

**Consultation Paper on the
Future Arrangement of Special Condition 3.4 of the Fixed Carrier Licence
Held by PCCW-HKT Telephone Limited and Hong Kong
Telecommunications (HKT) Limited**

4 December 2009

Introduction

This consultation paper seeks views and comments on the existing Special Condition (“SC”) 3.4 in relation to interconnection related tariffs under the Fixed Carrier Licence (“FCL”) jointly held by PCCW-HKT Telephone Limited (“PCCW-HKT”) and Hong Kong Telecommunications (HKT) Limited (“HKT”) (hereafter collectively referred to as “PCCW”). The FCL was issued to PCCW-HKT on 14 January 2005 to replace its Fixed Telecommunications Network Services (“FTNS”) licence issued on 29 June 1995 for implementation of *ex post* regulation of the tariffs of the company.

2. This paper sets out the preliminary views of the Telecommunications Authority (“TA”) on the proposed options for the future arrangement of SC 3.4 under PCCW’s licence. For the avoidance of doubt, all the views expressed in this consultation paper are for the purpose of discussion and consultation with the industry only. Nothing in this consultation paper represents or constitutes any decision made by the TA and the consultation contemplated by this consultation paper is without prejudice to the exercise of the TA’s power under the Telecommunications Ordinance (Cap. 106) (the “Ordinance”) or any subsidiary legislation.

Background

3. Among all the local fixed network operators (“FNO”), SC 3.4 (see Annex 1) is a special obligation applicable only to PCCW. Prior to 14 January 2005, PCCW was the only FNO subject to an *ex ante* tariff supervision due to its presumed dominant position as the incumbent operator in the market of local fixed telecommunications service, which was liberalised in July 1995.

4. During the period between July 1995 and January 2005, all PCCW's tariffs for its services (both wholesale and retail) were subject to prior approval of the TA, including the introduction of new tariff or a change or amendment to an existing tariff. In October 2004, the TA issued a Consultation Paper entitled "Moving from *Ex Ante* to *Ex Post* Regulation of the Tariffs of PCCW-HKT Telephone Limited and the Proposed Fixed Carrier Licence to be Issued to PCCW-HKT Telephone Limited"¹ ("*ex post* consultation") to review the price regulation regime. In that consultation, the TA considered that in the light of the change of market conditions after nine years of liberalisation, there was a need to review that specific regulation. The TA proposed that the *ex ante* tariff regulation approach should be scaled back in favour of an *ex post* approach as the market developed.

5. The TA subsequently concluded the *ex post* consultation and issued a Statement entitled "Implementation of *ex post* Regulation of the Tariffs of PCCW-HKT Telephone Limited under a New Fixed Carrier Licence"² ("*ex post* Statement") on 13 January 2005. In that Statement, the TA decided to implement the *ex post* regulation of the tariffs of PCCW by means of a FCL replacing the company's FTNS licence. Under the terms and conditions of the replacement FCL, the requirement for PCCW to obtain approval of tariffs or discounts before they became effective was removed, although the relevant notification and publication requirements were enhanced to facilitate the implementation of *ex post* tariff supervision.

6. While the *ex post* tariff approval arrangement was to be applied in general to all retail services of PCCW, the TA decided to maintain *ex ante* control on certain then ongoing interconnection related tariffs. The aim was to safeguard against plausible anti-competitive interconnection charges in the light of concern³ raised by a number of respondents to the *ex post* consultation.

7. As a result, SC 3.4 was incorporated in the *ex post* FCL granted to PCCW specifying that any amendment to the published interconnection tariffs of PCCW which were in force since 1 Dec 2004 and listed in a schedule of the

¹ Available at <http://www.ofta.gov.hk/en/report-paper-guide/paper/consultation/20041008.pdf>.

² Available at <http://www.ofta.gov.hk/en/tas/ftn/tas20050113.pdf>.

³ Most of the respondents to the *ex post* consultation were of the view that the wholesale interconnection market still lacked effective competition and thus PCCW might easily engage in margin squeezing and raise the costs of its competitors. Mobile networks operators were especially concerned that they would have little bargaining power on negotiation of fixed-mobile interconnection charges with PCCW and this would result in huge number of section 36A determination requests.

FCL must first be approved by the TA in writing. Under the *ex ante* approval scheme, the TA may disapprove an amendment of interconnection tariff if the TA forms a view that it is in contravention of the competition provisions under the Ordinance. However, that decision must be made within a period of 30 days from the day of the application submitted by PCCW. If the TA is not able to decide whether or not to approve the amendment of the interconnection tariff, it would be deemed approved after 30 days from the day of the application being made.

8. In deciding to incorporate SC 3.4 in the *ex post* FCL granted to PCCW, the TA made it clear in the *ex post* Statement that:

- (a) There are the following three ways to establish the terms and conditions for an interconnection:
 - (i) bilateral agreement as a result of commercial negotiation;
 - (ii) TA determination pursuant to section 36A of the Ordinance, should commercial negotiation fail or on the TA's own initiative in the public interest; and
 - (iii) the licensee establishing a tariff which is open for all parties seeking to interconnect.

Therefore, carriers and service providers have alternatives on seeking interconnection with PCCW on such terms and conditions as may be commercially agreed or determined by the TA other than those based on the published tariffs of PCCW.

- (b) The pre-approval requirement under SC 3.4 alone does not compel a licensee to offer interconnection under tariffs, let alone at particular terms and conditions. It is only under section 36B(1)(a)(iii) that the TA is empowered to positively direct a licensee to interconnect, and section 36A of the Ordinance that the TA is empowered to positively determine the specific terms and conditions of interconnection.
- (c) A licensee has to comply with sections 7K, 7L and 7N in setting interconnection charges by way of tariffs or otherwise. These powers are separate from the tariff regime, and will not change whether tariffs are regulated *ex ante* or *ex post*.

9. PCCW duly took up the *ex post* FCL on 14 January 2005. Under SC 3.4 of that licence, the following interconnection tariffs set out in Schedule 7 of the FCL are governed under the *ex ante* scheme:

- a) Interconnection between PCCW and mobile carrier licensees, public mobile radiotelephone service licensees or personal communications services licensees (this item is popularly referred to by the industry as the fixed mobile interconnection charge (“FMIC”)).
- b) Interconnection between value-added services (“VAS”) and the public switched telephone network operated by the PCCW.
- c) Broadband copper local loop and exchange co-location services.
- d) Internet protocol – virtual private network services (MegaLink Access and MegaLink VPN).
- e) Residential cell relay services.

PCCW’s Increase of FMIC Tariff

10. Since January 2005, there was only one application⁴ from PCCW pursuant to the SC 3.4, and that concerned an increase of FMIC tariff by 25%. The TA set out his considerations on PCCW’s application in an associated Statement published on 23 May 2008⁵. In considering the application under SC3.4, the TA has three options:

- a) to approve the application where, in the TA’s opinion, the amended tariff would not be in contravention of section 7K, 7L or 7N of the Ordinance (SC 3.4(a));
- b) within 30 days after receiving the proposed amendment, to disapprove the application if the TA is of the opinion that the amendment would contravene section 7K, 7L or 7N (SC 3.4(b)); and
- c) not to form a definitive view on whether the proposed amendment would or would not contravene section 7K, 7L or 7N, with the

⁴ On 17 April 2008, PCCW applied to amend one of its parallel tariffs for interconnection services between PCCW and Mobile Network Operators. The details are available at <http://www.ofta.gov.hk/en/tas/interconnect/tas20080523.pdf>.

⁵ See the Statement on “Increase in Charges for Mobile Network Interconnection by PCCW-HKT Telephone Limited” issued on 23 May 2008 and available at <http://www.ofta.gov.hk/en/tas/ftn/tas20080523.pdf>.

consequence that the amendment will be deemed to be approved after 30 days (SC 3.4(b)).

11. All the above options require the TA to consider the impact of the tariff amendment in the context of the competition conduct rules only. On that particular occasion, the TA did not arrive at a definitive view that the tariff increase would, or would not, contravene section 7K, 7L or 7N, and upon the lapse of the 30 days negative vetting period, PCCW's application for tariff amendment was therefore deemed to be approved. The new tariff took effect on 1 June 2008.

12. It should be noted that the above *deemed approval* mechanism governing new tariffs and tariff amendments had for a long time been adopted for tariff regulation of PCCW under its previous FTNS licence granted in 1995. Even though a tariff or its amendment was deemed to be approved under the *ex ante* mechanism, it however did not mean that there was no regulatory remedy if it was subsequently confirmed after more thorough investigation to be anti-competitive. In the Statement of 23 May 2008, the TA made it clear that since he has not given positive clearance to the FMIC Tariff increase under SC 3.4, the question of whether the tariff increase, once implemented, contravenes section 7L is an open one which can still be considered under the *ex post* regime i.e. after the increase has come into effect. Any party who considers that the tariff increase has an anti-competitive effect in any telecommunications services market in contravention of section 7L may state its case to the TA. The TA has subsequently received an industry complaint and the concerned investigation is continuing.

Removal of Item (a) from SC 3.4

13. During the consultation exercises for Fixed-Mobile Convergence ("FMC") and the Unified Carrier Licence ("UCL") in 2006 and 2007 respectively, PCCW submitted that there was no reason why the obligation under SC 3.4 of its FCL should be retained and be carried over to the new UCL which might be granted to it for replacement of its FCL when it expires in June 2010.

14. Having considered the views and comments of the respondents, no decision was made in the FMC and UCL consultation exercises as to the future

arrangement of SC 3.4. The TA said in his Statement entitled “Licensing Framework for Unified Carrier Licence”⁶ (“UCL Statement”) issued on 9 May 2008 that since the *ex post* regime had been in place for three years, there might be a need for a review of the SC but until the TA decided to carry out such a specific review, the SC would have to remain in the licence of PCCW.

15. With the de-regulation of the FMIC on 27 April 2009, the TA removed the item related to FMIC (i.e. item (a) in paragraph 9) from Schedule 7 of the *ex post* FCL of PCCW on the same day.

PCCW’s Application to Remove SC 3.4

16. On 16 July 2009, PCCW made another request to the TA to carry out a review on SC 3.4 and applied for removal of SC 3.4 from its FCL.

17. Since SC 3.4 came into operation in January 2005, the TA has introduced a number of regulatory changes to the fixed and mobile telecommunications sector, including the introduction of the services-based operator licensing regime, the withdrawal of regulatory guidance on FMIC and the implementation of the UCL. In view of these significant changes and in the light of the impending expiry of the *ex post* FCL granted to PCCW in June 2010, the TA considers that it is appropriate and timely to carry out a review of the future arrangement for SC 3.4.

Existing Market Situation

18. As explained in paragraph 6, SC 3.4 of PCCW’s FCL was introduced in response to the industry concerns regarding certain interconnection services (e.g. the FMIC and interconnection for VAS) provided under tariffs and relied upon by other carriers and service providers in the market. The scope of SC 3.4 is rather limited and is restricted to certain legacy interconnection services then in force in December 2004.

19. At present, there are 10 FNOs providing wireline-based local fixed services⁷ and one FNO providing wireless-based local fixed services⁸. Among

⁶ Available at <http://www.ofta.gov.hk/en/tas/others/ta20080509.pdf>.

⁷ Namely, ComNet Telecom (HK) Limited, HKC Network Limited, Hong Kong Broadband Network

them, five new FNOs have been active in rolling out their self-built customer access networks. According to the latest figures of March 2009 available to the TA, the networks of those FNOs other than PCCW provide an aggregated coverage of about 85% of residential households in Hong Kong. In other words, most of the residential households have a choice of alternative FNOs and facility-based competition in the market of residential fixed telecommunications services is vibrant.

20. On the other hand, the market of business fixed telecommunications services is less rosy. According to the information available to the TA, the five new FNOs together have achieved a coverage of slightly less than 60% of all the commercial buildings in the territory. In view of this, the new FNOs may find it difficult to compete on a fully fledged basis with PCCW, which has territory-wide service coverage. In fact, the TA has received feedback from time to time that given the extensive scale and reach of its legacy network, PCCW remains the only FNO at a large number of locations where there is no viable alternative for the business customers. Many FNOs have to continue to rely on the interconnection services provided by PCCW on a wholesale level for the provision of territory-wide services to their business customers.

Item (a) FMIC

21. As mentioned in paragraph 15, this item was removed from Schedule 7 of PCCW's FCL on 27 April 2009 and as such, it is irrelevant to this consultation exercise.

Item (b): Interconnection between VAS and the public switched telephone network operated by PCCW

22. The VAS tariff is related to the interconnection charge paid by VAS providers to FNOs for delivery of the VAS traffic. The level of this VAS interconnection charge was last reviewed in November 2004⁹, and was then set

Limited, Hong Kong Cable Television Limited, Hutchison Global Communications Limited, New World Telecommunications Limited, PCCW-HKT Telephone Limited & Hong Kong Telecommunications (HKT) Limited, Towngas Telecommunications Fixed Network Limited, TraxComm Limited and Wharf T&T Limited.

⁸ SmarTone Communications Limited.

⁹ See the Statement on "Charges for Interconnection between Public Mobile Radiotelephone Services (PMRS), Personal Communications Services (PCS) and Value Added Services (VAS) and the Public Switched Telephone Network (PSTN) operated by PCCW-HKT Telephone Limited" issued by the TA on 12 November 2004 and available at <http://www.ofta.gov.hk/en/tas/interconnect/ta20041112.pdf>. Other than the per minute charge for delivering the VAS traffic, there is a separate line rental charge.

at a level of two cents per minute. Although other FNOs also offer hosting service to service-based licensees for providing VAS (such as dial-up Internet, store-and-forward fax services), PCCW still maintains a significant market share for VAS interconnection.

23. The TA however observes that the volume of VAS traffic has decreased significantly over the years. This downward trend is probably due to the reduced use of dial-up Internet access by end customers, which fell by more than 70% between 2005 and 2008¹⁰, as a result of the increased popularity and affordability of broadband Internet service. The traffic volume should further decrease with the increased substitution by broadband and mobile services in future. The TA is therefore doubtful whether there is a need to maintain a stringent *ex ante* regulation on this dwindling service. If the *ex ante* regulation for this service is removed, the TA considers that his power under section 36A and the competition provisions of the Ordinance should provide sufficient safeguard against excessive pricing of the interconnection charge, if this ever becomes a regulatory concern.

Item (c): Broadband copper local loop (“BCLL”) and exchange co-location services

24. The BCLL tariff is related to the interconnection charge for Type II copper local access loops provided by PCCW to other FNOs for broadband services with the following service characteristics:-

- (i) connect the main distribution frame at the exchange site of PCCW and the customer interface point; and
- (ii) have a bandwidth of up to 1.1 MHz for the carriage of telecommunications services with nominal transmission rates of at least up to 1.5Mbps provided (however, in respect of applications using DSL technology, PCCW will not guarantee transmission rates above 1.5Mbps).

25. According to PCCW, no FNO has ever made use of this tariff since it was published in October 2001, and so far the BCLLs that PCCW has provided to other FNOs are made available through commercial arrangement. In fact, since the withdrawal of regulation for mandatory Type II interconnection at the

¹⁰ Based on the information available to the TA, the total traffic minutes for dial-up Internet access decreased from 1,060 million minutes in 2005 to 305 million minutes in 2008.

telephone exchange level was fully implemented on 30 June 2008 (except for buildings meeting the “essential facilities” criterion), the provision of Type II interconnection service at the exchange level should be subject to commercial agreement. Consistent with the Government’s policy to fully withdraw mandatory Type II interconnection and in line with the industry practice, the TA does not see a continuing need to maintain the *ex ante* regulation on this service.

Item (d): Internet protocol – virtual private network services (MegaLink Access and MegaLink VPN)

26. The MegaLink services are related to broadband access lines provided to business customers, service providers and other carriers. With effective facility-based competition already in place among the FNOs, there ought to be choices available in the market and PCCW’s service ought to be subject to competitive constraint. But as explained in paragraph 20 above, there is a need for service providers or other FNOs to continue relying on the Megalink services at the wholesale level in order that they may provide retail service to their end customers. At present, there is still a large customer base for the Megalink services¹¹ and an abrupt change to the concerned tariff may result in significant adverse impact to the service providers as well as the end customers. It appears that there are still some merits of retaining *ex ante* vetting on any change to this tariff item.

Item (e): Residential cell relay (“RCR”) services

27. The RCR tariff is related to broadband access lines provided by PCCW on a wholesale basis to Internet Service Providers (“ISPs”) to provide residential Internet access service to their end customers. According to the latest figures, the four largest ISPs (i.e. Hong Kong Broadband Network, Hong Kong Cable Television Limited, Hutchison Global Communications and PCCW) account for almost 95% of the residential broadband service market. These ISPs provide services mainly using their own self-built platforms and customer access networks. The RCR service is mainly used by independent service-based ISPs, who should have a choice of wholesale service providers (including PCCW). At present, the broadband lines provided under the tariff account for a very small portion of the total number of residential broadband lines¹². Similar to

¹¹ According to information available to the TA, PCCW holds a significant share of the wholesale non-residential broadband market as at end 2008.

¹² Based on the figures provided by PCCW, there are only a few thousand lines provided under the residential cell relay service.

items (b) and (c), the TA does not see a continuing need to maintain the *ex ante* regulation on this service.

The Available Options

28. Having considered the background of SC 3.4 and the latest market situations, the TA has identified two possible options to deal with the future of SC 3.4 under PCCW's FCL:

- (1) Option 1 – Remove SC 3.4 in its entirety from PCCW's FCL; and
- (2) Option 2 – Retain SC 3.4 in PCCW's FCL but remove individual tariff items governed by SC 3.4 as set out in Schedule 7 of the FCL on a case by case basis.

Option 1 – Remove SC 3.4 from PCCW's Licence

29. If the *ex ante* regulatory control of the interconnection tariffs of PCCW is to be lifted altogether, the TA would remove SC 3.4 from PCCW's FCL and it would not be carried over to the UCL which may be granted for replacement of the FCL in future. This withdrawal of regulation may be justified given the state of competition in the local telecommunications market, the choice of other carriers and service providers to seek interconnection with PCCW or with other FNOs and to negotiate acceptable terms and conditions. In addition, as the Government has all along encouraged facility-based competition in the market, there may be doubts on whether such *ex ante* regulatory control of the interconnection tariffs of PCCW might inadvertently prolong the continual reliance on the facilities of PCCW for providing service by other FNOs and act as a disincentive to the latter to extend their network coverage.

30. As explained in paragraphs 11 and 12, the investigation conducted by the TA against the industry complaint against PCCW's increase of the FMIC tariff on 1 June 2008 is continuing. The experience of the TA in that case was that a negative vetting period of 30 days would not be sufficient for him to arrive at a definitive view as to whether or not the tariff increase would, or would not, contravene section 7K, 7L or 7N. The extra value of SC 3.4 to the TA in overseeing PCCW's interconnection tariffs on top of the power which the TA already possesses under the Ordinance is quite marginal. The existing SC

3.4 as an effective *ex ante* tariff control mechanism is therefore doubtful.

31. On the other hand, given the fact that PCCW is still the only FNO for 15% of residential households and the vast majority of the commercial buildings, the service-based operators and even the other FNOs will have to continue to rely on the concerned interconnection services regulated under SC 3.4 for providing services to their end customers in the foreseeable future. If the current *ex ante* regulation on PCCW is lifted in its entirety and abruptly, the choice of services and service suppliers to the end customers may be adversely affected.

32. If it is ultimately decided to pursue this option, the TA considers that a proper transitional arrangement has to be put in place such that parties relying on the concerned tariffed services of PCCW will have sufficient time to adjust their business plans in order to phase in the changes.

Q.1 Do you agree with the withdrawal of ex ante regulation for interconnection tariffs under SC 3.4 of PCCW's FCL ?

Q.2 Please state with substantiation whether you support Option 1 or not.

Q.3 If Option 1 should be adopted by the TA, should there be any transitional arrangement? Please give detailed suggestions on this.

Option 2 – Retain SC 3.4 but Remove Individual Items in Schedule 7

33. As mentioned in paragraph 6, SC 3.4 was added to PCCW's FCL in response to the concern raised by respondents during the *ex post* consultation so that the status quo with respect to certain then ongoing interconnection arrangement would not be disturbed. It was accepted by PCCW when it took the *ex post* licence in January 2005. However, unless the concern raised in 2005 is longer applicable today, there may not be sufficient justification and merit to remove the relevant items from Schedule 7 to PCCW's FCL. Therefore, it may be more appropriate to review individual items in Schedule 7 to ascertain whether the removal of *ex ante* approval is justified.

34. Compared with Option 1, this option is a less drastic approach which

allows for the withdrawal of unnecessary regulation on a case by case basis. Such an approach may be justified on the following grounds:-

- (a) Since SC 3.4 came into operation, there has not been any opportunity to conduct a market review for the items that have remained in Schedule 7. It is uncertain whether the removal of SC 3.4 would promote or dampen effective competition in the market for the respective services in the relevant market. A case by case lifting of *ex ante* regulation under SC 3.4 would allow the detailed analysis and consideration of each item on its own merit.
- (b) Given that the duration of a UCL is 15 years and SC 3.4 cannot be reinstated after it has been removed, a less drastic approach as compared with Option 1 would cause less abrupt impact on other FNOs and service providers relying upon the interconnection services of PCCW as listed in Schedule 7 of its FCL.

35. Based on the market analysis of items (b) to (e) given in paragraphs 22 to 27, the TA is of the preliminary view that if Option 2 is adopted, then it is likely that only Item (d): Internet protocol – virtual private network services (MegaLink Access and MegaLink VPN) will need to be retained in Schedule 7.

36. If it is ultimately decided to pursue this option, the TA is mindful that the *ex ante* tariff approval mechanism is a regulatory intervention which should not continue for an indefinite period of time and should be phased out once sufficient facility-based competition has been achieved in the market for supply of the concerned services. In this regard, a “sunset” period may be considered after which the *ex ante* approval requirement on any remaining interconnection tariff items governed by SC 3.4 should be removed and be replaced by *ex post* regulation.

Q.4 Please state with substantiation whether you support Option 2 or not.

Q.5 If you prefer Option 2, please state with substantiation which items in Schedule 7 of PCCW's FCL should be removed and which should remain.

Q.6 If Option 2 should be adopted by the TA, should there be any sunset arrangement? Please give detailed suggestions on such an arrangement.

Invitation for Comments

37. The TA is open-minded to the adoption of either options proposed above. Moreover, he would welcome the industry to come forward with other options, with supporting reasons.

Q.7 If you consider that there other options which should be considered by the TA in handling SC 3.4 in PCCW's FCL, please give details with substantiation.

38. The TA welcomes views and comments on the issues discussed in this consultation paper, in particular on the questions mentioned above.

39. All representations, comments and suggestions should be made in writing, and should reach the Office of the Telecommunications Authority, preferably in electronic form, on or before **4 February 2010**. The TA reserves the right to publish all views and comments as well as the identity of the source. Any part of the submissions, which is considered commercially confidential, should be clearly marked. The TA would take such markings into account in making his decision as to whether to disclose such information or not. Submission should be addressed to:

Office of the Telecommunications Authority
29/F Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong
(Attention: Senior Telecommunications Engineer (Regulatory 31))
Fax: 2123 2187
Email: SC34@ofta.gov.hk

Office of the Telecommunications Authority
4 December 2009

**SC 3.4 in the FCL Held by
PCCW-HKT and HKT**

SC 3.4 Any amendment to any published tariff of the licensee for interconnection, which was in force at 1 December 2004 and continues in force, including those interconnections listed in Schedule 7, must first be approved by the Authority in writing, and

- (a) the Authority shall approve every such amendment where, in the Authority's opinion the amended tariff would not be in contravention of section 7K, 7L or 7N of the Ordinance; and
- (b) any such amendment shall be deemed to be approved unless the Authority notifies the licensee in writing, within 30 days after receiving the proposed amendment from the licensee, of the Authority's opinion that the amendment would contravene section 7 K, 7L or 7N of the Ordinance.