

# **RECLASSIFICATION OF MAINLAND CHINA ROUTES**

## **Statement of the Telecommunications Authority**

**12 June 2000**

### **Introduction**

On 21 January 2000, Cable & Wireless HKT Limited<sup>1</sup> (CWHKT) submitted a request (the “Application”) to the Telecommunications Authority (TA) for reclassification of the Mainland China routes as Category A routes and declaring CWHKT non-dominant in the retail Mainland China call services market upon reclassification of the three routes. The TA issued a consultation paper on 11 February 2000 (the “first consultation paper”) seeking views from the industry on the Application. Having considered the submissions received in response to the first consultation paper, the TA issued a second consultation paper (the “second consultation paper”) on 12 April 2000 giving his preliminary findings on the issues and seeking further comments from the industry. In response to the second consultation paper, the TA received a total of five submissions. Respondents included CWHKT, CTI International Limited, New T&T Hong Kong Limited, New World Telephone Limited and SmarTone Mobile Communications Limited. A summary of comments from the respondents is given in Annex.

2. Views and comments of the respondents focused on two proposals of the TA set out in the second consultation paper. The first proposal was to lift the gateway price control for the route of Rest of China. The second proposal was to proceed with reclassification of the three Mainland China routes to Category A immediately without further consultation with the industry when there is sufficient evidence showing that return traffic based on the proportionate return principle has been initiated to the new Fixed Telecommunication Network Services (FTNS) operators.

3. Taking into consideration the views and comments in response to the two consultation papers, the TA sets out his final views in this Statement on the Application.

### **Reclassification Tests**

4. In considering the application for route reclassification, the TA

---

<sup>1</sup> The application was submitted by CWHKT on behalf of the group of companies comprising Cable & Wireless HKT Telephone Limited (CWHKTC), Cable & Wireless HKT International Limited (CWHKTI) and Cable & Wireless HKT CAS Limited which jointly hold a Fixed Telecommunication Network Services Licence.

reiterates that he would apply the same tests on the status of competition as stated in paragraph 7 of the Statement entitled “Local Access Charge and Modified Delivery Fee Arrangements” issued on 25 November 1998. The two tests are:

- (a) whether a service provider in Hong Kong may physically establish connection to and from a particular location without transiting the gateway of CWHKT, for example, by International Simple Resale (ISR) operation over leased circuits, or by separate correspondent relationship in bypass of CWHKT’s gateway. In considering whether alternative connections could be made, the TA would consider direct and indirect routing, for example, using refile or transit arrangement and all technologies capable of providing a reasonable substitutable service; and
- (b) whether the costs of utilizing the connections identified in the first test would allow genuine price competition in the supply of external services to and from the locations.

### **Lifting Control on Gateway Prices**

5. Whilst CWHKT argued that there is genuine competition in the wholesale market for calls to Mainland China because of low usage of its gateway services by its competitors, some respondents did not agree to the TA’s proposal of lifting gateway price control for the route of the Rest of China on the ground that by so doing the TA would give CWHKT greater price flexibility and advantage over its competitors.

6. One respondent pointed out that in determining whether gateway price control for a particular route should be lifted, it would only be fair if the provision costs of gateway services by different means are compared on a net cost basis, i.e. including the benefit of receiving inpayment from the accounting rate arrangements.

7. The TA agrees that in applying the tests referred to in paragraph 4, he should consider whether genuine price competition between the gateway services of CWHKT and the other services through alternative connections would be allowed if CWHKT would use the inpayment revenue to offset part of the cost in the outgoing direction. The net cost of the gateway services has in fact been considered by the TA in coming up with the proposal of lifting the gateway price control for the route of Rest of China in the second consultation paper.

8. In view of the fact that there has been a lapse of one and a half months since the issue of the second consultation paper, the TA has re-visited

this issue and has done a net cost comparison again based on the latest accounting rates (including both standard and bulk discount) and refile rates offered by an established refile service provider. The results indicate that for the route of the Rest of China, the former is higher than the latter; but for the route of Guangdong, the net cost of CWHKT's gateway service and the refile cost are more or less the same. This shows that if the price control over the gateway services of CWHKT is lifted, the services through the alternative connections would still be capable of competing with CWHKT even though initially it would only be CWHKT that would be receiving the bulk of the inpayment and would use such revenue to offset partially the cost in the outgoing direction. Thus the TA considers that the gateway price control should be lifted for the routes of Guangdong and the Rest of China.

9. On the other hand, for the route of Shenzhen, the net cost of CWHKT's gateway service is still lower than the refile cost. The TA observed that more than 75% of the outgoing traffic to Shenzhen was still routed through CWHKT's gateway as of March 2000. Although CWHKT argues that some competitors are not sending traffic for Shenzhen through CWHKT's gateway and this shows that alternative connections, as well as genuine price competition through those connections, exist at least in the outgoing direction. However, as the net cost through CWHKT's gateway is lower than the costs of alternative connections, if the price control over CWHKT's gateway services were lifted, CWHKT might be able to price the services at a level that its competitors would not be in a position to match due to absence or uncertainty of return traffic. Thus until such time when the competitors of CWHKT are in a position to receive significant and steady incoming traffic based on the proportionate return principle, the control over the gateway services over the route of Shenzhen should be retained.

### **Reclassification without Further Consultation with the Industry**

10. In the second consultation paper, the TA has proposed that he would proceed with reclassification of the three Mainland China routes to Category A immediately without further consultation with the industry when there is sufficient evidence showing that return traffic based on the proportionate return principle has been initiated to the new FTNS operators.

11. One respondent submitted that interested parties of the industry should have the rights to express their views on the fast changing market situation at the moment just before the TA is going to take a decision. It further suggested that the TA might consider a shorter consultation period. One respondent opposed the proposal but suggested a shorter consultation period similar to that for reclassifying routes on the Category B Observation List.

12. An FTNS operator submitted that the details in the application of the proportionate return principle under the agreements with China Telecom are still subject to changes, therefore the TA should consult the industry to confirm and ensure not only that return traffic to the new FTNS operators has been initiated but also that the details on the implementation of the proportionate return traffic principle have been finalised before the TA considers to reclassify the three Mainland China routes to Category A routes.

13. As the TA pointed out in the second consultation paper, the Mainland China wholesale market has been changing rapidly since the liberalization of external facility-based services on 1 January 2000. It would be unfair to CWHKT if there is undue delay in reclassification of routes so as to allow it to react to the rapidly changing market situation. On the other hand, if no consultation is conducted prior to reclassification, the TA could overlook some relevant factors which he was not aware of and this would make his decision susceptible to legal challenge.

14. Having considered the arguments for and against the step of further consultation before reclassification, the TA decides that he would place the three Mainland China routes on the Observation List under Category B. This would mean that he would apply the “fast track” consultation procedure with the industry when there is sufficient evidence showing significant and steady return traffic based on the proportionate return principle has been initiated to the new FTNS operators.

#### *Other Issues*

15. In CWHKT’s response, the company insisted that the “addressable market” concept should be adopted for defining the wholesale market and stated that the “addressable market” concept was used by regulators of other jurisdictions. CWHKT’s traffic generated by its retail services and delivered through its own external gateway is not part of the “addressable market” because it is not contestable. Its arguments are summarised in the Annex.

16. Though the factor of the market share in wholesale services in the outgoing direction has been considered in this reclassification exercise, the TA would like to point out that this market share was not the determining factor in reaching the interim position in the second consultation paper that the routes should not be reclassified to Category A at this stage. The principal consideration in reaching that position was whether genuine price competition through the alternative gateway services could exist before incoming traffic based on the proportionate return principle is initiated to those alternative gateways.

17. The TA does not consider that CWHKT's retail traffic must necessarily be routed through CWHKT's gateway services if CWHKT has taken rational commercial decisions in routing the traffic. CWHKT would have considered the combined profit of its local network and external gateway operations, and taken into account the loss of profit from the incoming traffic which might be routed through alternative gateways if the outgoing traffic were not routed through its own gateway, and chosen a routing that would maximise the overall profit of CWHKT. This means that CWHKT's cost of routing the outgoing traffic from the retail services would be the net cost taking into account revenue from incoming traffic. The fact that CWHKT has chosen its own gateway to route the outgoing traffic shows that the net cost of the chosen route is lower than sending the traffic through the alternative gateway services of its competitors. This reinforces the TA's observation that the services through the alternative gateways would not be able to offer genuine price competition without net accounting from incoming traffic.

18. The relationship between the wholesale market and the retail market is not necessarily just one way. For instance, if a CWHKT's competitor should reduce its wholesale price significantly, then it could also reduce its retail price markedly. As a result, this competitor would be able to attract CWHKT's retail traffic and, in turn, the wholesale traffic of CWHKT as well. Thus price changes in a competitor's wholesale services could attract traffic from what is outside the "addressable market". This is exactly what has been happening since the deregulation of the facilities market in January 2000. Under such circumstances, it is doubtful whether it is appropriate to treat CWHKT's retail traffic handled by CWHKT's gateway and the so-called "addressable market" as two unrelated and separate segments in defining the wholesale IDD market.

19. The Office of Telecommunications (OFTEL) adopts the "addressable market" concept but this is for the assessment of market power in deciding whether a particular operator is a "Well Established Operator". The accompanying parameter for the threshold for "Well Established Operator" is only 25%. In the competition tests for route reclassification, the market share is to be used as evidence of whether genuine price competition through the alternative connections exists. Thus the concept adopted by OFTEL may not be directly applied to Hong Kong without careful consideration of the background and objectives of the regulatory regimes in the two jurisdictions. In any case, the threshold of 25% accompanying the OFTEL's "addressable market" concept would not be directly applicable to the competition tests in a route reclassification. If the TA had taken 25% as the threshold for reclassification, then the TA would have arrived at the same result as stated in the second consultation paper even if the TA had adopted the "addressable market" concept in the calculation of the market share of CWHKT's gateway.

20. Suppose, for the sake of analysis only, there were a change of ownership of the entity within the CWHKT group operating the local network such that this entity and the entity operating the external gateway services were controlled by different parent companies. Applying the concept of “addressable market” proposed by CWHKT would result in the market share of CWHKT’s gateway services suddenly changing and possibly the classification of the Mainland China routes should change also. This is a strange result as the route classification should be based on the status of competition over the routes only and not on the ownership of particular operators.

## Conclusions

21. The TA has carefully considered all the views, opinions and comments received in response to the two consultation papers. In view of the current strong market position of CWHKT in the wholesale market of the route of Shenzhen in terms of the low net cost it enjoys compared to the higher cost of routing traffic through alternative connections, the TA is not convinced that genuine price competition over alternative connections in the route of Shenzhen has been established when the price control over CWHKT’s gateway services is lifted. For the route of Guangdong and the Rest of China, the TA considers that there is sufficient competition in the outgoing direction, but there is still insufficient competition in the incoming direction. *As such, the TA is of the view that while the three routes should still be classified as Category B routes, the CWHKT’s gateway prices of the Rest of China and Guangdong will not be determined by the TA with immediate effect, but CWHKT is still 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.* Consequently the question of whether the TA should accede to CWHKT’s request that it should be declared non-dominant in the Mainland China retail services market upon the reclassification of the Mainland China routes as Category A routes does not exist.

22. OFTA will continue to collate traffic data and monitor developments of the Mainland China call services market closely, particularly the implementation status of the correspondent agreements. However, the TA notices that the Mainland China wholesale market has been changing rapidly since the liberalization of external facility-based services on 1 January 2000. It would be unfair to CWHKT if there is undue delay in reclassification of routes so as to allow it to react to the rapidly changing market situation. However, the TA would run the risk of overlooking relevant facts if he should proceed with a reclassification without consultation. In view of that, *the TA will put the Mainland China routes on the Observation List under Category B so that he will apply the “fast track” consultation procedure prior to a decision on re-classification when there is sufficient evidence showing that significant*

*and steady return traffic based on the proportionate return principle has been initiated to the new FTNS operators.*

**Office of the Telecommunications Authority**  
12 June 2000

**Summary of Comments in Submissions in Response to the  
“Second Consultation Paper” Issued on 12 April 2000 on  
the Proposed Reclassification of Mainland China Routes  
from Category B to Category A**

*Cable & Wireless HKT*

. CWHKT clarified that it has not claimed that the STM-1 channel is currently being used to deliver traffic to China. The emphasis is on the channel's potential to carry China traffic. It is alleged that it is a fundamental principle of competition law and overseas regulatory precedent that it is not necessary for CWHKT's competitors to absorb all China traffic overnight. It will be sufficient if they have the capacity to do so in the future.

2. CWHKT claimed that the TA's analysis in the second consultation paper has omitted an important comment made by CWHKT, namely that its competitors have 10 E1's currently in use for their China traffic. The 10 E1's, it is alleged, provide sufficient capacity for the majority of its competitors traffic to Shenzhen and Guangdong to bypass the CWHKT gateway and thus are relevant when considering potential capacity constraints.

3. The TA, it is alleged, held similar views as those of CWHKT that the competitiveness of the China routes is more like Category A routes when he ruled on CWHKT's application for non-dominance in the International Call Services Market for Non-China Routes.

4. CWHKT's did not agree with its competitors' claim that the capacity available to them on SMW-3 is not sufficient to carry their China traffic. The fact is, as alleged by CWHKT, the vast majority of its competitors' traffic bypasses the gateway by one means or another. Information is produced to show the usage of CWHKT's gateway by its competitors. The low levels usage by other ETS operators shows that it is not necessary to hold an FTNS licence in order to bypass the CWHKT gateway.

5. CWHKT reiterated that NT&T's offer of IPLC's to Guangdong of up to E1 capacity at 50% of CWHKT's rates is further evidence that the competitors have significant quantities of capacity to Southern China at their disposal.

6. CWHKT challenged SmarTone's claim that 'cheap' rates arrangement for Mainland China routes offered by a number of wholesale service resellers are unofficial. If such is the case, there are questions as to the legality and

propriety of these arrangements. Further, the continued downward trend in refile rates shows that low refile rates are sustainable

7. CWHKT considered the 'total market' approach adopted by TA in defining the relevant wholesale market a wrong one. It insisted that the use of 'addressable market' concept (ie excluding any wholesale traffic which CWHKTI carries in relation to CWHKTC's retail business) is consistent with the principles which most major overseas jurisdictions apply. An analysis of the concepts and practices adopted in various jurisdictions is made.

8. CWHKT argued that a market is defined by reference to the concepts of demand side and supply side substitution. By this approach, it is apparent that CWHKTC's traffic is not part of the relevant market because it is not contestable. That is, there is no demand side substitution for the associated wholesale traffic because CWHKTC will always use CWHKTI for its wholesale carriage and, therefore, CWHKTC's traffic is not in the same market as that of its competitors' wholesale traffic (ie the addressable market).

9. CWHKT contended that any of TA's analysis which relies upon total market share data is invalid. If the addressable market definition is adopted, CWHKT's current wholesale market shares are less than 50% [actual figure supplied to TA] for Shenzhen, less than 25% [actual figure supplied to TA] for Guangdong, less than 20% [actual figure supplied to TA] for Rest of China, and less than 30% [actual figure supplied to TA] for China as a whole. This, it is claimed, is not a 'high' market share. Further it does not indicate any capacity constraints on its competitors, nor any lack of price competition.

10. CWHKT claimed that TA has given consideration to criteria which are inconsistent with the tests for reclassification set out in paragraph 7 of TA's statement dated 25 November 1998 on Local Access Charge and Modified Delivery Fee Arrangements. CWHKT alleges that the tests only provide for both actual and potential alternatives to the CWHKT gateway. They do not include the following criteria (which TA has taken into account): requirement that specific market share levels and particular level of price differentiation between CWHKT's gateway price and available refile rates have to be reached before reclassification can be achieved.

11. In view of the arguments, CWHKT maintained that the tests have been met and it should be allowed pricing flexibility on all the routes (Shenzhen, Guangdong and Rest of China) in the outgoing direction.

12. CWHKT claimed that TA has placed too much significance upon the inability of its competitors to receive inpayments (until 1 July 2000 according to their respective agreements with China Telecom on return traffic) in his assessment of the competitiveness of the wholesale market. Operators who

use refile services are already enjoying rates as good as, if not better than, the rates they could achieve through net accounting. Therefore, it argued that the overall wholesale market is competitive, and all three China routes should be reclassified as Category A. CWHKT should also be declared non-dominant in the China retail market upon reclassification.

13. Nonetheless and without prejudice, CWHKT supports TA's proposal to proceed with reclassification of the China routes immediately without further consultation once there is evidence of return traffic to the new FTNS operators. In order to avoid delay in reclassification, CWHKT proposed that there be more frequent monitoring and reporting of traffic for the first one or two months following return traffic initiation, e.g. by weekly provisional reporting with final monthly reports submitted according to the existing schedules, so that prompt action can be taken once return traffic is in evidence.

*CTI International Limited (CTI)*

14. CTI supported the TA's view of retaining the three China routes in Category B. However, it urged the TA not to lift gateway price control for the route of the Rest of China until both incoming and outgoing call markets of the route are competitive. It also opposed the TA's suggestion of classifying the China routes as Category A routes without further consultation once there is evidence of return traffic to the new FTNS operators because interested parties of the industry should have the rights to express their views on the fast changing market situation at the moment just before the TA is going to take a decision. CTI suggested that the TA can consider a short consultation.

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

15. New T&T agreed with the TA's conclusion that the definition of market share should include the traffic delivered by CWHKTI on behalf of CWHKTC. New T&T also supported the TA's conclusion that: (i) to reclassify the China routes now would put the other operators in a disadvantageous position and so doing would violate the principle of ensuring a level playing field for operators in the market; (ii) CWHKTI is still required to pay modified delivery fees determined by the TA to the local network operators for the delivery of incoming traffic originating from other parts of Mainland China; and (iii) OFTA will continue to collate traffic data and monitor developments of the Mainland China call services market closely, particularly the implementation status of the correspondent agreements.

16. However, New T&T had concerns that the TA would proceed to reclassify the three Mainland China routes to Category A immediately without further consultation with the industry when there is sufficient evidence showing

that return traffic based on the proportionate return principle has been initiated to return traffic to the new FTNS operators.

17. New T&T maintained that even if there is a correspondent agreement signed between China Telecom and the new operators, the proportionate return traffic principle may still be subject to changes at the China Telecom's discretion from time to time. Therefore New T&T submitted that the TA should consult the industry to confirm and ensure that China Telecom has not only initiated to return traffic to the new FTNS operators but has also indicated its willingness and readiness to follow such proportionate return traffic principle without any change in the future before the TA considers to reclassify the three Mainland China routes to Category A routes. Otherwise the new FTNS operators will be put into a disadvantageous position if shortly after the TA's reclassification, China Telecom changes its position and decides not to return traffic to the new FTNS operators according to the agreed proportionate return traffic principle.

*New World Telephone Limited (NWT)*

18. NWT supported the TA's view that there is insufficient competition in the wholesale market for Shenzhen and Guangdong as well as the incoming market for the rest of China. However, it did not agree with the TA's view that the wholesale outgoing market for the Rest of China is genuinely competitive. NWT argued that CWHKTI's wholesale outgoing market share of almost 50% to the Rest of China indicates significant market power. NWT maintained only if the refile cost is significantly lower than CWHKTI's net costs then the alternative be regarded as genuinely competitive. NWT therefore considered it premature to relieve CWHKT of the pricing restriction applicable to the wholesale outgoing market to Mainland China on CWHKTI.

*SmarTone Mobile Communications Limited (SmarTone)*

19. SmarTone supported the TA's approach on the definition of market share. The market should include the traffic delivered by CWHKTI on behalf of CWHKTC.

20. SmarTone questioned the accuracy of CWHKT's submission regarding the existence of alternative arrangement and it took the view that such data is based on CWHKT's belief without concrete evidence. Even if there are alternative gateways, the gateway prices are still controlled by 4 FTNS operators. Hence, any possible reduction in gateway prices is still limited and would not necessarily be passed onto end users.

21. SmarTone stated that ISR operations over leased circuits connecting China and ETS operators is prohibited and indirect routing such as refile does

not provide the same level of service quality as that provided by CWHKT gateway. SmarTone opined that giving CWHKT the flexibility in wholesale pricing of outgoing traffic to the Rest of China would inevitably give them the same flexibility in retail price. SmarTone further suggested that because of CWHKT's strong market position of Mainland China bound traffic, it would be able to bargain and obtain not only lower accounting rates but also lower refile rates through its connections to almost every major refiler. SmarTone took the view that there is still no alternative connection of a significant scale of traffic at this stage for the China routes in both outgoing and incoming directions.

22. As regards reclassifying the China routes without further consultation, SmarTone opposed the proposal but suggested a shorter consultation period to be the same as that for reclassifying routes on Category B Observation List.

\*\*\*\*\*