



**Telstra Corporation Limited and controlled entities**

**Directors' Report**

**For the half-year ended 31 December 2006**

## Directors' report

In accordance with a resolution of the Board, the directors present their report on the consolidated entity (Telstra Group) consisting of Telstra Corporation Limited and the entities it controlled at the end of or during the half-year ended 31 December 2006. Financial comparisons used in this report are of results for the half-year ended 31 December 2006 compared with the half-year ended 31 December 2005.

### Results of operations

As previously indicated to shareholders, the fiscal 2007 year is the high spend year of our major transformation on the business. Our earnings for the first half of fiscal 2007 have been impacted by these one-off costs but are slightly better than our guidance. We are thirteen months into our five year transformation and have reached a turning point, with positive earnings growth to recommence in the second half.

Telstra's net profit after minority interests for the half-year was \$1,704 million (2005: \$2,143 million). This result was after deducting:

- net finance costs of \$520 million (2005: \$440 million); and
- income tax expense of \$706 million (2005: \$902 million).

Earnings before interest and income tax expense was \$2,938 million, representing a 15.7% or \$546 million decrease on the prior corresponding period result of \$3,484 million.

Basic earnings per share decreased by 20.2% from 17.3 cents per share in the half-year ended 31 December 2005 to 13.8 cents per share in the current half-year. The lower earnings per share were due to the decrease in net profit.

### Review of operations

Our achievements in the past half-year, as we execute our five year transformation strategy, are:

- built our national Next G™ network in ten months;
- launched 3GSM 850 nationwide wireless broadband network;
- upgraded the network's speeds to 14.4 megabits per second (Mbps) nationwide - world's fastest wireless broadband network;
- extended Next G™ network range up to 200 kilometres (at selected sites);
- reached one million 3GSM customers in sixteen months, nearly 40% 3G market share;
- launched national high-speed ADSL with network speeds up to 20Mbps;
- maintained retail broadband average revenue per user (ARPU) while growing market share to 45% (increase of 1% from June 2006); and
- achieved increase in residential fixed line market share for the first time since 1992.

Other highlights over the last six months include the following:

- improved service ratings and increased revenues were achieved while reducing the total workforce by 4,596 (pre acquisitions and investments) since 1 July 2005. We are on track to achieve our target reduction of 6,000 to 8,000 by 30 June 2008;
- increased scheduling flexibility for our customers, meeting more than 90% of our appointments and completing 97% of PSTN service calls on the first attempt; and
- 6,400-plus staff participating in the Telstra Learning Academy to advance their product knowledge, customer service and technical skills.

Our total income for the half-year (excluding finance income) increased by 2.2% or \$253 million to \$11,797 million (2005: \$11,544 million).

The growth in total income was mainly attributable to:

- mobiles revenue - \$296 million or 11.8%; and
- broadband revenue - \$236 million or 43.7%.

Mobile goods and services revenue increased largely due to the continued growth in the number of mobile telephone subscribers, as well as growth in mobile data revenue and international roaming revenue. We also experienced increased revenue from mobile handset sales.

Retail and wholesale broadband subscribers increased by 47.1% in the half-year to 3.5 million subscribers.

Offsetting the sales growth was a decline in PSTN product revenues of \$216 million or 5.6% as the market continues to move towards mobile and broadband products. This decline has slowed when compared with the 7.6% decline in the first half of fiscal 2006. The rate of loss of retail basic access lines has slowed to 1.7% this half due to competitive offers in the market. In particular, we have experienced a slight increase in the number of retail lines since October 2006.

Our advertising and directories revenue decreased 12.7% compared with the prior corresponding period due to the deferred Melbourne Yellow™ print directory production causing a one month delay in distribution into the second half of fiscal 2007. Excluding the impact of the revenue deferral, advertising and directories revenue increased by 7.0%.

Total operating expenses (before depreciation and amortisation, finance costs and income tax expense) increased by 9.9% or \$621 million to \$6,881 million for the half-year (2005: \$6,260 million). This growth was mainly attributable to:

- goods and services purchased – increased by \$371 million or 16.9%; and
- other expenses - grew by \$307 million or 15.3%.

Goods and services purchased increased due to:

- higher handset subsidies from a rise in the take up of handsets on subsidised plans as well as higher subsidies offered associated with our marketing and campaign for Next G mobile;
- cost of goods sold – other, increased mainly due to higher sales volumes for mobile handsets and a higher average cost per handset again associated with strong Next G take up;
- partially offset by lower network payments as a result of a reduced mobile terminating access rate, and lower payments for international capacity and termination costs due to lower net costs from Reach Ltd, our jointly controlled entity.

Other expenses increased largely due to higher service contracts and other agreements as a result of costs associated with transformational initiatives.

This was offset by a decrease in labour expenses of \$57 million or 2.8%. Labour costs decreased mainly due to lower staff levels, a lower charge in redundancy costs, and lower overtime payments partially offset by higher contractor and agency payments.

Depreciation and amortisation costs increased by 9.9% to \$1,978 million, primarily due to accelerated depreciation and amortisation associated with our transformation strategy and planned closure of the CDMA network, upgrade of switching systems and software, and growth in communications plant.

Net finance costs increased by 18.2% to \$520 million, primarily due to higher borrowings to fund capital expenditure and the dividend payments, combined with the impact of increased interest rates in the half-year.

Income tax expense decreased by \$196 million to \$706 million as a result of the lower net profit. The effective tax rate of 29.2% was marginally lower than the rate in the prior corresponding period of 29.6% mainly due to the non taxable profit on sale of the Australian Administration Services Group which was offset by carried forward CGT losses.

### **Cash flow**

Our cash flow before financing activities (free cash flow) position remains strong despite declining to \$862 million in the half-year from \$1,956 million in the prior corresponding period. This position combined with our borrowing program will continue to support our ongoing operating and investing activities within our target debt ratios.

Our cash flow from operating activities decreased to \$3,431 million for the current half-year compared with \$3,948 million in the half-year ended 31 December 2005. The decrease primarily due to:

- the 7.0% decline in earnings before interest, income tax expense, depreciation and amortisation; and
- lower tax payments.

Cash used in investing activities was \$2,569 million, representing an increase of \$577 million over the prior corresponding period. The increase was mainly attributable to:

- our payments for property, plant and equipment as we continue to improve and invest in our core infrastructure;
- the payment for SouFun Holdings Limited;
- offset by the proceeds received from the sale of Australian Administration Services Group.

Our cash used in financing activities was \$1,089 million for the half-year, which represents a decrease of \$1,632 million over the prior corresponding period. The decrease was mainly due to the reduced payment of dividends as the half-year ended 31 December 2005 included a special dividend of 6 cents per share and an increase in borrowings.

### **Dividends**

The directors have declared an interim ordinary dividend of 14 cents per share (\$1,740 million). The dividends will be fully franked at a tax rate of 30%. The record date for the interim dividend will be 2 March 2007 with payment to be made on 30 March 2007. Shares will trade excluding entitlement to the dividends on 26 February 2007.

Our final ordinary dividend for the financial year ended 30 June 2006 of 14 cents per share (\$1,739 million) was provided for and paid during the half-year ending 31 December 2006. These dividends were fully franked at a tax rate of 30%. The final dividend paid had a record date of 25 August 2006 and payment was made on 22 September 2006.

It is the current intention of the Board to declare fully franked ordinary dividends of 28 cents per share for fiscal 2007. This assumes that we continue to be successful in implementing our transformation strategy and there are no further material adverse regulatory outcomes during the course of fiscal 2007. The amount of dividends (including the level of franking) is a decision for the Board to make twice a year in its normal cycle having regard to our earnings, cash flows and the position as well as future regulatory impacts and all other factors that affect our operations.

## **Sale of the Commonwealth's remaining interest in Telstra**

The Commonwealth proceeded with the sale of its 51.8% ownership interest in Telstra in the half-year ended 31 December 2006 where it sold 34.2% of its ownership interest through a public sale. The Commonwealth's remaining 17.6% interest in Telstra is expected to be transferred to the Commonwealth Future Fund by 24 February 2007.

The final public sale of Telstra shares was a success with the level of interest from investors, both retail and institutional, much higher than expected resulting in 4.25 billion shares sold. Retail investors were sold 2.5 billion shares at a price of \$3.60 and institutional investors were sold 1.7 billion shares at a price of \$3.70. The total offer size was \$15.5 billion making it the second biggest share offering in Australian history.

## **Directors**

### ***Directors who held office during the half-year and until the date of this report were:***

Donald G McGauchie	- chairman, non-executive director
Solomon D Trujillo	- chief executive officer
Geoffrey Cousins	- non-executive director (elected 14 November 2006)
Belinda J Hutchinson	- non-executive director
Catherine B Livingstone	- non-executive director
Charles Macek	- non-executive director
John W Stocker	- non-executive director
Peter Willcox	- non-executive director
John Zeglis	- non-executive director

## **Auditor's independence declaration**

The independence declaration of our auditors is on page 6 and forms part of this report.

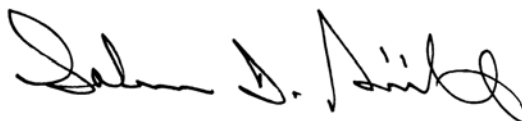
## **Rounding of amounts**

The Telstra Entity is a company of the kind referred to in the Australian Securities and Investments Commission class order 98/100, dated 10 July 1998 and issued pursuant to section 341(1) of the Corporations Act 2001. As a result, amounts in this report and the accompanying financial report have been rounded to the nearest million dollars, except where otherwise indicated.

This report is made in accordance with a resolution of the directors.



Donald G McGauchie AO  
Chairman



Solomon D Trujillo  
Chief Executive Officer

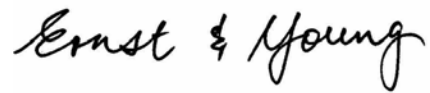
15 February 2007  
Melbourne, Australia

## Independence Declaration

---

### Auditor's Independence Declaration to the Directors of Telstra Corporation Limited

In relation to our review of the financial report of the Telstra Group (the Telstra Entity and the entities it controlled during the period) for the half-year ended 31 December 2006, to the best of my knowledge and belief, there have been no contraventions of the auditor independence requirements of the Corporations Act 2001 or any applicable code of professional conduct.



Ernst & Young



Mirco Bardella  
Partner

15 February 2007  
Melbourne, Australia