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Hon SIN Chung-kai
Chairman
Panel on Information Technology and Broadcasting
Legislative Council
Hong Kong SAR

Dear Mr. Sin,

Policy Review on Type II Interconnection

I thank you for your time at Legco on 25 February 2004 where the industry participants, the Administration and Legco members discussed the policy review on Type II interconnection, in particular the industry response to the second consultation paper issued by OFTA on 16 December 2003. I thought I should write to you to further explain or clarify our views on Type II interconnection.

First of all I note from the response from some of the members that they were most interested in Mr Jack So's promise of a price reduction for telephone service from PCCW-HKT Telephone Limited ("PCCW"). I believe you understand why PCCW has to be regulated. I refer you to the press release by OFTA on 26 February 2004 (a copy is enclosed), which explains very well the policy reason for such control on PCCW. I have nothing more to add to that except to say that a price reduction may sound very attractive at first glance but it is not necessary a good thing in the longer term as price reduction may hurt competition. For the longer-term benefits to consumers, we want a healthy competitive process. Price reduction, particularly by a dominant operator, is not necessarily a healthy competitive process.

On the subject of Type II interconnection, you may be aware that in other parts of the world such as USA, Canada, UK, Australia, Singapore, European countries, similar mandate such as that of Type II interconnection has also been imposed on the incumbent fixed lines operators. Hong Kong is not unique in that respect. There are perfectly good policy reasons why PCCW, the incumbent, has been mandated to provide the other operators access to its network. I shall try to explain why.

PCCW's network was constructed over decades and under the protection of monopoly rights until 1995 when the Government liberalised the fixed lines market. PCCW's network therefore reached *every* part of Hong Kong including those residing in the outlying islands.

For social welfare reason, PCCW is required by the Government to provide basic telephony service to anyone in Hong Kong irrespective of where he or she lives; this is what is known as the Universal Service Obligation ("USO"). In return for carrying this USO, PCCW receives compensation in the form of Universal Service Contribution ("USC") from all external services providers including Wharf T&T. Even to this day PCCW still receives subsidy in the form of USC from all operators of external services so that PCCW's costs will be covered in having the USO. This USC in part helps to fund PCCW's network and service provisioning costs.

It is an undeniable fact that the construction of alterative fixed lines network takes considerable period of time (PCCW has had decades) and involves a very significant amount of investments upfront. These act as effective barrier for new entrants into the market to compete equally with the incumbent. New entrants such as Wharf T&T have not been around for decades to have constructed such an extensive network as that of PCCW. Neither do we have the monopoly grant that PCCW has enjoyed for decades nor the subsidy in the form of USC.

Apart from that, there are physical constraints in buildings, either due to insufficient lead-in into the building or shortage of space for equipment in the building, which may make it impossible for alternative network to be constructed to those buildings. There are buildings in Hong Kong, which are old and small which do not provide the scale required to justify investment in extending fixed network to those buildings. In addition construction of fixed network creates environmental disruptions to the public, as streets are being dug up and installation causing disruptions to residents within buildings. We have seen many streets in Hong Kong being dug up every day causing great nuisance to the public.

Type II interconnection is therefore introduced in Hong Kong and indeed in many parts of the world as an essential element in introducing competition in the fixed lines market. Without Type II interconnection competition will be very slow to take off and may not take off at all in some areas.

As the Telecommunications Authority ("TA") has put it succinctly in his statement No. 6 (Revised) on interconnection,

> "<u>*Interconnection on customer request only*</u> - *……………………………… The TA takes the view that if a customer connected to the end of a local loop could exercise free choice not to continue with the local access service supplied by the operator owning the local loop, the piece of wire and the associated facilities constituting the local loop would immediately become idle. In the Hong Kong environment, it might be difficult for the new entrant network operators to establish an alternative local loop to serve this*

> *customer. Many buildings have bottlenecks and it may, in fact, be impractical to install a second local loop. Clearly it would compound the difficulties if existing wiring was pulled out and withdrawn from service simply to enable a new wire to be laid. In addition, the construction of additional parallel local loops to serve the same customer amounts to wasteful duplication and may cause disruption and inconvenience to a number of end customers. The TA therefore considers it desirable for interconnection to be permitted at local loop level but subject to the provision that such interconnection will only be permitted at the request of the customer being connected to the local loop concerned… The owner of the local loop will be compensated by an interconnecting network operator for the reasonable relevant cost incurred in interconnecting that network operator to its local loop."*

Indeed there are buildings where alternative networks can be constructed. Where it is physically and commercially viable, alternative networks have been extended to these buildings, as we have seen with the construction of networks from Wharf T&T, Hong Kong Broadband Network ("HKBN") and Hutchison Global Communications ("HGC"). But that do not represent majority of the buildings in Hong Kong, they only represent part of Hong Kong. Even then these buildings may not be able to accommodate multiple networks roll out to them. There are altogether 9 fixed lines network services licensees in Hong Kong today.

Type II interconnection does not, as some people claim, distort the market and it is <u>not</u> "free-ride" as wrongfully claimed by PCCW. Where we lease the local loops from PCCW, PCCW will be compensated for an asset that was in the majority of instances built by it in a monopolistic era and would otherwise become idle when customers exercise their choice to switch to another operator.

HGC and HKBN have claimed extensive coverage of their network and the lack of bottleneck. How true is it? We should look behind their vested interests. Obviously PCCW has the most to lose if the current Type II interconnection policy is retained. In the case of HGC, it has collocated to many exchanges of PCCW, the scale comparable to that of Wharf T&T, if not more. HKBN is the only active FTNS operator with no right to Type II interconnection and of course it has to argue against it. Interestingly though HKBN argued in its response to PCCW's application for declaration of non-dominant status in the business direct exchange lines market that, "*…if and without Type II interconnection, the newcomers would encounter many operational obstacles if they choose to roll out their own network in the retail market. It would take many years for them to build up significant network coverage to compete…*" The interests of PCCW, HGC and HKBN in this debate are not necessarily aligned with those of the consumer and of Hong Kong. Further HGC and HKBN claim that Type II interconnection will deter their continual investment in infrastructure. Again how true is it? Type II interconnection has been implemented since 1996 and widely deployed and that has not deterred them from rolling out their own network.

Type II interconnection policy review will be very significant to consumers and to Hong Kong in many ways and I wish to provide the following perspective for your reference in closing:

1. This review will decide whether consumers and businesses will be deprived of choice of telecommunication service provider. In the Kwun Tong colocation footprint, we estimate for instance that over 3,000 businesses currently using Wharf T&T lines will
have *no* choice but to move back to PCCW if Type II interconnection were phased out. The vast majority of them are SMEs.

2. This review will decide whether the Government is pro-competition. Where Type II interconnection was implemented PCCW's market share has fallen to about 40% due to competition. On the other hand, where there is no Type II interconnection, PCCW's market share remains at virtually 100%.

3. This review will decide whether Hong Kong's telecommunications policies are consistent. The Government introduced Type II interconnection in 1995 and actively encouraged the industry to invest in Type II interconnection in 1998 and 1999. In response to that, Wharf T&T invested substantial capital and time to increase its Type II interconnection sites and its installed base very significantly. As is typical of the industry, the invested capital will take a very long time to pay back. The invested time and other bygone opportunities will never be repaid.

Thank you for your time.

Yours sincerely,

Agnes Tan
Director, Legal, Regulatory & Carrier Affairs

Encl.

c.c.: Marion Lai, Deputy Secretary, Commerce, Industry and Technology Bureau
MH Au, Director-General of Telecommunications

Press Release
OFTA Responses to Comments made by PCCW Ltd. on Tariff Regulation

The Office of the Telecommunications Authority (OFTA) today (26 February 2004) responded to the comments made by Mr Jack So Chak Kwong, Deputy Chairman and Group Managing Director, PCCW Ltd, at the meeting of the Panel on Information Technology and Broadcasting, Legislative Council, held yesterday concerning the regulation of the tariffs of PCCW-HKT Telephone Limited (PCCW).

A spokesperson of OFTA said, "The allegation made by Mr So that OFTA did not allow PCCW to bid for the business of the Kowloon Canton Railway Corporation, Fire Services Department and Immigration Department was groundless. As PCCW is a dominant operator in the local fixed network market, under its licence conditions, it is required to submit application to OFTA for approval of its tariffs to be offered in the bids. The purpose of such licence conditions is to foster the development of effective competition in the market for the benefits of all consumers and users."

"PCCW's proposed tariffs were rejected mainly because the prices quoted by PCCW were below cost which would force other operators to compete at an unsustainable price level. As OFTA considered such proposals to harm competition in the market, it is considered anti-competitive under the licence conditions. OFTA therefore declined the application."

"OFTA has never intended to obstruct PCCW from bidding for any telecommunications projects. In fact, in 2003 alone, PCCW submitted a total of 27 tender tariff applications, among which only 6 were declined," the spokesperson added.

"We would like to reiterate that in order to ensure effective competition can develop in the market, it is essential for OFTA to enforce licence conditions to ensure the dominant players play fairly. Without such licence conditions, the development of competition can be stifled or distorted. The eventual result will be higher prices, less choices or poorer quality of services which will be detrimental to consumer interests, even though such offerings may look attractive in the beginning."

"For instance, the "Buy-Four-Get-One-Free" tariff application made by PCCW in 2002 was rejected by OFTA because the discount was only selectively offered to customers in 14 estates. OFTA believed this would substantially restrict the competition in the market and the majority of customers would not be able to enjoy the discount brought about by the competition between operators. Should a similar offer be made available to all customers and it is above cost, OFTA would welcome such a proposal from PCCW," the spokesperson continued to say.

"However, the restrictions imposed on dominant players do not imply that PCCW is not allowed to compete in the market or to reduce prices. In fact, we have been adjusting our regulation of PCCW in accordance with the rapidly changing market landscape. In 2003 alone, a total of 126 tariff applications were received from PCCW, among which only 10 were declined and 8 were withdrawn by PCCW. These applications were mainly to seek to reduce prices by offering discounts on its existing services, or to stipulate prices of its new services," the spokesperson said.

"We repeat our earlier position that the purpose of tariff regulation on the dominant operator is to foster the development of effective competition in the market so that the benefits of competition will flow to all customers, not only customers on a selective basis," the spokesperson emphasized.

"OFTA recognizes that dominant player regulation needs to be reviewed to take account of the development of competition in the market. OFTA is now assessing the two applications of PCCW for a declaration of non-dominance in the fixed-line markets. We will come to a conclusion after taking into account the submissions received during the consultation period and all other relevant factors," the spokesperson elaborated.

Office of the Telecommunications Authority
26 February 2004