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**Paper for the House Committee meeting
on 22 June 2001**

**Report of the Subcommittee on Telecommunications (Method for
Determining Spectrum Utilization Fees) (Third Generation Mobile
Services) Regulation and Telecommunications (Designation of Frequency
Bands Subject to Payment of Spectrum Utilization Fees) Order**

Purpose

This paper reports on the deliberations of the Subcommittee on Telecommunications (Method for Determining Spectrum Utilization Fees) (Third Generation Mobile Services) Regulation and Telecommunications (Designation of Frequency Bands Subject to Payment of Spectrum Utilization Fees) Order.

Background

2. The Government announced in February 2001 that it would issue four carrier licences for Third Generation (3G) mobile services by way of a hybrid method comprising a pre-qualification exercise, followed by spectrum auctioning. The pre-qualification exercise will serve to ensure that the 3G networks to be built by eligible applicants will reach an acceptable quality within a certain period of time. Spectrum auctioning will be based on bidding of royalty percentages subject to a minimum guaranteed payment.

3. The Telecommunications (Method for determining Spectrum Utilization Fees) (Third Generation Mobile Services) Regulation ("the Regulation") and the Telecommunications (Designation of Frequency Bands Subject to Payment of Spectrum Utilization Fee) Order ("the Order") are made under section 32I(1) and (2) of the Telecommunications Ordinance, as amended by the Telecommunications (Amendment) Ordinance 2001 passed by the Legislative Council on 16 May 2001. The Regulation provides for the method of determining the spectrum utilization fee for the spectrum allocated in the 3G licensing exercise. The Order sets out four sets of frequency bands

which will be subject to the payment of the spectrum utilization fees. Both the Regulation and the Order will come into operation on 4 July 2001.

The Subcommittee

4. At the House Committee meeting on 4 May 2001, members supported the resumption of the Second Reading debate of the Telecommunications (Amendment) Bill 2001 on 16 May 2001 and noted the Administration's plan to gazette the related subsidiary legislation on 1 June 2001 after enactment of the Bill. To expedite scrutiny, members agreed that a subcommittee should first be set up to examine the drafts of the Regulation and the Order provided by the Administration. The membership list of the Subcommittee is at **Appendix I**. At the House Committee meeting on 8 June 2001, members agreed that the same subcommittee which studied the draft subsidiary legislation should continue to examine the Regulation and the Order as gazetted.

5. Under the chairmanship of Hon James TIEN Pei-chun, the Subcommittee has held five meetings and met with deputations from the telecommunications industry. A list of organizations which have submitted views to the Subcommittee is at **Appendix II**.

Deliberations of the Subcommittee

6. The major areas of concern arising from the Regulation and the Order are summarized in the following paragraphs.

The Regulation

"The 4th leaver rule"

7. The Regulation prescribes an auction based on bidding of royalty percentages as the method for determining the spectrum utilization fees. A main auction will be held when there are more than four bidders. All the successful bidders will be subject to the same royalty percentage set by the lowest successful bidder when he withdraws (the 4th leaver rule). If there are four bidders or less, there will not be any main auction and the spectrum will be allocated at the reserve price set by the Secretary for Information Technology and Broadcasting (SITB) under section 8 of the Regulation.

8. Under the said 4th leaver rule, the auction will not end when the fifth bidder drops out. It will continue until the fourth last bidder also withdraws and the royalty level will be the highest common royalty percentage willing to be paid by all of the four successful bidders.

9. The Subcommittee notes that the six existing mobile services operators unanimously object to the 4th leaver rule. They urge that a 5th leaver rule should be adopted whereby the auction should end when the fifth bidder withdraws and the royalty level should be the current bid willing to be paid by the four successful bidders. The operators argue that the most economically efficient price should be achieved by eliminating the bidders in excess of the intended number of successful bidders.

10. The operators considers that the 4th leaver rule is inconsistent with the Government's declared position that its primary objective is not to maximize revenue through auctioning. In their view, this auctioning method is neither fair nor efficient and is only useful in yielding a substantial windfall for the Government

11. Some industry operators refer members to overseas experience in spectrum auctioning in which the high cost of obtaining a 3G licence will result in reduced capital available for network investment and delay in the launch of 3G services. They are concerned that under the 4th leaver rule, the four successful bidders have to continue to bid against each other, thus driving the auction price high above the fair market price. According to one operator, it is possible that the price may be pushed up by some 100%. They caution that the additional financial burden on future 3G operators will likely be translated into high tariffs to be borne by 3G consumers.

12. The Administration confirms that in adopting a royalty-based auction instead of an upfront cash auction, maximization of revenue is not its primary objective. It has noted recent adverse changes in market environment and has therefore decided on a royalty-based ascending auction to promote entry and minimize the immediate upfront financial burden on the bidders. Moreover, the Administration only requires a 5-year rolling guarantee, as opposed to a full 15-year guarantee, during the 15-year licence period.

13. On the 4th leaver rule, the Administration points out that it appreciates the commercial considerations of the mobile services operators in seeking to pay a lower bid. However, after careful study, the Administration believes that the 4th leaver rule will meet the policy objectives of promoting entry, enhancing competition, preventing collusion, minimizing market distortion and allocating frequency bands efficiently. It is a fair method for determining the "optimum" price for allocating spectrum which is a scarce public resource.

14. The Administration disagrees that the 4th leaver rule will push the auction price unreasonably high as qualified bidders will be bidding what they are willing to offer. Moreover, the common royalty percentage as set by the fourth leaver may actually be lower than the bid willing to be paid by the other successful bidders. On the other hand, the Administration cautions that if the 5th leaver rule is adopted resulting in a much lower bid, the successful licensee

may simply choose to make a profit by re-selling its licence instead of investing in launching 3G services.

15. The Subcommittee notes that the industry operators do not subscribe to the Administration's view. While members agree with the policy objectives of the Administration, some members of the Subcommittee have cast doubt on the proposed 4th leaver rule in arriving at a fair market price. They are concerned that the higher auction price resulting from the said method will become a heavy financial burden on the 3G licensees and may affect their investment and service roll-out. This will handicap the longer-term growth of the telecommunications industry and sharply reduce Hong Kong's competitiveness. 3G consumers will also suffer as a result. The majority of the members of the Subcommittee are in support of the 5th leaver rule whereby the royalty percentage for 3G licences will be determined by the current bid willing to be paid by the four successful bidders when the fifth bidder withdraws from the auction. The Subcommittee has decided that it will move an amendment to the Regulation to this effect if the Administration will not do so.

16. In the course of deliberation, one member of the Subcommittee has considered the proposed 4th leaver rule acceptable. As spectrum is a scarce public resource, it should only be awarded at a good price and the revenue thus generated can then be put to worthwhile uses. The member does not fully subscribe to the industry's view that the increment extracted by the 4th leaver rule, as opposed to the 5th leaver rule, will necessarily bring about unreasonably high auction prices to the detriment of the industry and consumers. The member believes that under the current market environment, the bidders are less inclined to offer excessively high prices in order to obtain a 3G licence.

17. Having considered the Subcommittee's majority view and the implications of the 5th leaver rule, the Administration has agreed to amend the Regulation to provide that the royalty percentage payable will be the lowest common royalty percentage bid which is offered by all the successful bidders. It should not be less than the royalty percentage bid offered by the fifth highest bidder. In the event that there is no fifth highest bidder, which may be due to one of the provisional winners ceasing to be qualified, the royalty percentage payable will be the reserve price set by SITB. The draft resolution to amend sections 2 and 4 of the Regulation is at **Appendix III**.

18. In reply to members, both the Administration and the legal adviser to the Subcommittee have confirmed that the sections as amended will provide a clear legal basis to facilitate the adoption of the 5th leaver rule. The Administration has nevertheless pointed out that it cannot quantify the potential revenue effects of such a change, as interest in the auction will depend on the market conditions at the time.

Network turnover

19. As the spectrum utilization fee payable by 3G licensees in future will be a royalty based on a percentage of the licensee's network turnover, some members and operators have questioned the scope of the term as defined in the Regulation.

20. In response, the Administration has confirmed that the network turnover of a 3G licensee arising from the provision of all telecommunications services over any telecommunications network using the frequency bands assigned to the 3G licensee will be taken into account when calculating the spectrum utilization fee. However, the revenue from content and/or value added service provision will not be subject to royalty payment.

Connected bidders

21. To avoid dominance by the same commercial group in the future 3G market, the Regulation prescribes a cash auction to remove connected bidders among the successful bidders. Most of the existing mobile services operators are of the view that the cash auction should be the last resort and that the issue of connected bidders should be resolved prior to the main auction.

22. The Subcommittee notes the Administration's clarification that bidders will be encouraged to sort out and remove the connection, if any, before they submit applications. Bidders will be required to provide a declaration on connections during pre-qualification. To cater for all eventualities, if there are indeed connected bidders among the successful bidders, they will be given another chance to disconnect after the main auction. It is only when they fail to disconnect will they enter into a cash auction to select the winner.

23. As regards the definition of "connected bidders" and the procedures for dealing with them, the Administration has advised that these issues have been the subject of a consultation conducted by the Office of the Telecommunications Authority (OFTA) in March 2001. The detailed arrangements will be spelt out in the relevant auction rules on connected bidders and other ownership issues.

Detailed arrangements for the auction

24. The Subcommittee notes that while the principal ordinance and the related subsidiary legislation will provide the legal basis for the licensing framework, the terms and conditions of the auction will be set out in a notice to be published in the Gazette and the Information Memorandum (IM), both of which are not subsidiary legislation.

25. One of the most controversial features of the auction is the confidentiality of the number and identity of the bidders and their bids during the auction. The Administration maintains the view that preservation of confidentiality is necessary in order to promote entry and prevent collusion.

26. The operators disagree with the proposed approach as it will deny bidders of the necessary information to enable them to make a sound decision on their bids. They also contend that such a dark-room approach will create uncertainties which will not be conducive to the objective of promoting entry. Besides, the concealed process is vulnerable to post-auction challenge by unsuccessful bidders.

27. Some members of the Subcommittee share the industry's concerns and query that land auctions have been conducted in Hong Kong for many years, but it is not evident that open auctions have deterred interested bidders. One member however agrees that a certain degree of confidentiality is necessary to prevent collusion.

28. Responding to members' concern about the disclosure of information, the Administration has agreed to provide for maximum transparency within the restrictions necessary to the auction design. The progress in bidding increments in the main auction will be published in OFTA's website with a slight lag behind real-time. The results of the main auction and the two cash auctions will be published at the end of each auction. The Administration will give a full account of the auction, including the identities and bids of the unsuccessful bidders.

29. As the IM contains pertinent information such as the level of reserve price and the detailed auction rules, members share the operators' concern about the importance of prior consultation and the early promulgation of the IM. In response, the Administration has advised that in drawing up the IM, the industry has been consulted on major provisions therein (such as those relating to open network requirement, connected bidders etc) and the IM will be issued after enactment of the subsidiary legislation. To facilitate follow-up action, the Administration has been asked to inform the Panel on Information Technology and Broadcasting of the publication of the IM in about mid-July 2001.

Open network requirement

30. The Subcommittee notes that although not specified in the subsidiary legislation, it is a mandatory requirement on future 3G licensees to lease not less than 30% of their 3G network capacity to non-affiliated mobile virtual network operators (MVNOs) and/or content providers. While members have no objection to the requirement which serves to enhance competition at the service and content level over the 3G platform, they have sought the Administration's clarification on the implications of the said requirement on the

scope of network turnover of 3G licensees subject to royalty payment.

The Order

31. The Subcommittee has raised with the Administration some operators' comments on the quality of the four sets of frequency spectrum. In reply, OFTA has indicated that it is aware of the minor differences between the four sets of frequencies for 3G services in terms of capacity and interference potential. However, whether and the extent to which this actually affects the operation of the 3G networks must be assessed by each individual bidder having regard to its own business plan. Members also note that as prescribed in the Regulation, a cash auction will be conducted to determine the respective priority rights of the successful bidders in allocation of the specific sets of frequency bands. Regarding one operator's specific measurements that the frequency band 1964.9-1979.7 is subject to interference, the Subcommittee has requested OFTA to take up the matter with the operator and report the outcome of its investigation to members in due course.

32. The Subcommittee has taken up with the Administration some operators' suggestion to migrate one of the proposed assignments of the Time Division Duplex (TDD) frequency block (1914.9 - 1919.9 MHz) to another part of the TDD band. The Administration has advised that the only available band for TDD will be used in other countries for apparatus which requires no individual licensing. As such apparatus will potentially be of use in Hong Kong, its use will be restricted if Hong Kong allocates this band for licensed public service. Furthermore, there would be a serious risk of interference with the licensed public service from such apparatus brought back from overseas markets. The Administration therefore considers it undesirable to move the TDD band as suggested.

33. On the assignment of frequency spectrum as proposed in the Order, the Subcommittee notes that TA's proposed frequency plan has been developed by reference to a widely accepted band plan decided by the European Radiocommunications Committee and that the said band plan has been adopted by other countries including the United Kingdom, Germany and Singapore. The adoption of such a plan in Hong Kong will have the advantage of enabling users to enjoy international roaming services and a wider choice of equipment.

Recommendation

34. The Subcommittee supports the Regulation, with the amendments to be moved by the Administration, and the Order.

Advice sought

35. Members are invited to support the recommendation of the Subcommittee in paragraph 34 above.

Council Business Division 1
Legislative Council Secretariat
21 June 2001

Subcommittee on Telecommunications (Method for Determining Spectrum Utilization Fees) (Third Generation Mobile Services) Regulation and Telecommunications (Designation of Frequency Bands Subject to Payment of Spectrum Utilization Fees) Order

Membership List

Chairman Hon James TIEN Pei-chun, JP

Members Hon David CHU Yu-lin
Hon Eric LI Ka-cheung, JP
Hon CHAN Kwok-keung
Hon SIN Chung-kai
Hon Howard YOUNG, JP
Hon YEUNG Yiu-chung
Hon Emily LAU Wai-hing, JP
Hon Albert CHAN Wai-yip

(Total : 9 Members)

Clerk Miss Polly YEUNG

Legal Adviser Miss Connie FUNG

Date 8 June 2001

Subcommittee on Telecommunications (Method for Determining Spectrum Utilization Fees) (Third Generation Mobile Services) Regulation and Telecommunications (Designation of Frequency Bands Subject to Payment of Spectrum Utilization Fees) Order

A list of organizations which have submitted views to the Subcommittee

1. Hong Kong CSL Limited
2. Hutchison Telecommunications Hong Kong Limited
3. New World PCS Limited
4. Peoples Telephone Company Limited
5. SmarTone Mobile Communications Limited
6. Sunday Communications Limited

INTERPRETATION AND GENERAL CLAUSES ORDINANCE

RESOLUTION

(Under section 34(2) of the Interpretation and
General Clauses Ordinance (Cap. 1))

TELECOMMUNICATIONS (METHOD FOR DETERMINING SPECTRUM
UTILIZATION FEES) (THIRD GENERATION MOBILE
SERVICES) REGULATION

RESOLVED that the Telecommunications (Method for Determining
Spectrum Utilization Fees) (Third Generation Mobile Services)
Regulation, published in the Gazette as Legal Notice No. 115
of 2001 and laid on the table of the Legislative Council on
6 June 2001, be amended -

(a) in section 2 -

(i) in subsection (1) -

(A) by repealing the definition of "highest
common royalty percentage";

(B) by adding -

"applicable royalty percentage"

(適用專營權費百分率), in

relation to an auction, means

the lowest common royalty

percentage bid -

- (a) offered by all the remaining successful bidders; and
 - (b) which is not less than the royalty percentage bid offered by the fifth highest bidder;" ;
 - (ii) in subsection (2), by repealing "highest common" and substituting "applicable";
- (b) in section 4 -
- (i) by repealing "在該拍賣中";
 - (ii) in paragraph (a) -
 - (A) by adding "subject to paragraph (c)," before "the bidders";
 - (B) by repealing "highest common" and substituting "applicable";
 - (iii) in paragraph (b) -
 - (A) by adding "該" before "拍賣所關乎";
 - (B) by repealing "highest common" wherever it appears and substituting "applicable";
 - (C) by repealing "concerned." and substituting "concerned;" ;

(iv) by adding -

"(c) if there is no fifth highest bidder, as mentioned in the definition of "applicable royalty percentage" and as determined in accordance with the relevant terms, then the spectrum utilization fee shall be the relevant minimum fee, and paragraph (b) and the other provisions of this Regulation shall be construed accordingly." .