

**Review of
Gateway Prices and Modified Delivery Fees
for Category B Routes**

Statement of the Telecommunications Authority

29 April 2000

Introduction

The Office of the Telecommunications Authority (OFTA) issued an industry consultation paper on 8 March 2000 (the “Consultation Paper”) inviting comments from the industry and interested parties on issues regarding review of the gateway prices and modified delivery fees (MDFs) determined by the Telecommunications Authority (the “TA”) on 30 December 1998 (the “Determination”) for the interconnection between the local networks and external gateway operated by Cable & Wireless HKT FTNS¹ (“CWHKT FTNS”).

2. The TA seeks views and comments particularly regarding
 - (a) the proposed procedure to determine new gateway prices and MDFs based on the new accounting rates (paragraphs 8 and 9 of the Consultation Paper);
 - (b) the proposed procedure to determine new gateway prices and MDFs based on new exchange rates (paragraphs 10 and 11 of the Consultation Paper); and
 - (c) whether or not the current level of gateway prices and MDFs for Cambodia, Korea DPR, Macau, Myanmar and Vietnam should be revised by reverting to the methodology of TA Statement of 25 November 1998 for the determination of those rates (paragraph 12 of the Consultation Paper).

¹Cable & Wireless HKT FTNS means the group of companies comprising Cable & Wireless HKT International Limited, Cable & Wireless HKT Telephone Limited and Cable & Wireless HKT CAS Limited holding the Fixed Telecommunication Network Services Licence.

Summary of Responses to the Consultation Paper

3. In response to OFTA's Consultation Paper, a total of six submissions were received. Respondents included Cable & Wireless HKT Limited (CWHKT), CTI International Limited (CTI), New T&T Hong Kong Limited (New T&T), Hutchison Global Crossing Limited (HGCL), New World Telephone Limited (NWT) and SmarTone Mobile Communications Limited (SmarTone). A summary of the responses is given in Annex.

Discussion of Submissions

Accounting Rate Adjustments

4. All respondents basically agreed to TA's proposed procedure in the Consultation Paper to determine new MDFs and gateway prices based on the new accounting rates. However, some respondents suggested to making modifications to the TA's proposal.

5. CTI and New T&T suggested that retrospective arrangement for handling the effect of accounting rate reduction should be in place so that the effective date of the reduced gateway price and MDF should coincide with the effective date of the accounting rate reduction. The TA considers that the suggested retrospective arrangement would create immense administrative and billing burdens on the industry.

6. CWHKT proposed that the revised gateway prices and MDFs arising from revisions to accounting rates come into effect from the first of the calendar month following the *later* of the effective date of the new accounting rates or the conclusion of the agreement for the new accounting rates because sometimes commercial negotiation processes mean that accounting rate revisions are not finalized until one or two months after the date from which the revised rates are to be effective.

7. CWHKT's proposal tends to push back the actual effective date of new accounting rates and therefore to a certain extent delays the revision of gateway prices and MDFs. This would be unfair to the other operators.

8. In the Consultation Paper, the TA proposed that the date of adjustment of gateway prices and MDFs should be brought into effect in the next calendar month after the effective date of the new accounting rate. In most cases of accounting rate negotiations for Category B routes, the effective dates of accounting rate adjustments coincide with the dates of conclusion of agreements. In a few cases, the conclusion of an accounting rate agreement may lag behind the effective date of the accounting rate adjustment due to complicated negotiations. The dates of adjustment of gateway prices and MDFs should still be brought into effect in the next calendar month after the effective date of the new accounting rate adjustments. In these few cases, retrospective settlement arrangements should be made between CWHKT FNTS and the operators. The TA considers that the proposed arrangement would minimize the administrative and billing workload required by operators while ensure fairness to both CWHKT FTNS and the operators.

9. The “seven days” mentioned in paragraph 9 of the Consultation Paper means seven calendar days. This is in response to HGCL's request for clarification.

10. As regards CTI's request of publishing the accounting rate to the public, the TA does not wish to take a view on this issue at this point in time without a proper consultation with the industry.

Exchange Rates

11. As regards the exchange rate adjustments, all respondents basically agreed to TA's proposed procedure in the Consultation Paper to determine new MDFs and gateway prices based on new exchange rates. However, some respondents suggested alterations to the TA's proposal.

12. CWHKT suggested that the gateway prices and MDFs be revised on the first of each month using the exchange rates ruling on the 15th of the preceding month – per the Financial Times – or the last working day before the 15th if the 15th falls on a weekend or holiday.

13. Although CWHKT's suggestion to a certain extent reflects the level of exchange rates in the month, as it is rightly pointed out by CWHKT itself, this suggestion does not precisely reflect the exchange rate on the date of a

particular transaction or settlement for CWHKT's gateway services. More importantly, the TA considers that the use of exchange rate in a day for the settlement of gateway prices and MDFs in Hong Kong Dollars for the whole month would bring in unnecessarily high volatility into the gateway prices and MDFs.

14. NWT proposed that only when exchange rate deviates by more than 5% of the rate used in prior determination should trigger a revision in gateway price. The TA considers that the standard deviation of daily exchange rates over a reference period (say, one year) is a better measure of exchange rate volatility than just a certain percentage of the adopted exchange rate which may be rather arbitrary.

15. After taking into consideration the views of the respondents, the TA is of the view that the proposal of handling exchange rate variation made in the Consultation Paper provides a fair, steady and less volatile environment for all participants to operate in the external call market of Category B routes.

16. Regarding CTI's request of publishing settlement currency for each route, the TA considers the request is not unreasonable. However, the TA needs to point out that there are only a few destinations, the accounting rate settlements of which are in currencies other than SDR.

Below-cost Gateway Prices

17. Among the responses to whether or not the current level of gateway prices and MDFs for Cambodia, Korea DPR, Macau, Myanmar and Vietnam should be revised by reverting to the normal mechanism, one advocated for the revision, three opposed any revision and the other two did not provide any specific view.

18. CWHKT who advocated for the revision argued that by retaining the existing gateway prices of the five routes under consideration without reflection the underlying cost leads to market distortions. On the other hand those respondents who argued against the revision put forward the adverse and sudden impact on consumers calling the destination in question as supporting reason.

19. In making any decision on telecommunications issues, the TA is always mindful of two important aspects, namely economic efficiency and consumer benefits and in case there is conflict between the two, he will attempt to hit the right balance to ensure that optimal benefit for the whole community can be achieved.

20. The phenomenon of below-cost gateway prices of the five routes is the legacy of the pre-deregulation era of the external telecommunication services market. The below-cost gateway prices were set by the incumbent in light of having delivery fees as a source of revenue. The operating environment for the five routes, especially in term of lavish inpayments enjoyed by the incumbent before the deregulation did not differ significantly from what it is now.

21. CWHKT argued that the below-cost gateway prices with the associated MDFs have lead to a net cost or loss of HK\$6.4 million from January 1999 to the end of February.

22. The TA would like to point out that CWHKT, in calculating the loss of HK\$6.4 million, has not taken into consideration of the inpayments from the incoming traffic of these five routes, bearing in mind that CWHKT's market share of the incoming calls from the five routes is still 100%.

23. CWHKT was concerned that the below-cost gateway prices would attract transit traffic via Hong Kong, an indication of which is CWHKT's market share of outbound gateway service is near or over 100%.

24. According to statistics compiled by OFTA, there is no sign as such for most of the five routes. It appears that there are indications of alternative means to most of these destinations. If at this stage the TA allows the gateway prices increasing to the level determined by the normal mechanism, then either the end users will face a sudden increase in prices for calling these destinations or CWHKT's competitors will be squeezed out of the market because the incumbent has already offered discounts up to a maximum of 24% for calls making to most of these destinations through its call plans. These discounted rates are very close to cost based on the below-cost gateway prices.

25. After considering all the arguments submitted, the TA does not see any compelling needs to revise the gateway prices and the associated MDFs of the five routes based on the methodology of TA Statement of 25 November 1998 for the determination of those rates

Others

26. SmarTone had the impression that the MDF arrangement is based on the rationale of equal sharing of **revenue** derived from incoming minutes between CWHKT International Limited who operates the gateway and the local terminating operators who are either mobile operators or fixed line operators. Under the Universal Service Contribution (USC) payment arrangement, operators receiving the MDF would have to pay the USC. Hence, SmarTone considered that local terminating operators should not bear the full responsibility for USC and proposed that the MDF should include the USC component.

27. The TA has to point out that in paragraph 53 of the TA Statement entitled “Local Access Charge and Modified Delivery Fee Arrangements” issued on 25 November 1998, it is stated that the **extra profits** (not revenue) would be shared equally between the sole external network operator and the local network operators. Furthermore USC payment to CWHKT Telephone Limited is to compensate for its obligation for providing universal basic services to Hong Kong and it has nothing to do with the modified delivery fee for delivering incoming traffic of Category B routes terminating at the local network.

Conclusions

28. The TA has thoroughly considered all the views, opinions and comments received in response to the Consultation Paper of 8 March 2000 and has reached the following conclusions on three issues.

Accounting Rate Adjustments

29. The TA concludes that his proposal on handling accounting rate adjustments in determining gateway prices and MDFs balances the interests of different sectors of the industry. Hence, the recommended process is that for

any newly agreed accounting rates for Category B routes, CWHKT FTNS should report to OFTA within seven calendar days after the conclusion of the agreement. Gateway prices and MDFs will then be revised in accordance with the formulae given in the TA Statement of 25 November 1998 and brought into effect in the next calendar month after the effective date of the new accounting rates. The revised Schedules to the Determination of 30 December 1998 will be notified to the licensees concerned and published on OFTA's Web site. The accounting rate adjustments of the four routes of Shenzhen, Guangdong, the Rest of China and the Solomon Islands have already been put into effect in April 2000. According to the arrangement, the adjustments of gateway prices and MDFs of the four routes will be effective on 1 May 2000.

30. The arrangement will provide a more responsive mechanism to review gateway prices in response to the change of accounting rate. However, for some routes due to more complicated accounting rate agreements, such as traffic volume sensitive multi-tier agreements under which the accounting rates vary with traffic volume and they may also vary (can be up or down) from month to month in the short term. That means the gateway prices will vary accordingly. This is a fact of life that all participants have to live with and get prepared to face.

Exchange Rates

31. The TA concludes that the proposal of handling exchange rate variation made in the Consultation Paper provides a fair, steady and less volatile environment for all participants to operate in the external call market of Category B routes.

32. The arrangement is that on a monthly basis, TA examines the mean plus and minus one standard deviation of the daily exchange rates (of HK\$:SDR, HK\$:GFc and HK\$:US\$) over the past 12 months. Unless the exchange rate used for the determination falls outside this range, the TA will not consider and commence any process for revision of gateway prices and MDFs on the basis of changes to the exchange rate. When the exchange rate used for the determination falls outside the range, the TA will revise the gateway prices and MDFs based on the mean exchange rate for the past twelve months. The TA will also conduct periodic reviews at yearly intervals to see whether the delivery fee arrangements, including the methodology for determination of the exchange rate to be used, are still appropriate.

33. The exchange rate determination arrangement will be put into effect on 1 May 2000. The revised Schedules to the Determination of 30 December 1998 will be notified to the licensees concerned and published on OFTA's Web site together with the exchange rate used by the TA in the revision.

Below-cost Gateway Prices

34. After considering all the arguments in response to the Consultation Paper and weighting the interests of all the concerned parties, the TA concludes that the gateway prices and the associated MDFs of the five routes of Cambodia, Korea DPR, Macau, Myanmar and Vietnam should not be revised based on the methodology of TA Statement of 25 November 1998 for the time being.

35. The TA will continue to monitor closely the future accounting rate adjustments (most likely in the downward direction in the long term) of these five routes. If the gateway price of any one of the five routes determined by using the methodology of TA Statement of 25 November is found to be less than or very close to the existing gateway price, the gateway price of this route will be revised accordingly.

Office of the Telecommunications Authority

29 April 2000

Cable & Wireless HKT Limited (CWHKT)

CWHKT agreed in principle with the TA's proposals that there is an urgent need to implement mechanisms which enable changes in accounting rates and exchange rates to be reflected in the gateway prices and MDFs for Category B routes on a timely basis. CWHKT, however, suggested amendments to the TA's proposals regarding changes in accounting rates and exchange rates.

2. CWHKT proposed that the revised gateway prices and MDFs arising from revisions to accounting rates should come into effect from the first of the calendar month following the later of the effective date of the new accounting rates or the conclusion of the agreement for the new accounting rates because sometimes commercial negotiation processes mean that accounting rate revisions are not finalized until one or two months after the date from which the revised rates are to be effective.

3. To cater for the change of exchange rates, CWHKT suggested that the gateway prices and MDFs be revised on the first of each month using the exchange rates ruling on the 15th of the preceding month – per the Financial Times – or the last working day before the 15th if the 15th falls on a weekend or holiday. CWHKT opined that although its suggestion will not precisely reflect the exchange rate on the date of a particular transaction for CWHKT's gateway services, it will be a closer approximation than is a rate within one standard deviation of the last twelve months exchange rates as proposed in the consultation paper – which has the effect of weighting the exchange rate used toward the more out of date exchange rates. CWHKT was concerned that the TA's proposal is unnecessarily complicated and confusing. It believed that foreign exchange movements are a common and normal business risk which other operators should be expected to accept and should not be cushioned from this risk through a smoothing mechanism.

4. CWHKT maintained that the gateway prices and MDFs for the five routes of Cambodia, Korea DPR, Macau, Myanmar and Vietnam should be amended to reflect the underlying accounting rates. Not to do so will continue the current market distortions brought about by this regulatory mandated

subsidy from CWHKT to the rest of the industry, and further the refile arbitrage opportunities. CWHKT pointed out that this anomaly costs CWHKT a loss of HK\$6.4 million from January 1999 to the end of February which is the net cost of below-cost gateway price and MDFs associated with non-CWHKT outgoing and incoming traffic through the CWHKT gateway.

CTI International Limited (CTI)

5. CTI accepted the TA's proposed procedure for revising gateway prices and MDFs in relation to accounting rate increase but suggested that retrospective arrangement for handling accounting rate reduction should be in place so that the effective date of the reduced gateway prices and MDFs should coincide with the effective date of the accounting rate reduction.

6. CTI opined that since accounting rate is a key factor in determining the gateway prices and MDFs, all operators should have the right of accessing the accounting rate information and the TA is urged to publish the information.

7. CTI understood that Special Drawing Rights (SDR) is not the only currency used in accounting rate settlement. Gold Francs (GFc) and US Dollars are used in settlements for some destinations. CTI argued that external telecommunication services (ETS) operators should be given the information of which currency is used for settlement of each destination so that they can make arrangement to cater for the fluctuation of the currencies involved. CTI expected that GFc is linked to SDR as Hong Kong Dollar is linked to US Dollar.

8. CTI was concerned about the sudden upsurge of gateway prices to the five routes, particularly the Macau route because of the high traffic volume to the destination if the TA reverts to the normal mechanism in determining the gateway prices of these routes. CTI argued that by retaining these gateway prices would encourage CWHKT FTNS to negotiate with distant carriers for lower accounting rates for the routes in question.

Hutchison Global Crossing Limited (HGCL)

9. HGCL accepted the TA's proposed procedure for incorporating the newly agreed accounting rates for Category B routes into revising the gateway

prices and MDFs but HGCL requested the TA to clarify whether the “seven days” mentioned in paragraph 9 of the Consultation Paper are in the unit of calendar day or working day.

10. HGCL also accepted the proposed calculation approach for the determination of exchange rate.

11. HGCL shared the views that in case the determination of the gateway prices for the five routes are reverted to the normal mechanism, the gateway prices for these routes would be increased drastically. HGCL recommended that before this issue can be resolved, the reduced MDFs of the five routes are allowed to continue to offset the loss incurred in delivering the outgoing traffic to these destinations at below-cost gateway prices.

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

12. New T&T generally supported the procedure proposed by the TA to determine new gateway prices and MDFs based on the new accounting rates. However, New T&T expected that the revised Schedules to the Determination will be notified by the TA to the licensees concerned promptly after the TA receives any new accounting rates from CWHKT FTNS.

13. New T&T suggested that CWHKT FTNS reports to the TA within two days after the conclusion of the relevant agreement in view that CWHKT FTNS would be aware of the changes and the reporting should be a simple exercise which would not involve significant amount of work.

14. New T&T accepted the TA's proposed procedure for incorporating the exchange rates in determining gateway prices and MDFs.

15. New T&T did not have any specific view on whether the TA should revert to the normal mechanism in determining gateway prices and MDFs for the five routes but New T&T had reservation on the current arrangement that the MDFs over these routes for incoming traffic are correspondingly reduced to off set the loss in the outgoing direction.

New World Telephone Limited (NWT)

16. NWT in principle agreed with the TA's proposed arrangement to adjust the gateway price and MDFs based on change in accounting rate provided that sufficient lead-time is given to interconnecting operators.

17. NWT was of the opinion that that range proposed by the TA to judge whether the exchange rate fluctuation is large enough to warrant a revision is too narrow. To reflect the change in exchange rate while minimizing the frequency of such adjustment NWT proposed that only when exchange rate deviates by more than 5% of the rate used in prior determination should trigger a revision in gateway price.

18. NWT saw no compelling need to revise the gateway price and MDFs of the five routes under consideration because the below-cost gateway price is offset by a corresponding reduction in MDFs in the incoming direction. NWT pointed out that if the gateway price and MDFs of the five routes are revised according to the normal mechanism, then retail prices of calls to these destinations would increase sharply and end users of the service would suffer.

19. In case the TA decides to revise the gateway prices and MDFs to reflect the underlying cost, NWT proposed that it should at least be done progressively under a phase approach over a reasonably long period of time (e.g. 1 year) to minimize the impact on operators relying on the CWHKT gateway.

SmarTone Mobile Communications Limited (SmarTone)

20. SmarTone had the impression that the MDF arrangement is based on the rationale of equal sharing of revenue derived from incoming minutes between Cable & Wireless HKT International Limited who operates the gateway and the local terminating operators who are either mobile operators or fixed line operators. Under the Universal Service Contribution (USC) payment arrangement, operators receiving the MDF would have to pay the USC. Hence, SmarTone considered that local terminating operators should not bear the full responsibility for USC and proposed that the MDF should include the USC component.

21. SmarTone supported the proposed procedure on the regular review process for gateway prices and MDFs based on new accounting rates.

22. SmarTone supported annual review of the methodology for determination of the exchange rate to be used in setting the gateway prices and MDFs.

23. SmarTone supported review of the gateway prices and MDFs of the five routes of Cambodia, Korea DPR, Macau, Myanmar and Vietnam.