# APPLICATION BY PCCW-HKT LIMITED FOR RECLASSIFICATION OF MAINLAND CHINA ROUTES AS CATEGORY A AND DECLARATION OF NON-DOMINANCE IN THE RETAIL MARKET FOR EXTERNAL CALL SERVICES OVER MAINLAND CHINA ROUTES

## Statement of the Telecommunications Authority

**17 January 2001**

### Background

On 21 January 2000, PCCW-HKT Limited[1], then called Cable & Wireless HKT Limited, submitted a request (January 2000 Application) to the Telecommunications Authority (TA) for reclassification of the three Mainland China routes[2] under Category A and for declaring PCCW-HKT[3] non-dominant in the retail market for call services over the Mainland China routes upon reclassification. On 11 February 2000, the TA issued two consultation papers (one on route reclassification and a second one on declaration of non-dominance in the retail market) seeking views from the industry on PCCW-HKT Limited's application. Having considered the submissions received in response to the consultation paper, the TA gave his initial views on route reclassification in a paper entitled "Preliminary Analysis of Comments Received and Further Consultation" issued on 12 April 2000 (April 2000 Preliminary Analysis). On 25 May 2000, the TA issued a Statement entitled

[1] Formerly known as Cable & Wireless HKT Limited. PCCW-HKT Limited is the holding company of the group of companies comprising PCCW-HKT Telephone Limited, PCCW-HKT International Limited, and PCCW-HKT CAS Limited holding on a joint and several basis the Fixed Telecommunications Network Services (FTNS) licence issued on 29 June 1995.

[2] For the purpose of considering the interconnection arrangements between the external services/gateway operators and the local network operators, the Mainland China market is divided into three routes, namely the Shenzhen, Guangdong and Rest of China routes.

[3] In this Statement, "PCCW-HKT" refers to the group of subsidiaries of PCCW-HKT Limited holding on a joint and several basis the Fixed Telecommunications Network Services (FTNS) licence issued on 29 June 1995.

"Application for a Declaration of Non-Dominance in the External Call Services Market for Mainland China Routes by Cable & Wireless HKT Limited" (May 2000 Statement) rejecting the January 2000 Application on declaration of non-dominance in the retail market. On 12 June 2000, the TA issued another statement entitled "Reclassification of Mainland China Routes" (June 2000 Statement) rejecting the January 2000 Application on route reclassification.

2. The TA in his June 2000 Statement rejecting the January 2000 Application on route reclassification stated that he was not convinced that genuine price competition over alternative connections in the route of Shenzhen had been established (in both the outgoing and incoming directions). For the routes of Guangdong and the Rest of China, the TA considered that there was sufficient competition in the outgoing direction, but there was still insufficient competition in the incoming direction. As a result, the three routes remained as Category B routes, but the gateway price control on PCCW-HKT in respect of the Rest of China and Guangdong routes was lifted. PCCW-HKT was required to pay modified delivery fees determined by the TA to the local network operators for the delivery of incoming traffic originating from all parts of Mainland China.

3. On 23 October 2000, PCCW-HKT Limited submitted another application for reclassification of the Mainland China routes as Category A routes and declaration of non-dominance in the retail market over these routes upon reclassification (Application). The TA issued a consultation paper on 20 November 2000 (Consultation Paper) seeking views from the industry on the Application. In response to the Consultation Paper, the TA received five submissions. Respondents include Hutchison Global Crossing Limited (HGC), New T&T Hong Kong Limited (New T&T), New World Telephone Limited (NWT), PCCW-HKT Limited and SmarTone Mobile Communications Limited. A summary of the comments from the respondents is given in the Annex.

4. Taking into consideration the views and comments in response to the Consultation Paper, the TA sets out his views and decisions in this statement on the Application.

## Route Reclassification

Route Reclassification Tests

5. In considering the application for route reclassification, the TA would apply the same tests on the status of competition as stated in paragraph 7 of the TA Statement entitled “Local Access Charge and Modified Delivery Fee Arrangements” issued on 25 November 1998 (November 1998 Statement). The tests are:

(a) whether a service provider in Hong Kong may physically establish connections to and from a particular location without transiting the gateway of PCCW-HKT, for example, by international simple resale (ISR) operation over leased circuits, or by separate correspondent relationship in bypass of PCCW-HKT’s gateway. In considering whether alternative connections could be made the TA would consider direct and indirect routings (e.g. using refile or transit arrangements) and all technologies capable of providing a reasonably substitutable service; and

(b) whether the costs of utilising the connections identified in the first test would allow genuine price competition in the supply of external services to and from that location.

The TA would also give due regard to materials or arguments that have been raised during consultation.

Control of Gateway Prices

6. In the April 2000 Preliminary Analysis, the TA was satisfied that there had been alternative connections to all three Mainland China routes in the outgoing direction. Therefore, Test (a) had been met. As for Test (b), in the June 2000 Statement, the TA performed a “net cost”[4] comparison between the cost of using PCCW-HKT’s gateway service and the cost of using the refile service offered by an established refile service provider on all three Mainland

[4] The “net cost” takes into account the revenue from calls in the incoming direction which will be used to offset the cost of sending calls in the outgoing direction.

China routes. The results indicated that, for the route of the Rest of China, the former (i.e. using PCCW-HKT gateway service) was higher than the latter (i.e. using the refile service); for the route of Guangdong, the "net cost" of PCCW-HKT's gateway and the refile cost were more or less the same. This showed that even if the price control over the gateway services of these two routes were lifted, the services through alternative connections would still be capable of competing with PCCW-HKT. However, for the route of Shenzhen, the "net cost" of PCCW-HKT's gateway service was at that time still lower than the refile cost. Hence, the gateway price control on the Guangdong and Rest of China routes was lifted, whilst the gateway price for the Shenzhen route remained to be subjected to control.

7. In considering the Application and the comments received from this consultation, the TA has again performed a "net cost" comparison between PCCW-HKT's gateway service and refile. The "net cost" of PCCW-HKT's gateway service would take into account any inpayment under the accounting rate settlements, if any, to subsidize operating cost in the outgoing direction.

8. Downward revision of inpayment would reduce the excess margin that would be available for "net accounting" purposes. According to the TA Statement on the "Updated Gateway Prices and Modified Delivery Fees for Category B routes" issued on 15 December 2000, owing to the revision of the exchange rates, the modified delivery fees for the three Mainland China routes would have been adjusted to HK$0.15/minute, which was less than the local access charge of HK$0.158/minute. The TA considered that the modified delivery fee of any Category B routes should not be lower than the local access charge of HK$0.158/minute for incoming calls for Category A routes. The modified delivery fees for these three routes were therefore kept at HK$0.16/minute. The delivery fee arrangement is basically a revenue sharing mechanism under which the dominant operator would share the excess margin from the inpayment with the local operators after deducting the costs of external switching and transmission and of domestic connection (i.e. the local access charge). The fact that the modified delivery fees, by calculation, would have been less than the local access charge indicates that there is no excess margin in the inpayment which can be available for profit sharing or "net accounting". Rather, for every minute of incoming traffic, PCCW-HKT has to pay an extra HK$0.01/minute to make up the local access charge.

9. In considering the Application, a "net cost" comparison is again performed between the PCCW-HKT's gateway price for the Shenzhen route and the refile cost. The refile cost is calculated on the basis of the refile rates offered by an established refile service provider over the Shenzhen route, plus the circuit cost. The result indicates that the net cost of PCCW-HKT's gateway service is higher than the refile cost. This means that operators can make use of the alternative connections to compete effectively with PCCW-HKT provided that PCCW-HKT will comply with fair competition rules in setting the gateway prices.

10. The TA notes that in paragraph 9 of the June 2000 Statement, he mentioned that whether the competitors of PCCW-HKT were in a position to receive significant and steady incoming traffic based on the proportionate return principle was relevant in determining whether the PCCW-HKT gateway price control on the Shenzhen route would be lifted. The importance of incoming traffic to the competitors of PCCW-HKT was that the excess margin, if any, received from inpayment might be used for "net accounting" purposes, thus reducing the cost of using the direct connections to Mainland China to a more competitive level. In the present consultation exercise, the respondents submit that return traffic has only been received from the Guangdong and the Rest of China routes. This information accords with the TA's own data. However, incoming traffic is only relevant when excess margin from the inpayment is available for "net accounting". The current situation is that little excess margin from the inpayment is available for such purpose. This, coupled with the availability of competitive alternative connections through indirect routing, removes the TA's concern that PCCW-HKT would gain price advantage in its gateway services despite the imbalance in the distribution of incoming traffic.

11. Further, based on the TA's own data collected from the operators, the TA observes that as of October 2000, the market share of PCCW-HKT's gateway services in the outgoing direction of Shenzhen has fallen to well below the 75% threshold that would trigger the presumption of dominance[5]. All these indicators show that alternative connections are not only available in the Shenzhen route but that these alternative connections are also able to support a genuine price competition, which has contributed to reducing the market share

[5] As of March 2000, the market share of PCWW-HKT gateway in respect of the Shenzhen route was still above 75%. Please refer to paragraph 9 of the June 2000 Statement.

of PCCW-HKT gateway in the past months.

Competition in the Incoming Direction

12. Regarding traffic from the incoming direction, the SEA-ME-WE3 (SMW-3) cable, in which HGC, New T&T and NWT all have indefeasible right of use (IRU), is fully operative. Correspondent agreements for both-way traffic in respect of all three routes between these operators and China Telecom are in place. The TA is therefore of the view that Test (a) of the reclassification tests for the incoming direction is satisfied. In reaching this conclusion, the TA takes into account of the respondents' submissions that the other cross border cables, whether for connection with the gateway of China Telecom or China Unicom, are still not in operation for live traffic. The TA is also aware of some of the respondents' claim that despite the correspondent agreements, no incoming traffic has so far been received from one or all of the three routes. However, the TA considers that these arguments do not prevent the meeting of the criteria that alternative physical connections and separate correspondent relationship in bypass of PCCW-HKT's gateway are indeed established.

13. According to the TA's own data, there has been steady incoming traffic in respect of the Guangdong and Rest of China routes that bypasses PCCW-HKT's gateway since the issue of the June 2000 Statement. Admittedly, PCCW-HKT gateway still has a market share of above 75% on these routes in the incoming direction. PCCW-HKT also appears to be the sole receiver of all incoming traffic from the Shenzhen routes. However, as indicated in paragraph 8 of this TA Statement, the receipt of incoming traffic by PCCW-HKT's gateway may no longer be a lucrative business that enables PCCW-HKT to retain the surplus after payment of the modified delivery fees to subsidize the gateway cost. Thus the importance of traffic in the incoming direction has diminished in assessing if genuine price competition is possible using the alternative connections.

14. Further, in response to the Consultation Paper, PCCW-HKT submits evidence to prove that it has been approached by a competitor of China Telecom to establish corresponding relationship. The outpayment and inpayment rates offered by this Mainland operator are below those currently agreed between PCCW-HKT and China Telecom. PCCW-HKT also claims

that the Mainland operator has made similar offers to PCCW-HKT's competitors. Given that the other operators have not been given the opportunity to comment on this assertion, the TA would not take this particular assertion into account when forming his view. However, he is satisfied that the information supplied shows that there is a downward trend for the level of both the outpayment and inpayment rates, and that there is already competition in the routing of external traffic in the direction of Mainland China to Hong Kong. This is reinforced by the recent announcement by the Ministry of Information Industry that call charges from the Mainland China to Hong Kong will be reduced significantly downwards in early 2001. Based on all these considerations, the TA is satisfied that not only alternative connections have been established, but these alternative connections also allow genuine price competition.

<u>Conclusion</u>

15. Given that the reclassification tests have been satisfied for both the incoming and outgoing directions, the TA considers that all three routes of the Mainland China should be reclassified as Category A.

**Non-Dominance in the Retail Market**

16. In the Application, PCCW-HKT Limited requested a declaration of non-dominance in the retail market for the Mainland China routes upon reclassification based on the TA Statement entitled "Application for a Declaration of Non-dominance in the International Call Services Market for Non-China Routes by Cable & Wireless HKT Telephone Limited" (August 1999 Statement). For the reasons set out in paragraphs 4.2 - 4.5 of the Consultation Paper, the TA is of the view that the proposition of "automatic retail non-dominance" arrangement in the August 1999 Statement should not be extended to the Mainland China routes and before declaring PCCW-HKT non-dominant in the retail call services market over the Mainland China routes, the tests for non-dominance against all the factors set out in the August 1999 Statement should be satisfied. The factors include market share, barriers to entry (contestability), prices in the market and vertical relationships.

17. Having considered that all three routes of the Mainland China should now be reclassified as Category A (paragraph 15 of this Statement), the TA has

examined whether PCCW-HKT should also be declared non-dominant in the retail market. He followed the approach set out in the “Guidelines to Assist the Interpretation and Application of the Competition Provisions of the FTNS Licence” issued by OFTA in June 1995, the August 1999 Statement and in particular, the May 2000 Statement.

18. The May 2000 Statement was issued in response to PCCW-HKT Limited’s application filed in January 2000 for a declaration of non-dominance in the external call services market for Mainland China routes. It set out the basis upon which the TA examined PCCW-HKT Limited’s application, his findings and conclusion. The conclusion, as set out in the May 2000 Statement, was that the application was refused. The basis upon which the TA examined the application was the same as that set out in the August 1999 Statement.

19. The TA, in considering the Application, examined what was the relevant market and then whether PCCW-HKT was dominant in that market. In considering whether PCCW-HKT was dominant in the market, the TA examined the market share of PCCW-HKT in the market, the fluctuation of it, the market concentration, any barriers to entry, pricing of the services over time, vertical relationships that may exist, etc. Once the TA has established the position of PCCW-HKT in the market, he would consider whether the Application for a declaration for non-dominance could be acceded to with or without any conditions.

<u>Relevant Market</u>

20. In paragraph 43 of the May 2000 Statement, the TA accepted that the relevant market should be the External Call Services market for Mainland China routes and the geographical market is the whole of Hong Kong. In relation to whether Mainland China routes should be considered as a single market or three different markets: Shenzhen, Guangdong and Rest of Mainland China, the TA stated in paragraph 17 of the May 2000 Statement that he noted that there were legitimate reasons for treating all routes as a single market as well as for sub-dividing the market into three separate markets. However, he found it was not unreasonable to accept PCCW-HKT’s proposal that Mainland China routes should be treated as a single market for the sake of assessing the application.

21. In its response to the Consultation Paper related to the Application, PCCW-HKT Limited stated that while it still considered that treating Mainland China routes as a single market would be the most appropriate approach. PCCW-HKT also believed that the facts supported its case for reclassification and “automatic retail non-dominance” regardless of whether the China routes were considered as a single market or three sub-markets.

22. New T&T Hong Kong Limited (New T&T) stated in its response to the Consultation Paper that the three Mainland China routes should be considered as separate markets because the customer base of Shenzhen is different, the calling patterns and durations are different over the three routes, the three routes have different accounting rates and the industry players treat the Mainland China market as three different market segments.

23. The TA notes the comments made by both PCCW-HKT Limited and New T&T on whether Mainland China routes should be treated as a single market or three different markets in processing the Application. The TA notices that recently, some external call services operators apply one single rate to more than one of the three Mainland China routes (e.g. one peak rate for calling Guangdong and Rest of China; one standard rate for Shenzhen, Guangdong and some cities in Rest of China; or one off-peak rate for the whole of Mainland China). He also notices from the recent announcement by Ministry of Information Industry that from early 2001, calls made from any part of Mainland China to Hong Kong will be charged at a unified rate. He is also of the view that most consumers would probably choose service providers based on their perception of the competitiveness of the prices of individual providers for all Mainland China routes as a whole. Taking these into consideration, the TA maintains that it is more appropriate to treat Mainland China as one single market in processing the Application.

Market Share

24. Based on the figures of the traffic reported regularly by each licensee, the TA calculated the actual market share of each of them. The traffic figures used were supplied by each licensee on a monthly basis and were not supplied specifically for the Application.

25. Having examined the market share of each licensee over the period from May 2000 to October 2000 inclusive, the TA noted that there were small fluctuations in the market share of PCCW-HKT. However, the market share was consistently no more than 50% throughout the period and was on a decreasing trend since July 2000.

26. The TA also examined the market concentration. He noted that the gap between PCCW-HKT and the second biggest market player, Operator X (name withheld) for the period from May 2000 to October 2000, was about 30% and has been narrowing since July 2000. Operator X and the third biggest market player, Operator Y (name withheld), representing a total market share of approximately 30%, had respective market shares of below 20% and above 10%. The TA noted that the total market share of the other competitors (i.e. excluding X and Y), has been increasing slowly since July 2000.

Barriers to Entry

27. As stated in paragraph 28 of the May 2000 Statement, the TA was satisfied that there are no regulatory restrictions on the number of operators that can offer external telecommunications services. There has not been any change in this respect.

28. As stated in paragraph 58 of the August 1999 Statement, the TA considered that in all Category A destinations, it would be easy for a competitor to switch to alternative connections in bypass of PCCW-HKT gateway, but in cases where the wholesale market was not competitive, it would not be easy for the competitor to do so. Therefore, if PCCW-HKT was to try to abuse its position in any Category A destinations, its competitors could easily offer competitive prices without relying on PCCW-HKT. In respect of the Mainland China routes, the TA stated in paragraph 30 of the May 2000 Statement that he was aware that only those operators who hold an FTNS Licence could seek to enter into correspondent agreements with carriers in Mainland China. The TA was therefore of the view that there was not yet significant competition from non-FTNS operators (i.e. non-facilities based external telecommunications services (ETS) operators) in the wholesale market (paragraph 34 of the May 2000 Statement).

29. There is no information available to the TA that non-FTNS operators

can seek to enter correspondent agreements with carriers in Mainland China. As pointed out by Hutchison Global Crossing Limited (HGC) and New World Telephone Limited (NWT) in their responses to the Consultation Paper, the TA is aware that the markets of the Mainland China routes are different from the markets of other Category A routes as international simple resale (ISR) is still not allowed in Mainland China. The TA is also aware of the fact that non-facilities based ETS operators have to rely on PCCW-HKT or the other FTNS operators who have interconnected with carriers in Mainland China for delivery of traffic over direct routing to Mainland China. However, as mentioned in the above reclassification tests, the TA notes that there are alternative wholesale services available at competitive prices to non-facilities based ETS operators. The TA is therefore satisfied that there is no barrier to entry to the retail market arising from the lack of alternative supply of wholesale services.

<u>Prices</u>

30. In relation to the power of PCCW-HKT in making decisions as to pricing or strategic matters, the TA stated in the May 2000 Statement that the competitions in the market for calls to Mainland China was very intense, however, in view of the fact that PCCW-HKT was required by its licence to seek approval from the TA for any tariff revisions, he could not be satisfied that PCCW-HKT, if free from restraints, would not be the price leader in the retail market.

31. In its response to the Consultation Paper, SmarTone Mobile Communications Limited (SmarTone) stated that the current drop in retail prices was not supported by the underlying provisioning cost and it was no more than a marketing strategy of operators edging into the market share of PCCW-HKT.

32. The TA observes that, as the wholesale services are fully competitive, and the PCCW-HKT gateway does not necessarily provide the lowest-cost routing for outgoing traffic to Mainland China, there should now be no restraints to competitors of PCCW-HKT in setting retail prices to compete effectively with PCCW-HKT based on the underlying costs of the wholesale services available to these competitors in the market.

<u>Vertical Relationships</u>

33. PCCW-HKT is subjected to the competition provisions in the Telecommunications Ordinance and its FTNS Licence. It is also subjected to the conditions imposed in the approval for the declaration of its non-dominance in the Category A routes market and any extension of this approval. The conditions are stipulated in the Directions accompanying the May 1999 Statement and the TA Statement entitled "Application for the Extension of the Direction issued to Cable & Wireless HKT Telephone Limited on 4 August 1999 pursuant to General Condition 44 of its Fixed Telecommunications Network Services Licence in response to "Application for Declaration of Non-dominance in the International Call Services Market for Non-China Routes" by Cable & Wireless HKT Limited" issued on 28 September 2000 (September 2000 Statement). The conditions are to ensure that proper compliance systems and robust pricing arrangements are in place so that competition can be protected. The TA is satisfied that these safeguards, if also applied to the market for Mainland China routes, are adequate to ensure the protection of competition under the current circumstances.

34. The TA has not taken into consideration the proposed transaction between Pacific Century CyberWorks Limited and Telstra Corporation because this transaction has not yet formally been concluded. However, he notes that this transaction, if concluded, would ease the concerns regarding the existing vertical relationship between companies providing the retail services and gateway services within PCCW-HKT.

Other Relevant Factors

35. As stated in its response to the Consultation Paper, SmarTone was concerned that PCCW-HKT would offer "cut throat" prices through subsidization of inpayment received from China inbound traffic. In fact, as stated in paragraph 42 of the May 2000 Statement, it was also the TA's concern that should the tariff approval process be lifted, PCCW-HKT was able to use the margin generated from the incoming call services market, which was dominated by PCCW-HKT and in which real and effective competition was unlikely to emerge before the third quarter of 2000, to finance deep discounts in the outgoing call services market.

36. However, as mentioned in paragraph 8 of this Statement, the modified

delivery fees for the three Mainland China routes would have been adjusted to HK$0.15/minute which would have been less than the local access charge of HK$0.158/minute. Further, the reduction in call charges from the Mainland China to Hong Kong might lead to a further downward adjustment in the inpayment rates. In the light of these changes, it appears to the TA that there would unlikely be any extra profit contributed from the inpayment for delivering incoming calls from Mainland China that PCCW-HKT could use to finance discounts on its outgoing call services although it is still the dominant operator in the fixed exchange line services market.

Conclusion

37. The TA is satisfied that the relevant market in processing the Application should be the External Call Services market for Mainland China routes as a whole and the geographical market is the whole of Hong Kong.

38. Considering that:

(a) the market share of PCCW-HKT was consistently no more than 50% for the period from May 2000 to October 2000 and was on a decreasing trend since July 2000;

(b) the gap between PCCW-HKT and the second biggest market player was narrowing as from July 2000;

(c) there is no entry barrier to the market;

(d) the safeguards currently in place are adequate to ensure the protection of competition under the current circumstances;

(e) the recent changes concerning the level of inpayment for delivering incoming calls from Mainland China render PCCW-HKT unable to have extra profit from the inpayment to finance deep discounts on its outgoing call services for the Mainland China routes;

(f) the conclusion reached that sufficient competition at the wholesale level has been established over three Mainland China routes which accordingly have been re-classified as Category A, the TA is satisfied that PCCW-HKT Limited's application for non-dominance of PCCW-HKT in the retail market for external call services over the Mainland China routes can be acceded to. He has therefore issued a direction on 16 January 2001 under General Condition (GC) 44 of the FTNS Licence held by PCCW-HKT to waive the application of GC 20(4), 21 and 22 to PCCW-HKT subject to the same conditions imposed on PCCW-HKT in previous declarations of non-dominance for retail market over all other Category A routes. As for all other routes over which PCCW-HKT has been declared non-dominant, the TA will continue to monitor the development of the market and ensure that the provisions in the Telecommunications Ordinance and conditions in the licences concerning fair competition are complied with.

**Office of the Telecommunications Authority**
17 January 2001

**ANNEX**

# Summary of Comments in response to the Consultation Paper on the Application for Reclassification of the Mainland China Routes as Category A and Declaration of Non-Dominance in the Retail Market by PCCW-HKT Limited issued on 20 November 2000

1. Hutchison Global Crossing Limited (HGC)

2. New T&T Hong Kong Limited (New T&T)

3. New World Telephone Limited (NWT)

4. PCCW-HKT Limited

5. SmarTone Mobile Communications Limited (SmarTone)

## 1. Hutchison Global Crossing Limited (HGC)

PCCW-HKT's application for reclassification and declaration of non-dominance should be rejected.

**Established physical alternative connections**

2. The capacity in the E1s of SEA-ME-WE3 (SMW-3) that HGC has activated is fully utilized for outgoing traffic so that no incoming traffic from China is received. As regards the Second Fibre Ring, it is pursuant to China Telecom's preference and direction that HGC has yet to physically connect to that ring. It has nothing to do with there being other lower cost alternatives. The implementation of HGC's direct connection to China Unicom Fibre Ring is anticipated to take another four to six months to become operational. HGC's direct connection to the new China Telecom Fibre Ring is expected to become operational early next year.

3. The consequence is that HGC's incoming traffic from China is received through PCCW-HKT's gateway only. HGC has not been receiving return traffic from Shenzhen and Guangdong as PCCW HKT is purporting to assert.

**Cost of using alternatives**

4. The cost of HGC's alternatives principally comprises the comparatively expensive acquisition costs of indefeasible right of use (IRU) in the E1s on SMW-3 for the outgoing direction. This is by no means low.

**Whether new operators in China are providing competition to China Telecom**

5. Competition in the form of connection to the China Unicom Fibre Ring is not expected to be present until mid-2001. Even so, most traffic will terminate and originate from China Telecom's networks, as China Telecom is still very much the dominant operator in the Mainland China.

**Implementation of the proportionate return principle**

6. Due to the absence of return traffic from China to HGC's network, the proportionate return principle has yet to be implemented.

**Automatic retail non-dominance**

7. Automatic retail non-dominance should not apply to the Mainland China routes. The markets of the Mainland China routes are different from the markets of the other routes. For one thing, the Mainland China routes do not allow the operation of international simple resale (ISR). Without such stimulating effect, a market that has just been liberalised at the wholesale level could take some time for the dominance of the dominant operator to be removed.

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## 2. New T&T Hong Kong Limited (New T&T)

PCCW-HKT's application should be rejected.

**Establishment of alternative connections**

2. There is still an absence of effective alternative physical connections to and from Mainland China and a lack of competition in the supply of external services to and from Mainland China. As regards the Second Fibre Ring, it is China Telecom's own decision not to pursue connection for capacity reason. The Third Fibre Ring (with China Telecom) and interconnection with China Unicom are still in the testing stage and not yet operational for live traffic.

**Genuine price competition**

3. China Unicom is in a unique position of having both an external fixed telecommunications network service (FTNS) licence and a licence to operate in China. However the operation is still in its early days. It does not believe that the new operators in China are providing genuine competition to China Telecom.

4. The retail market is not competitive. New T&T suspects that the primary competition provided by external FTNS licensees may be at a below-cost level and the low cost strategy may not be sustainable in the long run.

5. New T&T does not agree that MJ Scheele's offered rates could represent the general market refile rates. Further, the cost factor is only one of the factors that operators consider in choosing their wholesale carriers. Other factors include the quality of traffic, reliability of the wholesaler, limitation of capacity of the wholesaler's route, long term relationship with the wholesaler, and whether the refile rates offered are temporary promotional rates.

6. By PCCW-HKT's own admission that its notional net gateway cost is slightly lower than using MJ Scheele's refile route, there is still no genuine competition in the wholesale market for Shenzhen. Further, New T&T is not aware that external telecommunications services (ETS) operators have established direct cable alternative to Shenzhen. PCCW-HKT's assertion that

the ETS licensees acquired capacity at the lowest outgoing wholesale price available and made their profit on their outgoing retail offerings is not substantiated. New T&T believes that the ETS licensees may not necessarily make a profit on their outgoing retail offerings as they may set their retail pricing for strategic reasons.

7. At present China Telecom only sends New T&T an immaterial amount of return traffic on Guangdong area. No return traffic on other areas is received. Further, the existing return traffic arrangement with China Telecom is based upon the commitment based return traffic principle, which enables commercial negotiation between China Telecom and a particular operator on the extent of commitment base ratio. PCCW-HKT, being the dominant carrier, will be able to negotiate a relatively better ratio. New T&T suspects that China Telecom could pass on all the remaining incoming traffic to PCCW-HKT when it fulfils all the incoming traffic commitments to other FTNS licensees.

8. China Telecom has implemented a three-tier wholesale outgoing traffic pricing scheme. If the gateway control for Shenzhen is lifted, PCCW-HKT will be able to reduce its wholesale outgoing rates and attract more outgoing traffic from other operators. PCCW-HKT will then be in a position to pass on the increased traffic to China Telecom to achieve a better wholesale rate. Where all the Mainland routes have been reclassified to Category A, PCCW-HKT will be able to further subsidise its retail pricing by using the increased inpayment revenue to offset part of the cost in the outgoing traffic. This will render the retail pricing market very uncompetitive.

**Automatic retail non-dominance**

9. The automatic retail non-dominance should not apply. For the Mainland China routes, PCCW-HKT has established a very solid customer base, which is a distinct group of customers from that for other IDD routes. This distinct group is price insensitive and is not susceptible to retail price changes. This group includes the elderly, the less sophisticated users and the new immigrants. New T&T believes that this group forms the majority of PCCW-HKT's customer base, and suspects that the promotional pricing strategy that the industry adopts has immaterial effect on the market share of PCCW-HKT, which is still within a range of 50% and 40% between July and

September 2000 despite the continuous aggressive pricing promotions that the industry has put to the public.

10. In order for other operators to tap into this very solid customers base it will cost the operators $X to potentially churn a customer. These costs, known as customer acquisition cost, may be ineffectual at the end. Even if the customers do churn it may not bring in the associated and expected revenue and benefits given the customers may subsequently churn to other operators in a free market environment.

11. PCCW enjoys competitive advantages over the other operators:

- it could leverage on its 95% of the fixed lines coverage to acquire new IDD customers
- economics of sale barriers – it enjoys economic of scale in advertising, promotion and provision of cost
- established customer base barrier – it has maintained a large established customer information data base, thus enabling it to gain access to information that other operators do not have.

All these illustrate that the retail market is not competitive and operators are not competing on equal footing.

12. The Mainland China routes which are currently priced at different rates should be considered as separate markets for the following reasons:

- Shenzhen customer base is different from the rest of the China routes in that the customers are more business oriented and is less price elastic than the other routes.
- there are different calling patterns and duration among the customers over the three routes
- different routes have different accounting rates with China Telecom
- the industry players on the whole treat the China market as three different market segments and that is why different pricing and discounts are given to three different regions in China.

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# 3. New World Telephone Limited (NWT)

The Telecommunications Authority (TA) should reject PCCW-HKT's application.

**Licensed competitors**

2. The presence of new carriers in Hong Kong and China is insufficient to confirm adequate competition for traffic to and from China. These operators are either not yet operative, or not fully competitive due to licensing restriction.

**Alternative connection**

3. It is speculative on the part of PCCW-HKT to claim that the new FTNS operators have chosen not to use the Second Fibre Ring because there are lower cost alternatives which have been profitable bypass of PCCW-HKT's gateway. In any event, the backhaul circuit constitutes only a small portion of the overall cost of delivery and the saving, if any.

**PCCW-HKT's wholesale market share**

4. The PCCW-HKT gateway price is based on cost incurred in delivering a minute of external traffic to the respective destination and is before netting. After taking into account inpayment received on return traffic, the net cost of delivery would be lower. Thus the gateway price offered by PCCW-HKT for using its gateway is in fact higher than the genuine cost incurred by PCCW-HKT. Therefore as long as the cost of delivery is below PCCW-HKT's gateway price, the external operators would endeavour to route all external traffic using alternatives such as wholesale service of other external operators or direct correspondence relationship with overseas carriers. The declining trend of PCCW-HKT's competitors' use of its gateway service was probably attributable to the fact the PCCW-HKT has failed to offer the full benefit of "net accounting" to its competitors. This however does not mean that PCCW-HKT is suffering from a cost disadvantage. With the benefit arising on incoming settlement, PCCW-HKT may be able to achieve even lower net cost of delivery.

**Extent of incoming bypass**

5. In reply to PCCW-HKT's claim that there has been large scale incoming bypass for the Rest of China traffic, NWT answers that with the equalisation in accounting rates for different provinces in China, such arbitrage opportunity has substantially vanished. The projected degree of incoming bypass based on historical figures (ie statistics from TeleGeography) is highly speculative.

**Rigidity of PCCW-HKT in using other delivery options**

6. If PCCW-HKT has committed to use a particular means to deliver its external traffic, only later to find that there are some even lower cost alternatives present, it is a mistaken decision for which it should be responsible.

**Return traffic under correspondence agreement with China Telecom**

7. Due to the lack of direct connection to the Shenzhen gateway, there is no return traffic for the Shenzhen route. For the Guangdong and Rest of China routes, NWT's return traffic is insignificant compared to its outgoing traffic.

**Automatic declaration of non-dominance**

8. There are notable differences in terms of supplier characteristics, customer perception and product differentiation that do not justify automatic declaration of non-dominance. For example, international simple resale is still not allowed in China.

**Implication of pre-mature reclassification and declaration of non-dominance**

9. PCCW-HKT would be able to abuse its position by pricing its service at the "net accounting" cost.

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## 4. **PCCW-HKT Limited**

**Reclassification matters**

PCCW-HKT provides the latest data (as at 1 December 2000) showing the level of bypass of its external gateway [actual figures provided to the TA]:

- less than 20% of PCCW-HKT's competitors China traffic transits its external gateway.
- Shenzhen route – both New T&T and CIT International Limited (CTI) transit less than 10%, and other ETS licensees transit less than 12% of their traffic through PCCW-HKT's external gateway.
- Guangdong route – New T&T transit less than 5%, and NWT and other ETS licensees transit less than 10% of their traffic through PCCW-HKT's external gateway.
- Rest of China route – New T&T transit less than 5%, and NWT and the other ETS licensees transit less than 10% of their traffic through PCCW-HKT's external gateway.
- PCCW-HKT's share of the total wholesale and retail markets for the China routes are now respectively below 50% and 45%.

2. Recently, PCCW-HKT has been approached by a China Telecom's competitor [name provided to the TA] with offers of accounting rate outpayments and inpayments below those currently agreed between PCCW-HKT and China Telecom. The inpayments rates sought are so low that there is no 'excess' inpayment from which to pay a modified delivery fee or to net account. PCCW-HKT understands that this operator has made similar offers to PCCW-HKT's competitors, demonstrating that China operators are willing and able to enter into multiple agreements in competition with China Telecom. Further PCCW-HKT has seen steady increases in the levels of traffic from China Telecom's competitors for termination in Hong Kong.

3. The sustained loss of PCCW-HKT's market share at both wholesale and retail levels shows that low alternative 'net outgoing' wholesale prices have been available for a considerable period of time. The fact that there has also been intense retail price competition on the China routes for over a year, supported by low wholesale costs, demonstrates that theses competitive

wholesale rates are sustainable in the long-term.

**Retail non-dominance**

4. PCCW-HKT provides the latest data (as at 1 December 2000) showing its retail market share on all three China routes [actual figures provided to the TA]: Shenzhen below 42%, Guangdong below 40%, and ROC below 36%.

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## 5. SmarTone Mobile Communications Limited (SmarTone)

Reclassification to Category A for the China routes and declaration of non-dominance in the retail market are still too early to be concluded. The industry still needs time to develop a healthy and competitive market.

**Automatic retail non-dominance**

2. The dominant position of PCCW-HKT in both local market and China routes enables it to exercise its influence in setting the accounting rates with its China counterpart, or offering cut throat prices through subsidization of inpayment received from China inbound traffic. A too early reclassification would give PCCW HKT further room of subsidization.

3. Although PCCW-HKT claims that its market share is below 50%, the remaining market share is distributed amongst over 150 ETS operators and the three incumbent operators. SmarTones believes that PCCW-HKT has an absolute edge over its next strongest contender.

4. Given the close relationship between PCCW-HKT's international arm and its local arm, PCCW-HKT would definitely be in a better position to have first hand information of delivery costs and hence benefits from vertical integration. The existing safeguards are not adequate.

5. The current drop in retail price is not supported by the underlying provisioning cost. It is no more than a marketing strategy of operators edging into the market share of PCCW-HKT. A number of operators may be adopting the "net accounting" policy to lower their cost. However, before competition in the incoming traffic is proved, PCCW-HKT, having the largest fixed line customer base, is still the major recipient of all inpayments from China inbound traffic. If China routes are reclassified as Category A routes, PCCW-HKT will no longer be constrained by the determined gateway price, most ETS operators would be prematurely driven out of the market.

6. Based on the above reasoning, SmarTone believes that operators have to compete on both Category A and Category B routes to sustain their operations. Further, it believes that the China routes, which are currently

priced at different rates, should be considered as separate markets.

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