Submission on behalf of Flip Ltd

Unbundled Bitstream Access Service Price Review Consultation

Public Version

Background:

Flip Ltd is a subsidiary of CallPlus Ltd.

Flip is presenting a submission independent of its parent company, as its objectives provide a different perspective to the competitive landscape than its parent company.

Flip's business plan was created from the opportunity presented by the major change in the regulatory environment, the government plan for an Ultra-Fast Broadband network, and the split of Telecom into a wholesale and retail business.

Flip commenced operations in New Zealand in September 2012

The initial aim of Flip was:

- Focus solely on the areas where the CallPlus LLU network had been rolled out. This gives Flip a coverage of nearly 450,000 direct-connected residences (where the residence was fed directly from an exchange where CallPlus had installed equipment), and another 550,000 residences that are fed by cabinets that are connected to the exchanges where CallPlus equipment is installed.
- Reduce the overall costs of support by providing no other services apart from the voice and internet services in this coverage area. By specializing we avoid the significant additional support and infrastructure costs that our competitors face.
- Specialise in total automation of our services (to reduce Call Centre Support), by measures such as port authentication, which removes the need for customers to enter usernames and passwords in their DSL modems – they will just work regardless of the settings.
- Provide the lowest cost of any provider (in our coverage area) by providing free broadband where the customer purchases a phone service for $49.95 (incl GST) per month.[1]
- Provide the same or better quality of both voice and internet services, as our major competitors.
- No contract terms
- Provide a 100% New Zealand-based Call Centre.

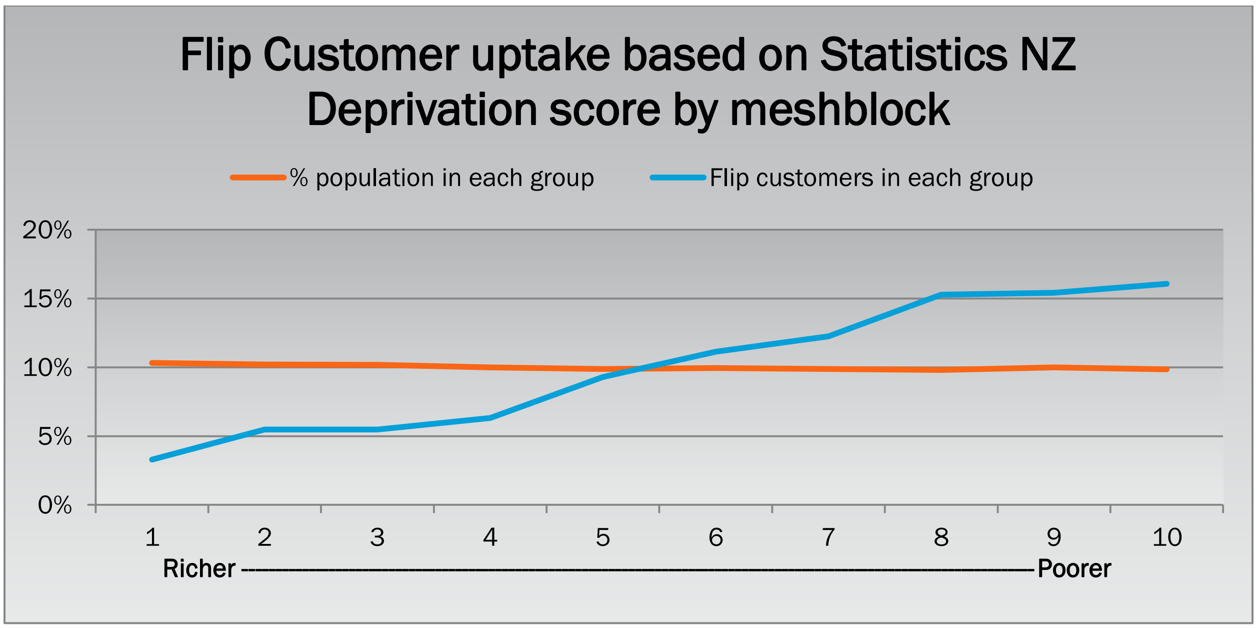
[1] Flip offers 5GB of data at full DSL modem speed, and then the service is either reduced to a 256k broadband speed, or the customer purchases additional unlimited speed data.

Progress to date

We have had a very encouraging initial uptake in the service, with many thousands of customers signing up since launch, and a current uptake rate of [] COI[2].

What we did not expect was that the bulk of our customers currently 73% of them are first-time broadband users, and are primarily from the poorer areas of New Zealand – the regions with the highest social deprivation index within our coverage area. This was not anticipated, as the service quality has not been compromised at all – this service was expected to appeal to the general population.

[] COI



This did cause a few initial issues, as we do not include free DSL modems as any existing ones will work and there is an installation fee we need to recover (We have to pay Chorus $70.46 for each LLU connection, plus a fee to port each number to our network).

Many potential clients did not have the financial resources to pay an up-front connection fee or the price of a DSL modem, so we adapted our plan to enable them to pay these off over a 12 month period.

Our staff are very proud that we are not only providing a high-quality service developed from the ground up, but we are also giving a sector of the New Zealand population the benefit of a critical service that they could otherwise not afford.

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[2] Confidential Commission Only Information

The point of this submission.

Setting the retail price point at $43.43 (excluding GST) for phone and internet was a very challenging move, as to survive with this price point we had to cut out the areas outside our UCLL footprint, and significantly reduce our support costs while retaining our goal of a New Zealand-based Call Centre.

The other important consideration was whether to include the cabinetised customers within our footprint.

For the directly connected customers at the Exchange, we have a cost to Chorus of $19.08 per connection per month for urban, and $35.20 for the 8% that are rural.

For the customers that are connected via a cabinet in the coverage area however, we have a cost to Chorus of $44.98, and this currently accounts for 55% of our connections.

We decided to offer the service at the flat rate of $49.95 (incl GST) as:

- There was no logical long-term reason why there should be a major difference in the cost of delivering the service from a roadside cabinet as opposed to an Exchange. The only reason for the differential is that under the current regulations it is not viable to install our own equipment in a cabinet so we have to use UBA, and the UBA cost is based on traditional retail-minus pricing rather than cost+ pricing
- The regulations call for a move to cost-based pricing by the end of 2014, so we expected this to come in line by then, and felt that the additional customers signing up would ultimately compensate for the initial loss-leading.
- We know from our own experience that the additional cost of the equipment to convert unbundled copper into a full Internet service is in the range of $3.50 - $4.00 depending on how you value the cost of capital. And the per-unit cost for a large volume deployment such as undertaken by Chorus would be significantly less than this.

So we decided to give those residences the benefit of this service on the expectation that the cost for a cabinetised service was only going to be about $4.00 more than the exchange-based customers.

To put this into perspective, here is the current situation of the service that we are providing to our customers in unbundled exchange areas:

	Cabinetised	**Non-Cabinetised urban**	**Non-Cabinetised rural**
Minimum Revenue per customer	$43.43	$43.43	$43.43
Minimum payment to Chorus	$44.98	$19.08	$35.20
Gross Margin(loss)	**($1.55)**	**$24.35**	**$8.23**

We then have many other costs to absorb, such as Infrastructure costs, National and International internet backhaul, Staff including call centre staff, general/admin costs, sales and marketing costs, one-off provisioning and porting costs paid to Chorus/Telecom. These other costs are the same for each of the three categories.

In anticipation of a reduction of the payment to Chorus to no more than $27 for this cost+ based service, our expectation was for the cabinetised customers to be viable in two years' time when the new regulated price became effective.

Conclusion:

You can imagine our concern for our rationally thought-out business plan when we see

- The draft pricing is significantly higher than the cost, and we know this for a fact as we have deployed a smaller scale version of exactly the same thing
- The Government claiming they are going to 'change the law' to prevent this reduction – a law the current government set themselves!
- A Minister (Amy Adams) claiming that the ISP's would not pass on the cost reductions if they were given – we already have!

The questions which now need to be considered are:

- Chorus and Telecom were both well aware that this was going to happen, and it was even disclosed in the Telecom Demerger Prospectus (section 9.2.5)
- Market Analysts[3] were also aware that this was going to happen, and forewarned prospective investors in their assessment of risk
- Why should foreign Chorus shareholders (more than 50% of Chorus shares are currently foreign-owned) get the benefit of windfall dividends at the expense of many of New Zealand's poorest households? Why would a New Zealand government do this?
- Is it reasonable to encourage uptake of fibre for the affluent sector of our society, by adding a charge of something in the vicinity of $15 per month to New Zealand's poorest households?
- Without a determination based on the additional cost of providing UBA over UCLL, it is obvious we will have to significantly increase our price to these customers which will be a further setback to what should be the government's goal of removing the digital divide and give all New Zealanders – no matter how poor – decent broadband.

There should not be a tax on the poor for the benefit of Chorus shareholders.

The final determination that you make must not be swayed by questionable politics of the day. You must stay true to your brief and determine an honest cost-based price, which will be in the best long term benefit for New Zealanders.

Malcolm Dick

Executive Chairman

CallPlus Group

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[3] Refer Macquarie Private Wealth research on Telecom NZ dated 10 November 2011