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RECLASSIFICATION OF CATEGORY B ROUTES ON THE OBSERVATION LIST

Statement of The Telecommunications Authority

4 August 1999

Introduction

1. Hong Kong Telecommunications Ltd. ("HKT"), which is now renamed as Cable & Wireless HKT Ltd., submitted an application on 15 April 1999 to the Telecommunications Authority ("TA"), asking him to reconsider his findings and conclusions on HKT's previous application dated 8 January 1999 ("the Previous Application") for reclassification of eleven (11) routes on the Category B Observation List (for the application of the local access charge and modified delivery fee arrangement) to Category A routes.

2. Following the receipt of the request ("the Application"), the Office of the Telecommunications Authority ("OFTA") issued an industry consultation paper on 29 May 1999 ("the Consultation Paper"), inviting comments from the telecommunications industry and interested parties on the Application in general, and views from the respondents in relation to certain specific issues, particularly whether the market share of HKT for incoming traffic would affect the conclusion on the existence of genuine price competition provided by the alternative connections over the routes in question.

3. After considering all the responses, the TA held the view that in the outgoing direction, except the Vietnam route, there is sufficient evidence of alternative physical connections and that there is genuine price competition in the external service market for outgoing traffic. However, there was insufficient information on incoming traffic to allow him to form a view on whether or not the tests for Category B to Category A reclassification are also satisfied in the incoming direction. Accordingly, OFTA issued an interim report on 11 June 1999 ("the Interim Report") and invited the telecommunications industry and interested parties to provide further information on:

- a) whether there are alternative physical connections for traffic

in the incoming direction to Hong Kong;

- b) whether such alternative physical connections have provided genuine price competition; and
- c) the volume of incoming traffic over each of the 11 routes in question before and also since 1 January 1999 so that the TA could assess if significant amount of traffic has bypassed HKT's gateway since the introduction of liberalization in January 1999.

Responses to the Interim Report

4. In response to OFTA's invitation of further comments and information, a total of six (6) submissions were received. Respondents include HKT, New T&T Hong Kong Limited, Hutchison Telecommunications (Hong Kong) Limited, New World Telephone Limited, Singapore Telecommunications Limited and SmarTone Telecommunications Holdings Limited. A summary of comments from the respondents is given in the following paragraphs.

Cable & Wireless HKT ("HKT")

5. HKT in general agreed to and supported the TA's conclusion in the Interim Report. It therefore attempted to direct its efforts in providing information to demonstrate that there is genuine competition in the incoming direction. The company, however, reiterated the difficulty in quantifying the amount of incoming traffic, which has been refiled from any particular location. It further admitted that analysis of outgoing and incoming traffic patterns would not necessarily show a clear-cut shift at any point in time because of the tremendous change in the structural and competitive environment of the international market, refile, callback and IP telephony brought about by rapid technology development and the very volatile economic conditions in Asia in the 1990s.

6. HKT has developed a methodology to estimate the amount of incoming traffic bypassing Hong Kong Telecom International Limited's (HKTI's) gateway for the 11 routes. A pre-callback ratio of incoming to outgoing traffic (in/out ratio) was established. The reason for establishing the ratio, according to HKT, is that assuming everything

being equal, with proportionate return the ratio should remain relatively stable irrespective of the absolute traffic volume. The ratio for each route was applied to the estimated total outgoing traffic (including HKT's competitors') in 1999 to come up with the estimated total incoming traffic. The difference between the estimated and the actual would be incoming traffic bypassing HKT's gateway.

7. HKT claimed that with the exception of Pakistan and Vietnam it received much less incoming traffic than should be expected. This indicates significant incoming traffic bypass does occur. It opined that the exception of Vietnam is due to the below cost wholesale rate distortion and in the case of Pakistan the "spiky" data defies analysis.

8. To supplement its direct route analysis, HKT also reviewed the incoming/outgoing ratio of traffic with the four major callback and refile hubs, namely Australia, Canada, UK and US between May 1993 and May 1999. The ratios have plummeted since January 1999. HKT attributed the phenomenon partly to the result of its competitors shifting from callback to lower cost options such as ISR, refile and alternative correspondent agreements, and the rest to incoming refiled traffic moving from the international settlement arrangement to IPLC connections with HKT's competitors.

9. HKT expressed its surprise as to why other FTNS/ETS operators have opposed the reclassification of the 11 routes. It went on reiterating that other operators would enjoy cheaper wholesale rates as a result of the reclassification and HKT's competitors in the wholesale market are Tier-1 carriers instead of FTNS/ETS operators. It further contended that after providing the incoming traffic analysis there is more than sufficient justification for reclassification of the 11 routes into Category A.

Hutchison Telecommunications (Hong Kong) Limited ("Hutchison")

10. Hutchison objected to the re-classification on the ground that from its traffic statistics there is no indication of a significant amount of incoming traffic bypassing HKT's gateway and no genuine price competition for any routes in consideration. It also highlighted that HKT with 98% of the local subscriber base, receives almost all incoming traffic. The revenue from incoming traffic reduces its cost for outgoing IDD services to a level which no other player in the market can match. It also pointed out that the tariff control applicable to Category B routes and

the delivery fees payable to FTNS operators provides the margin which allows ETS operators to survive.

11. Hutchison also raised the point that the high termination rates of the correspondent carrier compared to its local termination rates do not permit reciprocal trading of traffic. This together with the reclassification will enable HKT to oust their competitors out of business.

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

12. New T&T maintained that HKT's application for reclassification of the 11 routes should be rejected because the tests on the status on competition as established by the TA in respect of inbound traffic have not been met. The company submitted that all its incoming traffic from nine countries under consideration and a significant portion of the incoming traffic from the remaining two countries, have been delivered through HKT's gateway. It therefore argued that there is a decided absence of competition with respect to inbound traffic on the 11 external routes.

13. The company once again referred to the reason for the modified delivery arrangement and the significance of the loss in net revenue to FTNS operators resulting from the reclassification of the 11 routes. Hence it strongly disagreed with the initial comment made by the TA that the abolition of the delivery fee over Category B routes would not have a significant financial impact on the new fixed network operators. It went on arguing that the loss of this revenue would reduce incentive for FTNS to continuing their network roll-out; and HKT would be allowed to enjoy the extra profit which would be used to compete unfairly with its competitors.

New World Telephone Limited ("NWT")

14. NWT submitted that effective competition has not developed in the incoming direction and therefore the application by HKT to reclassify the 11 external routes to Category A must be rejected. It furnished the TA with its incoming traffic statistics, which show only two routes out of the 11 routes with incoming traffic from external circuits operated by NWT. It claimed this is evidence of lack of effective competition in the incoming direction.

15. The company further argued that the premature re-

classification of the 11 routes would drastically reduce the delivery fees entitled by NWT. This, NWT opined, defeats the objective of channeling the supra-normal profit to the local operators delivery mechanism and would further strengthen HKT's position against its competitors. It went on arguing that the loss of delivery fees would also retard the network roll-out by the new FTNS operators.

Singapore Telecommunications Limited ("SingTel")

16. SingTel reiterated its opposition to the re-classification of the Singapore route from Category B to Category A. It maintained that it applies the same accounting arrangements with all Hong Kong operators, therefore it argued there is insignificant competition among Hong Kong operators in both incoming and outgoing directions of the Singapore route.

17. The company also indicated that a very significant portion of its both way traffic is transacted with HKT and direct links with other FTNS/ETS operators only permit low volumes of traffic. Other alternative means not permitted by the Singapore regulator will not survive because those illegal operators have been prosecuted.

SmarTone Telecommunications Holdings Limited ("SmarTone")

18. SmarTone did not consider price competition had been established to warrant the re-classification. It worried that that with re-classification HKT would not have to pay incoming delivery fees on the 11 routes, would only enhance HKT's dominant position in the market.

Discussions of Submissions

19. In the TA Statement of 25 November 1998 which set out the framework for Category A/Category B route classification, it was stated that a Category B route would be re-classified as a Category A route once effective competition on that route exists. The tests concerning the status of competition would be: -

- a) whether a service provider in Hong Kong may physically establish connection to and from a particular location without transiting the gateway of Hong Kong Telecom, for example by ISR operation over leased circuits, or by

separate correspondent relationship in bypass of HKT'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;

- 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.

20. The issue raised in the Consultation Paper and the Interim Report was whether or not the above competition tests should be satisfied in both the outgoing and the incoming directions before a route can be reclassified from Category B to Category A. The tentative view in the Interim Report was that the existence of genuine price competition in the incoming direction should not be disregarded in the consideration of reclassification (paragraph 30 of the Interim Report). The main concerns were

- whether the absence of competition in the incoming direction would lead to supra-normal profit from the above-cost inpayment without HKT being required to share with the local network operators part of the profit; and
- the possibility of HKT using the supra-normal profit to undercut the prices of its competitors in the outgoing direction.

21. To address these concerns, it would be useful to recap on the rationale behind the competition tests. In the outgoing direction, when there is no genuine price competition with the HKT's external gateway, by classifying the route under Category B, the TA determines the gateway price of HKT so that the price would be at the cost level, i.e. the outpayment rate plus HKT's cost in operating the external gateway. Once there is genuine price competition from the alternative connections, it would not be necessary to control the gateway prices of HKT in this manner because competitive pressure would force HKT to lower the gateway prices in the outgoing direction. The costs of the alternative connections would be based on the alternative correspondent agreement using IPLCs or refiling and it would be unreasonable to require HKT to hold the gateway price at the outpayment rate plus cost level. At this price level, it would not be possible for HKT to compete against the corresponding prices of the alternative connections. Thus where

genuine price competition exists in the outgoing direction, the TA will reclassify the route to Category A whereby the TA will no longer determine the gateway price of HKT and HKT will be allowed to operate under a “maximum pricing” regime.

22. As regards the incoming direction, 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 HKT’s external gateway to the called parties. This is the continuation of the delivery fee arrangement before 1 January 1999 although the level of the delivery fee is adjusted and varies with the level of the inpayment. Once there is genuine price competition in the incoming direction, competitive pressure would force HKT 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. The delivery fee can be replaced by the cost-based local access charge once the route is re-classified to Category A.

23. The issue in this exercise is what should be the classification of a route if genuine price competition from alternative connections is established in the outgoing direction, but is not sufficiently evident in the incoming direction. If the route continues to be classified as Category B and the rules concerning gateway price regulation for Category B routes continues to be applied in the outgoing direction, HKT will be bound by the gateway price determined by the TA and is not free to offer any discount to meet competition from the alternative connections. As the costs of the alternative connections are likely to be based on ISR or refiling, the gateway price determined by the TA based on the outpayment rate would not be a realistic price to meet competition in the market. If the TA continues to require HKT to charge this price, effectively the TA will be restraining HKT’s ability to compete in the outgoing direction despite the fact that HKT’s gateway would be constantly losing market share to its competitors. This is not the intention of the regulatory regime to promote competition in this manner.

24. If the route is re-classified as Category A, HKT may lower the gateway price below outpayment rate in competition with alternative connections in the outgoing direction. This will be financed from the supra-normal profit in the incoming direction as HKT will no longer be required to pay delivery fee to the other local network operators.

HKT's competitors have expressed their concerns about the re-classification to Category A despite the absence of genuine price competition in the incoming direction. First, payment of delivery fee would be stopped even though HKT is still enjoying supra-normal profit from the above-cost inpayment. Second, the supra-normal profit from incoming traffic would be used to finance reduction in the gateway prices, undercutting the prices of HKT's competitors in the outgoing direction. It would be unfair for HKT to use the revenue which would have been received by the other local network operators (had the route stayed in Category B) to undercut the prices of the HKT's competitors, including the other local network operators, when the route is re-classified to Category A.

25. The TA does not consider pricing below the outpayment level, in the so-called "net accounting" approach, to be unfair *per se* so long as the gateway price of HKT in the outgoing direction is not below a level that is anti-competitive. The prices of the alternative connections are not related to the outpayment for traffic through HKT's gateway. Therefore it is not unfair for HKT to price its gateway services in a similar manner as its competitors would price them. There are safeguards under HKT's FTNS licence to prevent it from practising anti-competitive behaviour. HKT may not price its outgoing gateway service below cost. In deciding what is the cost level of HKT, it has been the TA's practice (in vetting the pricing of HKT's gateway services) to compare HKT's prices with that achievable using the technology and accounting arrangement of its competitors. For example, if the HKT's competitors have to lease IPLC from HKT to operate ISR services, the cost level of HKT should be based on the tariffed price of the IPLC, not the cost of IRU acquired by HKT. Thus if the competitors of HKT could not benefit from revenue from incoming traffic, the TA would not include revenue from such incoming traffic in vetting whether HKT's gateway prices are below cost and therefore at a level which the HKT's competitors cannot reasonably compete against. The use of the "net accounting" approach would also lower the gateway prices of HKT, benefiting the users of the gateway services of HKT in delivering outgoing traffic and potentially intensifying the competition in the outgoing direction.

26. There are also submissions that because of the reclassification, delivery fee payment by HKT to other FTNS operators will be reduced. HKT's competitors consider that this would affect the rollout plan of the new FTNS operators. The TA does not accept that the amount of delivery fee affected would have this effect on the rollout

plans. The traffic over the eleven routes on the Observation List constitutes a relatively small proportion of the traffic of HKT. Over the first quarter of 1999, the total volume of incoming traffic of HKT over the eleven routes was 36 million minutes. The total amount of delivery fee payable is estimated to be about HK\$40.2 million. As at present HKT has 97% market share of all directly connected customers, the share of the delivery fee for incoming traffic payable to three new FTNS operators totalled only HK\$ 1 million for the quarter in question. The resultant delivery fee payment is therefore small and should not significantly affect the finance of the rollout plan of the new FTNS operators.

27. The TA does accept the argument from some respondents that it would be unfair for HKT to stop paying this delivery fee to the other local network operators while it is still enjoying supra-normal profit from the inpayment as a result of absence of competition in the incoming direction. The TA considers that HKT should use its own share of the delivery fee to finance the gateway price reduction in the outgoing direction, subject of course to compliance with the licence conditions on prohibition of anti-competitive practices.

28. In conclusion, the TA takes the view that competition in the incoming direction should not be disregarded in the consideration of route re-classification. A route should remain in Category B until competition in both the outgoing and incoming directions has been established. However, once genuine price competition has been established in the outgoing direction, even though the route stays in the Category B because of lack of competition in the incoming direction, it would be unfair to HKT to put it under the price control of gateway prices applicable to Category B routes. Over this particular group of Category B routes, HKT should be relieved of this price control applicable to the other Category B routes. In other words, the TA will no longer determine the gateway price of HKT and HKT will be allowed to operate under a "maximum price" regime, subject to compliance with conditions prohibiting anti-competitive practices, including pricing. However, for incoming traffic over these routes, HKT should continue to pay delivery fees to the other local network operators as long as inpayments stay at the above-cost level. HKT should not use this payment to finance its price reduction in the outgoing direction.

Applications of the Competition Tests

29. As was stated in the Interim Report, the TA has formed the view that both competition tests have been satisfied in the outgoing direction with the exception of Vietnam. Regarding the tests for competition in the incoming direction, based on the submissions to the TA and the information available to OFTA, it is confirmed that

- (a) alternative correspondent agreements exist for two routes, namely Singapore and Taiwan;
- (b) incoming traffic through IPLC operated by parties other than HKT has been recorded since January 1999 on four routes, namely Malaysia, Philippines, Singapore and Taiwan;
- (c) incoming traffic from Singapore and Taiwan is significant in terms of volume and is increasing. The incoming traffic from Malaysia and the Philippines is insignificant.

Singapore and Taiwan

30.. For Singapore and Taiwan, as there are alternative correspondent agreements, it is obvious that alternative means for sending IDD traffic from these two destinations to Hong Kong without transiting HKTI gateway exist. The remaining question is whether genuine price competition exists.

31. SingTel submitted that because it has adopted the same accounting arrangements with all Hong Kong operators, the scope for competition among Hong Kong operators in both incoming and outgoing direction of the Singapore route is insignificant. The TA considers that genuine price competition in the outgoing direction has been established by observing the actual market share of the external gateway of HKT. The TA assumes that if the alternative connections did not offer a more attractive price, the competitors of HKT would not have used the alternative connections to bypass the HKT's gateway. Even though the outpayment to Singapore under the different correspondent agreements may be the same or similar, the operators in Hong Kong can price their gateway services differently using the "net accounting" approach. However, in the incoming direction, the TA accepts that the terminating prices in Hong Kong are determined by the correspondent agreements which are all with a single carrier at the distant end. There appears to be

no genuine price competition because of the same accounting rate adopted for all correspondent agreements with operators in Hong Kong. The TA considers that these two routes should stay in the Category B, but the revised rules stated in paragraph 28 should apply.

Malaysia and Philippines

32. According to the return from external telecommunications service providers, there are direct IPLC connections between Hong Kong and two destinations, namely Malaysia and the Philippines. It is therefore technically feasible for the Hong Kong operators to provide a termination service for incoming traffic from Malaysia and the Philippines. The traffic return, according to the traffic return from operators so far, is insignificant. HKT estimates that there is significant amount of incoming traffic that has been routed through other alternative means such as refile. The TA considers that the estimates of HKT could be subject to the errors discussed in the next paragraph. The TA considers that these two routes should stay in the Category B, but the revised rules stated in paragraph 28 should apply.

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

33. As regards the routes of India, Indonesia, Pakistan, South Africa, Sri Lanka and Thailand, there are no alternative IPLC connections. However, according to HKT's estimates, with the exception of Pakistan, there is significant amount of incoming traffic that has been routed to Hong Kong without transiting HKTI's external gateway. Regarding Pakistan, HKT was unable to prove that bypass of the HKTI's external gateway exists in the incoming direction. The TA however considers that HKT's estimates could be subject to errors. The HKT's estimates were based on an expected outgoing/incoming ratio which HKT considers should have returned to the pre-callback level. HKT then compared this estimated incoming traffic to the actual incoming traffic through HKTI's external gateway. Any shortfall would be attributed to bypass. However this estimate is subject to the uncertainty of whether or not the ratio of outgoing/incoming traffic volume has changed from the level of the pre-callback days. Any error in the estimate of this ratio would be translated into error in estimating the shortfall.

34. New T & T and NWT submitted that there is no incoming traffic through these operators as demonstrated in the ETS statistics submitted to OFTA. The data of these operators only show that these operators do not operate any IPLC's to the locations concerned. These

operators have not proved (and probably have no data on) whether traffic incoming from routes over which these operators did operate IPLC contained traffic originated from the locations concerned.

35. Therefore the TA considers that the analyses of HKT, New T & T and NWT to be inconclusive in assessing whether significant bypass of HKT's gateway in the incoming direction has occurred. The TA considers that these six routes should stay in Category B, but the revised rules stated in paragraph 28 should apply.

Vietnam

36. Based on information available to the TA, he is unable to come to the conclusion that stable, long-term alternative means other than HKT's external gateway is available in both the outgoing and incoming directions for IDD service with Vietnam. Although HKT has shown in the submission made in May 1999 that one of its competitors had started sending traffic to Vietnam via means other than HKT's external gateway from May 1999, the TA takes the view that he needs to observe the sustainability of this alternative connection. Accordingly, he considers that Vietnam should remain on the Category B Observation List. In response to HKT's comments that the traffic pattern is somehow distorted due to a below-cost gateway price, the TA is in the process of reviewing the current gateway prices and the modified delivery fees. He will make suitable adjustments if there is a justifiable reason to do so (e.g. a downward adjustments of accounting rates).

Conclusions

37. Following the analysis above, the TA concludes that
- (a) for the ten routes of India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, South Africa, Sri Lanka, Taiwan and Thailand, while genuine price competition can be established in the outgoing direction, such competition in the incoming direction has not yet been established. These ten routes should stay on the Category B Observation List until such time when genuine price competition in the incoming direction can be established. However, the TA will remove the control of the gateway prices in the outgoing direction as

if the routes have been reclassified to Category A. However, HKT will be required to continue to pay delivery fees determined by the TA in the incoming direction for these routes in the same way as for other Category B routes;

- (b) for the route of Vietnam, genuine price competition in the outgoing and incoming directions cannot be established. This route should stay in the Category B Observation List and will be treated as other Category B routes in the control of gateway prices and the payment of delivery fee determined by the TA. The TA is prepared to consider an application from HKT to revise the gateway price to Vietnam to address the concerns of the company regarding the loss incurred in the outgoing direction due to the gateway price being lower than the settlement rate paid to the Vietnam carrier.

Office of the Telecommunications Authority

4 August 1999