

**APPLICATION FOR RECLASSIFICATION OF
ALL THE CATEGORY B OBSERVATION LIST ROUTES
AS CATEGORY A**

Statement of the Telecommunications Authority

25 August, 2003

Introduction

1. The Telecommunications Authority (TA) has received an application by Reach Ltd. (REACH) on behalf of Reach Networks Hong Kong Limited (Reach Networks) for reclassification of all the 44 external voice traffic routes on the Category B Observation List (the Routes) as Category A routes (the Application). On 15 July 2003, the TA issued a consultation paper (the Consultation Paper) seeking views from the industry on the Application. He asked the following questions in particular:

Question 1: whether the Modified Delivery Fees (MDF) regime remains necessary, appropriate and efficient in maintaining a level playing field for the external call services market. Industry comments should be supplemented with any quantified impact on competition as well as the administration cost incurred.

Question 2: specific comments on those routes highlighted by REACH in the Application for abrupt traffic changes, accounting rate declines and misreported refile traffic.

Question 3: any other issues relevant to the competitive status over any of the Routes that may not be directly reflected in the traffic or pricing figures.

2. The consultation period ended on 5 August 2003. The TA received 3 submissions from the following parties (in alphabetical order):

- (a) Hutchison Global Communications Limited (“HGC”)
- (b) Reach Ltd. (“REACH”)
- (c) Wharf T&T Limited (“WT&T”)

3. A summary of the comments from the respondents (with confidential information excised) together with the TA's responses are shown in the **Annex**. Taking into account the views and comments in response to the Consultation Paper, the TA sets out his views and decisions in this statement on the Application.

Background

4. On 1 January 1999, following the liberalization of the external telecommunications services market, external traffic routes were divided into Category A and Category B routes¹. Category A routes are those with genuine competition at the wholesale external gateway level and Category B are those reliant on a single external gateway then operated by PCCW-HKT (now by Reach Networks). Interconnection between external services operators and local network operators are settled in Local Access Charge (LAC) for Category A routes. For Category B routes, the prices of Reach Networks' gateway services in the outgoing direction are determined by the TA while the terminating local network operators receive a Modified Delivery Fee (MDF) for incoming traffic. Within Category B, some routes are classified as 'Category B Routes on the Observation List', representing competitive routes in the outgoing direction only.

5. Since the beginning of 1999, the TA has processed a number of applications from REACH (formerly PCCW-HKT) for the reclassification of various routes to Category A. Prior to the Application, there were 44 routes remaining on the Category B Observation List (the Routes) and no more 'normal' Category B routes². In other words, the TA has lifted the gateway price control over Reach Networks for all routes in the outgoing direction but maintained the MDF arrangements on incoming traffic for the Routes. See **Appendix** for a list of the Routes.

Route classification tests

6. The criteria for the classification of external traffic routes are stated in paragraph 7 of the 1998 LAC Statement:

¹ TA Statement *Local Access Charge and Modified Delivery Fee Arrangements* dated 25 November 1998 (the 1998 LAC Statement).

² TA Statement *Application for Reclassification of All the Category B and Category B Observation List Routes as Category A* dated 30 December 2003 (the 2002 Reclassification Statement).

- (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 (e.g. using refile or transit arrangements) and all technologies capable of providing a reasonably 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 that location.

7. The TA also maintains that “[i]n assessing whether effective competition can take place on the routes, consideration will be given to whether effective competition has taken place or can potentially take place. Based on the consideration of potentially effective competition, Category A would include those routes for which operators other than the incumbent choose not to establish physical connections, even though it is possible for such connections to be established.” (paragraph 8, 1998 LAC Statement).

Test (a) – alternative connection

8. In various applications made by REACH previously, the TA had relied on the monthly submissions of traffic statistics by external call service providers to calculate the market share of Reach Networks and used that as the basis in performing Test (a). On the same basis, Reach Networks’ market share for incoming traffic during the first six months of 2003 (the Period) was consistently 100% (or very close to) over each of the Routes, except for Jordan, Paraguay and Tonga where no industry traffic were reported.

9. REACH maintains in its submission that its market share in the Routes was overstated because competitive traffic via refile was often mis-reported as traffic from ‘hubbing’ locations rather than that from the true origins. The TA has already concurred with this view in the 2002 Reclassification Statement, and he therefore relied on Test (b) as an indirect indication of whether the availability of alternative

connection under Test (a) has been satisfied³.

Test (b) – genuine price competition

10. In the 2002 Reclassification Statement, the TA stated that the convergence between MDF and LAC should be the main criterion for the Routes to satisfy the reclassification tests in the incoming direction:

“When there is genuine price competition in the delivery of incoming traffic to Hong Kong, competitive pressure would force Reach Networks to negotiate for lower accounting rates in order to compete with the alternative connections. The level of accounting rates in relation to cost is best reflected by the difference between MDF and [LAC]... When the settlement inpayment is equal to the sum of the costs of external switching and transmission and the cost of domestic connection, the MDF is simply the LAC.” (Paragraph 27)

11. Although there were 19 routes where accounting rates have declined since the beginning of 2003, only Brunei and South Africa have shown the adequate convergence between MDF and LAC.

12. REACH submits that while accounting rate reductions are strong indications of competitive pressure, the absence of accounting rate reductions is not necessarily an evidence that genuine price competition does not exist. The inertia on accounting rates often comes from the distant end which is beyond the control of Reach Networks. Given that Hong Kong is a net payer of international settlement for most of the Routes, it is in the interest of foreign administrations to maintain high levels of accounting rates to maximize foreign exchange inflow. The TA agrees that accounting rate movements are often subject to other factors beyond market forces, although the argument itself is not an evidence for any actual or potential competition either.

13. While most of the Routes still do not, on the surface, satisfy Tests (a) and (b) during the Period, the TA is well aware of the limitations in the proxies used for these tests. As such, the TA will pragmatically consider the comments in relation to the overall significance of the LAC regime raised by Reach Networks in the Application.

³ Paragraph 25 of the 2002 Reclassification Statement.

The significance of the MDF regime

14. In the 2002 Reclassification Statement, the TA stated that *“by lifting the gateway price control in the outgoing direction..., the only significance for retaining Category B regulation is the sharing of any supernormal profits from settlement inpayment between external gateway and local network operators under the MDF regime”* (Paragraph 26). In essence, the MDF mechanism was designed to enable fair sharing, between Reach Networks and the local network operator, of the supernormal profits from the inpayment for terminating incoming calls. The MDF mechanism is also a competitive safeguard in the outgoing direction because Reach Networks’ ability to use the supernormal profits from incoming calls to finance discounts on outgoing calls, i.e., ‘net accounting’, is reduced as a result of the profit sharing.

15. The result of Test (b) above suggests that Reach Networks is still having some room for ‘net accounting’ over most of the Routes. In the 2002 Reclassification Statement, however, the TA had already lifted the gateway price control on Reach Networks in the outgoing direction, based on a route-specific analysis (including the Routes) that the costs of refile were cheaper than Reach Networks’ cost-based gateway price, even after adjusting for any ‘net accounting’ possibilities⁴. He further analyzed that, while Reach Networks may as well ‘net account’ across different routes, the maximum benefits are insufficient to offset its gateway price premium over refile rates in general⁵. As such, the TA is satisfied that Reach Networks’ ability to ‘net account’ over the Routes would not cause significant detriment to competition in the absence of the MDF regime, no matter on a collective or route-specific basis.

16. REACH has also submitted on confidential basis the amount of MDF paid to different operators in June 2003. The TA is satisfied that the sum was negligible in the context of revenues from external call services for Reach Networks as well as other industry players. In addition, the total consideration could barely cover the administration costs incurred between REACH and OFTA in relation to the various regulations under the MDF regime, including but not limited to the monthly monitoring and publishing of MDF rates following accounting rate changes and the procedures in route reclassification applications. Although the TA does not consider administration cost to be the most important factor in assessing the Application, he is conscious of the principle that regulation should be maintained only if the benefits to the community outweigh the regulatory cost.

⁴ Paragraph 18 of the 2002 Reclassification Statement.

⁵ Paragraph 21 of the 2002 Reclassification Statement.

Conclusion

17. For the Application, considering that:

- on the surface, most of the Routes still do not satisfy the route classification tests on the alternative connection and genuine price competition in the incoming direction;
- the result of Test (a) for alternative connection based on the statistics reported by external operators is affected by those refile traffic that are misreported in origin;
- the result of Test (b) for genuine price competition based on the difference between MDF and LAC is also affected by the accounting rate inertia from less developed countries and regions that are often beyond market forces;
- refile cost analysis suggests that the extent of Reach Networks' ability to 'net account' would not cause significant detriment to competition in the external call services market, no matter on a route-specific or collective basis;
- the total consideration of MDF payments can barely cover the administrative costs incurred by the industry from the related regulations,

the TA is satisfied that Category B regulation and the MDF regime is unnecessary at the present stage of the external call services market. As such, all the 44 Routes on the Category B Observation List are now reclassified as Category A routes. However, it is still necessary to retain the route categorization criteria to provide for any situation of competitive concern in the future, albeit unlikely. The TA will continue to monitor the external call services market and cannot rule out a revisit of the classification of routes as and when necessary.

Office of the Telecommunications Authority

25 August, 2003

SUMMARY OF SUBMISSIONS RECEIVED AND RESPONSES BY THE TA

1. Hutchison Global Communications Limited – does not support the Application

	Comments	TA’s response
i.	Refile may account for the incoming traffic decline of Reach Networks over certain routes, but other FTNS operators in Hong Kong still cannot establish physical connections.	‘Alternative connection’ refers not only to direct physical links, but also refile. With refile, FTNS operators can compete with Reach Networks’ gateway for refiled traffic from hubbing locations even though direct physical connections cannot be established.
ii.	Other countries can easily refile their traffic to Hong Kong to save costs, while maintaining high termination rates of their own to maximize inpayments. They have no incentive to negotiate bilateral relationship with other FTNS operators in Hong Kong.	Noted, but Reach Networks is also a victim rather than a beneficiary of the imbalance of settlement payment provoked by refile. Reach Networks may ameliorate this imbalance by using refile in the outgoing direction. FTNS operators can compete in terminating the refiled traffic from hubbing locations.
iii.	Reach Networks, via its established bilateral relationship with overseas administrations, has the first right to obtain return traffic from these countries to subsidize its outgoing traffic.	In comment ii above, HGC stated that overseas administrations tend to refile their outgoing traffic to Hong Kong to bypass the accounting rate system. The significance of the “first right to obtain return traffic” should be considered accordingly.

2. Reach Limited – supports the Application

	Comments	TA's response
i.	<p>The Routes account for a negligible proportion of incoming external traffic.</p> <p>The amount of 'supernormal' profits is immaterial in the context of international settlement payments.</p> <p>No competitive harm can arise from 'net accounting' by Reach Networks.</p> <p>Actual figures are provided to the TA on a confidential basis.</p>	<p>The actual figures are noted.</p> <p>When the TA concluded in the 2002 Reclassification Statement that the Routes were competitive in the outgoing direction, he has already compared the costs of refiling against Reach Networks' gateway price adjusted for any possibility of 'net accounting'.</p> <p>The TA therefore concurs that no competitive harm can arise from 'net accounting'.</p>
ii.	<p>The MDF regime should be abolished because the underlying objective as a competition safeguard has already been achieved.</p>	<p>Classifying the Routes into Category A would render MDF irrelevant.</p> <p>However, retaining the criteria for route categorization is necessary to provide for situations of competitive concerns in the future, albeit unlikely.</p>
iii.	<p>Administration costs are significant relative to the size of MDF payments.</p> <p>Actual figures are provided to the TA on a confidential basis.</p>	<p>The actual figures are noted.</p> <p>Although administration cost is not the most important consideration for the Application, such costs can be saved on public interest grounds when there is little or no competitive harm arising from the absence of MDF payments.</p>
iv.	<p>Incoming traffic over the Routes are often refiled and misreported as coming from hubbing locations.</p> <p>According to Telegeography, the total outgoing traffic from some countries are larger than the incoming traffic of Hong Kong from the corresponding Routes.</p>	<p>The TA has already concurred with this view in the 2002 Reclassification Statement (paragraph 25).</p> <p>Data from Telegeography are not comprehensive enough for the TA to draw conclusions on the Routes in general.</p>

v.	<p>Reach Networks' traffic over some of the Routes have declined abruptly and drastically, revealing that alternative connection must have been established.</p> <p>Actual figures are provided to the TA on a confidential basis.</p>	<p>The actual figures are noted.</p> <p>Based on the statistics submitted to the TA by external service operators, Reach Networks' market share of incoming calls were still consistently 100% (or close to) during the Period.</p> <p>The TA is aware that some refile traffic may not have been reported properly.</p>
vi.	<p>Reach Networks does not have direct connections over some of the Routes and competes openly with other operators in the refile market.</p>	<p>For these routes, Reach Networks still has incoming traffic reported as well as accounting rates filed to the TA for monthly MDF updates, indicating that direct connection is not necessarily a prerequisite for bilateral agreements.</p>
vii.	<p>The difference between MDF and LAC is not a good indicator of the absence of genuine price competition.</p> <p>Since Hong Kong is a net settlement payer for most of the Routes, it is in the interest of overseas administrators to maintain higher accounting rates.</p>	<p>Agree that international accounting rate movements are often beyond market forces.</p> <p>However, the argument itself does not prove the existence of genuine price competition.</p>
viii.	<p>There have been accounting rate reductions in 20 of the Routes since the beginning of 2003.</p> <p>The inpayment rates of Brunei and South Africa are below the cost of external switching and transmission together with LAC.</p>	<p>Apart from Brunei and South Africa, MDF and LAC have not yet converged to an adequate extent.</p>
ix.	<p>If there is genuine price competition via refile in the outgoing direction, the same will be true for the incoming direction, because refile rates are available in both directions.</p>	<p>Noted, although the costs to establish connections from the originating countries to hubbing locations are uncertain.</p>

Annex

x.	Reach Networks is constrained by its legacy of bilateral agreements with overseas administrations under the accounting rate system and does not have the same flexibility as other operators to choose where and how to send and receive external traffic.	Bilateral agreements are purely commercial in nature. Reach Networks may as well have other incentives to send traffic via direct connections and abide by the accounting rate system. Operators are free to search for the most efficient way of running their business.
xi.	Sri Lanka has recently liberalized its wholesale external telecommunications market.	Noted.
xii.	Guam is an Unincorporated Territory of the United States. Diego Garcia is a British Indian Ocean Territory.	Noted.

3. Wharf T&T Limited – does not support the Application

	Comments	TA's response
i.	Reach Networks should continue to pay MDF because the margins for 'supernormal profits' over the Routes are still rich, as reflected by the difference between MDF and LAC.	<p>The TA has examined the level of 'supernormal profit' in the incoming direction and the sharing ratio among the different local fixed network operators. He is satisfied that the administration costs involved outweigh the 'supernormal profit'.</p> <p>Since the MDF mechanism is to neutralize Reach Networks' advantage of 'net accounting', the impact of MDF payments on competition should be quantified in that context.</p> <p>The LAC for incoming direct calls should be 12.6 cents rather than the 10.6 cents per minute used in WT&T's analysis.</p>
ii.	<p>Administration cost should be minimal given the low level of traffic and limited number of routes.</p> <p>Administration cost cannot be avoided by abolishing the MDF regime, because LAC still needs to be paid.</p>	<p>MDF, unlike LAC, is route-specific, and therefore requires more active monitoring of the status of competition. MDF over the Routes are updated by the TA on a monthly basis.</p> <p>The administration costs associated with the MDF regime are highly traffic-insensitive.</p>
iii.	Although traffic over the Routes may be insignificant to Reach Networks, it could be significant to some 'niche' competitors in the market.	<p>According to the monthly statistics submitted by external operators, Reach Networks' market share of incoming calls over the Routes were consistently 100% (or close to) during the Period. There is no such 'niche' player in the market.</p>
iv.	The MDF regime should not be abolished because one cannot dismiss a possibility that some routes on Category A may be reclassified as Category B routes.	Noted.

v.	Reach Networks has a comparative advantage in incoming calls due to its bilateral arrangements with overseas administrations and its dominant position is unaffected by refile.	Both direct and refile connections are considered under the route classification tests. Reach Networks is also subject to competition from refile traffic.
vi.	Abrupt and drastic decline in traffic is not sufficient as an evidence for alternative connections, let alone genuine price competition.	Noted.
vii.	Not having direct connections over some of the Routes does not mean that Reach Networks has no bilateral agreement with these administrations, as it continues to file accounting rates to the TA for monthly MDF updates.	Noted.
viii.	The fiscal year of TeleGeography is different from that reported by OFTA, so the statistics can be different. The discrepancies may not necessarily be attributed to refile, but incomplete capturing of network traffic, misreporting by operators, etc.	Noted, but the confidential traffic data submitted by Reach Networks are also compiled according to the fiscal years of TeleGeography. Incomplete capturing of network traffic and misreporting by operators, etc. are precisely the reasons why the origins of refile traffic are misreported.

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**LIST OF THE ROUTES RECLASSIFIED TO CATEGORY A
FROM THE CATEGORY B OBSERVATION LIST**

1 Argentina	23 Mexico
2 Bahrain	24 Mongolia Pr
3 Bangladesh	25 Myanmar (Burma)
4 Brazil	26 Nakhodka
5 Brunei Darussalam	27 Nepal
6 Cambodia	28 Pakistan
7 Chile	29 Paraguay
8 Cyprus	30 Peru
9 Diego Garcia	31 Poland
10 Egypt	32 Qatar
11 Fiji	33 Russia
12 Guam	34 Sakhalin
13 India	35 Saudi Arabia
14 Iran	36 Seychelles
15 Israel	37 South Africa
16 Jordan	38 Sri Lanka
17 Kenya	39 Tonga
18 Korea DPR (North Korea)	40 Turkey
19 Laos	41 United Arab Emirates
20 Maldives	42 Uruguay
21 Mariana Is	43 Vietnam
22 Mauritius	44 Yemen Rep