



**CHECK AGAINST DELIVERY**

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**Being a successful and sustainable challenger**

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**Introduction**

Good morning ladies and gentlemen.

Picking up on the theme of today’s conference “The year of change”, I want to talk about how Optus is navigating this change – and executing its strategies.

Today, I want to do three things.

Firstly, to talk to you about the essence of Optus. I will show you how we have moved through many phases of our history – but throughout these phases we have held true to some principles which are at the core of our approach to creating value for customers and shareholders.

Secondly, I want to identify the key trends in the major areas of our industry – in mobile, in mass market fixed, and in the corporate market.

Thirdly, I will demonstrate that Optus is executing clear and disciplined plans to leverage these trends and strengthen its position.

And I will conclude today with some observations on the Fibre to the Node debate raging right now and give you an update on the activities of the G9.

## **The Essence of Optus**

So let me start by talking about how our history reveals the essence of Optus.

Fifteen years ago we brought competition to Australian communications and the first calls were made on the Optus national fibre long distance network

During our history we have pushed for sustainable growth. We have grown very strongly over our life time – going from zero to \$7 billion in revenue in fifteen years.

This growth was achieved through competing aggressively, moving quickly and meeting customer needs better than our competitors. Growth is the very essence of our brand and strategy.

Indeed the entire industry has enjoyed several years of sustained growth but Optus has captured the largest share.

In the last two years, the telco industry has faced some of the toughest conditions in our history.

There has been a significant down turn in operating performance across the industry.

From this slide you can see one aspect of this – that free cash flow across the industry has declined from \$4.4B in FY03 down to \$3.5B in FY06.<sup>1</sup>

This kind of cycle in industry profitability is a universal phenomenon.

If you look the way that Optus has behaved through the business cycle, through good times and bad, you can identify two clear themes about the way we create value.

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<sup>1</sup> UBS Australian Trend tracker

These are really the essence of Optus.

Firstly, we have consistently led a revolution in customer service levels and customer value through innovation. We were among the first to offer value added plans and tribal offers.

Offers like Yes Time and Turbo Charge pre-paid have changed the way that customers use communications products.

Secondly Optus has thrived and continues to thrive where a level playing field for competition is created. Typically we use this to develop our own infrastructure, get to scale and establish sustainable competitive economics.

For example in the last few years we have established market share leadership in Mobile in Australia's main cities and are now focused on growing our share beyond this. In January we announced we'll spend up to \$800 million to roll out our 3G network to 96 percent of the population.<sup>4</sup>

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<sup>4</sup> Media Release 30.01.07 Optus announces bold expansion of its 3G mobile network across a national footprint

Building our own networks allows us to be disruptive, to define and differentiate the customer experience and innovate on the technology offer.

For example, Optus was one of the first companies to offer ADSL 2+ delivered over our own network. Because we have our own electronics, we can set the data speed rather than just reselling whatever the incumbent dictates.

### **The Key trends in our Industry**

Let me now turn to look at some of the key trends in our industry. These are having a substantial impact on all players. But as I will demonstrate later, the medium term trends favour a profitable and sustainable scale challenger and in particular favour Optus.

First the trends in Mobile.

Growth in mobile is slowing. Mobile caps are washing through the industry. Subscriber penetration is flattening and termination rate reductions have lowered many players' revenues and diluted margins.

Some of this is offset by tremendous growth in mobile data. SMS usage and 3G applications like Google search and music and

image downloads are fuelling the growth. Optus is at the forefront in this area with data as a percentage of Average Revenue Per User sitting at 24 percent.<sup>6</sup> Our customers send on average 53 SMS per month compared to 43 for our major competitor – we've created a customer base with a higher propensity to use the Mobile as a data device.

There is evidence of the structure of the mobile market settling out. Consolidation of some smaller players may be on the horizon as they continue to come to grips with slowing subscriber growth and struggle to reach sustainable margins that provide an acceptable return on investor capital.

Optus' priority in mobile is maximising our advantageous scale and profitability.

In fact it's insightful to look at the reported numbers and see the different strategies of the key players feed through.

Clearly, when you see margin compression like this it raises questions about the value of the revenue growth that has been achieved by several players and about its sustainability. Optus is the only player to avoid margin destruction in the industry.

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<sup>6</sup> Optus internal estimates

Having said that, there are some areas where we want to improve and one is the need to increase our growth in post-paid mobile.

We are uniquely placed to comfortably fund future growth through expansion into regional and rural areas and through specialising in broadband data applications.

And with our strong margins and scale, we will take full advantage of industry consolidation should that occur in the future.

Second, in the area of Mass Market Fixed, we are seeing several trends:

The large scale movement of fixed voice traffic to Mobile is largely driven by mobile caps.

And although the fixed market remains dominated by the incumbent, we know that they are sacrificing mobile margin to protect their large fixed base against the threat from mobile caps.

A brief look at the huge amount of profit still made by the incumbent in the fixed market shows the logic for them in following this strategy – but also highlights their vulnerability to this long term trend.

The second key trend is the take off of first generation broadband. There are around 500 ISPs and the number of carriers investing in infrastructure has expanded well beyond our selves and the incumbent.

There is a third mass market trend beginning – and which is generating an enormous amount of attention. That is the inevitable rise of second generation broadband. One aspect of this – a fibre to the node network – is a hot topic throughout the industry, in the halls of government and among media and analysts.

I will return to this topic later.

Optus' focus in Mass Market Fixed is winning share 'on net' where we can get to scale, establishing competitive economics and delivering a better customer experience. Indeed in the coming years, migration from Telstra resale to our own network will reduce our payments to Telstra by hundreds of millions of dollars.

Turning from the Mass Market to the corporate market, we are seeing the continuing growth in Corporate Internet Protocol – or IP- services.

Across the industry, there is a major move underway from legacy to IP networks.

Optus is fortunate that we do not face an “incumbent dilemma”, We are not trying to protect a large installed base of customers using legacy technology.

On the contrary, we have a strong incentive to welcome and encourage the use of the latest IP services.

Added to that is the fact that the oldest part of our network is 14 years old. So we have an exceptionally modern network architecture – one that the incumbent is struggling to catch up to.

Putting these factors together, it is no surprise that we are a leader in the area of IP.

And the proof of this claim is in our performance. We win more bids offering IP solutions than we do when we offer solutions using ‘legacy’ networks and this can be seen by growth in marketshare.

### **Why Optus is better positioned to manage through the trends**

I have talked about Optus’ history, and about the key drivers in the industry today.

Let me now turn to the third part of my comments – whilst our focus on sustainable scale and profitability has indeed limited our recent growth it is also true that Optus is positioned to benefit from these trends.

First it is worth looking at how we have avoided the massive value destruction in the industry that has impacted our main competitors. That leaves us well placed to drive positive business cases for investment.

As you can see from this chart – our performance to date has significantly contrasted with the other players.

This is the case even though Optus has embraced the profit diluting impact of caps whilst our major competitor has yet to see this manifest. At year end approx 25 percent of the Optus Mobile base were on caps compared to what we believe to be around 10 percent for Telstra.

Secondly, the ongoing downward pressure on Mobile call prices will increase migration of voice traffic from fixed to Mobile networks – from a sector where we have a market share sub 20 percent to one where we have share of well over 30 percent. As I showed you earlier we also have a better margin structure than any competitor in Mobile.

Thirdly, the growth in Broadband and the multiplicity of players there is delivering us circa 20 percent market share versus our traditional 13 to 14 percent in consumer fixed markets. Equally importantly, it is weakening our major competitor – which is forced to work with approx 45 percent market share compared to the 80 percent of industry profits it holds in legacy fixed products. Indeed the effects of competitors migrating voice to ULL is not yet visible on the incumbent as most players are still using Telstra resale for voice and in some cases voice and broadband. This will likely change in the coming two to three years.

Fourth, the need to move to IP based networks in Corporate Australia means CIOs must accept a disruption and shift to new voice and data networks even if they stay with the incumbent.

This presents a level playing field for Optus – as compared to the previous world of legacy technology where CIOs were reluctant to shift. They preferred to avoid disruption by staying with the incumbent.

In summary: we generate a sustainable cash position which more than funds our Capex needs. We have developed a modern infrastructure and an ongoing transformation program which is comfortably funded within a sustainable Capex to revenue ratio.

And we have a strategic view of where we will invest and play to build long term sustainable value and profit.

In this respect we are better positioned than the smaller players for the future. Smaller players will be challenged by scale and the level of investment required to manage through these industry trends. We are – of course – very happy to continue to partner with them as our wholesale customers.

We expect the market structure to continue to transform and consolidate over time and this will favour Optus as the only scale player apart from the incumbent.

### **Update on FTTN**

Let me take a moment to give Optus' perspective on Fibre to the Node. And let me make what I hope will be a measured and constructive contribution from one of Australia's largest investors in this industry.

We have a strong interest in maximising customer welfare, choice and economic well being in the broadband market. That is the best outcome for customers – as well as being the best outcome for us as the leading competitive supplier of broadband.

What I will show you is:

Firstly: that there is not a “crisis” and that Australia will be better served by calm and considered review of the facts and the options to achieve nationally available high speed broadband.

Secondly that the factual evidence from the last 15 years since competition was introduced into Australian communications provides a clear set of minimum requirements for achieving internationally competitive broadband prices, service and product choice – and also provides clear evidence of the huge costs in customer welfare if we ignore these.

Thirdly that it is simply not true that Telstra is the government’s only option to provide this network and the Government therefore has no choice but to accept an anti-competitive deal with Telstra.

And fourthly, that the Government and our Minister have a track record of growing competition and choice in Australian communications.

If they choose to do a deal with Telstra, there are certain elements which must be included if that track record is to be maintained.

Otherwise we will be left with a legacy of high prices, poor choice, poor service and a sharp reduction in jobs and investment in the communications sector.

There has been a great deal of hysteria about high speed broadband and increasing speculation that the incumbent and the Government are close to doing a deal.

The incumbent has argued that Australia is an international backwater in broadband and hence Australia's need for its proposed network is urgent – so urgent that the Government should toss aside the existing regulatory regime.

This would let the incumbent restore its fixed line monopoly in broadband services - a great outcome for it and a terrible outcome for Australia.

Government has so far resisted this proposition – for several very good reasons.

Not least of these is that it is just not right that Australia is a broadband backwater. With the growing penetration of ADSL 2+, some 35 per cent of premises on ADSL 2+ exchanges can now receive over 6 megabits per second,<sup>7</sup> and those close to the exchange can reach up to 20 megabits per second.

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<sup>7</sup>[http://www.dcita.gov.au/communications\\_for\\_consumers/internet/broadband\\_blueprint/broadband\\_blue\\_print\\_html\\_version/chapter\\_three\\_broadband\\_in\\_australia](http://www.dcita.gov.au/communications_for_consumers/internet/broadband_blueprint/broadband_blue_print_html_version/chapter_three_broadband_in_australia)

Optus is getting on with the job. We deliver this service to over 200 exchanges, on target for 340 by the end of the calendar year. Many of our competitors are doing the same.

Indeed, the incumbent could flick the switch tomorrow and bring this dramatic broadband upgrade to millions of Australians. But they refuse to – though they are doing it in exchanges where a competitor offers it. Demonstrating again the power and importance of competition.

So the existing regulatory regime – and the unconditioned local loop service – is working effectively to begin unleashing competition and in turn drive higher speeds, more innovation and better pricing for customers.

So we do not have a crisis; instead we have an important decision to make on how we build on this success and set ourselves up for a self sustaining market that will deliver high speed broadband and ongoing upgrades and improvements to the nation.

That leads me to the second important factual point in this debate. It is clear that there are certain elements of Government and regulatory policy that have driven our escape from near the

bottom of the OECD league table for broadband. Last year, we were one of the seven countries to experience the strongest per capita subscriber growth<sup>9</sup> and our league position lifted.

Indeed, according to an ABS report, from March 2005 to September 2006, broadband subscribers grew from 1.8 million to 3.91 million.<sup>10</sup>

Apart from HFC areas, until 2003 the only supplier of broadband internet access for many Australians was Telstra: through the likes of ISDN or limited availability of business grade broadband True, competitors could access some of these services via a resale model – but Telstra effectively set the prices and defined the product. In our industry, we've consistently seen that a lack of competition and resale only models will drive high prices and limited choice.

In this case, we had residential ISDN prices higher than the majority of advanced economies<sup>11</sup> and high speed broadband was beyond the affordability of most Australians.

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<sup>9</sup> OECD Broadband statistics to June 2006.

[http://www.oecd.org/document/9/0,2340,en\\_2649\\_34223\\_37529673\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/9/0,2340,en_2649_34223_37529673_1_1_1_1,00.html)

<sup>10</sup> ABS Report – Internet Activity Australia, September 2006 (issued 16.02.07)

<sup>11</sup> Productivity Commission 1999. International Benchmarking of Telecommunications Prices and Price Changes

In 1999, the ACCC declared the ‘unconditioned local loop service’<sup>12</sup>. This introduced two key elements to the broadband market that created competition:

- The right for competitors to access the national copper network to deliver broadband services in return for paying Telstra an access charge – covering Telstra’s costs plus a return on investment.
- The right to connect your own equipment to the local loop network and create differentiated broadband products and pricing for customers.

Over time, these two elements drove the competition we are now seeing, particularly once the ACCC started to set clear prices for the use of ULLS.

And in February 2004, literally on the eve of Optus’s launch of a rival broadband service to consumers, Telstra slashed prices; widespread competitive discounting occurred and the takeoff in penetration began.

The lessons are clear: without the ability to offer differentiation and choice in products, pricing and service; the broadband market

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<sup>12</sup> ACCC Report Expiry dates for declared services June 2003 page 7

lagged behind international economies. Competition is the lifeblood of our success as an industry and has been critical to success in broadband.

I will add one more point here: many commentators have missed the significance of the proposed high speed broadband network for media and content delivery. The proposed network will be capable of delivering multiple channel high definition TV and customised web video to most homes in Australia.

Think of the power and potential abuse of power that will be created if one company is allowed to own and operate this network without effective competition. Many here today may find their access to Australians via electronic media will be dictated by Telstra – a company which has clearly stated an ambition to be not just a Telco but a media company.

My third fact is to state that the G9 group of telcos has a very keen appetite to build this network and create open access and competition. It is an attractive commercial opportunity – and we can make money even while charging much lower prices than the incumbent is proposing.

It is worth noting that the G9 is not asking for any taxpayer contribution for its proposed network.

Of course, when weighing up the costs of different offers, you need to look at all of the costs – including the costs of regulatory changes.

The incumbent's access arrangement would reportedly involve a very high access price of \$90<sup>13</sup> which will undoubtedly feed into very high retail prices for broadband.

It is true that G9, too, wants regulatory changes before we could build. We would be happy to have the cost impacts of our changes weighed up against the impacts of those proposed by Telstra.

But our access price is much lower – in the range of \$21 to \$24. And we are also working actively to find ways to reduce the extent of government regulation that would be required.

The fourth fact draws on evidence of the earlier facts: if government does choose to do a deal with Telstra, that deal must contain two key elements if it is to ensure Australia does not get a bad deal on high speed broadband:

- It must provide competitive access for all competitors at a price that allows a level playing field versus Telstra's true

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<sup>13</sup> Age, High-speed poll cycle propels the broadband debate by Alan Kohler, 11 April 2007

costs. As I said: our detailed modelling of the costs of the network indicates that an access price of \$21 to \$24 will generate a sufficient return to the network operator/investor and indeed our proposal to government includes this number. This is well below the \$90 Telstra is reportedly seeking. (Even in this debate we can see how important competitive forces are to driving efficient outcomes!).

- It must allow competitors to access the technology so they can differentiate their products, tariffs and service levels and not just take Telstra's defined product.

Let me add these comments on high speed broadband with a positive proposal for the Government.

We can all agree that our national objective is to get higher speed broadband available to all Australians. The more who have it and use it, the more that we will get all kinds of social and economic benefits.

The right policy approach here, and one that we would fully support, is to seek the benefits of this new network at the lowest cost to the community.

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When it comes to getting a new network at the lowest possible cost, the approach you typically take in business is to set up a structured process of competitive bids.

At the G9 we would see merit in that approach – particularly if the process specified in some detail the criteria that the Government would apply. These should include the access price; the regulatory changes required by each bidder; and of course detailed technical specifications and build plans.

We suggest a way forward for Government is to establish a structured public process under which each interested party is required to come forward with a formal proposal.

This could be done within a clearly specified and tight time frame – with bids due by say the end of September.

There would not be any need for Government to specify a subsidy, or propose co-ownership. After all, there is a clear commercial appetite from both the incumbent and G9 to build a network. What is in contention is the regulatory changes required.

This competitive tender process has been used by this Government previously - in seeking greater broadband

availability for rural and regional consumers through the Broadband Connect Infrastructure Program. While the final outcome is unknown, most of the industry would agree the process was sound.

I have one final observation on broadband.

These are exceptionally complex issues with long term major consequences for the wealth of Australians. The Government should not rush into deals or decisions.

It should not contemplate for a second doing a deal with *any* network builder without full and extensive consultation with all affected parties including those who would seek access to the network.

To do so would damage broadband in Australia forever.

Thank you.

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