APPLICATION FOR RECLASSIFICATION OF CATEGORY B OBSERVATION LIST ROUTES AS CATEGORY A ROUTES BY REACH NETWORKS HONG KONG LIMITED

Statement of the Telecommunications Authority

24 July 2001

Background

On 27 March 2001, Reach Networks Hong Kong Limited (Reach Networks)[1] submitted an application (Application) to the Telecommunications Authority (TA) for reclassification of the following Category B Observation List routes (Routes) as Category A routes:

- India
- Indonesia
- Malaysia
- Pakistan
- South Africa
- Sri Lanka
- Thailand
- Vietnam

On 2 May 2001, the TA issued a consultation paper (Consultation Paper) seeking views from the industry on the Application. The consultation ended on 23 May 2001. The TA received a total of two submissions. The respondents are New T&T Hong Kong Limited (New T&T) and Reach Networks. A summary of the comments from the respondents (with confidential information excised) is given in the Annex.

2. 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

[1] Reach Networks Hong Kong Limited (Reach Networks) was formerly known as PCCW-HKT International Limited and, before that, as (1) Cable & Wireless HKT International Limited and (2) Hong Kong Telecom International Limited. Reach Networks holds a licence for the provision of external facilities-based fixed telecommunications network services.

the Application.

Route Reclassification

3. 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 [Reach Networks], for example, by international simple resale (ISR) operation over leased circuits, or by separate correspondent relationship in bypass of [Reach Networks’] gateway. In considering whether alternative connections could be made the TA would consider direct and indirect routings (eg 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.

Current Status of the Routes

4. In the TA Statement “Reclassification of Category B Routes on the Observation List” issued on 4 August 1999 (August 1999 Statement), the TA lifted the gateway price control on the Routes (except the Vietnam route) on the basis that genuine price competition could be established in the outgoing direction. The Routes should however stay on the Category B Observation List as competition in the incoming direction had not yet been established. Delivery fees should continue to be payable. For the Vietnam route, the TA was not satisfied that genuine price competition in either the outgoing or

incoming direction had been established. The Vietnam route has therefore remained on the Category B Observation List and subject to both gateway price control and payment of delivery fee determined by the TA.

Competition in the Outgoing Direction of the Vietnam Route

5. When the status of competition of the Vietnam route was reviewed in August 1999, the TA found that almost all the outgoing traffic from Hong Kong to Vietnam transited through the gateway of Reach Networks (then Cable & Wireless HKT International Limited). Hence, he was not satisfied that there was sufficient evidence of alternative physical connections and genuine price competition in the outgoing direction.

6. The TA is aware that the situation has since changed. According to the data available to the TA, the average traffic that transited through Reach Networks' gateway between May 2000 to April 2001 was less than 85%. The TA is of the view that this is clear indication that alternative physical connections must have been established by Reach Networks' competitors.

7. To satisfy the route reclassification test, not only must there be alternative physical connections established to Vietnam, but the costs of utilising the alternative connections would allow genuine price competition in the supply of external services. In this connection, the TA has performed a cost comparison between the cost of using Reach Networks' gateway and that of other alternatives for the outgoing traffic to Vietnam. The alternative cost is calculated on the basis of the market rates offered by an established service provider over the Vietnam route, plus the circuit cost. The result indicates that the cost of using Reach Networks' gateway service is much higher than the cost of the alternative route. This means that operators will be able to make use of alternative connections to compete effectively with Reach Networks even if the gateway price control is lifted. The TA is satisfied that the costs of utilising the alternative connections would allow genuine price competition in the supply of external services to Vietnam and would agree to lift the gateway price control.

Competition in the Incoming Direction of the Routes

Indonesia and Malaysia

8. Based on the data available to the TA, with the exception of the Indonesia and Malaysia routes, Reach Networks still receives virtually all the incoming traffic from the Routes. For the Indonesia and Malaysia routes, the TA notices that, since mid-2000, there has been steady incoming traffic bypassing the Reach Networks' gateway. Although Reach Networks still has an overwhelming majority of the market share of the incoming traffic, there is clear indication that alternative connections have been established in the incoming direction.

9. The traffic bypass for these two routes coincides with the fact that Indonesia and Malaysia are the only two markets (among the Routes) that have more than one international carrier in business. Indonesia has two official international carriers, whilst Malaysia has five. The liberalisation and competition in the external telecommunications markets in Indonesia and Malaysia would no doubt make it easier for overseas carriers to enter into corresponding agreements for these two markets.

10. Indeed, for the Indonesia and Malaysia routes, there has been a downward trend for the level of the inpayment rates received by Reach Networks. This is clearly evidenced by the reduction of the delivery fees payable by Reach Networks. According to the November 1998 Statement, the delivery fees applicable to the incoming traffic over the Category B routes are calculated as follows[2]:

> 50% x (settlement inpayment – the costs of external switching and transmission – the costs of domestic connection (ie the local access charge set by the TA for the Category A routes) + local access charge

This means that the delivery fees depend on the level of settlement inpayment. In the same TA Statement[3], it is also said that "[w]hen the settlement inpayment is equal to the sum of the costs of external switching and transmission and the costs of domestic connection, the delivery fee is simply the local access charge". As at 4 August 1999, the delivery fees payable for the Indonesia and

[2] Paragraph 54 of the statement.
[3] Paragraph 54

Malaysia routes were set respectively at HK$1.55 and HK$1.11[4]. As at 19 July 2001, the delivery fees have been reduced respectively to HK$0.16 and HK$0.18[5], which are among the lowest of the Routes, and very close to the current level of the local access charge (LAC) of HK$0.126[6].

11. As explained in paragraph 22 of the August 1999 Statement, when there is no genuine price competition in the delivery of incoming traffic to Hong Kong, the inpayment under the international accounting rate system is likely to be at the above-cost level. It is therefore fair for this supra-normal profit to be shared with the local network operators who deliver the incoming calls from Reach Networks' gateway to the called parties. Once there is genuine price competition in the incoming direction, competitive pressure would force Reach Networks to negotiate lower accounting rates in order to compete with the alternative connections. Thus in due course, the supra-normal profit in the incoming direction is expected to be eliminated through competition.

12. The current situation for the incoming traffic from the Indonesia and Malaysia routes reflects exactly the prediction of paragraph 22 of the August 1999 Statement. The delivery fees payable for these two routes have been spiralling down to almost the level of the local access charge, an indication that there has been genuine price competition in the incoming direction. Moreover, the profit available to be shared with the local network operators can hardly be termed as "supra-normal"[7]. The amount is in fact rather insignificant to accord any meaningful "net accounting" advantage to Reach Networks.

13. For the analysis given above, the TA will re-classify the Indonesia and Malaysia routes as Category A routes.

India, Pakistan, South Africa, Sri Lanka, Thailand and Vietnam

14. For the rest of the Routes, virtually all the incoming traffic still passes

---

[4] TA Statement entitled "Implementation of Local Access Charge and Modified Delivery Fee Arrangements", issued on 4 August 1999.

[5] TA Statement entitled "Updated Gateway Prices and Modified Delivery Fees for Category B Routes", issued on 19 July 2001.

[6] TA Statement entitled "Review of Local Access Charges", issued on 28 June 2001.

[7] For the Indonesia route, the net profit after deducting the local access charge would be HK$(0.16-0.126) x 2 = HK$0.068. For the Malaysia route, the net profit would be HK$(0.18-0.126) x 2 = HK$0.108.

through Reach Networks. Further, different from the Indonesia and Malaysia routes, the distant ends of these remaining routes are still controlled by monopoly. Despite Reach Networks' claim that its competitors must have either ownership or indefeasible rights of use (IRUs) in cables directly connecting these routes, or substantial owned or leased capacity in cables to a regional hubbing centre from which the traffic is refiled, the TA cannot discern or deduce from any available sources that these alternative connections do exist and the gateway of Reach Networks is bypassed.

15. Although there has also been a downward trend for the level of the inpayment rates received by Reach Networks for these routes, with the exception of the Thailand route, the rates are still considerably above the cost level, as reflected from the delivery fees currently payable on these routes[8]. For the Thailand route, the delivery fee was recently reduced to HK$0.13 per minute[9] as a result of the revision of the accounting rates. This is a gross reduction from the delivery fee of HK$1.24 as at 4 August 1999[10]. The TA is however aware that price competition had no direct bearing on the revision of the accounting rates and as such, the circumstances referred to in paragraph 22 of the August 1999 Statement are not applicable for the case of Thailand route.

16. The TA considers that none of the considerations mentioned above help advance the argument that either test (a) or test (b) of the reclassification test has been met with regard to the traffic in the incoming direction to Hong Kong. The TA is not prepared to reclassify these routes as Category A routes.

Conclusion

17. For traffic in the outgoing direction to the Vietnam route, the TA considers that the reclassification test has been satisfied. The gateway price control is to be lifted. For traffic in the incoming direction, the TA considers that the reclassification test has been satisfied in respect of the Indonesia and Malaysia routes. These two routes are to be reclassified as Category A routes. For the India, Pakistan, South Africa, Sri Lanka, Thailand and Vietnam routes, the TA is not satisfied that alternative connections have been established in

---

[8] See TA Statement entitled "Updated Gateway Prices and Modified Delivery Fees for Category B Routes", issued on 19 July 2001 for the current delivery fees set for these routes.

[9] TA Statement entitled "Updated Gateway Prices and Modified Delivery Fees for Category B Routes", issued on 19 July 2001

[10] TA Statement entitled "Implementation of Local Access Charge and Modified Delivery Fee

respect of traffic in the incoming direction. These routes shall remain as Category B routes on the observation list. Reach Networks shall continue to pay delivery fees to the local network operators for delivery of the incoming calls.

Office of the Telecommunications Authority
24 July 2001

Arrangements", issued on 4 August 1999.

ANNEX

Summary of Comments in response to the Consultation Paper on the Application for Reclassification of Category B Observation List Routes as Category A Routes by Reach Networks Hong Kong Limited

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

Outgoing Traffic

New T&T submitted that a lower refile cost than that offered by Reach Networks does not necessarily mean that operators would transit via these refilers from Reach Networks' gateway. Operators offering IDD retail services compete with each other on a number of elements, primarily, pricing, quality of calls, consumer's accessibility to the services. Operators' traffic may therefore still transit Reach Networks' gateway despite an assumption that there may be other alternatives.

2. With respect to the Vietnam route, New T&T submitted that it does not have any agreements with any refiler and/or other carriers for the outgoing Vietnam route and that Reach Networks gateway price is still one of the lowest.

Incoming Traffic

3. New T&T submitted that there are no other direct or indirect routings to Reach Networks' network for the incoming traffic for the routes. Therefore, it does not accept that the incoming traffic over these routes is competitive.

Other Issues

4. New T&T submitted that the crucial test in deciding whether to reclassify the routes to Category A is whether payment of delivery fee should be stopped even though Reach Networks is still enjoying super-normal profit from the above cost payment. The following is a net cost comparison

between modified delivery fees and the local access charges for showing whether there is any excess margin in the inpayment for profit sharing or "net accounting":

Routes	Modified Delivery Fees[11] per minute (HK$)	Local Access Charges per minute (HK$)	Net Proft / (Loss) to Reach Networks (HK$)	Profit Margin
India	1.98	0.158	1.822	1153%
Indonesia	0.17	0.158	0.012	7%
Malaysia	0.20	0.158	0.042	26%
Pakistan	1.72	0.158	1.562	988%
South Africa	0.58	0.158	0.422	267%
Sri Lanka	1.21	0.158	1.052	665%
Thailand	0.81	0.158	0.652	412%
Vietnam	2.48	0.158	2.322	1496%

It is clear that Reach Networks continues to enjoy an excess profit up to a margin of 1500% for the incoming traffic as being the dominant operator. It is inequitable for Reach Networks to take up its profit given that this is by virtue of its dominant position.

5. New T&T requested the TA to reject the Application.

[11] The TA Statement on the "Updated Gateway Prices and Modified Delivery Fees for Category B Routes" issued on 19 April 2001.

2. Reach Networks Hong Kong Limited (Reach Networks)

Distant Market End Status

Attached to the end of this summary is a list provided by Reach Networks showing the distant end market status for the Routes. Reach Networks submitted that from the information supplied, it is clear that Malaysia has a highly competitive international telecommunications, followed by Indonesia. The Malaysian and Indonesian international markets offer choice of distant end administrations and opportunities for Hong Kong operators to enter into a variety of alternative agreements.

2. For the remaining six routes, while it seems that these "closed" market situations offer little choice, there is, common to all six routes, a thriving and growing voice over Internet Protocol (VoIP) and very small aperture terminal (VSAT) international communications link and traffic business. In India, Internet service provider (ISP) operators are actually allowed to build their own cable stations – which they often do in parallel with agreements with major global carriers.

Alternative Physical Connections

3. With regard to Vietnam, Reach Networks maintained that there are sustainable alternative physical connections. The most recent information available shows that at least 60% of external traffic on the Vietnam route, excluding PCCW-HKT Telephone Limited (HKTC) traffic, did not transit Reach Networks external gateway, and at least 40% if HKTC traffic is included[12].

4. Reach Networks also submitted that the scope of alternatives has widened and cost of these alternatives fallen. In 1999, the majority of connectivity on the Routes was acquired by direct international private leased circuit (IPLC) connections or direct IPLC connections plus refile or hubbing. Today, none of the non-HKTC fixed telecommunications network services

[12] Source – "PCCW-HKT Limited Application on behalf of PCCW-HKT Telephone Limited for a Declaration of Non-Dominance in the Retail Markets for External Call Services over Category B Observation List routes", dated 23 February 2001. Available on OFTA website: www.ofta.gov.hk.

(FTNS), external FTNS, or major external telecommunications services (ETS) licensees have direct IPLCs on any of the Routes, but between 60% to 90% of their external traffic on the Routes bypasses the Reach Networks external gateway[13]. Reach Networks believes these operators have owned capacity in cables to Indonesia, Malaysia, and Thailand and entered into correspondent agreements on terms even better than Reach Networks.

5. For the remaining five routes, they will use their substantial owned, IRU or leased capacity in cables to regional hubbing centres, eg Singapore, and refile from there. It is virtually impossible to identify the origin of refile traffic as it will be reported simply as traffic from the refile hub, thus competition for incoming traffic will not be discernable from these traffic flows.

Costs of Alternatives Support Genuine Price Competition

6. Reach Networks compared its net gateway costs (ie net of inpayments) against the cost of similar connectivity using MJ Scheele refile rates. The result is that for Indonesia, Malaysia, Thailand and Vietnam, the cost of using refile is lower than Reach Networks net gateway costs. Reach Networks believed that other refilers may even offer lower rates than MJ Scheele or Reach Networks competitors may use an altogether different connectivity alternative, eg capacity swaps. So for the other four routes, there may still be lower costs alternatives.

7. Further, Reach Networks argued that the discontinuance of IPLC leasing by FTNS and external FTNS licensees confirms that direct ownership or IRUs in international cable networks offer lower prices than IPLCs plus refile. As for those who have interests in cables to major regional hubs (from where they can refile to their final destinations), they probably incur lower costs than Reach Networks, who does not have direct cable connections to all of the Routes and has to transit traffic via other locations, and the refile rates are often lower and more flexible than transit rates.

8. With regard to the sharing of the incoming supra-normal profits with the local network operators, competitive pressure has driven down both outpayments and inpayments to a point where there is little or no supra-normal

[13] Source – see footnote 9.

profit to be shared. In the case of Indonesia the net inpayment, after switch and transmission costs, LAC and universal service contribution (USC), is a loss of [actual figure provided to the TA] per minute. In the case of Malaysia, it is a profit of just a small amount [actual figure provided to the TA].

9. Reach Networks submitted that the ultimate test of whether the cost of using these alternatives is able to allow genuine price competition is the level of price competition in the retail markets supported by these wholesale markets. The fact that some of HKTC's competitors have equal or higher retail market shares than HKTC for the Routes[14] indicate highly competitive retail markets for the Routes. This directly reflects the competitiveness of the underlying wholesale markets.

Category B Observation List Routes
Status of Distant End Markets
(provided by Reach Networks)

India

IDD is still a monopoly under VNSL, although termination of this monopoly has been brought forward to April 2002 from 2004. Most liberalisation has focused on the ISP and domestic long-distance markets. But, apart from using VSAT, ISPs are now allowed to set up their own cable stations anywhere in India – often in collaboration with global undersea bandwidth carriers.

Indonesia

There is a choice of official international carriers; Indosat and Satelindo. The ISP market has been liberalised, and VoIP is widely available through the ISPs.

Malaysia

There are five official international carriers; Telecom Malaysia, Celcom, Time, Maxis, and Digicom – offering a range of operators with whom to enter into

[14] Source – see footnote 9

correspondent or other agreements. Additionally, applications service provider (ASP) licences have been issued and allow the provision of international voice services using VoIP.

Pakistan

IDD is still a monopoly under Pakistan Telecom.

South Africa

Only one official international carrier.

Sri Lanka

Only one official international carrier. However, VSAT is allowed.

Thailand

Only one official international carrier (CAT), although it is thought that the Thai authorities are seeking to accelerate market liberalisation. Reach Networks understands that [name provided to the TA] may have established direct connections with CAT in September / October 2000. Since then, there has been a small decline in the reported traffic incoming from CAT to Reach Networks.

Vietnam

IDD is still a monopoly under VNPT.