/V) + (Rd \times (1-Tc) \times D/V)$$

where:

E	=	the market value of equity
D	=	the market value of debt
V	=	*D + E*
Re	=	the cost of equity capital
Rd	=	the cost of debt capital (being the risk free rate plus a borrower's margin)
Tc	=	the corporate tax rate

Accordingly, the calculated WACC is:

$$WACC = (10.0\% \times 75\%) + (7.0\% \times (1-30.0\%) \times 25\%)$$

$$WACC = 8.7\%$$

6 Limitations

The cost of capital is not a precise or proveable number nor can it be estimated with any degree of reliability. The cost of equity capital is not directly observable and models such as CAPM do no more than infer it from other data using one particular theory about the way in which security prices behave. Any estimate therefore depends on the efficacy of the theory and the robustness of the data.

The CAPM is probably the most widely accepted and used methodology for determining the cost of equity capital. There are more sophisticated multivariate models which utilise additional risk factors but these models have not achieved any significant degree of usage or acceptance in practice. While the theory underlying the CAPM is rigorous, the practical application is subject to very substantial shortcomings and limitations. Results from application of the CAPM model should only be regarded as a general guide. There is a tendency to regard the rates calculated using CAPM as inviolate. To do so is to misunderstand the limitations of the model:

- the model has limited empirical validity. The CAPM has been subject to intense criticism over many years with empirical studies demonstrating that it does not accurately portray movements in individual share prices and has limited explanatory power. There are competing formulations such as the Classic, Brennan-Lally, Officer or Monkhouse which can give different results;

- the CAPM theory is based on expectations but these are virtually impossible to obtain, at least with any accuracy or reliability. There are attempts to estimate forward looking market risk premiums and betas but these are frankly of little practical use and give highly variable estimates. Accordingly, historical data (primarily observed premiums and betas) is used as a proxy for the future. However, the future is not necessarily the same as the past and there are plenty of examples of companies making changes that fundamentally alter the risk profile of their businesses and impact their beta. Similarly, while it can be argued that investors are likely to expect that, on average, equity markets will deliver premium returns consistent with the long run average, it is clear that attitudes to risk and the "price of risk" fluctuate substantially over time;

- there are multiple simplifying assumptions:

- the financial structure of companies is usually far more complex than just equity and one tier of debt. Many companies also have tiers of debt and hybrid capital. Accordingly, the standard WACC formulation is simplistic;
- it assumes a constant debt/equity structure which is not necessarily realistic. Capital structures can change over time (often quite dramatically) and the recent volatility of equity markets has also changed the effective mix of debt and equity for many listed entities in a very short space of time; and
- it ignores all investor taxes, which may or may not have an impact in the real world. Even where models do attempt to reflect this it is based on assumed averages which may not be accurate or appropriate given the diversity of individual tax positions;

■ much of the data is of dubious statistical reliability:

- the measurement of historical data such as risk premia and beta factors is subject to very high levels of statistical error and tends to be unstable. The data changes materially over time. Measurements often vary widely depending on source (e.g. betas from Ibbotson, Barra, AGSM or Bloomberg), time period and sampling frequency. Similarly, there are multiple different measurements of historical risk premia depending on time period, basis (over bonds or bills) and method (arithmetic or geometric averages). The historical data is also a logical oxymoron (when equity returns are high, suggesting a lower risk premium, the measured risk premium will be high);
- the measurement of beta and debt/equity mix is often undertaken by reference to other companies in the same industry as well as the subject company if it is listed in order to avoid one-off issues. However, none of these other companies is likely to be exactly comparable to the entity for which the discount rate is being calculated and the comparable companies may operate in very different markets. In any event, the data seldom yields a clear and consistent pattern; and
- parameters such as the debt/equity ratio can be problematic. The observed betas of comparable companies can be delevered and relevered to the subject company's (actual or target) ratio. However:
  - there are alternative formulas for this process that give different answers;
  - many practitioners use the latest ratios but this is not correct. The de-gearing adjustment should be based on the gearing over the same period as the beta measurement. Given the volatility in equity values over this period the result may be materially different and still very imprecise; and
  - the target debt/equity ratio of the subject company is a subjective estimate.

  This approach only serves to compound the other data measurement variations or errors (beta, risk premium etc); and
- even something as seemingly straightforward as debt margins is subject to uncertainty:
  - margins vary significantly depending on the maturity of debt. It would not be appropriate to use a 10 year maturity margin (i.e. the same term as the risk free rate) as companies do not in fact generally borrow for such terms. Most companies' term facilities are typically between three and seven years (within which there is still considerable variation). Margins also vary across markets (e.g. domestic retail bonds versus US private placement versus bank debt). An accurate single margin is very difficult to ascertain; and

- the gap between interbank rates (the usual benchmark for many debt facilities) and government bonds (i.e. the risk free rate) of equal tenor varies depending on maturity and country/currency; and

- there are unresolved issues. There is not unanimous agreement as to how the model should adjust for factors such as taxation. The CAPM was developed in the context of a "classical" tax system. Australia's system of dividend imputation has a significant impact on the net returns to domestic investors but in Grant Samuel's view there is no compelling evidence that it actually affects valuation in the real world (e.g. if imputation actually lowers the cost of capital for domestic investors why do offshore investors buy Australian equities?).

It is easy to over-engineer the process and to credit the output of models with a precision it does not warrant. The reality is that any cost of capital estimate or model output should be treated as a broad guide rather than an absolute truth. The cost of capital is fundamentally a matter of judgement, not merely a calculation.

Appendix 3
Financial Modelling Assumptions

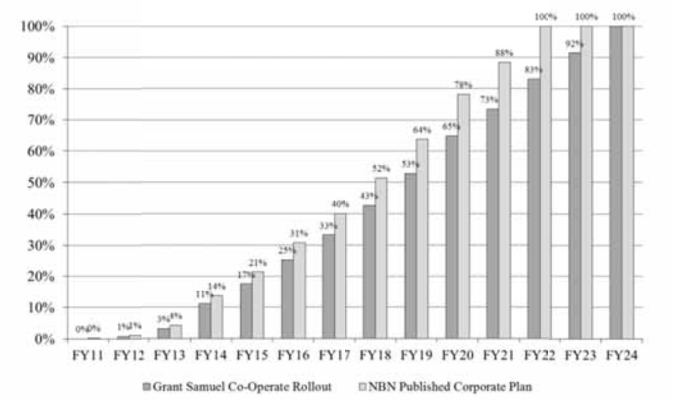
1. Common Assumptions

NBN Roll out

Co-operate Scenario

Grant Samuel has assumed the fibre roll out will follow the published NBN Co roll out profile but extended by two years

Co-operate Scenario and NBN Co Rollout Profiles



Source: NBN Co and Grant Samuel analysis

Compete Scenario

The roll out assumption is the same as far as the Co-operate scenario (NBN roll out profile extended by two years) but is delayed one year. This delay recognises that if the Proposal is rejected NBN Co will need to replan its entire roll out which is premised on the access to Telstra's infrastructure.

It is not clear whether a decision to reject the Proposal would also extend the NBN roll out period. There would be logistical difficulties because of the lack of access to Telstra exchanges and ducts (except as allowed for by current laws and regulations). On the other hand, NBN Co could revert to greater use of aerial transmission for the street level network and aerial connections to homes. This would arguably be faster than the current plan to use Telstra ducts and lead-in conduits. For the purposes of the analysis, it is assumed that the roll out period (post the delay) is the same.

Penetration and Market Share

Co-operate Scenario

Broadband

Broadband penetration is currently estimated to be approximately 60% of service addresses (including just under 10% of wireless broadband). As the NBN is rolled out it is assumed that broadband penetration increases to 84% by FY24.

Of the 84%, approximately 14% is assumed to be wireless broadband. There is much speculation and considerable debate as to the extent to which homes will become wireless only for broadband services. Some commentators believe that wireless will become a very powerful factor in the market. They tend to believe that technological developments (e.g. more cell splitting, enhanced compression, more effective spectrum use) will enable many customers to use wireless for all their needs and that the added attraction of mobility will lead to a high proportion using it as their only service. While there is merit in this position, Grant Samuel holds the view that wireless does have inherent physical limitations (which will be

Compete Scenario

Broadband

Grant Samuel has assumed that by FY24:

- NBN take up is approximately 35% of all service addresses that the NBN passes (50% of fixed line broadband users):
- 24% of addresses still use an ADSL service over the copper network and 10% use the HFC cable network (or Optus HFC); and
- overall broadband penetration is slightly lower than in the Co-operate scenario (81%) because of consumer inertia (i.e. there is no need to make a decision). Wireless penetration is assumed to be slightly lower than the Co-operate scenario because of the continued presence of lower cost ADSL based services.

Telstra's overall market share by FY24 is assumed to be slightly higher than in the Co-operate case reflecting the impact of the HFC cable network upgrade (offset in part by a

Co-operate Scenario

exacerbated by the anticipated rapid growth in demand) and that wireless substitution will be more constrained. It is more likely to appeal to low end users and other niche situations such as highly mobile single person households. Grant Samuel believes that most users, particularly heavy users, will use both fixed line services (for intensive applications) and wireless as a complement (for mobility). As the market evolves over the next 20 years, it is expected that new applications will be data intensive. Fixed line services are expected to remain materially more cost effective for other than low end users.

Of the NBN broadband customers, approximately 90% are assumed to take a bundled version and 10% to be broadband only (i.e. no fixed telephone service).

Grant Samuel has assumed that Telstra's market share in broadband remains relatively stable across the forecast period at approximately 40% but with a slight decline in its share of fixed line broadband services. This percentage is broadly consistent with:

- Telstra's broadband market share over the past five years in what is a competitive and reasonably mature market where Telstra had less incumbency benefits; and
- overseas analogues.

Voice

Telstra estimates its current market share of PSTN connections at approximately 80% while its share of mobiles is slightly under 40% giving it an overall share of the voice market of approximately 72%.

Grant Samuel has assumed that as the NBN is rolled out, Telstra's share of fixed line voice market converges towards its share of the broadband market such that by FY24 it has a share of under 45% of NBN voice services (including both bundled services and those who only take voice services).

This assumption is based on the view that with the NBN roll out every customer has a decision point about their telecommunications supplier. Customers will need only one supplier for voice and broadband. Telstra will be actively seeking to retain all customers with a particular focus on those with a Telstra voice service but an alternative ISP. However, for the purposes of analysis, it is conservatively assumed that all customers who currently have a Telstra voice service but an alternative ISP will choose the ISP to provide the new bundled service.

Compete Scenario

lesser share of NBN connections within its HFC cable network footprint). The model assumes a high degree of success in securing new HFC customers (the HFC cable will be available in many metropolitan areas well ahead of the NBN). Telstra's share of wireless substitution is substantially lower because of the impact of the Digital Dividend spectrum prohibition.

Voice

In terms of penetration of the voice market by FY24:

- NBN's share is less than its broadband share by approximately 5% to allow for users who opt for wireless voice (or VoIP) only (offset by a small number who take only the NBN voice service);
- the PSTN's share (almost 30%) is higher than the ADSL share of broadband because of the non- broadband users who nevertheless have a voice service;
- wireless substitution is substantially lower than in the Co-operate scenario because of the continued availability of PSTN services

Telstra's overall share of the fixed line voice market by FY24 is assumed to be materially higher than in the Co-operate scenario (close to 50% compared to less than 45%). This assumption reflects Telstra's current strong market position in PSTN (assumed to remain above 80%) and the assumed retention of customers on a new HFC cable network voice service.

Telstra ARPU

Co-operate Scenario: Customers are segmented by product type (wholesale and retail, fixed and wireless), product tier (four 'averaged' product tiers) and region (5 cities, regional towns, rural and remote). Telstra's five hundred plus products are grouped into ten main product categories (including PSTN, ULL, ISDN, mobile, wireless broadband and so on) and ARPUs are then calculated by dividing average revenue per category by the number of customers in the category. Further, customer movements are extensively

Compete Scenario: In the Compete scenario, the ARPU modelling process is adjusted to allow for a competitive response. This process involved modelling forecast NBN and competitor ARPUs under varying market conditions and estimating optimal pricing strategies such as price discounting in order to maximise Telstra's profitability.

Grant Samuel has assumed that by FY24:

<table>
<tr><th>Co-operate Scenario</th><th>Compete Scenario</th></tr>
<tr><td>modelled (within each product groupings, product tiers and region) based on estimates of existing customers retained, new customers won and existing customers lost.

Current pricing is used as a starting input into the ARPU modelling process underpinned by an overall approach that assumes:
■ the share of disposable income spent on telecommunication services will not grow; and
■ ARPU and NBN access costs must provide a sustainable margin for retailers.

Grant Samuel has assumed Telstra's retail ARPUs decline over the forecast period. Broadband ARPUs decline from current levels of $55-60 per month (depending on product) to just under $50 per month for NBN based broadband (typically as part of a bundle). Wireless broadband is assumed to be much lower at approximately $30 per month.

Telstra's retail PSTN voice ARPU is currently approximately $54 per month and is assumed to decline to just under $40 per month. NBN related voice services are assumed to generate ARPUs of $35-40 per month. This decline in voice ARPU reflects a view that pressure from retail competition and technologies such as VoIP will continue to drive down revenues and, in particular, that there will be a continued shift towards inclusive access charges and away from supplementing call charges.</td><td>■ Telstra's NBN retail broadband ARPUs are approximately $3 per month less than in Compete (after allowing for Telstra's NBN customers in this scenario being on average, higher tier customers than in the Co-operate scenario);
■ Telstra's ADSL ARPU is down to $40 per month in part because ADSL will serve a greater proportion of low end users; and
■ Telstra's voice ARPUs are not substantially different to the Co-operate scenario except for some minor components.</td></tr>
<tr><th colspan="2">NBN Access Costs</th></tr>
<tr><td>Telstra's access costs are based on NBN's published rates. Four segments of users were assumed with an estimated proportion in each segment based on Telstra's existing customer profile. The underlying access costs are assumed to remain constant in nominal terms over the full period of analysis, implying the NBN's bandwidth (CVC) unit cost declines over time in response to growth in data demand. This pattern is based on an overarching assumption that access costs need to be set at levels that provide sustainable industry margins.

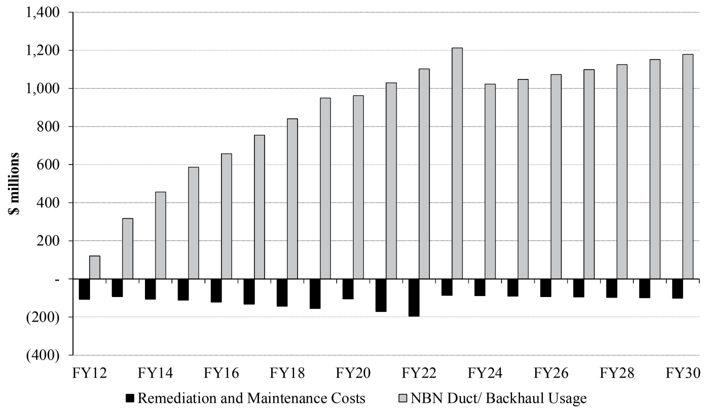
There is a marginal increase in the average access cost per customer over the forecast period as customers increase their data requirements.</td><td>The Compete scenario assumes the same access costs as the Co-operate scenario but adjusted for a different mix of customer segments (Telstra will likely use the NBN only for high end customers in this scenario).</td></tr>
<tr><th colspan="2">Operating Expenditure and Capital Expenditure</th></tr>
<tr><td>Operating expenditure comprises:
■ Direct variable costs which are modelled as a fixed percentage of revenues for each Telstra business (very low for the PSTN business but much higher for mobile and wireless services). As PSTN, DSL and cable revenues decline as the copper network is deactivated, variable costs fall, producing significant operating expenditure savings. These savings are partly offset by new variable costs (in addition to NBN access costs) associated with delivering NBN services; and
■ Network operating costs and other overheads. Although these costs are fixed</td><td>Operating and capital costs are determined by the same cost parameters (direct variable cost percentages, variability of network costs, other overheads, capital expenditure to sales envelope). No specific savings or additional costs are assumed but costs move in line with customer numbers on the network. Incremental costs (such as functional separation) are included separately.</td></tr>
</table>

Co-operate Scenario	Compete Scenario
in nature, the progressive disconnection of the copper network impacts the size of the PSTN, DSL and cable businesses, which over time leads to a reduction in fixed costs. Network costs are assumed to be between 50% and 80% variable and decline as the copper and HFC broadband networks are disconnected. The remaining network costs service the USO and the HFC network (for delivery of FOXTEL). All residual costs related to the copper network cease at the end of the USO contract period (along with associated revenues). Other Overheads are the costs directly attributable per subscriber and comprise billing, call centre overheads, credit checking, mail outs and related costs. Other Overheads are between approximately \$30 and \$55 per customer per annum depending on the service (voice, fixed broadband, mobile). These costs decline as customer numbers decline. Telstra's total capital expenditure is governed by a 14% capital expenditure envelope (capital expenditure to sales ratio) set by the Telstra Board. Network related capital expenditure comprises new access lots, enablement and backhaul. These costs are a function of customer numbers and product development and accordingly, savings are generated as the customers are disconnected. Spectrum acquisition costs are assumed to occur within this existing envelope (i.e. Digital Dividend Spectrum is not incremental).	

2. Co-operate only Assumptions

Co-operate Scenario	Compete Scenario
Transaction	
Transaction elements comprise PSAA payments, government payments, infrastructure provision to NBN Co and costs relating to infrastructure provision.	
(a) PSAA Payments PSAA payments are received upon disconnection of copper and HFC lines. It is assumed that Telstra has 7.4 million active service fixed line addresses (on copper and Telstra HFC cable) across Australia, growing at 0.8% per annum (including from new brownfield development). Disconnection is assumed to lag the NBN roll out and payments are spread over the 18 month window from the time areas are declared ready for service. PSAA payments are impacted by wireless substitution. It is assumed that wireless-only service addresses for voice increase from 8% to 27.5% of total service addresses by FY24. This reduces the base level of connections available for PSAA payments. It is assumed that at the time of disconnection a proportion of customers elect not to become NBN subscribers (wireless-only homes). Telstra will not receive PSAA payments for those who do so and become Telstra wireless (or fibre) customers which is determined broadly in line with Telstra's existing share of the wireless market. The model also incorporates assumptions regarding winning back wireless customers to the NBN and therefore securing additional PSAA payments.	
(b) Infrastructure ***Payments*** Transit infrastructure (dark fibre links and some exchange rack spaces) is assumed to be progressively provided over a 3.5 year period and be fully provided from that point. Access infrastructure payments are based on the minimum agreed amounts and follow the NBN roll out pattern on a pro rata basis but are assumed to commence slightly earlier than the roll out. Infrastructure access payments and payments for lead-in conduits are indexed to inflation from 1 January 2012. ***Remediation and Maintenance costs*** Remediation costs and maintenance costs incurred by Telstra in ensuring infrastructure meets (and continues to meet) agreed fitness standards for NBN Co are assumed to be, on average, approximately $160 million per annum out to FY20, thereafter falling to approximately $130 million per annum on average.	**(b) Infrastructure** It is assumed that NBN Co is able to access a fixed quantum (substantially less than under the Proposal) of Telstra ducts under the existing facilities access regime (at a price between the current rates and the rate in the Proposal).

Co-operate Scenario	Compete Scenario
Expenditure on these items is already incorporated within the management plan. As there are significant cost savings built into the operating costs of the Co-operate scenario (see above) the net incremental cost to Telstra is substantially lower.	



The fall in cash inflows in FY24 reflects the end of the roll out period, after which no payments for the transfer of lead-in conduits will be received.

(c) Government Package

Universal Service Obligation

The amounts payable to Telstra for provision of the USO are $230 million per annum from July 2012 to supply the standard telephone service nationwide, $40 million per annum to supply and maintain payphones and $20 million for the emergency call service. New USO receipts are offset by the loss of existing USO receipts Telstra currently receives from competitors (currently approximately $55 million per annum). Incremental operating expenses and capital expenditures have been estimated by the Telstra divisions responsible for the maintenance of the standard telephone and payphone networks.

Other Government Package Elements

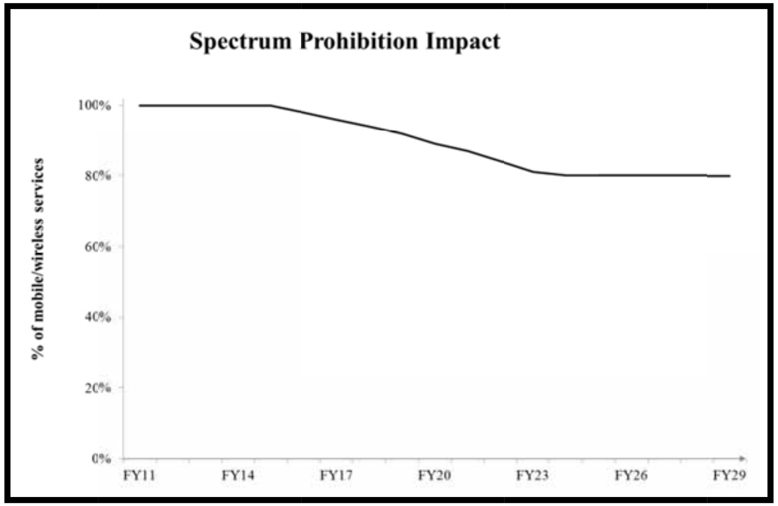
The value from other elements of the government package are spread over the relevant periods, generally over the roll out period although some are more concentrated in the early years (e.g. the retraining funding). A number of these items are avoided costs rather than cash inflows to Telstra and partially offset incremental migration costs that have also been included in the model (see below).

Co-operate Scenario	Compete Scenario
(d) Other Transaction Related Costs Telstra will incur (or would have incurred in the absence of the Government Package) a number of costs from entering the transaction with NBN Co in addition to the remediation and maintenance costs. These include: ▪ operating costs and capital expenditure associated with migrating voice and broadband customers on to the NBN; and ▪ redundancy and/or retraining costs for staff. These costs are partly offset by the other (i.e. non USO) elements of the Government Package. The incremental cost to Telstra is assumed to be an average of $47 million per annum (before tax) over the roll out period.	

3. Compete only Assumptions

Co-operate Scenario	Compete Scenario
Digital Dividend Spectrum	

The impact of Telstra being prohibited from acquiring Digital Dividend spectrum has been modelled as a percentage scaling of Telstra's mobile revenues (voice and data). This scaling assumed by Grant Samuel is shown below:



This pattern was premised on the following:

- the reduction commences in FY16. The prohibition is not expected to begin having material impact for some years based on:
  - capacity within existing spectrum;
  - the anticipated rate of customer and usage growth, primarily in data traffic; and
  - the ability of Telstra to ameliorate the effect for a period through measures such as cell splitting;
- the impact over time is expected to be significant as high speed data services are anticipated to be the primary driver of market growth over the next decade. Telstra's ability to compete will be hindered by absolute capacity on its existing spectrum and other issues such as handset compatibility;
- eventually, in the absence of future technological innovation, anticipated data demand growth will exhaust the capacity of the Digital Dividend spectrum. ACMA is already contemplating the need for additional spectrum beyond the 700 MHz and 2600 MHz bands. Accordingly, Telstra's loss of market share has been capped as the CCS Act does not prevent it from acquiring spectrum outside these bands. Grant Samuel has

Co-operate Scenario	Compete Scenario
	assumed Telstra loss of share stops at 80% in FY24 and that from that point on it can maintain its pro rata share of the market. The financial model also allows for some spillover impact on Telstra's fixed line business because of the impact on Telstra's ability to offer competitive bundled products. It is assumed Telstra loses a percentage of fixed line market share (increasing to 4% over time). 4G related services are the key to the future wireless data market. Being heavily constrained in this market could have far reaching consequences for Telstra (e.g. it could impact on enterprise revenues). The impacts could be much greater and longer lasting than assumed above. Telstra's internal assumptions show a materially greater adverse impact. For the purposes of the analysis, Grant Samuel believes it is appropriate to assume a lesser impact which errs in favour of the Compete scenario. There are consequential impacts on operating costs and capital expenditure. Direct variable costs (40% of revenue) fall in line with revenue. Overheads are also assumed to be 60% variable with revenues but are partly offset by incremental operating costs in a Compete scenario. Capital expenditure in mobiles/wireless falls in line with the 14% capital expenditure envelope and this is then overlaid with increased capital expenditure on upgrading existing networks operating on Telstra's existing spectrum (and related items).
HFC Upgrade	
	HFC upgrade costs were based on Telstra experience with its recent HFC cable network upgrade in Melbourne. Total HFC upgrade costs are assumed to be approximately $1 billion. The bulk of the capital expenditure and operating expenditure relating to the HFC upgrade is incurred over FY12-FY14. It is assumed the anti cherry picking rules do not apply to the HFC network as it satisfies the speed test as at 1 January 2011. The increase in customers drives up HFC variable costs over the entire period of analysis.
Functional Separation	
	The CCS Act does not specify the details of how Telstra would be required to functionally separate. In addition, there is limited available data on costs incurred by other telecommunications companies in undertaking similar restructurings although there is some information relating to Telecom New Zealand and British Telecom. Telstra has undertaken some preliminary work on the costs of various forms of separation. The estimates are therefore relatively high level and assume that a high cost, comprehensive functional separation would be mandated. For the purposes of the analysis, Grant Samuel has assumed that: ▪ capital costs of just under $1 billion are incurred over the FY12-16 period; and ▪ incremental operating costs (IT and overheads) build up from FY12 and plateau at approximately $80 million per annum in FY16.

This page has been left blank intentionally.

ANNEXURE 2 – SUMMARY OF DEFINITIVE AGREEMENTS

On 23 June 2011, Telstra entered into conditional Definitive Agreements with NBN Co and the Commonwealth. The Definitive Agreements are eight separate but interdependent agreements that, together with the Structural Separation Undertaking and Final Migration Plan, create a framework for Telstra's participation in the rollout of the NBN.

Set out below are the detailed summaries of each of the Definitive Agreements that were lodged by Telstra with the ASX on 23 June 2011 (with one additional change to the summary of the Commonwealth Guarantee). These summaries contain definitions or capitalised terms that apply only to these summaries. Importantly, since the date on which these summaries were lodged with the ASX, a number of the Conditions Precedent have been satisfied. The Conditions Precedent that remain outstanding as at the date of this Explanatory Memorandum are set out in section 6.2.1, and a summary of the status of the key outstanding Conditions Precedent is set out in section 6.2.2. The risks associated with the fact that these key Conditions Precedent remain outstanding are described in section 3.4.1(a).

IMPLEMENTATION AND INTERPRETATION DEED (IID)

Topic	Summary
Purpose	Unlike the other agreements, the IID operates immediately on signing as it contains the mechanics needed to bring the transaction to life and specifies the conditions precedent (**CPs**) (such as shareholder and regulatory approvals) that must be satisfied or waived before the proposed transaction can be fully implemented. It also contains various interim arrangements to enable NBN Co to obtain immediate access to Telstra's facilities and infrastructure for its early phase rollout. Further, it links the SA, ISA and AD together by providing common clauses and definitions for each of those agreements, and by establishing a framework for various IT interaction systems to be developed.
Conditions Precedent	CPs that need to be satisfied or waived for the SA, ISA and AD to become effective include: • approval by each of Telstra's and NBN Co's shareholders of the proposed transaction; • ACCC acceptance of a SSU and approval of a Final Migration Plan in a form approved by Telstra and NBN Co and those documents come into force in accordance with the Telecommunications Act; • the TUSMA Agreement and the Information Campaign and Migration Deed being entered into by Telstra and the Commonwealth in a form acceptable to NBN Co; • the Commonwealth amending legislation or establishing other arrangements to implement its greenfields policy in a form acceptable to Telstra and NBN Co; • the Commonwealth introducing legislation considered necessary or desirable by the Commonwealth and NBN Co to facilitate NBN Co's rollout, in a form acceptable to Telstra and NBN Co; • separate ATO private tax rulings relevant to each party that confirm the tax treatment of elements of the transaction being acceptable to Telstra and NBN Co respectively; • if NBN Co notifies Telstra of a change to its stated intention, as at the execution date, to roll out fibre to 93% of premises in Australia at the execution date, Telstra being satisfied that the change does not adversely affect Telstra; • the parties agreeing to an initial plan establishing a program for the handover of specified infrastructure under the ISA over the course of NBN Co's Rollout; and • any other matters that the parties agree to be a condition precedent. Telstra has requested that NBN Co confirm that NBN Co has arrangements in place to ensure the cessation of supply by Telstra of certain products occurs in a non-discriminatory way.
Termination	If the CPs are not satisfied or waived by 5 pm on 20 December 2011, then the IID, unless varied by prior agreement, will automatically terminate (and the SA, ISA and AD will not come into force and effect). In this circumstance, the interim access provisions will continue in force for a period of 10 years to support Telstra infrastructure in use or ordered by NBN Co at that time. Those interim access provisions include a process the parties will follow to deal with any continuing need NBN Co has for access to Telstra infrastructure on expiry or early termination of the provisions.
Telstra representations and warranties	In addition to general corporate warranties, Telstra has given NBN Co a number of warranties relating to NBN Co's due diligence into the transaction, including Telstra's best estimate of a baseline number of relevant service addresses.

Topic	Summary
NBN Co representation and warranties	In addition to general corporate warranties, NBN Co confirms to Telstra that it intends to roll out fibre to 93% of premises in Australia. NBN Co is required to notify Telstra if its intention changes before the date on which all the conditions precedent have been satisfied or waived (**Commencement Date**).
Interim access arrangements (i.e. pre Commencement Date)	Telstra will provide information and infrastructure services for NBN Co to continue its rollout prior to all CPs being satisfied or waived (that is, on an interim basis). If the ISA does not commence, NBN Co will continue to obtain certain operations and maintenance services from Telstra in relation to the infrastructure that has been provided to NBN Co and that Telstra is otherwise committed to provide to NBN Co up to that time. In these circumstances, the provisions that apply will be a subset of those under the ISA, but for a shorter term. In addition, the price of supply will be adjusted to reflect that shorter term and the lower volume of infrastructure provided.
Liability caps	The IID sets out the liability caps which apply to the various agreements. In broad terms Telstra and NBN Co's liability to each other under the IID, the SA, the ISA and the AD are all capped at particular amounts which have been commercially agreed by the parties. There are certain exceptions to this liability regime which are consistent with market standards for these types of agreements.
Financial security	Each of Telstra and NBN Co can require the other to provide a financial security of an amount determined under the IID, to support its performance of obligations under the ISA (or the interim access arrangements described above) and the SA, if the other fails to maintain a credit rating that reflects an acceptable investment grade credit risk as specified in the IID. Reflecting the fact that, from execution of the agreements, Telstra will be the beneficiary of the Commonwealth Guarantee, Telstra is also only permitted to call for a financial security from NBN Co after that guarantee (and any replacement of it) has terminated.
Dispute resolution	The dispute resolution process which applies to each of the IID, SA, ISA and the AD comprises: • escalation within Telstra and NBN Co (ultimately to each Chief Executive Officer); • provision for disputes to be resolved by technical or financial experts (on an expedited basis in certain circumstances); and • ultimately, litigation.
Change of control of NBN Co	Commonwealth legislation allows NBN Co to be privatised at a future date, subject to compliance with a number of conditions including a declaration from the Communications Minister that the NBN should be treated as built and fully operational. Telstra may terminate the SA, the ISA and the AD if there is a change of control of NBN Co which results in a provider of retail telecommunications services in Australia controlling 15% or more of NBN Co, except where that provider has only a small market share in Australia based on a revenue threshold.
Permanent cessation of rollout or rollout is very slow	A permanent cessation of rollout occurs if there is a binding decision by NBN Co or the Commonwealth to cease rollout of the NBN. Consequences of a permanent cessation of rollout occurring are set out in the SA and ISA. A very slow rollout occurs if, after NBN Co has passed 20% of its expected fibre footprint, the pace of rollout is such that it falls below certain thresholds (measured over either a 12 month period or a 36 month period). The SA and ISA also set out consequences for a very slow rollout.
Illegality and change of law	If performance of any terms of the SA, the ISA or the AD becomes illegal, the IID contains a process under which these documents can be varied to make performance legal. This is a binding process involving resolution by agreement of the parties or by a determination made by a panel of experts appointed by the parties. In addition, the parties have agreed to a separate process to enable them to renegotiate one or more of the SA, the ISA and the AD in the event of certain changes in law which materially impact at least one of the parties and which relate to: • the NBN or Telstra infrastructure made available under the ISA; • disconnection from Telstra's copper and HFC networks or migration to the NBN; or • land access or occupational health and safety. If the parties are unable to agree on changes to those documents, then ultimately, they will have the right to terminate one or all of them.

SUBSCRIBER AGREEMENT (SA)

Topic	Summary
Purpose	The SA deals with the disconnection by Telstra of copper-based Customer Access Network services and broadband services on its HFC cable network (but not Pay TV services on the HFC) that are provided to premises in the NBN fibre footprint as the NBN is rolled out, and the maintenance of the parties' structural and network alignment during that process.
Disconnect standard copper-based Customer Access Network services and HFC cable broadband services on HFC Cable Network (but not Pay TV services)	As NBN Co rolls out the NBN to each rollout region (approximately 3,000 premises per region), Telstra will disconnect standard copper-based Customer Access Network services and broadband services on its HFC cable Network (but not Pay TV services on the HFC) that are provided to premises in the NBN fibre footprint in that rollout region. In broad terms, the disconnection must be completed within 18 months of NBN Co declaring that rollout region to be ready for service (which cannot happen until at least 90% of the premises in that rollout region are passed by NBN Co fibre). A separate regime (with a different time frame for disconnection) applies to disconnection of special services provided over the copper Customer Access Network. Disconnection protocols have been agreed to govern this.
Not reconnect	Telstra must not use those disconnected networks again to provide services (nor allow anyone to do so) except in very limited circumstances (set out below). To support this obligation, there are restrictions on Telstra's ability to dispose of the networks.
Limited temporary reconnection	Telstra may temporarily reconnect services in the event of a "material NBN unavailability" where the NBN is unable to be used to provide any services in the entirety of a region for a specific period.
Limited permanent reconnection	Telstra may permanently reconnect copper-based Customer Access Network services and broadband services on its HFC cable network provided to premises that have previously been disconnected if NBN Co is insolvent or the NBN permanently ceases ongoing operation.
Fixed line network preference for 20 years	For 20 years from the Commencement Date, Telstra must exclusively use the NBN as the fixed line connection to premises in the NBN fibre footprint. There are a number of exceptions to the network preference, including: • where Telstra provides point to point fibre services using Telstra fibre in operation, or fibre installed by Telstra in accordance with a right of first refusal process with NBN Co; • where Telstra provides interim fibre services including in respect of areas covered by the Commonwealth's greenfields policy. Generally speaking, these "interim fibre services" are subject to the same disconnection obligations as Telstra's copper-based Customer Access Network services and broadband services on its HFC cable network; and • fixed line connections between Telstra network elements. However, Telstra has agreed that certain types of wireless "femtocells" supplied for use primarily in residential premises or buildings will not be considered Telstra network elements. This means that, subject to any other applicable exceptions, the network preference for the NBN will apply to fixed line connections to those "femtocells" in the NBN fibre footprint. After the 20 year period Telstra is no longer required to preference the NBN Co fibre network as the connection to premises in the NBN fibre footprint.
Wireless as a substitute for fibre services	Telstra may not promote wireless services as a substitute for fibre based services for 20 years from the Commencement Date, but otherwise remains free to compete in the market for the supply of wireless services.
Not build any Passive Optical Network	Other than in limited, interim circumstances, Telstra must not build or operate Passive Optical Network infrastructure as the fixed line connection to premises for 20 years from the Commencement Date.
Payments Telstra will receive	Telstra is entitled to payment for disconnecting premises in the NBN fibre footprint in rollout regions as the NBN rolls out to those regions. This is based on various criteria, including the number of lines to the premises disconnected, whether or not commercial services were provided on those lines (and if so, the types of service provided on those lines), the time at which the disconnection occurs, and in some cases, whether or not the premises have connected to the NBN.

Topic	Summary
NBN rollout forecasts	NBN Co has absolute discretion as to when and where it will roll out the NBN. However, it will provide Telstra with a non-binding 12 month and 3 month forecasts before it declares a rollout region as ready for service (and Telstra understands that NBN Co intends to provide these to industry in parallel to the time it is provided to Telstra).
Compensation to Telstra if rollout permanently ceases or is very slow	If a permanent cessation of rollout or very slow rollout occurs (as described in the IID summary) NBN Co will, subject to limited exceptions, compensate Telstra for Telstra being left with a geographically dispersed network. This compensation is on a sliding scale from a maximum of $500 million (if the event occurs when NBN Co's fibre rollout has reached 20% of NBN Co's current coverage target of 93% of premises in Australia) reducing to zero (if the event occurs when NBN Co's rollout has reached that current coverage target). Compensation is not payable if the event occurs before the rollout has reached that 20% threshold. Telstra believes that, in addition to any compensation which might be paid to it as described above, in the event of permanent cessation or a very slow rollout, its commercial interests will be further protected. This will be through the cashflows Telstra expects to receive from the ongoing operation of its copper Customer Access Network and HFC cable broadband networks in those areas where the NBN rollout has not occurred, and any ongoing payments it will receive from NBN Co under the terms of the ISA (see the ISA summary for further detail). On a permanent cessation of rollout, Telstra's network preference and disconnection obligations shrink to the NBN fibre footprint that exists at the time of the cessation. For a very slow rollout event, while compensation may be payable to Telstra (as described above), the parties' rights and obligations under the SA will otherwise generally be unchanged.
Non-alignment dispute mechanism	Telstra or NBN Co may invoke a process which will result in an amendment to the SA if the other party engages in activities which have the effect of substantially affecting the business of the affected party in particular markets. For Telstra, the markets are for mobiles or for the supply of retail services to consumers, businesses or governments in Australia. For NBN Co, the market is for provision of carriage services to premises. There are provisions which allow the parties to engage in certain activities in particular markets or by exercising particular rights, without triggering the amendment process.
Pay TV service	The disconnection obligations in relation to the Telstra HFC cable broadband network do not require Telstra to stop the use of the Telstra HFC cable for the supply of Pay TV services (such as by Foxtel).
Termination	Termination rights arise under the SA if: • a party demonstrates an intention not to be bound by the SA or to fulfil its obligations only in a manner substantially inconsistent with its obligations under the SA; • a party breaches the SA such that the other party is deprived of the substantial benefit of that agreement; • an insolvency event occurs in relation to the party; or • a party breaches its obligation not to assign or novate rights or obligations under the SA without the other party's consent. NBN Co and Telstra view the SA and the ISA as a package. Accordingly, if a party terminates the SA on one of the grounds described above (which apply equally in the ISA – see the summary below), that party may also terminate the ISA. If NBN Co terminates the SA or it is terminated through the change of law process under the IID, Telstra must not reconnect copper-based Customer Access Network services or broadband services on its HFC cable network provided to premises which it has been paid to disconnect, and will remain bound by its network non-disposal obligations in respect of those premises. However, Telstra will cease to be bound by the network preference and wireless promotion restrictions.

INFRASTRUCTURE SERVICES AGREEMENT (ISA)

Topic	Summary
Purpose	The ISA contains the detailed terms for the long-term provision of access to three types of infrastructure and related services by Telstra to NBN Co: dark fibre links, rack spaces in exchanges, ducts and associated duct infrastructure (pits and manholes). Telstra retains property in all the infrastructure except for those Lead in Conduits ("LICs") used by NBN Co, which become NBN Co's property once used.
Term	The ISA has an initial term of a minimum of 35 years, with two options, each exercisable at NBN Co's option, of 10 more years each. The minimum 35 year initial term might extend to 40 years, depending on a number of factors including NBN Co's rollout schedule. Access to particular infrastructure units and payments for such use will commence progressively reflecting the progressive rollout of the NBN. This is expected to result in access payments for use of infrastructure over an average 30 year period, subject to a range of dependencies and assumptions over the life of the Agreement.
Infrastructure Included	Provisional specified lists of infrastructure and indicative rollout schedules for the initial build phases have been included in the ISA in relation to exchange rack spaces and dark fibre links. Finalising these lists into an initial rollout plan is a condition precedent to commencement (as described in the IID summary) of the DAs. Variations for those infrastructure types are permitted based on a range of factors and the party seeking the variation typically is responsible for the associated costs. Specified lists of ducts and LICs required by NBN Co are not included in the ISA, but are utilised on a rollout region basis and NBN Co will update Telstra periodically of its future infrastructure requirements for rollout. A brief description of each type of infrastructure is set out below.
Dark Fibre Access Services	Telstra agrees to provide NBN Co with the right to access and use dark fibre links. Telstra is responsible for the provision and remediation of existing dark fibre links to be used by NBN Co up to agreed fitness standards. Telstra must also provide ongoing maintenance and repair of those links used by NBN Co in accordance with agreed service levels.
Exchange Access Services	Telstra agrees to provide NBN Co with the right to access, occupy and use rack spaces in Telstra exchange buildings. NBN Co has the right to sub-licence these exchange spaces to access seekers to enable them to interconnect with the NBN. Telstra is responsible for the provision and remediation of a specified list of exchange spaces and associated exchange buildings to be used by NBN Co up to agreed fitness standards. Telstra must also provide ongoing maintenance and repair of those buildings.
Duct Access Services	Telstra agrees to provide NBN Co with the right to access, occupy and use duct sections and associated duct infrastructure (e.g. pits and manholes). Telstra is responsible for the remediation of that infrastructure up to agreed fitness standards and within agreed timeframes in each area as the NBN is rolled out. Telstra must also provide ongoing maintenance and repair of the ducts and associated duct infrastructure in accordance with agreed service levels.
Lead-in conduits (LICs)	Telstra agrees to initially provide NBN Co with the right to access, occupy and use LICs. Upon installation of a lead-in fibre in the LIC, NBN Co takes ownership of that LIC. Telstra has no remediation or service level obligations for LICs. Various mechanisms have been agreed to enable NBN Co to maximise use of Telstra LICs, including, in appropriate circumstances, the existing copper wire in the LIC being able to be connected to the new lead-in fibre and then used to "pull through" the new lead-in fibre. Once a LIC is transferred to NBN Co, NBN Co agrees to provide Telstra with the right to access, occupy and use the LIC at no cost to Telstra (e.g. for HFC cable used to provide Pay TV services).

Topic	Summary
Transit Network	Around 60% of the exchange spaces and all of the dark fibre links (which are required by NBN Co for its transit network) will be made available progressively over the first 3.5 years from execution of the DAs. This infrastructure will be delivered in a series of releases which will enable NBN Co to establish a series of interconnected fibre transmission rings.
Infrastructure Quantities	NBN Co has committed to pay for, and Telstra has committed to make available, certain minimum quantities of infrastructure which meets the agreed fitness standards. These minimum quantities reflect large volume levels of usage and availability and large scale access to each infrastructure type. The quantities can be reduced under specified circumstances. The payment and availability commitments are based on mechanisms known as "Provide or Pay" (or "PoP") and "Take or Pay" (or "ToP"). The PoP is an incentive mechanism to encourage Telstra to maximise the amount of infrastructure it makes available to NBN Co up to the agreed minimum quantities. Telstra will undertake remediation of infrastructure in order to maximise availability. The ToP is a mechanism to encourage NBN Co to maximise the use of the infrastructure that Telstra makes available. ToP/PoP may result in a price adjustment during several key points during rollout. In the case of transit network infrastructure, there is no ToP because there is a committed order for that infrastructure. The PoP mechanism (and payments based on that mechanism) for transit network infrastructure is assessed at the end of December 2014. For the other infrastructure types, the ToP/PoP (and payments based on that mechanism) is assessed when NBN Co reaches rollout completion (i.e. 93% of premises have been passed by NBN or are otherwise adequately served), and is assessed and pro-rated if the rollout to premises ceases early based on the level of NBN Co rollout at the relevant time (see below on early cessation of rollout).
Timing of Delivery of Infrastructure	NBN Co retains full discretion over its rollout in terms of when premises are passed and when certain infrastructure is ordered and required to be delivered. However, on signing of the Definitive Agreements, NBN Co will have provisionally ordered its core transit network. Those orders are confirmed before Commencement (as part of the initial rollout plan which is a condition precedent) with each dark fibre link and transit related exchange space (i.e. that supports transit rings connecting a series of Rollout Regions) being finished no later than the end of December 2014. Telstra is obliged to complete each dark fibre ring and associated exchange rack spaces in accordance with the agreed transit rollout plan and in any event by the end of December 2014. This transit milestone date is subject to extensions of time for events such as force majeure. For non-transit related exchange rack spaces and ducts, delivery is scheduled, LICs may be used, and payment by NBN Co commences, to match the pace of NBN Co's geographic rollout.

<table>
<tr><th>Topic</th><th>Summary</th></tr>
<tr><td>Early cessation of rollout</td><td>
Different infrastructure types are treated differently in the event of early cessation of rollout by NBN Co, and the cause of early cessation also gives rise to different outcomes. There are also consequences under the ISA if there is a very slow rollout by NBN Co (as further described in the IID summary).
1. Permanent cessation of rollout (other than for a Government change of policy)
If a permanent cessation of rollout occurs other than as a result of a Government change of policy:

NBN Co remains contractually committed to pay for all transit related infrastructure (dark fibre links and certain exchange spaces), and is entitled to use that infrastructure if it chooses to do so, for the full 35-40 year initial term;
NBN Co remains contractually committed to all non-transit related infrastructure (certain exchange spaces, ducts and LICs) that are used or for which a firm order has been placed, but Telstra is generally not required to accept and NBN Co is not incented to place any new orders; and
If more than 20% of the expected number of premises are passed at the time of permanent cessation of rollout, ToP/PoP for non-transit related infrastructure is brought forward to the permanent cessation date and the minimum quantities for the non-transit related infrastructure (and therefore the assessment for the ToP/PoP) are pro-rated based on NBN Co's level of rollout to premises at that relevant time. This will reduce the volumes of infrastructure services for which Telstra will earn revenue (compared with what would have occurred had the rollout reached 93% of the premises), but Telstra retains the benefit of operating its copper network in areas outside NBN Co's fibre footprint at it exists at the permanent cessation date (see Subscriber Agreement summary).

2. Permanent cessation of rollout – Government change of policy
If there is a change of Government policy in relation to the NBN that results in a permanent cessation of rollout, then the same consequences apply as set out in 1 above, except that NBN Co may cancel dark fibre links and transit related exchange rack spaces that form part of a transit ring that has not yet been completed without penalty. There are some restrictions on this cancellation right – for example, NBN Co may not cancel dark fibre links and associated exchange spaces they have already started carrying live traffic.
3. Very slow rollout
If there is a very slow rollout by NBN Co (as further described in the IID summary):

there is no early ToP/PoP assessment so NBN Co remains incented to place new orders, and Telstra remains generally obliged to accept them;
Telstra's timing obligations to remediate infrastructure, to bring it up to the agreed fitness standards, are lessened; and
if NBN Co subsequently plans to accelerate its rollout back up to an agreed rate, Telstra's original timing obligations for remediation are gradually re-introduced over time.

</td></tr>
<tr><td>Consequences of non-performance</td><td>
There are service levels specified for dark fibre links, exchange spaces and ducts in respect of faults and repair times. The service levels depend on the nature of the infrastructure type and the nature of the fault, as do the consequences that flow from the relevant service level not being met.
There are also consequences if there is any delay in making infrastructure available, primarily monetary compensation (including damages), and cancellation rights which impact what infrastructure is counted as having been made available by Telstra for the ToP/PoP assessment.
NBN Co can also cancel infrastructure units for certain Telstra breaches other than delay, and in the event of certain "shared risk" events such as prolonged force majeure.
</td></tr>
</table>

Topic	Summary
Changes to underlying infrastructure	There are mechanisms agreed, depending on the circumstances, for Telstra to decommission, relocate, or dispose of the underlying infrastructure. In general terms, NBN Co has a range of protective rights to ensure that this does not occur without its knowledge and consent, including a rationalisation regime and potential participation in any asset disposal process of underlying infrastructure, depending on the circumstances and the extent to which its interests are affected.
Termination and expiry of the ISA	Termination provisions, which are replicated in the other agreements, arise if: • a party demonstrates an intention not to be bound by the ISA, or to fulfil its obligations only in a manner substantially inconsistent with its obligations under the ISA; • a party breaches the ISA such that the other party is deprived of the substantial benefit of that agreement; • an insolvency event occurs in relation to the party; or • a party has breached its obligations not to assign or novate rights or obligations under the ISA without the other party's consent. NBN Co and Telstra view the ISA and the SA as a package. Accordingly, if a party terminates the SA on one of the grounds described above (which apply equally in the ISA), that party may also terminate the ISA (and vice versa). Telstra may also terminate the ISA where NBN Co seeks a regulated outcome on any of the infrastructure during the term of the agreement, subject to some limited exceptions. Because NBN Co's infrastructure cannot easily be removed from Telstra's infrastructure, and ongoing operation of the NBN Co may be necessary post-termination, the consequence of termination is not the removal of NBN Co's plant and equipment, but the entry into a further access agreement. The terms of that agreement will be either the terms of the ISA (as appropriately modified to reflect it only applies to existing infrastructure accessed at the time of termination) or on market based terms (at the discretion of the innocent party). Where Telstra terminates due to NBN Co seeking regulated access, the terms will be based on a combination of regulated terms and market based terms. Similarly, on expiry of the ISA or the further access agreement, provision is made for NBN Co to continue to use the Telstra infrastructure which is at that time being accessed by it. NBN Co can choose to seek regulated access or to use that Telstra infrastructure on market terms. There may also be ToP/PoP consequences upon termination.

ACCESS DEED (AD)

Topic	Summary
Purpose	The AD documents the high-level commitments made by NBN Co to Telstra in respect of the terms of supply for NBN Co's Basic Service Offering (**BSO**) and the charging for certain wholesale supply services. As NBN Co's product and service offering remains under development, and will be subject to industry consultation, the complete terms of supply are not yet able to be agreed and documented. Nothing in the AD prevents NBN Co from complying with its legislative obligations not to discriminate between access seekers.
Commitment term	The commitments given by NBN Co under the AD will commence on the Commencement Date (being the date on which all CPs are satisfied or waived under the IID), and will continue for 5 years.
NBN Co to offer to supply BSO to Telstra	Once NBN Co commences the supply of wholesale products to Telstra, it must offer to supply the BSO to Telstra in respect of premises in the fibre footprint which are serviceable by NBN Co.
BSO components	The BSO will comprise specific product components and product features (various technical details are set out in the AD), including speeds of 12 Mbps downlink and 1 Mbps uplink at peak information rates (that is, best efforts internet with no quality of service commitments).
BSO price	NBN Co must not, in respect of the BSO: (a) charge Telstra more than $24 plus applicable taxes per month per SIO; or (b) make any submission to the ACCC seeking, or include in a Special Access Undertaking (**SAU**), a price that is more than the BSO price referred to above. However, if certain regulatory related events occur (including if the regulated price is increased), then NBN Co may increase the price of the BSO in a manner consistent with those events. Under the IID, there is an obligation on NBN Co to seek a price for the BSO in its submissions to the ACCC that is no more than the BSO price referred to above. This applies at all times before the Commencement Date.
Commitments not to levy charges for standard installations	In connection with the BSO and certain other product offerings: (a) NBN Co has committed not to levy charges on Telstra for "standard installations"; and (b) if an installation is not standard, NBN Co may only charge the additional costs above those incurred for a standard installation (and only if NBN Co has obtained the consent of Telstra or the end user to those charges).
Non-discrimination in terms of supply	If NBN Co makes any wholesale product available on terms more favourable than these terms then, in complying with its non-discrimination obligations, NBN Co will offer to Telstra the opportunity to vary the terms of supply so as to be non-discriminatory.
Termination	The AD will automatically terminate upon the expiry of 5 years from the Commencement Date. Termination rights arise under the AD if: • a party demonstrates an intention not to be bound by the AD or to fulfil its obligations only in a manner substantially inconsistent with its obligations under the AD; • a party breaches the AD such that the other party is deprived of the substantial benefit of the AD; • an insolvency event occurs in relation to a party; or • a party breaches its obligation not to assign or novate rights or obligations under the AD without the other party's consent. NBN Co may also terminate the AD if: • NBN Co validly terminates the SA or ISA (other than through the change of law process under the IID); or • Telstra commits (and fails to cure) a material breach of NBN Co's terms of supply.

TELECOMMUNICATIONS UNIVERSAL SERVICE MANAGEMENT AGENCY (TUSMA) AGREEMENT

<table>
<tr><th>Topic</th><th>Summary</th></tr>
<tr><td>Purpose</td><td>The Telecommunications Universal Service Management Agency (TUSMA) Agreement aims to ensure:
• continued delivery of the universal service obligations (USO) (currently set out in the Telecommunications (Consumer Protection and Service Standards) Act 1999) (TCPSS Act) to ensure that standard telephone services (STS) and payphones are reasonably accessible to all people in Australia on an equitable basis, regardless of where they reside or carry on business;
• for premises not served by the NBN fibre network, continued reasonable access to the existing copper access network for STS;
• the ongoing delivery of emergency call handling (Triple Zero '000' and '112');
• that appropriate safety net arrangements are in place that will assist the migration of voice-only customers to a NBN fibre service as Telstra's copper customer access network is decommissioned; and
• if required, technological solutions will be developed for continuity of public interest services (i.e. public alarm systems and traffic lights).
The TUSMA Agreement consists of a series of modules, with the main service terms (being the terms on which Telstra will perform, and be paid for, certain public interest services) contained within Modules B to F. Module A includes general contractual terms, as well as terms relating to a contractual review, cost saving proposals and an adjustment mechanism to apply to scope changes.
The intention of the Government is to implement USO reform so that delivery of universal service outcomes and other public interest services will progressively transition from a regulatory model (with obligations imposed directly on Telstra and other service providers), to an open competitive contractual model. TUSMA, a Government statutory agency, will progressively assume responsibility for delivery of the USO and other public interest obligations and will fulfil its statutory functions by contracting with Telstra and third parties on behalf of the Government.
The TUSMA Agreement will be executed by the Commonwealth. It will be administered by TUSMA (on behalf of the Commonwealth) once TUSMA is established.
This agreement commences on 1 July 2012 and has a term of 20 years, though shorter terms apply to specified Modules.</td></tr>
</table>

Topic	Summary
Standard Telephone Service Universal Service Obligations	From 1 July 2012, for a term of 20 years, Telstra will have a contractual obligation to supply the STS nationwide, as necessary, to fulfil the STS USO such that: • in areas where the regulatory obligation has transferred to TUSMA, Telstra has a contractual obligation to fulfil the USO for TUSMA; and • in areas where Telstra is the primary universal service provider, Telstra has a contractual commitment to comply with its regulatory obligation. From 1 July 2012, TUSMA must pay Telstra $230 million pa (not indexed to CPI) for supply of the STS services, subject to payment adjustments to take account of increases or reductions in Telstra's costs if there is a change in the scope of the STS services Telstra is required to provide. Telstra is entitled to a payment adjustment whether Telstra is the primary universal service provider or responsibility has shifted to TUSMA. Within NBN Co's fibre footprint, Telstra will fulfil the role of retail provider of last resort (ROLAR) for customers who wish to take only a voice STS over the NBN (**ROLAR voice-only customers**). This commitment will apply as a contractual obligation even after the regulatory USO obligation shifts to TUSMA. Telstra will receive funding to operate and maintain its existing copper network, to provide STS, in areas outside NBN Co's fibre footprint (the "copper continuity obligation"). This obligation requires that Telstra not disconnect a service address that is connected to the copper network as at 1 July 2012: • in areas where the NBN will not be deployed, for the term of the TUSMA Agreement; and • in the NBN fibre footprint, until the copper line is disconnected in accordance with the Subscriber Agreement. This commitment is subject to a limited number of specified exceptions which allow Telstra to disconnect copper lines at a service address from the copper network, including (subject to an annual quota) where the copper line is damaged or has deteriorated or has been unused for a significant period.
Payphone USO	From 1 July 2012, for a term of 20 years, Telstra will have a contractual obligation to supply, install and maintain payphones, comprising the Telstra public payphones in place at the commencement date of the agreement and new payphones required over the term of the agreement to fulfil the USO, and supply payphone carriage services to fulfil the Payphone USO. From 1 July 2012, TUSMA must pay Telstra $40 million pa (not indexed to CPI) for supply of the payphone services subject to payment adjustments in qualifying circumstances. A payment adjustment will not be triggered if the number of listed Telstra public payphones increases or decreases within a specified range. When the NBN is deployed in a rollout region, TUSMA can decide whether to fund the migration of each listed Telstra public payphone in that rollout region to the NBN or to an alternative technology or fund an alternative payphone from a third party provider, in which case Telstra can close down the payphone. If a listed Telstra public payphone remains connected to the copper network 3 months before the disconnection date, TUSMA must fund its migration to the NBN. Telstra is required to comply with the payphone-related performance standards and other specific requirements set out in directions and determinations issued by the Minister or the ACMA under the relevant Act. These requirements will continue to apply as contractual obligations once Telstra ceases to be the primary universal service provider for payphones.

Topic	Summary
Technology review for STS USO and Payphone USO	There is a mandatory 10 year review to be undertaken by an independent expert of the technologies and systems used by Telstra to provide the USO STS and Payphones services, with a view to determining if the use of alternative technologies or systems (including by an alternative provider of the USO) would result in cost savings to Telstra (therefore reducing the amount that TUSMA pays to Telstra). The outcomes of this review process are binding. There are mechanisms to deal with any overlap between the geographic areas covered by the review and the NBN long-term fibre footprint. Separately, either party may, at any time, provide the other with a cost saving proposal. Such proposals cannot be unreasonably rejected.
Voice-only customer migration	This deals with the terms on which the Commonwealth will fund certain customer costs for migration of voice-only retail customers to the NBN who have not yet migrated six months before the disconnection date in each rollout region (**late voice migration customers**). It is anticipated that the Government will enter into similar arrangements with other retail services providers and Telstra is to be treated no less favourably than other providers. There are two components to the assistance that TUSMA will be required to provide: • customer management tasks – TUSMA must pay to Telstra customer management fees if Telstra performs customer management tasks to be specified by the Commonwealth after a public consultation process; • connection costs – TUSMA must fund the reasonable connection costs of (either Telstra or a third party contractor) installing in-house wiring that is required to connect late voice migration customers and ROLAR voice-only customers to the NBN, this work to be undertaken by Telstra or a third party contractor at TUSMA's election; and • the amount of these fees is to be determined by an independent expert if not agreed.
Emergency call service	From 1 July 2012, Telstra will have a contractual obligation to supply the emergency call service in accordance with applicable regulatory requirements. Telstra will be entitled to recover its costs, up to a cap of $20 million pa. TUSMA will also meet the reasonable costs of any major upgrade in the Telstra emergency services platform that is required to ensure the continued provision by Telstra of the emergency call service in accordance with applicable regulatory requirements. Telstra will be contracted for 20 years to deliver the emergency call service, subject to the outcome of a tender for the supply of the emergency call service which TUSMA is obliged to issue within the first 5 years with a view to appointing a new emergency call person. There is provision for a transition phase funded by TUSMA. If TUSMA has not received any acceptable tender bids, Telstra will remain the emergency call person and this module will continue to apply.
Migration of public interest services	Telstra may notify TUSMA that a technological solution does not exist for the migration of public interest services (defined as traffic light and public alarm services) from copper to fibre. If TUSMA is reasonably satisfied that a solution does not exist, TUSMA will either request Telstra or a third party for proposals to develop the solution. Any solution that is funded by TUSMA will be owned by TUSMA (unless agreed otherwise) and made available to all service providers on an equivalent basis.

Topic	Summary
Payments to Telstra	Payments to Telstra under the TUSMA Agreement (and other liabilities of TUSMA) will be funded by a combination of levy contributions and direct funding from the Commonwealth of $50 million in FY12/13 and FY 13/14 and $100 million for each subsequent FY during the term of Module B (relating to the STS USO). Telstra will be required to contribute its share of any industry levy contributions that are implemented for this purpose. At this stage the Government has announced that contributions from industry members will be determined based on eligible revenue principles similar to those currently used for the USO and NRS levy schemes, and that these schemes will be replaced by a new scheme. During the first two years of the new scheme, the aggregate contribution of telecommunications firms other than Telstra will remain at the level contributed by these firms under the existing scheme for 2011/12.
Remedies and termination	If Telstra commits a material breach, TUSMA may require Telstra to prepare and implement a rectification plan. If Telstra fails to perform in accordance with the rectification plan, TUSMA may: • withhold payments to Telstra for the module relevant to the breach until that breach is rectified; and/or • for a breach of the STS or payphone module, engage a third person to supply the relevant services during the period of breach (in which case Telstra must pay the reasonable costs of the third party supplier subject to the liability cap). TUSMA may terminate a module in defined circumstances, including extended non performance. In addition, either party may terminate the agreement in the event that a permanent cessation of rollout occurs under the Subscriber Agreement before the rollout has reached 20% of premises. Telstra must develop and implement a transition plan for termination of the STS or payphone module. If a permanent cessation of rollout occurs after the rollout has reached 20% of premises, either party may elect to seek renegotiation of the agreement. If the parties cannot agree amendments (having regard to specified facts, objectives and principles), a panel of independent experts maybe appointed to resolve any dispute. Where Telstra remains the primary universal service provider or emergency call person, there are limitations on TUSMA terminating the relevant module of the agreement or, where Telstra is also subject to regulatory remedies, exercising contractual remedies in respect of the same events.

RETRAINING FUNDING DEED

Topic	Summary
Purpose	The Retraining Funding Deed sets out the terms on which the Commonwealth will provide funding for Telstra to retrain certain staff over an 8 year period.
Commonwealth funding	The Department of Broadband, Communications and the Digital Economy (**DBCDE**) will pay Telstra $100 million (plus GST) after: • it approves the initial training plan; and • Telstra provides to DBCDE an initial budget.
Funding objectives	Telstra must consult with stakeholders in respect of the development of training plans and use the funds to develop and deliver training courses that facilitate the following objectives: • to support the availability of an appropriately trained workforce for the NBN; and • to establish a retraining arrangement for Telstra staff who may otherwise have faced redundancy due to the rollout of the NBN.

INFORMATION CAMPAIGN AND MIGRATION DEED

Topic	Summary
Purpose	The Information Campaign and Migration Deed sets out residual commitments by the Commonwealth relating to the valuation of the proposal and the migration of customers to the NBN.
Public information campaigns	The Commonwealth agrees to arrange for a public education campaign to be run by NBN Co to inform end users that Telstra may disconnect services from the copper network as part of migration to the NBN and that the end user is responsible for customer migration costs, and conduct a public education campaign regarding NBN migration generally.
Payments	The Commonwealth will make residual payments to Telstra, including in the event Telstra is unable to recover costs of migration in certain circumstances.

COMMONWEALTH GUARANTEE

Topic	Summary
Purpose	The Commonwealth Guarantee is a guarantee by the Commonwealth in favour of Telstra in relation to NBN Co's obligations under the IID, SA, ISA and AD (**Guaranteed Agreements**).
Commonwealth Guarantee to Telstra	The Commonwealth has guaranteed to Telstra the payments required to be paid by NBN Co to Telstra in connection with the Guaranteed Agreements. The amount that the Guarantee covers is capped at an amount that represents Telstra's current estimate of NBN Co's potential aggregate liabilities to Telstra, at any given time while the Guarantee is on foot and in circumstances where NBN Co, for some reason, does not meet its commitments to Telstra out of its own available assets.
Termination	The Commonwealth Guarantee is to remain in place until: • NBN Co has achieved a credit rating that reflects an acceptable investment grade credit risk as specified in the Commonwealth Guarantee; and • one of two milestones are met that also reflect that NBN Co is moving out of its initial phase where it requires Commonwealth support, being: – the Commonwealth has fulfilled its obligations to fully capitalise NBN Co at $27.5 billion or as articulated in subsequent formal Commonwealth documents relating to NBN Co's business plan and that provide details of the capitalisation figure for NBN Co; or – the Minister declares under the *National Broadband Network Companies Act 2011* that the NBN should be treated as built and fully operational.

ANNEXURE 3 – TELSTRA'S CURRENT RANGE OF PRODUCTS AND SERVICES

Figure 11 below provides details on Telstra's current range of products and services, as referred to in section 1.1.

FIGURE 11: TELSTRA'S RANGE OF PRODUCTS AND SERVICES

Retail	
PSTN (fixed line voice)	Fixed line voice services such as basic telephony and value added products over Telstra's Copper Network. As at 30 June 2011, Telstra delivered basic fixed voice access services to most homes and businesses in Australia, with approximately 7.2 million retail basic voice services in operation.
Fixed broadband	Broadband services on Telstra's Copper Network and via its HFC cable network. As at 30 June 2011, Telstra delivered its fixed broadband services to approximately 2.4 million retail customers.
Mobiles (including mobile broadband)	Mobile services utilising Telstra's wireless and satellite networks, with approximately 12.2 million mobile services in operation as at 30 June 2011, including 10.4 million 3G services across the Next G™ network and including mobile broadband services to 2.6 million mobile broadband customers.
NAS, IP and data, ISDN	Services include business DSL, virtual private networks, and ISDN delivering traditional telephony, as well as various data applications, including videoconferencing, internet access and EFTPOS.
Media	Includes advertising, directories search and information services, through Sensis, IPTV and resale of FOXTEL pay TV services.
Cable distribution	Services primarily for FOXTEL (50% owned by Telstra), which is Australia's leading cable subscription television provider with more than 1.6 million subscribers as at 30 June 2011.
Wholesale	
Fixed access services	Enable the supply of voice, broadband and data services by other carriers, carriage service providers and Internet Service Providers, as well as value added services such as voice-switching.
Fixed resale services	Services that a wholesale customer can on-supply, such as long distance voice calls, inbound services, voice messaging solutions and ISDN services.
Transmission	Connectivity services with extensive coverage and point-to-point synchronous digital hierarchy transmission capacity for voice, data and IP applications.
Backhaul	Interconnectivity between multiple points of presence and data centres.
Mobile services	Services for transmission on Telstra's mobile networks, including connectivity to meet the backhaul requirements of 3G networks, and voice and data services for resale.

Note: Statistical data represents management's best estimates.

This page has been left blank intentionally.